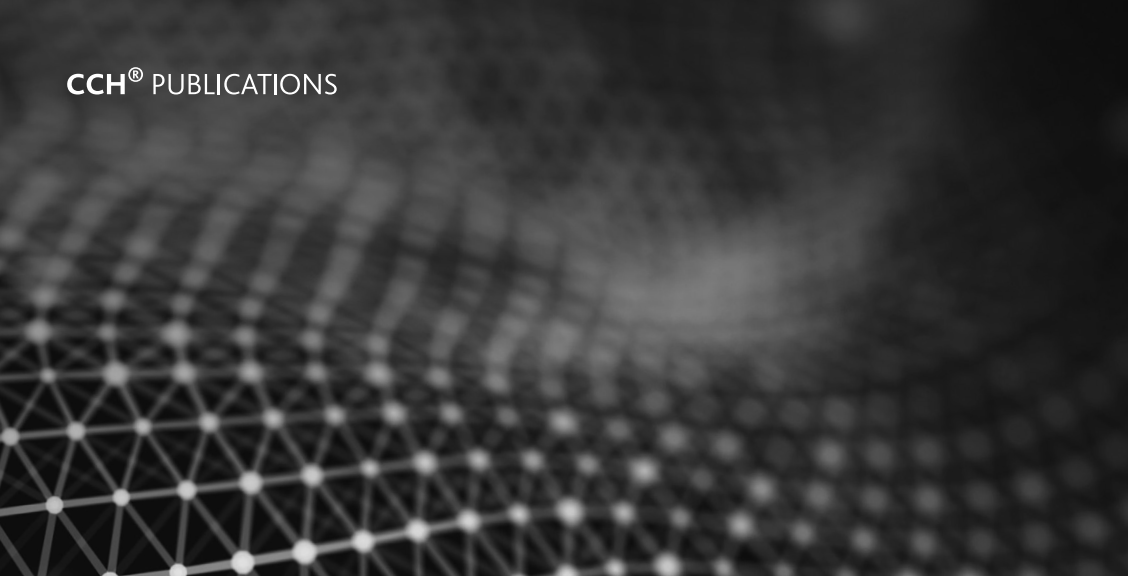
CCH® PUBLICATIONS



Top Federal Tax Issues for 2023 CPE Course

BONUS CPE COURSE!

Earn CPE Credit and stay on top of key accounting and auditing issues. Go to CCHCPELink.com/printcpe

Wolters Kluwer

Top Federal Tax Issues for 2023 | CPE Course

Allison McLeod, LLM, JD, CPA
Eric L. Green, Esq
Greg White, CPA
James R. Hamill, CPA, PhD
Jim Buttonow, CPA, CITP
Steven D. Mercatante, Esq
Steven G. Siegel, JD, LLM

Wolters Kluwer

Contributors

Contributing Editors . . . . . Allison McLeod, LLM, JD, CPA

Eric L. Green, Esq

James R. Hamill, CPA, PhD

Jim Buttonow, CPA, CITP

Steven D. Mercatante, Esq

Steven G. Siegel, JD, LLM

Production Coordinator . . . . . Mariela de la Torre; Jennifer Schencker;

Gokiladevi Sashikumar; Anna Dougherty

Production . . . . . Sharon Sofinski; Anbarasu Anbumani

2700 Lake Cook Road
Riverwoods, IL 60015
800 344 3734
CCHCPELink.com

Introduction

Each year, a handful of tax issues typically require special attention by tax practitioners. The reasons vary, from tax legislation, a particularly complicated new provision in the Internal Revenue Code, to a planning technique opened up by a new regulation or ruling, or the availability of a significant tax benefit with a short window of opportunity. Sometimes a developing business need creates a new set of tax problems, or pressure exerted by Congress, or the Administration puts more heat on some taxpayers while giving others more slack. All these share in creating a unique mix that in turn creates special opportunities and pitfalls in the coming year and beyond. The past year has seen more than its share of these developing issues.

Top Federal Tax Issues for 2023 CPE Course identifies those recent events that have developed into the current "hot" issues of the day. These tax issues have been selected as particularly relevant to tax practice in 2023. They have been selected not only because of their impact on return preparation during the 2023 tax season but also because of the important role they play in developing effective tax strategies for 2023 and beyond.

This course is designed to help reassure the tax practitioner that he or she is not missing out on advising clients about a hot, new tax opportunity; or that a brewing controversy does not blindside their practice. In addition to issue identification, this course provides the basic information needed for the tax practitioner to implement a plan that addresses the particular opportunities and pitfalls presented by any one of those issues. Among the topics examined in the *Top Federal Tax Issues for 2023 CPE Course* are:

- Overview
- 1099 Essentials Start with the W-9
- Data Validation Basics
- Watch Out for the Middleman
- Corrections Tips
- B-Notice Response Best Practices
- Protect Yourself
- Overview of Schedules K-2 and K-3
- Transition Relief
- IRS Frequently Asked Questions
- Other Issues
- AICPA Requirements
- The Top 10 Audit Issues
- Honorable Mentions
- Final Tips
- Six Key Takeaways
- Paycheck Protection Program Loans: Interaction with ERC
- American Rescue Plan Act Changes to the ERC
- Wages Paid to Majority Shareholders and Relatives
- Partial Suspension

- Centralized Partnership Audit Regime
- Pensions and IRAs
- Itemized Deductions
- IRS Issues and Developments
- Administrative Procedure Act
- Credits
- Gift and Estate Tax Issues
- Penalty Policy Considerations
- First Time Abatement
- Strategies for the Audit
- Abatement for Reasonable Cause
- Preparer/Promoter Penalties
- Payroll Tax
- Background
- New Corporate Alternative Minimum Tax
- Electric Vehicle Credits
- Excise Tax on Stock Buybacks
- Excess Business Losses
- Clean Energy Tax Credits
- Research Credit for Small Businesses
- Carried Interest Rules
- Excise Taxes on Fossil Fuels
- Depreciation
- Funding for the IRS
- CHIPS Act

Study Questions. Throughout the course you will find Study Questions to help you test your knowledge, and comments that are vital to understanding a particular strategy or idea. Answers to the Study Questions with feedback on both correct and incorrect responses are provided in a special section beginning at ¶ 10,100.

Final Exam. This course is divided into two Modules. Take your time and review all course Modules. When you feel confident that you thoroughly understand the material, turn to the Final Exam. Complete one, or all, Module Final Exams for continuing professional education credit.

Go to **cchcpelink.com/printcpe** to complete your Final Exam online for immediate results. My Dashboard provides convenient storage for your CPE course Certificates. Further information is provided in the CPE Final Exam instructions at ¶ 10,300. **Please note, manual grading is no longer available for Top Federal Tax Issues. All answer sheets must be submitted online for grading and processing.**

Note: The material contained in this publication was current at the time it went to print.

October 2022

PLEDGE TO QUALITY

Thank you for choosing this CCH® CPE Link product. We will continue to produce high quality products that challenge your intellect and give you the best option for your Continuing Education requirements. Should you have a concern about this or any other Wolters Kluwer product, please call our Customer Service Department at 1-800-344-3734.

COURSE OBJECTIVES

This course was prepared to provide the participant with an overview of specific tax issues that impact 2022 tax return preparation and tax planning in 2023. Each impacts a significant number of taxpayers in significant ways.

Upon course completion, you will be able to:

- Identify the key elements needed to comply with IRS requirements and discover how best to respond to the IRS
- Recognize what payments you are required to 1099 report and how to recognize when those payments are reportable
- Identify Form 1099-NEC/MISC boxes
- Describe what information you need from your payee to properly report a payment
- Recognize how to use the W-9 to collect the correct information and when you are required to obtain a signed W-9
- Identify how to use the IRS TIN Matching Program and how it can help ensure the information you have is correct
- Differentiate Code Sections that apply to 1099 reporting
- Identify best practices for B-Notices
- Understand the purpose of Schedules K-2 and K-3
- Identify the general requirements for Schedules K-2 and K-3
- Recognize each part of Schedules K-2 and K-3 and who is required to meet reporting standards
- Describe the relief options available for incomplete Schedule K-2 and K-3 filing
- Describe the reasons for compliance focus on small businesses
- Recognize the top 10 IRS audit focus areas for small businesses
- Describe how to evaluate a client's records and identify the critical records in an IRS small business audit
- Identify the steps to prepare for a small business audit
- Recognize how much annually the U.S. Treasury loses due to noncompliance
- Recognize approximately what percentage of the tax gap is accounted for by individuals
- Identify the factors the IRS uses to determine control with regard to worker status
- Identify clients who qualify for the employee retention credit (ERC)
- Explain how to compute the ERC
- Describe how to allocate wages between Paycheck Protection Program (PPP) loan forgiveness and the ERC
- Identify an advantage of using the prior quarter for the 80 percent test

- Identify in which types of situations a business would qualify for a partial suspension
- Recognize the establishments that would be subject to a partial suspension of the ERC caused by a government order
- Name the form that should be filed if a business missed claiming the ERC
- Identify key reporting issues in pass-through entities
- Recognize how to provide the most useful information to the owner
- Determine the amount in which phaseout of the qualified business income deduction (QBID) ends for single and married taxpayers
- Describe correct statements regarding capital account reporting
- Recognize the four situations that require reporting S corporation shareholder basis
- Identify issues in tax basis capital reporting
- Identify how to advise pass-through clients on the Tax Cuts and Jobs Act and CARES Act
- Recognize and apply the new effective tax rates and 20 percent deduction for K-1 income
- Describe tax incentives provided
- Summarize court cases that found the rental real estate in question was in fact a business
- Describe the different types of qualified opportunity funds
- Identify the 2022 threshold amount for the qualified business income deduction (QBID) for married filing jointly taxpayers
- Recognize aggregation factors with respect to QBID
- Identify the number of ways a rental can produce qualified business income
- Identify the 2021 maximum employee retention credit per employee per quarter
- Recognize which form is used to claim the employee retention credit
- Describe what constitutes blockchain and the various types of cryptocurrencies it supports
- Determine whether a cryptocurrency transaction creates a taxable event
- Identify the IRS forms needed to report cryptocurrency transactions
- Develop a working knowledge of possible reports due to other regulatory agencies
- Recognize the traps cryptocurrency traders could encounter that could unexpectedly increase the trader's tax liability
- Identify current enforcement actions employed by the IRS
- Recognize how estate and trust income is taxed
- Identify how estate and trust income is defined, calculated, and reported
- Describe key compliance and planning issues as well as concerns related to fiduciary income taxation
- Identify when the decedent's taxable year ends
- Recognize which type of trust has an annual exemption of $300
- Describe trust accounting income

- Recognize the annual net capital loss deduction limitation against ordinary income
- Recognize how many months an automatic extension could be filed for Form 1041 (by using Form 7004) for an estate
- Identify the annual exemption for complex trusts
- Recognize what would apply if a fiduciary fee may be deducted
- Identify important new tax cases
- Recognize how to apply important new IRS guidance
- Identify the impact of new legislation on clients
- Identify the various penalties applied by the IRS
- Recognize ways practitioners could have penalties removed
- Describe First Time Penalty Abatement
- Describe failure to file/pay based on reasonable cause
- Identify an indicator of responsibility with respect to trust funds
- Recognize the penalties for failure to pay
- Identify the newest tax developments contained in the Inflation Reduction Act of 2022
- Describe the new and extended credits available for green energy initiatives
- Recognize which taxpayers and assets qualify for credits for purchasing electric personal vehicles and clean commercial vehicles
- Recognize the implications of increased IRS funding
- Identify the newest tax developments contained in the CHIPS Act of 2022

Additional copies of this course may be downloaded from **cchcpelink.com/printcpe**. Printed copies of the course are available for $8.00 by calling 1-800-344-3734 (ask for product 10024491-0010).

Contents

MODULE 1: BUSINESS—Chapter 1: 1099 Essentials

¶ 101 WELCOME

This chapter is designed to help readers understand what Form 1099 reporting is, why it is important, and the negative outcomes possible if it is not done. The chapter covers Forms 1099-NEC and 1099-MISC, discusses the key elements needed to comply with IRS requirements, and outlines how best to respond to the IRS.

¶ 102 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify the key elements needed to comply with IRS requirements and discover how best to respond to the IRS
- Recognize what payments you are required to 1099 report and how to recognize when those payments are reportable
- Identify Form 1099-NEC/MISC boxes
- Describe what information you need from your payee to properly report a payment
- Recognize how to use the W-9 to collect the correct information and when you are required to obtain a signed W-9
- Identify how to use the IRS TIN Matching Program and how it can help ensure the information you have is correct
- Differentiate Code Sections that apply to 1099 reporting
- Identify best practices for B-Notices

¶ 103 OVERVIEW

The tax gap is what the federal government is owed from taxpayers, and is it estimated to be nearly $1 trillion per year. A significant portion of the tax gap is attributed to the underreporting of business income. Congress and the IRS are both focused on closing the tax gap; consequently, 1099 information reporting requirements are increasing. The IRS is cracking down heavily on noncompliant companies to decrease the tax gap.

The Internal Revenue Code (IRC) requires that payers of certain types of payments issue information returns (i.e., Forms like the 1099-MISC, *Miscellaneous Information*).

- Code Sec. 6041(a) provides that persons engaged in a trade or business must report certain payments on an information return (like the Forms 1099).
- Code Sec. 6109(a)(2) requires that a payee provide a taxpayer identification number (TIN) to the payer when the payment will be reportable on 1099 information returns.
- Code Sec. 3406(a) requires that, under certain circumstances, including the failure of a payee to provide a TIN, the payer must perform backup withholding.

In 2022, the IRS again updated its key information reporting forms; those being Forms 1099-NEC, *Nonemployee Compensation*, and 1099-MISC. Although the updates are superficial in appearance, they can have major consequences. One key change to be aware of is the new continual update feature. The forms have been converted from

annual updates to what the IRS is calling "continuous use." This means the IRS will update each 1099 and its instructions during the year. The following sections give an overview of each of these updated forms.

The 2022 Form 1099-NEC

A payment must be reported on the Form 1099-NEC in box 1 if:

- It is made to someone who is not your employee (note that this includes payments made by government agencies and nonprofit organizations to service providers).
- It is made for services in the course of your trade or business. This includes parts and materials used in conjunction with said services.
- It was made to an individual, partnership, estate, attorney, or, in some cases, a corporation.
- The payments made to that payee were at least $600 or more for the year.

The 2022 Form 1099-MISC

There continue to be a plethora of reporting boxes featured on the Form 1099-MISC. It remains the most complicated of the Forms 1099. However, there are certain boxes that those reporting payments to contractors in the ordinary course of their trade or business tend to use more than others. The primary reporting boxes on the updated Form 1099-MISC are 1, 2, 3, 4, 6, and 10. The following offers a brief overview of boxes 1 through 4 and box 6.

Box 1: Rents. One has to be careful in differentiating what rental payments are reportable here versus those exceptions that do not require reporting or require it on another Form 1099. Taxpayers do not have to report rent payments if they paid them to a real estate agent or property manager. Of course, from there, that real estate agent or property manager has to use the Form 1099 to report the rent paid to the property owner. Payers should be on the lookout for 1099-MISC reportable rents that are 1099-S reportable "sales" for reporting purposes. This is something that typically comes into play on very long-term leases, easements, and other such "rental" situations that last longer than 30 years (including any right to renew).

Box 2: Royalties. Royalty payments are typically made for intellectual property, such as for patents or copyrights, or trade names or trademarked software. There is a very low threshold for reporting royalty payments—only ten dollars. For most of you reading this, the big concern in this regard should be the reporting for usage of intellectual property. For instance, in situations where one is paying for the use rather than the creation of software, a license is used. To further this point, assume that a company is having off-site work done to electronically maintain and update software. In such situations, that is typically considered a royalty involving the use of a licensed product of intellectual property. That would be reported here in box 2 of the Form 1099-MISC and not, for instance, on the 1099-NEC. If, on the other hand, a vendor representative physically comes to the company's location and performs maintenance, that is considered performance of a service and would be 1099-NEC box 1 reportable.

Box 3: Other income. Prizes, awards, and other payments are reported in box 3. For prizes and awards, make sure to differentiate them from those reportable on the Form 1099-NEC. Also reported in box 3 are payments involving the death of an employee. From there, watch out for legal settlement situations. In these situations, the payee that would be reported in box 3 of Form 1099-MISC would be the claimant (formerly the plaintiff and now the recipient of legal damages to settle a claim or as a result of

adjudication). Practitioners must identify whether the payment is actually reportable or not, because there are some exceptions to reporting payments for these claims.

The other item that ties into this are box 10 payments made to the other side's attorney (meaning the claimant's attorney). If the attorney that represented the claimant has the right to negotiate the check, then there is 1099-MISC box 10 reporting to that attorney or law firm. Remember that, in general, payments made to attorneys or law firms are always reportable, whether they're incorporated or not.

Box 4: Backup withholding: Both the 1099-MISC and the 1099-NEC have reporting for backup withholding. How might a payer need to backup, withhold, and report backup withholding to a given payee on both forms? The most common situation is when a payer has a vendor that never provided it with its 1099, or there was a backup withholding notice (B-Notice) mismatch. The payer might be paying the vendor for royalties and services, for example. In this case, the payer should be backup withholding 24 percent on payments made to the vendor. The payer would be obligated to split that reporting between the backup withholding associated with the services payment done on the 1099-NEC and the backup withholding associated with the royalty payment done on the 1099-MISC.

Box 6: Medical payments. The IRS takes a broad view of the term *medical or healthcare services* when it comes to 1099-MISC reporting. That means that most services provided by a facility or a practitioner that provides medical services are included in box 6 reporting. The best way to determine whether something belongs in 1099-MISC box 6 versus 1099-NEC box 1 is to consider whether or not the medical service provider is using their expertise or training as a medical service provider to provide the service in question. If the provider is, the medical service goes in box 6 of the 1099-MISC. That also includes payments made by medical and healthcare insurers under health accident and sickness insurance programs.

¶ 104 1099 ESSENTIALS START WITH THE W-9

Form W-9, *Request for Taxpayer Identification Number and Certification*, is the starting point in this 1099 reporting process. The W-9 is a widely accepted form that records information for workers who are not employees. In addition, it records the promise that the taxpayer is not subject to backup withholding. The W-9 is signed under penalty of perjury by the person completing the form, attesting to the fact that the information they provided is correct. The person completing the form also certifies that they are a U.S. citizen, and that any Foreign Account Tax Compliance Act (FATCA) codes on the form are correct.

The biggest issues associated with the W-9 stem from its first two lines: Name and Business Name. In particular, there is often debate in accounts payable or tax departments about whether checks have to be made payable to the name on line 1, or whether the "doing business as" (DBA) name on line 2 can be used. The goal is to match the name provided on line 1 and tie that to the 1099, regardless of whether the checks are written to the name on line 2 or line 1. Commonly, the name on line 2 is what the IRS refers to as a *disregarded entity*.

In regard to line 3, payers should be careful when validating the payee who is a single-member limited liability company (LLC)/disregarded entity. That designation means that the IRS, and the payer, are supposed to disregard the actual LLC and report directly to the owner. The name entered on the name lines should never be a disregarded entity; the name on the name lines should be the name shown on the income tax return on which the income will be reported.

For example, if the vendor identified on the name line is an LLC, it will need to check the limited liability company box in line 3 and then enter the appropriate code for the tax classification in the space provided. However, if the vendor is an LLC that is disregarded as an entity separate from its owner, it would not check the LLC box. One of the most important clarifications that needs to be made up front as a payer in validating the W-9 is whether the vendor is a single-member LLC.

Name and TIN/EIN "Cheat Sheet"	
Account	**Give Name and SSN of:**
Individual	Individual
Joint account	Actual owner, or first name on account
Custodian of minor	Minor
Usable revocable savings trust (grantor is trustee)	Grantor-trustee
So-called trust account (not legal under state law)	Actual owner
Sole proprietorship or single-owner LLC	Owner

Account	**Give Name and EIN of:**
Sole proprietorship or single-owner LLC	Owner
Valid trusts, estate, or pension plan	Legal entity
Corporation or LLC electing corporate status on Form 8832	Corporation
Association, club, religious, charitable, educational, other tax-exempt entity	Organization
Partnership, multi-member LLC	Partnership
Broker, registered nominee	Broker or nominee
Account with Department of Agriculture in the name of public entity	Public entity

When to Get an Updated Form W-9

Having a Form W-9 for every vendor in the company's files is important. It will help the company determine if special exceptions to the general rules apply. It also reflects a culture of tax compliance, which can help in the event of an IRS or state-level tax audit examination. Therefore, companies should conduct a review of all their accounts payable vendors to ensure each has a completed W-9 on file.

A company must obtain a Form W-9 when the account is opened (if signature is required) and upon receipt of the first B-Notice. There are no other requirements to obtain new Forms W-9. There is no requirement to request a new W-9 if there is a mismatch in the TIN Matching Program.

Payee W-9 Solicitation/Validation Tips

A solicitation is a request for a payee's correct taxpayer identification number (TIN). Usually, the TIN is provided by way of the completed Form W-9. An initial solicitation is required when a vendor opens an account or when a transaction occurs. If the payee does not submit the information, a first annual and second annual solicitation are required at the end of each of the subsequent years.

Documentation of the TIN is critical, as is documentation of the process itself, to demonstrate efforts to acquire the payee's information. The IRS looks for not only whether a company properly backup withheld or not, but also whether it took all the steps needed to effectively solicit a TIN. A paper trail of documentation showing the solicitations made is a best practice for demonstrating due diligence and avoiding penalties.

Solicitations can be sent by mail, with a return envelope to ease the process; electronically via email; or by telephone. Payers should maintain documentation of the requests and the responses received in case an auditor requests the information at a later date.

Payers should also be alert to employer identification number (EIN) red flags. When a business changes its name, it doesn't necessarily need to get a new EIN. But if a payer is aware of such a change, it would be a good practice to ask the business for a new W-9. For example, if the name change is due to a merger or acquisition, the business would have a new EIN. Other indications for a new EIN include a change in business structure, such as a sole proprietorship subject to a bankruptcy proceeding or one that takes in partners and begins to operate as a partnership. These all are reasons to send the payee a new W-9.

When the Payee Refuses to Provide a TIN

If a payee refuses to provide its TIN when a payment is made, the IRS requires that the payer backup withhold at 24 percent. Tips for "encouraging" a payee to provide its TIN include the following:

- Remind the payee that this is an IRS requirement.
- Alert the payee that refusal to provide a TIN will slow payment.
- Inform the payee that refusal to provide a TIN means the cash paid to them is less 24 percent.
- Tell the payee that the IRS will still be notified of the payment.

¶ 105 DATA VALIDATION BASICS

Identifying a Payee: Who Is 1099 Reportable?

The 1099 reporting rules are very different depending on whether a payer is paying a U.S. or non-U.S. person. The IRS is auditing heavily on payments to non-U.S. persons that should have been reported on Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, and subjected to 30 percent withholding.

Because U.S. persons are subject to U.S. tax on worldwide income, the IRS presumes *all* payees are U.S. persons and therefore subject to some kind of reporting (and most likely withholding) unless the payer can prove otherwise. This means the IRS assumes payees are subject to reporting (and potential withholding) regardless of where in the world they are located.

If a payer wants to apply the "U.S. source income only rule," it must document that the payee is a non-U.S. person. Non-U.S. persons are subject to 30 percent U.S. federal income tax withholding on payments of U.S. source income unless an exception exists. The backup withholding rules are very strict in this regard. To avoid reporting and withholding altogether, a payer must document that:

- The payee is a non-U.S. resident (non-U.S. person/foreign person), and
- The payment is non-U.S. source income.

Payers are held to a standard of knowledge under the law and must use a critical eye in assessing incoming documentation to determine whether a payee is a U.S. or non-U.S. person. A mistake can lead to a very strong chance of audit.

U.S persons include U.S. citizens. That means individuals born in the United States or entities incorporated or registered within the United States. Resident aliens, who are in the United States under immigration documents or are present in the United States for a sufficient number of days for tax purposes, are typically 1099 reportable. Keep in

mind that Puerto Rican individuals have U.S citizenship and are subject to 1099 reporting. Corporations are eligible for a corporate exception to 1099 reporting, except for medical and legal service providers, which are always reportable. Payers should always ensure they have appropriate documentation on file.

Always Validate Claims of Non-Reportability

Many payers use the "corporate eyeball test" to earmark vendor exemptions. The IRS has allowed payers to exempt from TIN solicitation payees that are clearly exempt based on their name and information commonly known. For domestic entities, this means if *Inc.*, *Incorporated*, *Corp.*, *Corporation*, *Assurance*, *Reassurance*, *Indemnity*, *Insurance* or *Re-Insurance*, or *PC* is in the entity's name.

This author generally recommends against using the "eyeball test" to exempt corporations from reporting. Soliciting information from corporate payees helps identify payees that are:

- Not really corporations, for example, LLCs; or
- Foreign payees (exempt from 1099 reporting but not from the Form 1042-S reporting and tax withholding rules).

LLCs can take a variety of forms. They can be a single-member LLC (much like a sole proprietor) or a multi-member LLC (partnership—assuming it is not a disregarded entity). LLCs are *not* exempt from 1099 reporting as they are not corporations. They can file to be treated as corporations for reporting purposes; however, this is rare. To do so, they need to file Form 8832, *Entity Classification Election*, and choose the entity type. In return, the IRS will send a "determination letter" informing the LLC if the IRS accepts their corporate designation.

Payers should treat an LLC as a corporation only if they receive from the LLC a copy of the IRS determination letter granting it corporate status for tax reporting purposes.

An LLC can be owned by another entity and be a disregarded entity (which means disregarded as being separate from the owner). *Disregarded entity* is another term for a *flow-through* or *pass-through* entity to the parent company (e.g., a corporation that owns the LLC). If a multi-member LLC payee's business is sold to another, it can assume or combine reporting. Again, payers should remember that documentation is critical for accurate record keeping.

The Exempt Organization

Another step in validating a W-9 is to verify that tax-exempt organizations are who they say they are. The Tax Exempt Organization Search Tool (available at irs.gov) is a free IRS program that provides the information needed to validate exempt organizations. Payers must validate the tax-exempt organization before declining to report 1099 payments made to them in-year. Using the tool, payers can search for the following information about a payee's tax-exempt status and filings:

- Form 990 Series Returns
- Form 990-N (e-Postcard)
- Publication 78 Data
- Automatic Revocation of Exemption List
- Determination Letters

If the payer sees any evidence that the payee's exempt status was revoked, it should confront the payee. If the payee insists it had its exempt status reinstated, the payer should look for a determination letter that is dated after the date of revocation.

Validating Payee Data: TIN Matching Program

The IRS Taxpayer Identification Number (TIN) Matching Program is an Internet-based program that allows payers to check if a payee's name and TIN match what the IRS has on its records. Note that the TIN Matching Program is not part of the IRS B-Notice program. The only prerequisite for using the TIN Matching Program is that an organization must have filed a 1099 within one of the two most recent tax years; this includes Form 1099-MISC, 1099-NEC, 1099-B, 1099-DIV, 1099-INT, 1099-OID, 1099-PATR, and 1099-K. When an organization registers its name and EIN on the site, the IRS will check for that.

If there is a mismatch, the B-Notice process will start, and that will require a payer to do a lot of work to determine if the backup withholding process needs to be initiated.

> **NOTE:** Not just anybody can register to use the TIN Matching Program; the organization's principal has to register first. The principal is either a top officer in the company or someone with at least a 5 percent ownership interest. Once the principal is identified and registered, every person at the organization who wants to use the program must separately register to access it.

Those enrolled in the program can get an immediate response for up to 25 Name/TIN combinations supplied, or they can upload up to 100,000 Name/TIN combinations and receive a response within 24 hours. The program will return the Name/TIN combination with a match indicator to indicate whether the combination entered matches the IRS records. The results come back in a numerical format: a number from 0 to 8.

One of the most important things a payer can do is to ensure it has policies and procedures detailing its use of the program, because that is something an auditor will look for. Remember that all Form 1099s that a payer files must include the correct name/TIN combination to allow for the matching of the information reported against the income included on that payee's income tax return.

Best practices for using the TIN Matching Program are as follows:

- Get a W-9 from each vendor prior to making payment.
- Immediately run the vendor through the TIN Matching Program.
- Remember that the TIN Matching Program is especially valuable for reducing corrections and B-Notices and for responding to Proposed Penalty Notices.
- Create written policies and procedures outlining how the program is used.
- Do not be one of those companies that only uses the TIN Matching Program once per year. Use the program systematically and regularly (weekly, monthly, quarterly, etc.). Have a system and follow it.
- One of the best times to use the program is at year-end, as a validation step.
- A good idea is to assign particular individuals the role of using the program and creating written policies and procedures. (This can serve as a training tool and also help in responding to an IRS audit or to Notice 972-CG, *Notice of Proposed Penalty*.)
- Have a letter on file showing to whom the principal has delegated authority to use the program.
- When the responsible official changes (e.g., leaves the organization) document their name, title, and the dates they ran the program—and do the same for their replacement.
- Record who the delegated users of the program are, their effective dates of delegated use, and which responsible official chose the delegated users.

STUDY QUESTIONS

1. Which Code Section provides that persons engaged in a trade or business must report certain payments on an information return?

a. Code Sec. 3406(a)
b. Code Sec. 409A
c. Code Sec. 6041(a)
d. Code Sec. 6109(a)(2)

2. A payment is required to be reported on a Form 1099-NEC if the payments made to that payee were at least how much or more for the year?

a. $99
b. $125
c. $500
d. $600

3. Which of the following identifies a 1099-MISC issue with respect to box 1?

a. Low threshold
b. Reportable rents
c. Prizes and awards
d. Definition of medical services

¶ 106 WATCH OUT FOR THE MIDDLEMAN

When there are three or more parties to a transaction, a payer must identify who the beneficial owner of the income is to determine to whom to issue the Form 1099. The name on the check may be different from the name on the 1099. There might be a middleman involved, such as an agent, or maybe a garnishment or a levy situation or illegal settlement.

For example, assume the IRS sends a notice to levy on a worker's pay. The payer will make that check out to the IRS, but is the payment being reported to the IRS? No, the payer is reporting that to the worker on either their Form 1099, if the worker is a contractor, or W-2, if the worker is an employee. What if the amount garnished from the employee's wages was made payable to a lawyer? That would be reported to the lawyer on the 1099-MISC. But it would also show up on the employee's W-2 or, if the employee is a contractor, on his or her 1099.

The middleman analysis involves two questions:

- Who has management or oversight?
- Who has a significant economic interest?

¶ 107 CORRECTIONS TIPS

Reasons that necessitate 1099 corrections include the following:

- Incorrect money amounts, code, or checkbox
- Incorrect payee name
- Incorrect payee address
- Return was filed when one should not have been filed

- No payee TIN
- Incorrect payee TIN
- Original return was filed using the wrong type of return

Only payer mistakes that have tax implications for the payee create cause for a correction. Payers should not file a corrected return when the information reported reflects information provided by the payee, but after the return has been filed, the payee presents new information and requests a corrected return. There is no need to file a corrected return when the payee proved to be a tax-exempt recipient. In addition, a correction should not be filed when the payee only wants fees reported and not reimbursed expenses.

Proposed penalties for filing incorrect returns are not guaranteed, so payers should not be afraid to file when in doubt. Payers can use Form 8809, *Application for Extension of Time to File Information Returns*, to get a 30-day extension to file. Also keep the following in mind:

- If account numbers were on the original returns, make sure they are on the corrected return.
- Do not resend the entire file when submitting corrections.
- Do not comingle different tax years in the same filing.
- Corrections can be filed for the past three years (four if backup withholding or filing Form 1099-C, *Cancellation of Debt*).

¶ 108 B-NOTICE RESPONSE BEST PRACTICES

The IRS sends CP2100 and CP2100A notices, known as *B-Notices*, to financial institutions, businesses, or payers who filed certain types of returns whose information does not match the IRS records (see Code Sec. 3406). The notices alert payers that:

- The name/TIN combination does not match IRS or Social Security Administration (SSA) files.
- No TIN is provided by payee, or the TIN has invalid characters such as alphas or hyphens.
- The TIN is not a currently issued TIN, that is, the TIN cannot be found in IRS or SSA files, it has less than nine numeric digits, or it has redundant characters or alpha characters.

Affected returns include the following:

- Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*
- Form 1099-DIV, *Dividends and Distributions*
- Form 1099-G, *Certain Government Payments*
- Form 1099-INT, *Interest Income*
- Form 1099-K, *Payment Card and Third-Party Network Transactions*
- Form 1099-MISC, *Miscellaneous Income*
- Form 1099-NEC, *Nonemployee Compensation*
- Form 1099-OID, *Original Issue Discount*
- Form 1099-PATR, T*axable Distributions Received from Cooperatives*
- Form W-2G, *Certain Gambling Winnings*

Notice CP-2100 is typically delivered on a CD or DVD, and CP2100-A in paper form. Payers that filed up to 249 problematic files get a paper notice, whereas payers with 250 or more problematic files get a CD or DVD. CP2100 and CP2100A notices are generally

sent twice a year; an initial mailing in September and October and a second mailing in April of the following year.

The IRS compares the information returns against Social Security number (SSN) and employer identification number (EIN) files. It matches the first four characters of the business name or individual surname against the name used on the original application for an EIN or SSN. Note that sole proprietors must always include their individual name, not the business name.

Each notice has a list of payees, or the persons receiving certain types of income payments, with identified TIN issues. Payers must compare the accounts listed on the notice with their account records and correct or update their records, if necessary. This can also include correcting backup withholding on payments made to payees. The following lists outline what payers should do upon receiving the first or second B-Notice.

First B-Notice:

- First check the IRS information against your records.
- If the information matches, send the payee the first B-Notice and a Form W-9 to complete and return.
- If the payee does not respond, then begin backup withholding after 30 business days from the date provided on the Form CP2100.
- If new information is received, update your records but do not send a correction to the IRS.

Second B-Notice:

- Check the IRS information against your records.
- If the information matches, send the payee the second B-Notice. You are obligated to perform a second B-Notice mailing if you received a notice twice in three years. Do not send the payee a W-9.
- The payee must provide the payer with documentation obtained from the IRS or SSA.
  - For EIN: IRS Letter 147C verification.
  - For SSN: SSA information.
- If no response is received from the payee within 30 business days of the date provided on the Form CP2100, begin backup withholding.
- If new information is received, update your records but do not send a correction to the IRS.

Payers should keep a record of the solicitations sent to each payee to establish due diligence.

¶ 109 PROTECT YOURSELF

Payers must be diligent throughout the 1099 process: collecting data with the W-9, validating that data, and reporting that data. It is also essential to stay current on IRS rules and regulations. Although many aspects of 1099 reporting are relatively the same year after year, that can change at any given time. There might be changes to the forms, or the IRS might issue a Notice or a Revenue Procedure. Changes in the law might alter Code Sections—or add new ones.

The expectation is that payers are staying on top of the law, and if they are not, that can be held against them—further underscoring the need to stay attuned to the latest developments.

For example, in 2021 the IRS issued proposed rules on changes to 1099 filing requirements. However, it has been very slow in rolling out the regulations that will explain those changes. Practitioners should keep an eye out for the final rules, which likely will be released by the end of 2022.

STUDY QUESTIONS

4. With respect to 1099 reporting, which of the following forms should payers start with?

- **a.** Form W-2
- **b.** Form W-3
- **c.** Form W-4
- **d.** Form W-9

5. Which of the following IRS programs should a payer use to validate whether a payee's name and tax identification number matches?

- **a.** TIN Matching
- **b.** IRS2Go
- **c.** Tax Exempt Organization Search
- **d.** Fresh Start Program

6. Which of the following statements is correct with respect to LLCs?

- **a.** They cannot be single-member.
- **b.** They can be owned by another entity.
- **c.** They are exempt from 1099 reporting.
- **d.** They cannot file to be treated as corporations for reporting purposes.

MODULE 1: BUSINESS—Chapter 2: Understanding the New K-2 and K-3 Filing Requirements

¶ 201 WELCOME

This chapter discusses the purpose and general requirements of Schedule K-2, *Partners' Distributive Share Items—International*, and Schedule K-3, *Partner's Share of Income, Deductions, Credits, etc.—International*. It also examines recent developments and other issues related to the two schedules.

¶ 202 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Understand the purpose of Schedules K-2 and K-3
- Identify the general requirements for Schedules K-2 and K-3
- Recognize each part of Schedules K-2 and K-3 and who is required to meet reporting standards
- Describe the relief options available for incomplete Schedule K-2 and K-3 filing

¶ 203 INTRODUCTION

Schedules K-2 and K-3 have been an ongoing source of consternation for tax practitioners since draft schedules were released in mid-2021. First required for the 2021 tax reporting year, they require completion for any partnership, S corporation, or Form 8865 filer with items of "international tax relevance." Critically, this standard has been interpreted expansively by the IRS. Entities with no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3 based merely on stakeholder-level eligibility for foreign tax credits.

Most practitioners handling S corporation or partnership returns would fill out Form 1065, *U.S. Return of Partnership Income*, or Form 1120-S, *U.S. Income Tax Return for an S Corporation*. Since those are pass-through entities, practitioners would allocate elements of the income and the expenses and then also provide additional types of information on the Schedules K-1, which would be sent to the owners. Although certain information was fairly simple to report on those K-1s, some areas of the K-1 were a bit of a "dumping ground." Particularly, whatever information did not fit into the other boxes seemed to be deposited by default into box 14 or box 20.

Unless a practitioner had very sophisticated tax software—and had prepared the underlying Form 1065 or Form 1120-S—he or she could end up missing certain deductions or, conversely, recognizing certain income items because it was not clear on that K-1 exactly what those items were. In addition, if a client was filing for a foreign tax credit, the practitioner would not necessarily have all the information needed on the K-1; sometimes that information would have to be extrapolated.

As a result, the IRS decided to be more transparent with the information that is on the Schedule K-1s and have the taxpayer fill out a couple other forms to provide passive

information to the owners. These additional forms are extremely specific as to what type of item it is, whether it is income or a deduction, and whether it is foreign or not foreign.

¶ 204 OVERVIEW OF SCHEDULES K-2 AND K-3

The IRS issued draft versions of Schedule K-2 and K-3 in July 2020. The final versions, released in June 2021, are lengthy—Schedule K-2 is 19 pages long and K-3 is 20 pages. Their combined instructions total 34 pages. Schedules K-2 and K-3 are required for taxpayers filing the following returns with items of "international relevance."

- Form 1065, *U.S. Return of Partnership Income*
- Form 1120-S, *U.S. Income Tax Return for an S Corporation*
- Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*

The schedules replace the often-cursory information formerly required to be entered on Schedule K-1, which then often necessitated an attachment, but with no specified format for the information contained therein.

Purpose and Content of the Forms

The new Schedules K-2 and K-3 provide partnerships with a standardized format for reporting U.S. international tax information to their partners, including withholding and sourcing details for foreign partners and U.S. international inclusions, or foreign attributes relevant for domestic partners. These schedules will enable the IRS to verify tax compliance more efficiently.

Schedule K-2 is broken down into 12 parts:

- Part I, Partnership's Other Current Year International Information
- Part II, Foreign Tax Credit Limitation
- Part III, Other Information for Preparation of Form 1116 or 1118
- Part IV, Information on Partner's Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)
- Part V, Distributions From Foreign Corporations to Partnership
- Part VI, Information on Partner's Section 951(a)(1) and Section 951A Inclusions
- Part VII, Information to Complete Form 8621
- Part VIII, Partnership's Interest in Foreign Corporation Income (Section 960)
- Part IX, Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)
- Part X, Foreign Partners' Character and Source of Income and Deductions
- Part XI, Section 871(m) Covered Partnerships
- Part XII, Section 871(m) Tax Liability of a Qualified Derivatives Dealer (QDD)

The 13 parts of Schedule K-3 are as follows:

- Part I, Partner's Share of Partnership's Other Current Year International Information
- Part II, Foreign Tax Credit Limitation
- Part III, Other Information for Preparation of Form 1116 or 1118
- Part IV, Information on Partner's Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)
- Part V, Distributions From Foreign Corporations to Partnership
- Part VI, Information on Partner's Section 951(a)(1) and Section 951A Inclusions

- Part VII, Information to Complete Form 8621
- Part VIII, Partnership's Interest in Foreign Corporation Income (Section 960)
- Part IX, Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)
- Part X, Foreign Partners' Character and Source of Income and Deductions
- Part XI, Section 871(m) Covered Partnerships
- Part XII, Reserved for future use
- Part XIII, Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

What Is International Relevance?

International relevance is broadly defined. For example, the IRS instructions indicate that pass-through entities that have partners or shareholders claiming a foreign tax credit may be required to file Schedules K-2 or K-3 even if those entities have no foreign-source income or offshore assets. This is because income and deduction sourcing information may be relevant for partners claiming a foreign tax credit.

In an information release, IR-2022-38, the IRS noted that Schedules K-2 and K-3 do not have to be filed if:

- The pass-through entity has no foreign activities or foreign partners/shareholders; and
- There is no knowledge of a partner or shareholder need for information on items of international relevance.

The instructions to Schedules K-2 and K-3 reference "the international tax provisions of the Internal Revenue Code." Typically, partners will calculate on their own return their foreign tax credit on Form 1118, *Foreign Tax Credit—Corporations*, or Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*. Information contained on the K-2 could potentially impact the amount of foreign tax credit for which the taxpayer is entitled. Therefore, even partnerships with strictly domestic income and assets may have to complete Schedules K-2 and K-3 if they have partners that are claiming a foreign tax credit.

Examples of items of international tax relevance include the following:

- Foreign tax credit–related information, including the sourcing and basketing of income and deductions, research and experimental (R&E) expenses, and interest expense
- Interests in foreign entities or distributions from foreign corporations
- A foreign partner's U.S. source income and/or U.S. effectively connected income, including the distributive share of deemed sale items on the transfer of a partnership interest
- Investments in foreign entities, such as passive foreign investment companies
- Interests in controlled foreign corporations, global intangible low-taxed income (GILTI), and Subpart F income inclusions
- Foreign-derived intangible income (FDII)

Impact on Tax Preparers

Failure to file such forms or properly provide these information statements to partners or shareholders can result in significant penalties. Tax preparers may be required to survey each partner or shareholder to determine whether their returns will contain other international tax forms, such as Form 1116.

Changes to Previous Forms

Schedules K-2 and K-3 replace the following lines in the previous versions of these forms:

- Form 1065
  - — Line 16, Foreign transactions, of Schedule K, partners' distributive share items
  - — Line 20c, Other items and amounts
- Schedule K-1 (Form 1065)
  - — Line 16, Foreign transactions
  - — Part III, line 20, Other information

¶ 205 TRANSITION RELIEF

As mentioned earlier, the IRS issued the draft versions of Schedule K-2 and K-3 in 2020, and some lengthy changes were released in the final version in June 2021. Practitioners must determine whether the partner or shareholder is domestic or foreign, which could be time-consuming and difficult, especially when the practitioner did not prepare the partners' returns. This the reason why many practitioners have "protested" against having to prepare the Schedules K-2 and K-3. Preparing pass-through returns will potentially require much more time than prior to the advent of Schedules K-2 and K-3.

Confusion on Who Must File

Postings on the IRS website revising instructions about who must file Schedules K-2 and K-3 caused confusion among practitioners. Previous instructions seemed to imply that partnerships that lacked foreign partners or foreign activities had no "items of international tax relevance" and therefore did not need to file. However, in a note on its webpage on January 18, 2022, the IRS stated that a partnership may still need to file the schedules if, for example, a partner claims a foreign tax credit. This is despite the partnership having no foreign-source income, no assets generating it, and no foreign taxes paid or accrued.

Also, the filing of Schedules K-2 and K-3 might be necessary if the partnership made certain deductible payments to foreign-related parties as this information could potentially impact a partner's creditable foreign taxes on their personal return.

IR-2022-38

Although Schedules K-2 and K-3 are intended to make the reporting of international items clearer for partners and shareholders, the IRS has previously acknowledged the administrative burden the schedules impose and provided some transition relief in Notice 2021-39. Under this relief, eligible pass-through entities will not have to file new Schedules K-2 and K-3 for the 2021 tax year.

Relief is available for the 2020 tax year if:

- The domestic partnership or S corporation did not provide to its partners or shareholders, nor did the partners or shareholders request, the information on the form or its attachments regarding:
  - — Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S), and
  - — Line 20c, Form 1065, Schedules K and K-1 (controlled foreign corporations, passive foreign investment companies, 1120-F, Sec. 250, Sec. 864(c)(8), Sec. 721(c) partnerships, and Sec. 7874) (line 17d for Form 1120-S), *and*
- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for the 2021 tax year.

For the 2021 tax year, relief is available when:

- The direct partners in a partnership are not foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts.
- The domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate foreign-source income per Treas. Reg. § 1.861-9(g)(3).

According to Notice 2021-39, no penalties are imposed for the 2021 tax year if taxpayers could demonstrate a good-faith effort to comply by changing their *systems, processes, and procedures for collecting and processing the relevant information*, including obtaining information from partners, shareholders, or a controlled foreign partnership. Merely not filing the K-2 and K-3 would not be considered acting in good faith to attempt to comply.

The IRS cannot accept filing of the schedules via the modernized e-File/extensible markup language e-filing protocol until:

- March 20, 2022 (for partnerships)
- Mid-June 2022 (for S corporations)
- January 2023 (for Form 8865 filers)

Prior to these dates, the method for filing Schedules K-2 and K-3 is by PDF attachment. Obtaining a filing extension may be the best course for these taxpayers so the schedules can be e-filed instead of sent as an attached PDF.

What Constitutes a Good-Faith Effort?

Factors considered by the IRS in determining whether the taxpayer has made a good-faith effort to comply with the rules are whether the:

- Taxpayer has made changes to its systems, processes, and procedures for collecting and processing relevant information;
- Taxpayer has obtained information from partners, shareholders, or the controlled foreign partnership, or applied reasonable assumptions when information is not obtained; and
- The entity has a mechanism for sharing relevant information with partners and shareholders for purposes of preparing Schedules K-2 and K-3.

STUDY QUESTIONS

1. Schedules K-2 and K-3 are required for taxpayers filing certain returns with items of _____ relevance.

a. Intangible
b. Domestic
c. International
d. State

2. Which Part of Schedule K-2 relates to the Foreign Tax Credit Limitation?

a. Part II
b. Part III
c. Part IV
d. Part V

3. Which Schedule requires partners to calculate their foreign tax credit on Form 1118/Form 1116?

a. Schedule 1

b. Schedule K-1

c. Schedule K-2

d. Schedule K-3

¶ 206 IRS FREQUENTLY ASKED QUESTIONS

To help guide taxpayers and tax preparers, and alleviate some confusion, the IRS has published more than 20 frequently asked questions (FAQs) on Schedules K-2 and K-3 at https://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865. Some of the most useful FAQs are excerpted below.

FAQ 5

- *Question:* Do Schedules K-2 and K-3 require new information that wasn't previously required for partners or shareholders to accurately complete their own returns?
- *Answer:* Partnerships and S corporations may not have previously reported information in as much detail and for every fact pattern where reporting is required. The new schedules require more detailed and more complete reporting than partnerships and S corporations may have been providing previously to partners and shareholders, which is necessary for partners and shareholders to accurately complete their own returns.

FAQ 7

- *Question:* May these schedules be filed electronically, and what is the timeline?
- *Answer:* Yes, these schedules are currently available to be electronically submitted. However, Modernized e-File (MeF)/Extensible Markup Language (XML) electronic filing capability for the schedules K-2 and K-3 for tax year 2021 will not be available as of the beginning of the 2022 filing season (January 2022). Schedules K-2 and K-3 will be available for MeF/XML filing in the following time frames. If you electronically file your return before the time frames, submit the schedules as separate PDF files attached to the return. Taxpayers will also be able to file their Schedules K-2 and K-3 via PDF attachments for the entire 2022 filing season.

Form Number	Date Available
Form 1065, Schedules K-2 and K-3	March 20, 2022
Form 1120-S, Schedules K-2 and K-3	Mid-June 2022
Form 8865, Schedules K-2 and K-3	January 2023

FAQ 8

- *Question:* What electronic formats may be filed for Schedules K-2 and K-3 for tax year 2021?
- *Answer:* If you electronically file your return before the time frames as listed above in FAQ #7, submit the schedules as separate PDF files attached to the return. Taxpayers will also be able to file their Schedules K-2 and K-3 via PDF attachments for the entire 2022 filing season.

FAQ 10

- *Question:* Will the IRS penalize taxpayers who exercise a good-faith effort to comply with Schedules K-2 and K-3 for 2021 but struggle due to the difficulties in implementing the new schedules?
- *Answer:* Taxpayers who make a good-faith effort to comply with the new schedules for tax year 2021 will not be assessed a penalty, as described in IRS Notice 2021-39 PDF . . . a filer will not be subject to penalties if it made a good faith effort to determine whether it must file a part and how to complete a part if it determines it must file. The notice outlines some factors the IRS will take into account in determining if a partnership or S corporation made a good faith effort.

FAQ 11

- *Question:* Why would a domestic partnership or S corporation with no foreign activities and no foreign partners be required to complete Schedules K-2 and K-3?
- *Answer:* In many instances, a partnership or S corporation with no foreign partners, foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. For example, if the partner or shareholder claims the foreign tax credit, the partner generally needs certain information from the partnership on Schedule K-3, Parts II and III, to complete Form 1116.
- In general, the partnership or S corporation must complete the Schedules K-2 and K-3, Parts II and III because the source of certain gross income is determined by the partner or shareholder. In addition, some expenses of the partnership or S corporation are allocated and apportioned by the partner or shareholder. Because of this partner- or shareholder-level determination, it is not possible for the partner or shareholder to assume that all income of the partnership or S corporation is U.S. source and all expenses of the partnership or S corporation reduce U.S. source income.

FAQ 12

- *Question:* Can you provide some examples highlighting the need for K-2 and K-3 reporting when the domestic partnership or S corporation has no foreign partners or foreign activities?

EXAMPLE #1: U.S. citizen A and U.S. citizen B own equal interests in domestic partnership, which uses a calendar taxable year. In Year 1, domestic partnership has no foreign source income and no assets that generate foreign source income. Domestic partnership does not pay or accrue foreign taxes. In Year 1, A pays $2,000 of foreign income taxes on passive category income other than capital gains which was reported to A on a qualified payee statement. A does not pay or accrue any other foreign taxes and has no other foreign source income. B does not pay or accrue foreign income taxes. In Year 1, because B paid no foreign taxes for which it can claim a foreign tax credit, and such information was provided to domestic partnership by B, with respect to B, domestic partnership need not complete Schedule K-3.

Because A must complete Form 1116 to claim a foreign tax credit, domestic partnership must complete the relevant portions of Parts II and III of Schedules K-2 and K-3 (for A). The tax book value of domestic partnership's assets is $100,000 and A's share of those assets is $50,000. Not including its distributive share of the assets of domestic partnership, the tax book value of A's assets is $50,000. Of A's assets, $10,000 generate foreign source income and $40,000 generate U.S. source income. A has interest expense of $5,000 and domestic partnership does not have

interest expense. A has passive category foreign source taxable income before interest expense of $8,000. A's U.S. effective tax rate is 25%.

A's interest expense is apportioned between U.S. source and foreign source income ratably based on the tax book value of A's U.S. source and foreign source assets. Without taking into account the distributive share of domestic partnership assets, the amount of A's interest expense that would reduce foreign source gross income is $1,000 ($5,000 × $10,000 / $50,000). Therefore, A's foreign source taxable income would be $7,000 ($8,000 – $1,000). At a 25% U.S. tax rate, A may only use $1,750 (25% × $7,000) of the $2,000 of foreign taxes in Year 1 pursuant to section 904(d).

Taking into account the distributive share of domestic partnership assets, the amount of A's interest expense that reduces foreign source gross income is $500 ($5,000 × $10,000 / $100,000). Therefore, A's foreign source taxable income would be $7,500 ($8,000 – $500). At a 25% U.S. tax rate, A may use $1,875 (25% × $7,500) of the $2,000 of foreign taxes in Year 1—an additional foreign tax credit amount of $125 after taking into account A's share of the tax book value of the partnership assets.

Similar rules apply with respect to S corporations.

FAQ 13

- *Question:* What were the changes to the instructions posted on January 18, 2022?
- *Answer:* The updates clarify the prior instructions in response to public comments on reporting of personal property sales, as well as distributions and income inclusions with respect to foreign corporations. Compared to some interpretations of the prior instructions, the clarifications reduce potential reporting on these items.
- The changes generally clarify that domestic partnerships that have solely domestic activities and have less-than-10% limited U.S. citizen and U.S. resident individual partners are excepted from filing certain portions of Schedules K-2 and K-3.
- The updates reduce the requirement to attach certain forms to Schedule K-3.

FAQ 14

- *Question:* Do the instructions provide any exceptions to filing if a domestic partnership or S corporation has no foreign activities and no foreign partners?
- *Answer:* The partnership need not complete Schedules K-2 and K-3, Parts II and III if it knows that it has no direct or indirect partners eligible to claim a foreign tax credit.
- If a direct or indirect partner is eligible to claim a foreign tax credit, K-2 and K-3, Parts II and III, do not need to be completed if the partners are not completing Form 1116 or 1118. This would occur if the owners do not claim a foreign tax credit or if the owners qualify for an exception to filing the Form 1116 or Form 1118.
- Schedule K-2, Part II, and Schedule K-3, Part II, are not needed if:
  - — The partnership has only U.S. source income;
  - — None of the partnership's income or deductions must be sourced or allocated and apportioned by the partner; and
  - — All partners are less-than-10% limited partners.
- If all owners are less-than-10% limited partners, the partnership does not need to complete Schedules K-2 or K-3, Part III, Section 2.

FAQ 15

- *Question:* Is the IRS providing any additional exceptions for tax year 2021?
- *Answer:* The IRS is providing an additional exception for tax year 2021 to filing the Schedules K-2 and K-3 for certain domestic partnerships and S corporations. To qualify for this exception, the following must be met:
  - — In tax year 2021, the direct partners in the domestic partnership are not foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts.
  - — The domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated, or may reasonably expected to generate foreign source income (see Section 1.861-9(g)(3)).
  - — The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.
- If the partnership or S corporation believes they are under the exception but is notified after the return is filed (sans K-2 and K-3) by an owner that information contained on Schedule K-3 is needed to complete their tax return, then the information must be provided to the owner.
- If an owner notifies the pass-through before return is filed, the conditions for the exception are not met and the Schedules K-2 and K-3 must be filed with the IRS.

FAQ 16

- *Question:* Are there plans to update the Form 8082 [*Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*] instructions to address when an upper-tier partnership does not receive a Schedule K-3 from a lower-tier partnership?
- *Answer:* The instructions for the 8082 say on page 1: "Also use the form to notify the IRS if you did not receive Schedule K-1, Schedule Q, or a foreign trust statement from the foreign trust by the due date for filing your return (including extensions)." If you believe that you should have received a Schedule K-3 but did not, use Form 8082 to notify the IRS. The IRS will publicly release a new cover sheet for Form 8082 in the near future containing similar guidance.

¶ 207 OTHER ISSUES

Treatment of Undocumented Partners

Even if partners have an entity that has no cross-border investments or assets, they are still required to file Schedules K-2 and/or K-3 if they have foreign partners. Undocumented partners are presumed to be foreign. Therefore, it will be important for partnerships to verify that their partners are documented via a Form W-8 or W-9.

Additional Considerations

The forms are extensive and may require an in-depth understanding of complex international tax concepts such as sourcing rules, foreign-derived intangible income (FDII) rules, dual-consolidated-loss rules, Code Sec. 267A, and the Subpart F and global intangible low-taxed income (GILTI) rules, among others.

Private-equity and alternative asset management funds that have international activities may create an increased tax-compliance burden for funds, investor-relations issues, and timing issues related to delivering Schedules K-1, K-2, and K-3.

Other considerations for tax practitioners include the following:

- Consider separating the delivery of Schedules K-1 from Schedules K-2 and K-3.
- Ensure that partners are properly documented with a Form W-8 or W-9 and determine whether the Schedules K-2 and K-3 will apply by reviewing their 2021 transactions.
- While Schedules K-2 and K-3 consist of the most common international tax provisions, not all provisions are specifically identified on these schedules.
- If an international provision is impacted and is not otherwise specifically identified, the taxpayer should check box 12 on Schedule K-2, Part I, and Schedule K-3, Part I, and attach a statement to both Schedules K-2 and K-3 (for distributive share).
- If a computer-generated Schedule K-2 or K-3 conforms to and does not deviate from the official form and schedules, it may be filed without prior approval from the IRS.

Prepare for Possible Penalties

Historical errors may be discovered while implementing the new compliance protocol. These errors should be quickly identified and corrected as partners would not have been aware that their previous Schedules K-1 were wrong. There is a $280 penalty for each insufficient Schedule K-1 for the 2020 tax year for failure to provide all required information. The penalty is the greater of $560 or 10 percent of the aggregate amount of items required to be reported if the information requirement is intentionally disregarded.

Changes on the Horizon

President Joe Biden released his FY2023 budget in March 2022. In turn, the U.S. Treasury released the "Green Book," which explains the revenue proposals in the President's budget and serves as a guide to Congress for tax legislation. Proposed tax changes in the Green Book, if enacted, may cause drastic changes to Schedules K-2 and K-3 and affect the following:

- GILTI
- Foreign tax credits
- Country-by-country calculations
- Replacement of FDII and BEAT (Base-Erosion and Anti-abuse Tax) by SHIELD (Stopping Harmful Inversions and Ending Low-tax Developments)

The new Schedules K-2 and K-3 are not designed to report at that level of detail and therefore would require a total overhaul.

¶ 208 AICPA REQUIREMENTS

AICPA Comments

On February 18, 2022, the American Institute of Certified Public Accountants (AICPA) and CPA societies sent comments to the IRS Chief Counsel's Office and Large Business and International (LB&I) Division. The AICPA called for the Treasury Department and the IRS to delay implementation of Schedules K-2 and K-3 to the 2022 tax year and to suspend any assessment of penalties for failing to file or failing to timely provide

Schedules K-2 and K-3 for the 2021 tax year. Reasons for the AICPA's request includes recent changes to the instructions, the lack of time to reprogram tax compliance software, and the impact of the COVID-19 pandemic on operations.

The AICPA posits that the lack of a timely available Modernized e-File (MeF) filing option for these forms in electronic format will cause unnecessary hardship to all affected parties. Also cited as a reason for the delay in implementation is the fact that the taxpayer's reporting obligations are unresolved and that the IRS is unable to accept electronically filed returns via the MeF system until March 20, 2022 (for partnership returns) and until mid-June 2022 (for S corporations returns).

Increased Need for Extensions

Due to the recent changes and MeF dates that are past the original due dates, extensions will become necessary for significantly more partnership, S corporation, and owners' individual income tax returns than in prior years. The IRS will be tasked with processing unnecessary extensions in addition to the paper-filed returns for those entities that choose not to request an extension. Software providers also cannot offer sufficient solutions until the MeF system is complete.

Recent Expansion of Scope

The January 18, 2022, changes to the schedule instructions significantly expanded the applicable scope of the schedules. The final instructions included only a vague reference to "items of international tax relevance." This did not align with the previous understanding of scope based on the final instructions issued in August 2021. The changes announced on February 16, 2022, further modifying the applicable filing requirements, have created more confusion and whipsawed taxpayers as to whether they have a filing obligation.

Feasibility of Filing PDFs as Attachments

As mentioned earlier, the only option to timely file an electronic return prior to March 20, 2022 (partnerships) or mid-June 2022 (S corporations) is to attach a PDF file to the new Schedules K-2 and K-3. However, tax software providers and the IRS have technical limitations regarding transmitting PDF files that are over a certain size. The PDF attachment option is only feasibly available to certain small pass-through entities that fall within the page and file size limits.

Definition of "International Tax Relevance"

The AICPA wants the IRS to clarify on page 7 of the instructions that the exception to filing Form 1116 refers to the requirements provided in Code Sec. 904(j). There is an exception that would excuse pass-throughs from having to file Schedules K-2 and K-3 if:

- The entities have only U.S. sourced income, and
- U.S. individual partners/shareholders inform the entities that no Form 1116 is expected to be filed.

However, Code Sec. 904(j) provides that if individuals only have foreign-source gross income that is qualified passive income, all foreign-source income and foreign taxes are reported on a "qualified payee statement."

The AICPA is also requesting that the instructions refer to Code Sec. 904(j) to provide further clarity on the scope of this exception. The reason behind this request is that there are certain situations—such as when the amount of creditable foreign tax

paid or accrued by the individual during the taxable year does not exceed $300 ($600 for married persons filing jointly)—in which this information is reported on the appropriate Form 1099-MISC, Schedule K-1, or other substitute form.

Guidance on Late Receipt of Information from Owners

Timing issues may arise since pass-through entity returns are due before individual returns are. An owner-taxpayer may not know that he or she is required to file Form 1116 until the Form 1040 is prepared. This information may come after the pass-through entity has already filed Forms 1065, 1120-S, or 8865.

The AICPA is requesting that the instructions specify whether the entity is required to amend its return or file an administrative adjustment request (AAR) and include Schedules K-2 and K-3 when the entity receives owner certification after the entity has filed its return. Additionally, the instructions should provide whether the entity is then subject to penalties.

> **EXAMPLE:** Brokerage statements that are corrected in late March may change the owner's requirement to file a Form 1116. In such situations, the taxpayer's duty to inform the entity of its change in informational needs is unclear.

Changes to Part I, Box 8 Instructions

The AICPA recommends that the IRS clarify the instructions for Part I, box 8, with respect to required attachments. The instructions for Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, provide that a person may file Form 5471 and the applicable schedules for other persons who have the same filing requirement, and the filing is considered a joint information return. The non-preparing party of the joint information return need only attach a statement to their tax return referencing the Form 5471.

The recent changes to the instructions require a pass-through entity to check Part I, box 8, and attach any Forms 5471 to its Schedules K-2 and K-3 if another person filed on behalf of the pass-through entity. However, the Schedule K-3 attachment is not required if the pass-through entity knows that its owner does not need the information on Form 5471. Unnecessarily attaching the Form 5471 compounds the problem of e-filing via PDF attachments for software programs with attachment size limitations.

¶ 209 CONCLUSION

As mentioned earlier in this chapter, failure to correctly file the new Schedules K-2 and K-3 can result in significant penalties. Practitioners must understand the complexities of filing these detailed schedules and stay alert for new developments, which are likely on the horizon.

STUDY QUESTIONS

4. In what tax year is a partnership required to file the new Schedules K-2 and K-3?

a. 2020

b. 2021

c. 2022

d. 2023

5. Factors considered by the IRS in determining whether the taxpayer has made a good-faith effort to comply with the rules for Schedules K-2 and K-3 include each of the following, ***except?***

a. Delaying the filing of the new schedules until a later tax year

b. Taxpayer has made changes to its systems, processes, and procedures for collecting and processing relevant information

c. An entity has a mechanism for sharing relevant information with partners and shareholders for purposes of preparing Schedules K-2 and K-3

d. Taxpayer has obtained information from partners, shareholders, or the controlled foreign partnership

6. Which of the following organizations sent comments to the Chief Counsel's Office and LB&I in February 2022 requesting a delay in implementation of Schedule K-2 and K-3?

a. FASB

b. AICPA

c. PCAOB

d. IFRS

MODULE 1: BUSINESS—Chapter 3: How to Handle the Top 10 Issues in an IRS Small Business Audit

¶ 301 WELCOME

This chapter identifies which businesses the IRS primarily targets in small business audits. It discusses the scope of IRS small business audits and the most common issues the IRS focuses on in these examinations. The IRS's audit steps in examining income, and the records it expects in an examination, are outlined. The chapter also offers critical insight on preparing a client's records for an audit.

¶ 302 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Describe the reasons for compliance focus on small businesses
- Recognize the top 10 IRS audit focus areas for small businesses
- Describe how to evaluate a client's records and identify the critical records in an IRS small business audit
- Identify the steps to prepare for a small business audit
- Recognize how much annually the U.S. Treasury loses due to noncompliance
- Recognize approximately what percentage of the tax gap is accounted for by individuals
- Identify the factors the IRS uses to determine control with regard to worker status

¶ 303 INTRODUCTION

The 2021 IRS Taxpayer Attitude Survey (https://www.irs.gov/pub/irs-pdf/p5296.pdf) asked survey participants, "How much influence does each of the following factors have on whether you report and pay your taxes honestly?" The results reveal that "personal integrity, avoiding paying interest or penalties, and overall ability to pay most influence taxpayers to report and pay honestly, while perceptions of your community influences the least." The factors were ranked as follows, from those having the most influence to those having the least influence:

- Your personal integrity
- Avoiding paying interest/penalties
- Your ability to pay taxes due
- Fear of an audit
- Desire to help the government take care of citizens and national interests
- Third parties reporting your income to the IRS
- How government uses the taxes
- Having the option to pay taxes in installments
- Belief that your neighbors are reporting and paying honestly

Tax Gap Facts

The *tax gap*—the difference between taxes legally owed and revenue collected—has grown substantially over the past several years. According to recent IRS tax gap studies, small businesses are the most noncompliant taxpayer segment, accounting for the largest amount of what is currently estimated to be a $630 billion annual loss in tax revenue to the U.S. Treasury. Taxpayers voluntarily report approximately 83 percent of their tax liability, while 17 percent goes uncollected.

This noncompliance is largely due to the underreporting of income and overstating of credits and deductions. As a result, the IRS field audit resources focus much of their audit activity on small businesses.

While individuals make up about 81 percent of the tax gap, small business is the largest noncompliant segment. According to the U.S. Small Business Administration (SBA), there are almost 32 million small businesses in the country. Income subject to little or no information reporting contributes the largest to the small business tax gap. Small businesses are also the costliest to audit, and their reporting accuracy is estimated to be only 45 percent. Small businesses rely on voluntary compliance, not information statements. The following chart details characteristics of small businesses in the United States.

U.S. Small Businesses: Entities and Characteristics			
Entity Type	**Total #**	**% Are Small Business**	**Filings**
Total small business population	31.7M	• Median income = $51,816 • 6M have employees, employ 47% of workforce • 81% have no employees	Various
C corporation	2.1M	• 29% have assets <$25K • 65% have assets <$250K • Average income (assets <$250K) = $119,968	Form 1120
S corporation	5.4M	• 65% have one shareholder • 98% have <$10K in assets • 73% have <$500K in gross receipts • Number of taxpayers with S corporation income on Schedule E = 5.4M	Form 1120-S
Partnership	4.7M	• 2.7M are LLCs, 20% are domestic general partnerships • 25% have assets = $0 • 50% are real estate/rental ventures • Number of taxpayers with partnership income on Schedule E= 6.6 M	Form 1065
Schedule C Sole Proprietors	Schedule Cs = 31.5 M 1040s with Schedule Cs = 27.3 M	• 69% have gross receipts <$25K • 90% have gross receipts <$100K • 20% of filers are Schedule C-EZ • Only 1M Schedule C filers have employees	Form 1040, Schedule C
Employers	7.6 M	• 6M+ are small business owners • 5.3 M have 1–19 employees on payroll	Forms 941/940/944

Audit Rates

Although IRS audit rates have been relatively low over the past few years, in 2021 they began to increase slightly. They have not risen to the high rates that were seen in 2010 and 2011, but the IRS is recovering from the COVID-19 pandemic and will likely begin auditing many more taxpayers. The IRS is also issuing an increasing number of CP2000 Notices, which alert taxpayers that the income or payment information the IRS has on

file doesn't match the information the taxpayer reported on their tax return. About two and a half times more CP2000s were issued in 2021 than in 2020. CP2000s usually outnumber audits by a three-to-one ratio.

Who Gets Audited

The IRS has not been very transparent on who gets audited, but over the past decade, generally individuals with higher income (more than $1 million) have the highest audit rate. The audit rate for S corporations declined to 0.13 percent in 2021. And the rate for partnerships was even lower, at 0.09 percent. Consequently, the IRS likely is looking to conduct more partnership and S corporation audits in the future.

Common Business Audits

A business audit is an audit of taxpayers that file Form 1040 Schedule C (*Profit or Loss from Business*), Form 1120-S (*U.S. Income Tax Return for an S Corporation*), Form 1120 (*U.S. Corporation Income Tax Return*), or Form 1065 (*U.S. Return of Partnership Income*). Although businesses audits are primarily field audits, mail audits are also performed.

Clients can receive the following IRS forms, letters, and notices as part of the business audit:

- Letter 2205: Notifies the taxpayer that their tax return is being audited and asks the taxpayer to call the IRS to make an audit appointment.
- Form 4564, *Information Document Request* (IDR): Describes the documents the IRS needs from the taxpayer to perform the audit.
- Form 4549, *Income Tax Examination Changes*: Explains the proposed changes to the taxpayer's tax return.
- Form 886-A, *Explanation of Items*: Describes the specific changes to the taxpayer's tax return and the reasons for them.
- Letter 950: Presents the IRS's examination findings, informing the taxpayer of an increase or decrease in tax liability.
- Letters 525 and 915 ("30-day letters"): Alert the taxpayer that the IRS is auditing their Form 1040 and needs a response within 30 days. The auditor actually gives the taxpayer the final report, allowing 30 days for the taxpayer to appeal to the IRS Independent Office of Appeals. Taxpayers should always respond to the 30- and/or 90-day letters.
- Letter 3219 ("90-day letter"): Informs a taxpayer that they owe additional tax, penalties, and interest and have the right to appeal this decision with the U.S. Tax Court within 90 days.
- Notice CP22E: Notifies the taxpayer that as a result of its audit, the IRS made changes to the taxpayer's tax return and that the taxpayer owes money on their taxes as a result of these changes.

Audit Process and Representation of Client

In representing a client undergoing an audit, the tax practitioner should take a structured approach. For the audit appointment, the practitioner should file Form 2848, *Power of Attorney and Declaration of Representative*; start interacting with the IRS auditor; and begin the document request and analysis procedures.

To prepare for the audit, the practitioner should evaluate the client's records and systems, prepare responses, and conduct other pre-audit steps.

Issue development is typically the longest phase of the audit process, lasting an average of 13 months. However, this phase can be shortened if the practitioner has prepared well. Steps in this phase include examination of and response to IDRs, analysis of proposed issues, and issue negotiation.

The last part of the process is the appeal/audit finalization phase. The IRS Revenue Agent Report (RAR), which contains the information necessary to ensure a clear understanding of the adjustments and explains how the tax liability was computed, is issued. In this phase, the client will respond to the 30- or 90-day letters and appeal the IRS assessment, if desired.

Mail Audits

Mail audits are now the norm. Due to the COVID-19 pandemic and other reasons, the number of mail audits has increased, and three out of four audits are now done by mail. Mail audits on Schedule C expenses are now common. Tips for handing these audits include the following:

- Respond to IRS letters and notices on time; submit *one complete response.*
- The client may have voluminous records. Be sure to index them and provide explanations of receipts.
- If the client has no records, provide reconstruction and explanation (oral testimony).
- If it is within a week of the deadline, send the information to the IRS by fax.
- Follow up with the IRS by telephone for status—use the Practitioner Priority Service (PPS) phone number: 866-860-4259.
- Always request an appeal if the IRS disagrees with your findings.
- If you miss the 30- and/or 90-day letters, request reconsideration.

Unique Characteristics of Small Business Audits

Small business audits are unique in that there is little accountability through information statements; facts and circumstances apply. These audits are more intrusive and comprehensive than others. Small business audits are conducted by field auditors (revenue agents), and it takes approximately 46 hours, on average, for an agent to conduct an audit of each tax year.

Therefore, clients rely on tax professionals to help them with small business audits. Tax professionals prepare 55 percent of all tax returns, three of four small business returns, and more than nine of 10 corporation and flow-through entity returns.

¶ 304 THE TOP 10 AUDIT ISSUES

The top 10 issues or targets most commonly encountered in small business audits are listed below. Each will be discussed in more detail in this section.

- Unreported income
- Business versus hobby
- S corporation reasonable compensation
- Losses in excess of basis
- Construction industry
- Worker status

- E-commerce
- Related returns and multiple years
- Form 1099 noncompliance
- Penalties

Unreported Income

Unreported income is always the first issue in small business audits. Internal Revenue Manual (IRM) 4.10.4.3 states that the IRS examiner, in an audit, must always consider whether income is accurately reported on the tax return. The minimum field audit requirements for nonbusiness and individual "business" returns are as follows.

Non-business returns:

- Information statement reconciliation and specific items omitted
- Taxpayer interview
- Financial status analysis (cash-T)
- Bank deposit analysis if initial cash-T has a gross imbalance or there is an unreported Form 1099-MISC, *Miscellaneous Income*, or Form 1099-K, *Payment Card and Third-Party Network Transactions*

Individual "business" returns (Forms 1040, with Schedule C, E, or F):

- Financial status analysis (cash-T)
- Taxpayer interview
- Tour of business
- Internal control review
- Income reconciliation to books
- Information statement reconciliation
- Gross receipts test to books
- Bank analysis
- Ratio analysis
- E-commerce activity

Corporate/partnership returns have additional audit requirements:

- Balance sheet analysis
- M-1 and M-2 reconciliation
- Shareholder/partner tax return evaluation

Common issues encountered in information return matching include Form 1099-K reconciliation, Form 1099-MISC/NEC reconciliation, and Social Security Number (SSN) and Employer Identification Number (EIN) income information matching from the IRS. Tax professionals can request an Information Returns Processing Transcript Request (IRPTR) using the taxpayer's EIN to request data for a particular taxpayer.

Cash-T is basically a reconciliation of the cash in versus cash out. Early in the audit process, the auditor will ask about cash on hand at the beginning and end of the year. If there is a lot more cash going out than going in, the IRS will suspect unreported income.

The auditor may also perform a *bank deposit analysis*. For this analysis, the auditor may request all of a taxpayer's bank statements, starting from the month before the year is started through the month after the year is started. He or she will add up all the deposits and reconcile them against what is reported on the taxpayer's return. For example, the auditor will back out gross receipts, any refunds that were reported on the books, and items that were reported on other places on the return, such as rental

income. Auditors also may back out nontaxable items such as loans. This analysis may reveal that the total amount of deposits is not accounted for. The bank deposit analysis is crucial at the beginning of an audit.

Let's review two Tax Court cases involving small business audits and examination of income:

Porch v. Commissioner, TC Summary Opinion 2012-25 (March 21, 2012). The taxpayer owned a carpet sales and installation business and was audited for 2005 and 2006. The taxpayer reported $75,000/year in gross sales and provided documentation to prove $75,000 in income at the initial audit interview. The IRS auditor initially determined a cash-T imbalance of $49,000 in 2005. Few records were provided in the audit, so the taxpayer's bank records were summonsed and examined. Cash deposits were found, and the taxpayer stated these amounts were used to pay cash expenses. The taxpayer agreed to additional business income—$84,712 for two years—but wanted additional cash expenses and no fraud penalty.

The Court upheld the IRS's determination for the tax and penalties. The Tax Court did not like that the taxpayer and counsel were not cooperative with the IRS agent. The IRS's cash-T and bank deposits method prevailed and rendered the taxpayer's records and testimony implausible. The result was that the taxpayer was also liable for the fraud penalty.

Azimzadeh v. Commissioner, TC Memo 2013-169 (July 23, 2013). The taxpayer owned a used car business in California and failed to maintain good records. The taxpayer's bank deposits exceeded its income by $179,209. The Tax Court upheld the IRS bank deposit analysis, noting that unexplained bank deposits are prima facie evidence of income when a taxpayer fails to maintain adequate records. It is the taxpayer's burden to show the deposits were not income. This taxpayer did not meet that burden.

PRACTICE TIPS: The tax professional should conduct heightened due diligence at tax preparation:

- Follow three IRS audit litmus tests:
  - — Cash-T and "ask the second question" if there is an imbalance.
  - — Match bank deposits to client records.
  - — Match income against IRS income records.
- Look past the trial balance.
  - — Trace several transactions to the source.
- Are the ratios reasonable?
  - — Three-year review: Are there significant variances?
  - — Do the financials align with industry averages?
- Check information statements against client records.
  - — Do the client records reconcile to the Form 1099-MISC received from a customer?
- Correct the business/personal "co-mingler."
- Tax workpapers are critical. There must be workpapers that match the return, mapping back to the client's books and records.

Tax practitioners should do the IRS agent's analysis prior to the on-site examination:

- Reconcile the books to the return and be prepared to explain discrepancies.
- Provide chart of account mapping workpapers to the return.

- Do an income audit and be prepared to explain discrepancies.
- Perform the three litmus tests and test gross receipts against source documents, including digital cash.
- Analyze the business ratios against industry norms (www.bizstats.com).
- Review your client's website for questioned income sources (archive.org for the history).
- Be prepared for related-entity audits: File a Form 2848 or Form 8821, *Tax Information Authorization*, to receive information from the IRS agent.

NOTE: The IRS provides its audit "playbook" in the form of audit technique guides (ATGs) that "explain industry-specific examination techniques and include common, as well as unique industry issues, business practices and terminology." One of the most helpful ATGs is the *Cash Intensive Businesses Audit Techniques Guide* (https://www.irs.gov/businesses/small-businesses-self-employed/cash-intensive-businesses-audit-techniques-guide-table-of-contents), which basically outlines the IRS's audit steps. This ATG is a prerequisite to representing your client in an audit.

Business Versus Hobby

The question of whether an activity is a business, or a hobby has become even more important since the Tax Cuts and Jobs Act of 2017 (TCJA) completely eliminated the itemized deduction for hobby expenses. The taxpayer has burden of proof unless the taxpayer meets the presumptive rule under Code Sec. 183(d). The presumptive rule is that if a profit is shown for three of the last five years, the burden of proof shifts to the IRS. Section 183 target businesses in this area include the following:

- Multi-level marketing businesses
- Entertainers
- Farmers
- Writers
- Personal pleasure businesses
  - — Horse and dog breeding
  - — Yacht and airplane charters
  - — Fishing
  - — Auto racing
  - — Gamblers
  - — Photography
  - — Bowling
  - — Stamp collecting
  - — Craft sales

In determining whether a business is a hobby, questions to be considered include:

- What is the true intent of the taxpayer?
- Do the facts objectively support the intent to make a profit?

Treas. Reg. § 1.183-2(b) focuses on the following nine nonexclusive factors to make this determination:

1. Manner in which the taxpayer carries on the activity
2. Expertise of taxpayer and advisors

3. Time and effort expended on the activity
4. Expectations that the assets will increase in value
5. Success of the taxpayer in carrying on other activities
6. History of income/loss for the activity
7. Amount of occasional earned profits if any
8. Financial status of the taxpayer (tax savings benefit motive)
9. Elements of personal pleasure

In *Campbell v. Commissioner*, TC Memo 2011-42 (February 17, 2011), the taxpayers owned a multi-level marketing business with losses and were audited for 1998–2001. The taxpayers had other businesses in real estate and construction. They sold business opportunities for downstream pyramid revenue and sold products directly. The taxpayers did not develop their own business plan, and they purchased products for themselves using the business's money. Because the taxpayers had no budgets, they were not aware whether the business was making a profit until the tax returns were filed. Losses were reported for every year between 1995 and 2001. The taxpayers maintained separate records and bank accounts for the business and spent excessive time on the business. The business had significant gross receipts ($103,266); those were boosted by product sales to the taxpayers and their construction business.

The Court found that the taxpayers received significant tax benefits from the losses and never used records to analyze the business's profitability and adjust operations. Little effort was made to change business operations in seven years, despite the loss of $20,000 annually. The taxpayers made purchases that were withdrawn for personal consumption. The IRS agent had to reconstruct the proper cost of sales to eliminate personal items.

The Court also noted that the taxpayers did not seek independent advice on the business; they were persuaded by other "upline" marketers. The continued activity, despite losses, underscored the taxpayer's personal pleasure. Consequently, Code Sec. 183 limits were sustained.

PRACTICE TIPS: There are six litmus test questions to ask in business versus hobby audits:

- Are losses offsetting other income on the return, resulting in a significant tax benefit?
- Is the activity a personal pleasure activity?
- Are there separate books and records?
- Are there large expenses and little or no current (anticipated) income?
- Does the history of the activity show that it is generating any profit in any years?
- Does the client have "business-like" documents?

Having the following documentation can help in Code Sec. 183 arguments:

- Formal books and records
- Separate financial accounts
- A realistic, formal business plan (the IRS will not initially ask for this) and annual budgets
- Evidence that the business plan has been followed
- Business licenses, insurance, and permits
- Use of experts, their credentials, and how advice was utilized

- Advertising, signage, websites
- Evidence of time spent on activity
- Appraisals of asset appreciation
- Documentation of where taxpayer, in the past, abandoned unprofitable ventures
- Outside, independent investors

Tax professionals should prepare for these types of audits using the IRS's *Audit Technique Guide: Internal Revenue Code Section 183* (https://www.irs.gov/pub/irs-pdf/p5558.pdf), which explains how agents conduct a quality examination of an "activity not engaged for profit" issue under Code Sec. 183. They may consider invoking the presumption test using Form 5213, *Election to Postpone Determination as to Whether the Presumption Applies That an Activity Is Engaged in for Profit* (Code Sec. 183(e)). Another good practice is to be able to answer all the questions for the client to prevent the IRS from insisting on interviewing the client directly.

S Corporation Reasonable Compensation

The audit issue is whether officer/shareholder compensation is unreasonable, resulting in FICA and Medicare tax avoidance.

Two out of three S corporations have only one shareholder. Thirteen percent of S corporations examined by the IRS in 2003 and 2004 paid inadequate compensation to shareholders, and the average underpayment was $20,127. Red flags in this area include:

- Distributions and/or repayments to the officer/shareholder
- Little or no officer compensation
- S corporation has ordinary income

In *Glass Blocks Unlimited v. Commissioner*, TC Memo 2013-180 (August 7, 2013), a sole shareholder S corporation was a distributor of glass blocks used in construction. The sole shareholder worked full-time but did not pay himself a salary. His Form 1040 only showed $10,000 in ordinary income from the S corporation and repayment of a loan to a shareholder of $62,000. There was little evidence of loan transactions. The Tax Court found that the loans were not bona fide—they were contribution of capital to the S corporation, and the repayments were wages. The taxpayer did not file any Form 941s, so the IRS asserted failure to file and failure to deposit penalties in addition to FICA/Medicare taxes.

Another case, *McAlary, Ltd. v. Commissioner*, TC Summary Opinion 2013-62 (August 12, 2013), involved a sole shareholder S corporation that was a real estate broker. When the S corporation was set up, a salary of $24,000, plus commissions, was established for the taxpayer. The taxpayer worked full-time, but no salary was paid. The taxpayer's Form 1040 only had $231,454 in ordinary income from the S corporation. The taxpayer received distributions of $240,000 and argued that his compensation should be $24,000. The IRS used a valuation expert and proposed compensation of $100,755 based on median wages for the area. The Court disregarded the original compensation agreement because the salary (plus commissions) was never paid. It stated that the compensation was not at arm's length, but rather was "adopted as mere window dressing." According to the Court, the IRS had a flawed valuation. The Court stated the wages were $83,200. Because no Form 941s were filed, the IRS asserted failure to file and failure to deposit penalties in addition to FICA/Medicare taxes.

PRACTICE TIPS: Help your client determine the correct compensation by considering the following:

- What services are they performing?
- Make salary comparisons based on job title, duties, and skills.

- Carefully document the compensation arrangement before payment is made. Record it in the minutes.
- Follow the agreement and file payroll returns.
- Beware of distributions that are bonus compensation.
- If you do not make a salary payment in a quarter, file a -0-Form 941 to avoid any potential failure to file penalty if compensation is challenged.

NOTE: Authoritative websites, such as Payscale (www.payscale.com), can help with salary determinations.

Losses in Excess of Basis

S corporations are of increased focus in IRS audits. The IRS has studied S corporation compliance and found one major area of concern: deducting losses in excess of basis. Shareholders generally can only claim losses and deductions up to the amount of basis that the shareholder has in the S corporation's stock and debt. The calculations are often complicated and sometimes not completed before deducting the loss.

The IRS also states that an added barrier to compliance is that S corporations are not required to report any basis calculations to shareholders. It is at the Form 1040 level that you determine basis and the ability to deduct S corporation losses.

The question, then, is whether the shareholder or partner has basis to deduct the loss. IRS data shows that between 2006 and 2008, misreported losses exceeded basis limitations by $21,600 per taxpayer in audits of Forms 1040 with pass-through losses from Form 1120-S.

In audits of Forms 1040 with pass-through losses from Form 1120-S between 2006 and 2008, 71 percent of S corporation returns done by paid preparers contained errors. The IRS is holding tax preparers accountable for calculating basis for losses at the shareholder/partner level.

For the 2021 tax year, shareholders who have losses, as well as certain other transactions, are required to file Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*, to their tax return. Shareholders use this form to figure potential limitations of their share of the S corporation's deductions, credits, and other items that can be deducted. Taxpayers and tax preparers should expect the IRS to use the information reported on the Form 7203 in the audit of an S corporation and its shareholders to limit the losses deducted by the shareholder.

PRACTICE TIPS: The shareholder/partner tax preparer is responsible for basis/loss computations.

- Do the basis calculations.
- Correctly interpret debt basis issues.
- Watch for at-risk limitations and passive activity rules.

STUDY QUESTIONS

1. Behind personal integrity, which of the following factors has the greatest influence with respect to voluntary compliance?

a. Belief that your neighbors are reporting and paying honestly

b. Your ability to pay taxes due

c. Avoiding paying interest/penalties

d. Desire to help the government take care of citizens and national interests

2. Income subject to _____ contributes the largest to the small business tax gap.

a. Information reporting and withholding

b. Little or no information reporting

c. Information reporting

d. Some information reporting

3. Which of the following is the annual tax return filed for a C corporation?

a. Form 1040

b. Form 1120

c. Form 1065

d. Form 1120-S

Construction Industry

Construction industry audits have been an IRS focus area for years. Targets of these audits include contractors, general contractors, developers, commercial and residential construction, heavy construction, and subcontractors. Numerous issues are involved in these audits, including:

- Unreported income
- Accounting methods
- Capitalization of costs to long-term contracts
- Worker status
- Cash payments
- Depreciation
- Auto expenses

Error rates are high in construction industry returns (see the following chart), and these audits can get complicated. And according to an older version of the IRS's *Construction Industry Audit Technique Guide*, "residential construction is of particular interest because this group of taxpayers accounts for 73% of the return filings but reports only 10% of the gross receipts."

Error Rates in IRS Construction Audits			
Issue	**Schedule C**	**Form 1120-S**	**Form 1065**
Gross receipts	63%	47%	53%
Cost of sales	65%	No data given	57%
Depreciation	71%	73%	100%
Other deductions	78%	71%	86%
Car/truck expenses	74%	64%	No data given
Officer compensation	N/A	51%	N/A

Prevention of these issues starts with good accounting systems. Practitioners should ask their clients the following four questions. Before the return is filed, look at the profit ratios and then ask the second question.

- Are you a diligent recordkeeper?
- Should you be your own bookkeeper?

- If you are your own bookkeeper, do you understand your accounting method?
- How are you accounting for and paying subcontractors?

In an audit, the tax professional should give the IRS agent the client's "big picture," including the properties developed, contracts worked, accounting procedures used, financial conditions for the year under exam, unusual items for the year, and an overview of the accounting system.

NOTE: The IRS's *Construction Industry Audit Technique Guide*, last updated on April 19, 2021, is very helpful in understanding construction industry issues and audit techniques.

Worker Status

The main focus in most employment tax audits relates to worker status: Is the worker an independent contractor or an employee? In 2021, 46,204 employment tax returns were examined by the IRS, and the average recommended additional tax per return was $28,544.

Although many believe the chances of an employment tax audit are very low, the reality is all IRS field audits include employment tax compliance checks. Based on 7.6 million employers, the audit coverage rate is actually much higher as all small business audits review employment tax compliance.

The ultimate question in determining whether a worker is an employee (W-2), or an independent contractor (Form 1099) is: "Who has the right to control and direct the individual performing services?" The IRS uses three factors to determine control:

- **Relationship of the parties:** Agreements between them, how they each perceive the relationship, and how they represent the relationship to others.
- **Behavior controls:** How much control does the business have over the worker?
- **Financial controls:** Including the worker's risk of loss and whether he or she has made a significant financial investment.

The IRS has also provided 20 common law factors to consider. Each one can be weighted differently based on the facts and circumstances, making this a very subjective determination. There is no bright-line test. The 20 common law factors are as follows:

1. Instructions given to worker
2. Job-related training
3. Integration of worker's services into the business operations
4. Services rendered personally
5. Hiring, supervising, and paying assistants
6. Continuing relationship
7. Set hours of work
8. Full time required
9. Doing work on employer's premises
10. Order of sequence set
11. Oral or written reports required
12. Payment by hour, week, or month
13. Payment of business and/or traveling expenses
14. Furnishing of tools and materials

15. Significant investment by worker
16. Realization of profit or loss by worker
17. Working for more than one firm at a time
18. Making service available to general public
19. Right to discharge
20. Worker's right to terminate

As mentioned earlier, there is no bright-line test, but precedence may help in determining if a worker is an independent contractor or an employee. The case of *Atlantic Coast Masonry, Inc. v. Commissioner*, TCM 2012-233, examined whether masons were employees or contractors. An S corporation officer used a foreman to hire masons on a per-job basis (no contracts were made). The masons were paid by brick laid, and the corporation officer frequently reviewed and approved the masons' work. The masons worked eight-hour days and were paid weekly. They furnished their own tools and were considered an essential part of the business. Although they had a transitory relationship with Atlantic Coast Masonry, they mostly worked for that company.

In examining the common law factors, the Court held they weighed in favor of considering the masons "employees." Each mason received payment like an employee and had no significant investment and no profit/loss realization. The corporation furnished materials to the masons and had the right to discharge them. The Court also held that the masons were deeply integrated in the corporation and had a continuing relationship with it. For these reasons, the determination was that the masons were employees.

Audit defenses in these types of cases include the following:

- Step 1: Prove that the worker is an independent contractor.
- Step 2 (if applicable): If the worker is likely an employee, determine if your client is entitled to relief:
  - — Code Sec. 530 relief
  - — Classification settlement program (CSP)

Code Sec. 530 provides relief from taxes associated with the reclassification of workers if three factors are met:

- Consistent treatment of like workers (substantive consistency)
- Reporting consistency (i.e., filed all Forms 1099)
- Reasonable basis "safe haven" for treating the worker as a contractor
  - — Prior audit
  - — Judicial precedent
  - — Industry practice

The Classification Settlement Program (CSP), started in 1996, is one of the only settlements that can be offered at the agent level (see IRM 4.23.6). The program allows taxpayers and tax examiners to resolve worker classification cases as early in the administrative process as possible. CSP agreements are closing agreements that bind the IRS and the taxpayer to prospective tax treatment for future tax periods. It is available only if Form 1099s have been filed for workers. If a client is under audit, use the CSP. If the client is not under audit, use Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*, to apply for the program.

TIPS FOR BUSINESS CLIENTS TO HELP AVOID COMPLIANCE ISSUES

When hiring a contractor:

- Always obtain the contractor's taxpayer identification number (TIN) before making payments.
- Always timely file Forms 1099.
- Document the contractor relationship.
  - — Obtain the contractor agreement and other business documentation (invoices, proof of insurance, copy of necessary business licenses, EIN, etc.).
  - — Avoid non-compete agreements.
  - — Pay by the job or project completion deliverable.
  - — Allow the use of subcontractors and assistants.
  - — Have indemnification clauses.
  - — Treat the contractor as a vendor, not as an employee (employee events, separate contractor file, no benefits).

E-commerce

E-commerce issues, such as unreported income, hobby loss, personal deductions, and Form 1099-K reconciliation, are also an IRS audit focus. In 2012, the IRS instituted mandatory audit techniques for businesses that have e-commerce activity (IRM 4.10.4.3.7.1).

Form 1099-K reconciliation requires matching the digital payments coming through merchant card accounts against the client's tax return. Targeted e-commerce includes the following:

- Online sales
- Customer payments online
- Advertising income
- Online tip jars
- Sales of customer lists
- Referral fees

Cryptocurrency questions are now standard operating procedure for the IRS in small business audit of taxpayers who accept payment by cryptocurrency.

PRACTICE TIPS:

- Be confident that your client is reporting income from all sources.
- Test digital cash transactions: credit card, PayPal, etc.
- For 1099-K discrepancies, attach a statement to the return
- In an audit, review your client's past website and e-commerce activity. Go to www.archive.org and use the Wayback Machine to see website history.

Related Returns and Multiple Years

Small business audits are comprehensive in scope. Required filing checks include:

- All returns open under statute
- Key partners/shareholders
- Contractors (tracing the vendor payments)

- Employment tax compliance
- Information returns compliance
- Pension plans

A small business audit most likely will include prior and subsequent years filed, if within the IRS examination cycle; shareholders/partners; scrutiny of highly compensated employees; and very close scrutiny of related returns (e.g., Form 941s). See IRM 4.10.5 for further details.

Agents have also been told to make sure they perform "package audit" requirements and to look for worker classification and Form 1099 issues. If agents find noncompliance, audits will also expand into employment tax audits and Form 1099 penalty audit cases.

In the future, look for the IRS to expand its audits into more than the year under exam if it finds an issue. According to an IRS study (TIGTA Report Reference Number 2011-30-084), agents and compliance officers are required to review prior/subsequent year returns for potential adjustments. The average tax loss is approximately $9,600 per return not audited. Eighteen percent of the audits did not look into contractor/employment tax-related returns. IRS agents have been criticized recently by the TIGTA for missing prior and subsequent year issues.

PRACTICE TIPS: In the audit, tax professionals should treat all open years as if they were under audit.

- Prepare for multiple-year exams—prior and subsequent years.
- Prepare for shareholder/partner returns to be examined.
- Examine information statement filing compliance.
- Make sure the Form 2848 has multiple years/forms included.

Form 1099 Noncompliance

According to an older Government Accountability Office (GAO) study (GAO Report GAO-09-238), although there are many small businesses, few file Form 1099s. To ensure Form 1099 filing compliance, IRS audit steps include reviewing payments for missing 1099 filings. Penalties for information statement errors include:

- Code Sec. 6721 penalty for failure to file correct information statements (maximum 25 percent)
- Code Sec. 6722 penalty for failure to furnish correct payee statements (maximum 25 percent)
- Code Sec. 6723 penalty for failure to comply with other reporting requirements (e.g., supplying a correct TIN)

Charges for Each Information Return or Payee Statement				
Tax Year	Up to 30 Days Late	31 Days Late Through August 1	After August 1 or Not Filed	Intentional Disregard
2023	$50	$110	$290	$580
2022	$50	$110	$280	$570
2021	$50	$110	$280	$560
2020	$50	$110	$270	$550

To avoid such penalties, taxpayers should always obtain a contractor's TIN before making payments and always file the required Forms 1099.

EXAMPLE: Business ABC did not issue a Form 1099-MISC to a vendor. The IRS determines that the workers are employees. Business ABC's failure to comply is considered willful neglect, and therefore it has no relief options. It does not qualify for Code Sec. 530 relief, the CSP, or the VCSP.

The costs:

- 24 percent federal income tax withholding (under Reg. § 31.3402(g)-1)
- 15.3 percent FICA/Medicare
- FUTA at full rate (2021: 6.0 percent)
- Failure to file penalty (maximum 25 percent)
- Failure to pay penalty (maximum 25 percent)
- Failure to deposit penalty (10 percent)

The IRS's audit steps in investigating Form 1099 noncompliance include reviewing client records, including vendor files, accounts payable files, payments, Forms 1099 filed, and "B" notices received. The IRS will ask about the client's procedures, such as:

- Steps for identifying and issuing Forms 1099-MISC/NEC, and
- Controls for obtaining TIN on contractors (W-9 procedures).

The IRS is looking for situations that require backup withholding.

Penalties in Small Business Audits

These penalties include accuracy penalties and preparer penalties.

Accuracy penalties. There has been an 1154 percent increase in accuracy penalties from 2013 to 2020, with only an 8 percent increase in the number of individual returns. Consequently, there is an increased emphasis on accuracy penalties in small business audits. In 2021, 26 percent of audits/CP2000s had an accuracy penalty. According to IRM 20.1.5.7.1, "the most important factor in determining with reasonable cause is the taxpayer's effort to report the proper tax liability." The IRM goes on to state, "The determination is done on a case-by-case basis, taking into account all the relevant facts and circumstances." Treas. Reg. § 1.6664-4(b) also presents a facts and circumstances test: "honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances."

Tax practitioners must closely review accuracy penalty determinations. Accuracy penalties must be approved by an IRS manager (Code Sec. 6751(b)(1)) prior to issuing any written penalty determination. However, there is an exception for CP2000s. Practitioners should ask for the manager's written penalty approval document. If it is not provided, consider using a Freedom of Information Act (FOIA) request (IRM 20.1.1.2.3) to obtain this information. To dispute accuracy penalties, the tax professional should request a manager conference. In audits, many penalty determinations are proposed as an afterthought, so practitioners should dig deeper.

Preparer penalties. The IRS is pursuing preparer penalties in the following three areas:

- Substantial understatement of income (Code Sec. 6662(b)(1))
- Rental properties
- Losses taken in excess of basis

Fraud in small business audits. In small businesses, most fraud cases stem from unreported income:

- Omission of specific items of income, entire sources of income or substantial amounts of income
- Unexplained increases in net worth
- Unexplained bank deposits

Fraud red flags for the IRS include the following:

- More than one set of books and records
- False statements about material facts in an examination
- Attempts to hinder the investigation by failing or refusing to answer questions, canceling appointments, or refusing to supply records
- Employee testimony about irregular business practices
- Destruction of books and records
- Transfers of assets for purpose of concealment

Signs that an IRS agent is suspecting fraud include if the issues and IDRs are related to unreported income, and multiple years are under examination. Also beware if the IRS is using many third-party audit techniques or summons techniques. Another red flag is the IRS requesting documented interviews and signed affidavits. Also, if the IRS has not issued a RAR and the assessment statute is imminent, that might indicate the IRS suspects fraud.

REPRESENTATION TIPS:

- Know your privilege issues. See Code Sec. 7525.
- Consult an attorney.
- Be patient.

¶ 305 HONORABLE MENTIONS

Use of Small Business Accounting Software

Most small and midsize businesses use small business accounting software, and it is IRS audit standard operating procedure to request a small business's electronic accounting records. These requests have been upheld by the courts. An IRS agent's initial IDR usually requests small business accounting backup files; some agents are trained in QuickBooks and Sage/Peachtree. See IRM 4.10.4.3.7.5 for further discussion.

Controversial factors related to this activity include the following:

- The backup file is not limited to the year under audit.
- A business owner does not make a bookkeeper.
- The audit trail: Does it reflect poorly on my client's internal control?
- There is a balancing act for a CPA representing a client:
  - — Providing the IRS information versus providing too much information
  - — Circular 230 requirements
- Will the IRS use the information to go on a "fishing expedition? If so, it owes the taxpayer a determination.
- Will the IRS take an alternative? Some IRS agents will allow spreadsheets/financial statements in place of electronic records.

Misreporting Rental Income, Personal Expenses

Rental income is another high-noncompliance area. According to a 2008 GAO study (GAO Report GAO-08-956):

- 53 percent of rental real estate taxpayers underreport net income.
- Overstating expenses is the largest noncompliant area.
- 67 percent of rental properties are self-managed.
- 83 percent of rental properties are reported on Form 1040, Schedule E.
- 80 percent of rental real estate taxpayers use a professional tax preparer.

The last point above illustrates why the IRS is increasingly going after preparer penalties for this misreporting.

Another relatively easy issue to audit is personal expenses, which include travel and entertainment, automobiles, cell phones and computers, and legal and professional fees. According to Code Sec. 162, such expenses must be ordinary and necessary in carrying on a trade or business. Over the next few years, the IRS projects to hire several thousand new revenue agents, so the areas of rental income and personal expenses will likely see more audit activity.

¶ 306 FINAL TIPS

The IRS auditor has a lot to do in 46 hours. With no background or history, the agent must learn all about the taxpayer, including:

- Big picture of the people/entities involved
- Business operations
- Industry issues
- Books and records
- Tax return positions
- Related entities

The agent must then develop, propose, and conclude adjustments to the tax return and all related returns. IRS agents must propose a change in nine of 10 exams (on average). Keep in mind that agents may not have any experience with taxpayer's business or industry.

For the tax practitioner, the top 10 small business field audit tips are as follows:

- Be a facilitator in the audit.
- Prepare well (do the mock audit).
- Provide the big picture.
- Anticipate questions and issues.
- Focus on income and the "most important IRS issue."
- Google your client.
- Examine income closely prior to the audit.
  - — Do the "big three" income tests.
- Communicate with the auditor.
  - — Follow up with a written summary.
- Use your informal and formal appeal rights.
- Contest penalties.

Another tip is to get a second perspective in an audit. Although field audits have been rare, they are likely to increase in the future. Tax professionals may not get enough repetition in this area to stay practice-savvy, and the costs of an audit can be high. Why not ask another professional for their perspective?

¶ 307 SIX KEY TAKEAWAYS

1. Tax gap data concludes that small businesses are the most noncompliant taxpayer segment.
2. Small business audits can be very comprehensive in scope.
3. The IRS traditionally focuses on common issue areas in small business audits.
4. Awareness of these issues is beneficial in a tax practitioner's due diligence. Preparation is the key to a successful audit outcome.
5. Although the number of small business audits was down over the past 10 years, they are about to be a focus area again as IRS enforcement increases.
6. The IRS has one big compliance tool coming in 2023: the Form 1099-K.

STUDY QUESTIONS

---

4. You will likely do any of the following if you receive a mail audit on Schedule C expenses, ***except?***

a. Avoid responding until after 90 days.

b. Request a reconsideration if you miss the 30 and/or 90-day letters.

c. Follow up by phone for status.

d. Always request an appeal if the IRS disagrees.

5. Which of the following identifies the error rate found in IRS construction audits on Form 1065 related to gross receipts?

a. 47 percent

b. 53 percent

c. 65 percent

d. 100 percent

6. Which of the following is ***not*** one of the fraud red flags for the IRS?

a. Transfers of assets for purpose of concealment

b. Destruction of books and records

c. Submission of a tax return earlier than prior year

d. Employee testimony about irregular business practices

MODULE 1: BUSINESS—Chapter 4: Maximizing the Employee Retention Credit

¶ 401 WELCOME

This chapter covers the employee retention credit (ERC). It discusses how to qualify for the credit, how to compute it, and when businesses are subject to a partial suspension of the credit.

¶ 402 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify clients who qualify for the employee retention credit (ERC)
- Explain how to compute the ERC
- Describe how to allocate wages between Paycheck Protection Program (PPP) loan forgiveness and the ERC
- Identify an advantage of using the prior quarter for the 80 percent test
- Identify in which types of situations a business would qualify for a partial suspension
- Recognize the establishments that would be subject to a partial suspension of the ERC caused by a government order
- Name the form that should be filed if a business missed claiming the ERC

¶ 403 INTRODUCTION

The ERC is a refundable tax credit that businesses can claim on qualified wages. A business can qualify for the ERC in three ways: (1) it had a partial suspension of business due to a government shutdown, (2) it experienced a significant decline in business (gross receipts dropped below 80 percent compared to the same quarter in 2019), or (3) it is a recovery startup business.

President Biden signed the Infrastructure Investment and Jobs Act (HR 3684) into law on November 15, 2021. Prior to that, the ERC for 2021 was available to all eligible employers for wages that were paid before January 1, 2022, essentially making the credit available for all four quarters of 2021. The Infrastructure Investment and Jobs Act eliminated the availability of the credit for the fourth quarter of 2021 (retroactively) for all otherwise eligible employers, except those that are considered "recovery startup businesses." These can continue to claim the credit for Q4.

> **EXAMPLE:** Ronnie's Pizzeria Inc. began business in 2019. It is not a recovery startup business. It cannot qualify for the ERC in Q4 2021, even if it meets the "significant decline" test for Q4 2021. The only way Ronnie's could get the credit for Q4 is if it began business after February 15, 2020.

As mentioned above, a business can qualify for the ERC if its operations were partially or fully suspended from Q3 2020 through Q3 2021 due to a government order in effect, or if it suffered a significant decline in gross receipts. If in 2020, a business had one really bad quarter, no prior quarter election is available. For 2021, the business's gross receipts must drop below 80 percent of gross receipts for the same quarter in

2019 for it to qualify for the ERC. Entities can use the current quarter's gross receipts or elect to use the prior quarter's gross receipts in determining eligibility.

The third way to qualify for the ERC is if the business is a recovery startup business. This applies only in 2021 Q3 and Q4.

EXAMPLE: In 2021, Ronnie's Pizzeria Inc. had 10 employees who each made $10,000/quarter. Thus, it meets the under 80% gross receipts test each quarter. Its maximum credit for 2021 is $210,000: 10 × $10,000 × 70% × 3.

Gross receipts are determined under Code Sec. 448(c). Gross receipts for an employer include:

- Total gross sales (net of returns and allowances);
  - — *Not* reduced by cost of goods sold (except capital assets)
- All amounts received for services; and
- Any income from investments and incidental or outside sources.
  - — Includes interest, dividends, rents, royalties, and annuities, regardless of whether derived in the ordinary course of the taxpayer's trade or business.

For purposes of the ERC, taxpayers should use the same accounting method they use on their income tax return. Therefore, it they use the accrual method on the tax return, they should use the accrual method to measure for the ERC.

Note that a business can meet the "significant decline" test even if its decline in gross receipts was *not* caused by the COVID-19 pandemic. See the following example.

EXAMPLE: In 2019, Ellen decides to begin gradually shutting down her law firm over three years. Her gross receipts in 2021 have "significantly declined" *because* she is slowly shutting down business; it has nothing to do with the COVID-19 pandemic. Ellen's firm still qualifies for the ERC.

EXAMPLE: For 2021, Ronnie's Pizzeria Inc. is eligible for the ERC for Q1 and Q2 under the "significant decline" test. It is also eligible for Q3 (even if the decline is greater than 80 percent). Ronnie's can make an election to use the prior quarter's percentage in the current quarter. This applies for 2021 only.

	2021	2019	Percentage	Qualify
Q1	$79,000	$100,000	79%	Yes
Q2	$75,000	$100,000	75%	Yes

For 2021 only, a business can compare a 2021 quarter to the same quarter in 2019 or elect to use the percentage from the prior quarter. No formal election is required; the business can just claim the credit. This allows a "two-for-one deal": qualifying for one quarter automatically qualifies the business for the next quarter also.

EXAMPLE: Ronnie's Barbershop Inc. has the following gross receipts:

- 2021 Q1 vs. 2019 Q1 = 79%
- 2021 Q2 vs. 2019 Q2 = 81%

Ronnie's can qualify for both quarters: Q1 based on the actual Q1 percentage, and Q2 based on the election to use the Q1 percentage. The same applies for the first three quarters in 2021. Ronnie's can elect to use Q4 2020 to see if it meets the test for Q1 2021. Of course, Ronnie's cannot take the ERC for Q4 2021.

¶ 404 PAYCHECK PROTECTION PROGRAM LOANS: INTERACTION WITH ERC

Are pandemic-related benefits such as Paycheck Protection Program (PPP) loan forgiveness, shuttered venue grants, or restaurant revitalization grants considered part of gross receipts for purposes of determining ERC eligibility? Rev. Proc. 2021-33 provides a safe harbor that permits taxpayers to exclude the following items from "gross receipts":

- PPP loan forgiveness
- Shuttered Venue Operators grants
- Restaurant Revitalization Fund grants

Taxpayers must exclude the item for *all* calendar quarters. The rule applies to all employers treated as single employers under aggregation.

EXAMPLE: EXCLUDING PPP LOAN FORGIVENESS FROM GROSS RECEIPTS: Employer A had $100,000 in gross receipts in Q1 2019 and $99,000 in gross receipts in Q1 2021 ($20,000 in PPP loan forgiveness plus $79,000 in sales). If it elects to exclude the PPP loan forgiveness, it meets the "significant decline" test.

2021 Q1 total gross receipts	$99,000	
Less: PPP forgiveness	($20,000)	
Q1 gross receipts after election		$79,000
2019 Q1 gross receipts		$100,000
Percentage (meets test)		79%

¶ 405 AMERICAN RESCUE PLAN ACT CHANGES TO THE ERC

The American Rescue Plan Act of 2021 (ARPA), enacted on March 11, 2021, modified, and extended the ERC for the third and fourth quarters of 2021. Under ARPA, "recovery startup businesses" may also qualify for the ERC (*only* for 2021 Q3 and Q4). To qualify, such businesses:

- Must have begun carrying on *any* trade or business after February 15, 2020.
- Must have less than $1 million in annual average gross receipts for:
  - — The three-taxable-year taxable period preceding the calendar quarter for which that credit is claimed. This includes gross receipts of related businesses under common control.
- Cannot have a partial suspension or significant decline in gross receipts for the quarter in which to apply the "recovery startup business" rule.

Recovery startup businesses are limited to an ERC of $50,000 per quarter. According to IRS Notice 2021-49, Code Sec. 501(c) organizations can qualify as recovery startup businesses (Notice 2021-49, section III.D.).

NOTE: Gross receipts are determined under Code Sec. 448(c)(3). Gross receipts for short taxable years must be annualized. If the entity is only in existence for part of preceding three-year period, only the periods it was in existence are counted.

EXAMPLE: Parmjit's S corporation begins carrying on a business on March 1, 2020. It has less than $1 million in average annual gross receipts (including common control entities) for the prior three-year period, including gross receipts in 2020 (annualized). The S corporation does not qualify under the significant decline or partial suspension rules.

If the S corporation pays wages in all quarters of 2020 and in the first and second quarters of 2021, these *will not* qualify for the recovery startup business credit**.** The recovery startup business rule was not effective until July 1, 2021.

If the S corporation pays wages in the third and fourth quarters of 2021, the wages *will* qualify for the ERC under the "recovery startup business" rule. The credit is limited to $50,000 in each quarter.

EXAMPLE: Manuel owns 100% of a software company that has been in business for 10 years. Its trailing three-year average gross receipts are $2 million. Manuel forms a new S corporation for a consulting firm that begins carrying on business on March 1, 2020.

The author's view is that the entity does not qualify for a partial suspension or significant decline in Q3 or Q4. It would qualify *except* for its trailing gross receipts. All businesses under common control are treated as a single employer. Therefore, it will not qualify as a recovery startup business.

To qualify as a recovery startup business, an entity must be "carrying on" a business. It begins carrying on a business when it begins functioning as a going concern and performing activities for which it was organized (IRS Notice 2021-49, section II.D.).

EXAMPLE: An S corporation was organized to operate a TV station in February and started broadcasting on September 30. It didn't start carrying on a business until it began broadcasting (*Richmond Television*, 345 F.2d 285). If the station "begins business" by the end of the quarter, it will get credit for all wages paid during the quarter.

EXAMPLE: An entity has 20 2021 Q3 employees, each of whom has $10,000 in qualified wages. The credit (before the limitation) is $140,000 ($7,000 × 20). The credit will be limited to $50,000 for the quarter.

Limitation: Large Employers

"Qualified wages" for purposes of the ERC depends on whether the business is considered a small employer or a large employer, and this distinction is based on its number of employees. For a large employer, the thresholds are as follows:

- To qualify for the 2020 ERC, the business must have more than 100 full-time employees in 2019.
- To qualify for the 2021 ERC, the business must have more than 500 full-time employees in 2019.

Large employers are eligible for the ERC only for wages paid to an employee that is *not* providing services. However, small employers, which for the 2021 year would go back to 2019, count their full-time employees, and if they had fewer than 500, they all qualify for the ERC.

EXAMPLE: ABC Inc. is a large employer (eligible for the ERC). Rob is an employee of ABC Inc. Rob gets paid for working 32 hours (does not qualify for the ERC). Rob gets paid 8 hours while on furlough (qualifies for ERC).

Assume the same facts as above, but ABC Inc. is not a large employer. In this case, *all* of Rob's 40 hours qualify for the ERC.

STUDY QUESTION

1. Which of the following is ***not*** one of the three ways to qualify for the ERC?

- **a.** Government shutdown
- **b.** Investing in an opportunity zone
- **c.** Significant decline in gross receipts
- **d.** Recovery startup business

¶ 406 WAGES PAID TO MAJORITY SHAREHOLDERS AND RELATIVES

The IRS's position in Notice 2021-49 differs from initial guidance on this topic. Wages paid to a majority shareholder are not eligible for the ERC if the shareholder has "any living relative." This also applies to wages paid to a spouse of a majority shareholder. This position is retroactively effective for ERCs claimed in both 2020 and 2021.

This will not affect wages paid to shareholders who own 50 percent or less of the stock, after taking attribution into account. Wages paid to such shareholders will be eligible for the ERC. Note that this will not affect majority shareholders who do not have a living relative. The position in Notice 2021-49 is based on the following:

- Attribution rules under Code Sec. 267(c) incorporated into the majority shareholder provision, including attribution of the majority shareholders' stock to their relatives.
- A majority shareholder's relatives are *deemed* majority shareholders. And the actual majority shareholder is now a relative of a deemed majority shareholder, through application of Code Sec. 267(c).

Relatives covered by attribution include (Code Sec. 152(A)–(H)):

- A child or a descendant of a child
- A brother, sister, stepbrother, or stepsister
- The father or mother, or an ancestor of either
- A stepfather or stepmother
- 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 for the taxable year has the same principal place of abode as the taxpayers

NOTE: Spouses are not relatives for purposes of this rule. Notice 2021-49 provides that wages paid to spouses of majority shareholders are not eligible for the ERC.

There is no effect on wages of majority shareholders without living relatives.

EXAMPLE: MAJORITY SHAREHOLDER (NO LIVING RELATIVE): Carl's Plumbing Inc. is owned 100% by Carl. Carl has no living relatives (his parents passed away, he has no children, etc.). He is not related to a deemed majority shareholder. Wages paid to Carl are eligible for the ERC.

EXAMPLE: MAJORITY SHAREHOLDER (ANY LIVING RELATIVE): Gary's Roofing Inc. is owned 100 percent by Gary. Josh is Gary's son. Gary is an employee of the corporation, but Josh is not. Josh is attributed 100% ownership of Gary's Roofing Inc. (Code Sec 267(c)). Both Gary and Josh are *treated* as 100 percent owners (Josh is a "deemed" shareholder). Gary is related to a deemed shareholder, Josh (he is Gary's son). Because Gary is a relative of a deemed majority shareholder (Josh), his wages are not eligible for the credit.

The rule does not affect shareholders who own 50 percent or less of the stock, after taking into account stock attributed under Code Sec. 267(c).

EXAMPLE: NON-MAJORITY SHAREHOLDERS: AB Inc. is owned by Andrew and Bob (each owns 50%). Andrew and Bob are not related. Wages paid to Andrew and Bob are eligible for the ERC, as are wages paid to their family members. Neither Andrew nor Bob is a majority shareholder since neither owns more than 50%. And neither's stock is attributed to the other (because they are not related).

¶ 407 PARTIAL SUSPENSION

IRS Notice 2021-20 provides guidance on partial suspensions of businesses (caused by a governmental order). Entities can still get the ERC if they have a significant decline in gross receipts if they had no partial suspension. See the following chart for specific scenarios:

Scenario	Partial Suspension?
Retail store – density in store limited, but short wait outside for customers.	No
Essential business (stays open), but customers are not coming in.	No
Workplace is closed but continues business at a comparable level as before COVID-19 pandemic (remote).	No
Taxpayer has *both* essential and nonessential businesses.	Yes, if nonessential > 10% of gross receipts or hours
Essential business, but suppliers cannot provide enough materials due to a government order (e.g., an auto parts store).	Yes
Restaurant, takeout only. Restaurant—dining-in limited to 25% of capacity.	Yes Yes
Hospital, elective surgeries delayed.	Yes, if more than nominal (10%)

A business with a partial suspension can claim the credit for wages paid on days when *both*:

- Fully or partially suspended, and
- Due to a government order causing the suspension.

EXAMPLE: Per government order, Ronnie's Pizzeria was required to offer takeout only (no indoor dining) for the period January 18 through March 23, 2021. This resulted in a partial suspension of Ronnie's business. Therefore, Ronnie's wages paid between January 18 and March 23 qualify for the ERC.

Ronnie's very likely also has experienced a "significant decline" in business and should use the "significant decline" rule since all wages for the quarter will be covered.

Aggregation

The IRS identifies three types of commonly controlled businesses:

- Parent–subsidiary group: A common parent owns more than 50 percent of its subsidiaries.
- Brother–sister controlled group: Two or more corporations where:

— Five or fewer individuals own more than 80 percent of stock, and

— The same five or fewer individuals own more than 50 percent, counting only common ownership in the entities.

- Affiliated service groups.

According to Notice 2021-20, footnote 13:

> A parent-subsidiary controlled group of corporations is one or more chains of corporations where the common parent corporation owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the value of all classes of stock of each corporation. A brother-sister controlled group of corporations is two or more corporations where (1) five or fewer persons who are individuals, estates, or trusts own at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of each corporation; and (2) the same five or fewer persons, taking into account ownership only to the extent that it is identical with respect to each corporation, own more than 50 percent of the total voting power of all classes of stock entitled to vote, or total value of shares of all classes of stock of each corporation. A combined group of corporations is three or more corporations, each of which is a member of either a parent-subsidiary or a brother-sister controlled group, and at least one of which is both the common parent of a parent-subsidiary controlled group and also a member of a brother-sister controlled group. See Treas. Reg. § 1.52-1.

Also see the IRS's "FAQs Regarding the Aggregation Rules Under Section 448(c)(2) that Apply to the Section 163(j) Small Business Exemption" (https://www.irs.gov/newsroom/faqs-regarding-the-aggregation-rules-under-section-448c2-that-apply-to-the-section-163j-small-business-exemption), which addresses a different area but the same legal question.

All persons treated as a single employer under Code Sec. 52(a) or (b) are treated as a single employer for all purposes of the ERC, including in determining a substantial drop in gross receipts (Notice 2021-20, question 43), partial suspension, and number of employees (large employer).

> **EXAMPLE: PARTIAL SUSPENSION:** ABC Inc. and DEF LLC are under common control. Neither meets the "substantial decline" in gross receipts test. ABC has a partial suspension due to a government order. DEF does not have a partial suspension. According to IRS Notice 2021-20, question 37, however, both have partial suspensions because they are treated as one company.

¶ 408 PPP LOAN FORGIVENESS AND THE ERC: NO DOUBLE-COUNTING

Code Sec. 3134 states that taxpayers cannot "double-count" the same wages for both the PPP and the ERC. An entity must elect out of the ERC to utilize wages for the PPP. The PPP provides greater benefit than the ERC, so entities must elect out to provide sufficient wages for PPP forgiveness. According to IRS Notice 2021-20, an entity is deemed to elect out of the ERC if it uses payroll costs for PPP forgiveness.

"Walking the Tightrope": Maximize 40 Percent Costs (Nonpayroll)

For planning purposes, a business should report the smallest possible "payroll costs" on its PPP forgiveness application—just enough to get full forgiveness.

NOTE: At least 60 percent of the amount forgiven must be "payroll costs." If the entity's PPP loan is $100,000, it must have at least $60,000 in "payroll costs" to receive full forgiveness. If it has $70,000 in "payroll costs," it should consider reporting only $60,000 on the PPP loan forgiveness application. The remaining $40,000 can be eligible *nonpayroll* costs (provided the entity has that much).

Some payroll costs do not qualify for the ERC—for example, State Unemployment Tax Act (SUTA) and pension contributions. Businesses should be careful not to lose anything by treating those as payroll costs for the PPP; they should use up these costs to the fullest extent.

Forgivable Costs Expansion

Forty percent of costs (maximize these on the PPP forgiveness application):

- Covered rent
- Covered utilities
- Covered mortgage interest expense
- Covered operations expenditures
  - — Software and cloud computing facilitate business operations, processing payment, etc.
- Covered supplier costs
  - — To a supplier of goods for the supply of goods *committed* to
    - At any time *before* the covered period and paid during the covered period, or
    - If perishable goods (produce, meat, etc.), *before* or *during* the covered period
- Covered worker protection expenditures (Title III, p. 119)
  - — Operating or capital expenditures to facilitate adaptation to requirements/guidance by HHS/OSHA/CDC/state and local government from March 1, 2020, to the ending date of the presidentially declared disaster under 50 U.S.C. 1601 et seq.

EXAMPLE: Ronnie's Pizzeria Inc. has three employees. For its PPP loan, it should first allocate enough wages to receive full forgiveness. Ronnie's should elect out of the ERC (not claim the ERC on these wages on Form 941). Then, it should allocate the excess wages to the ERC.

¶ 409 THE ERC REDUCES DEDUCTIONS

On their tax returns, businesses must reduce their deductions by the amount of the ERC (Code Secs. 280C and 2301(g)), for example, deductions for wage expenses and qualified health plan expenses.

Even if a business filed a 2020 Form 941-X in 2021, it must reduce its deductions on its 2020 income tax return (Notice 2021-49, section IV.C.) even though it did not file a refund claim until 2021. If the business already filed its 2020 income tax return, it should amend it, or file an Administrative Adjustment Request (AAR) if it is a centralized partnership audit regime (CPAR) partnership (Notice 2021-49, section IV.C.).

However, the ERC is tax-free, according to Notice 2021-20, question 61:

> Question 61: Does an eligible employer receiving an employee retention credit for qualified wages need to include any portion of the credit in income?

> Answer 61: No. An employer receiving a tax credit for qualified wages, including allocable qualified health plan expenses, does not include the credit in gross income for federal income tax purposes. Neither the portion of the credit that reduces the employer's applicable employment taxes, nor the refundable portion of the credit, is included in the employer's gross income.

This is consistent with the general tax treatment of credits. Taxpayers do not report income when they receive the child tax credit or the research credit.

> **EXAMPLE:** Ronnie's Pizzeria Inc. filed its 2020 Q2 Form 941-X in February 2021 and received a $5,000 ERC Form 941 refund in March 2021. Ronnie's must reduce its 2020 deductions (wages) by $5,000. This will create a Schedule M-1 difference (increase taxable income). In 2021, Ronnie's receives a $5,000 credit. Ronnie's reports it as $5,000 in tax-free income. The M-1 difference ($5,000) reverses (decreases taxable income).

> **EXAMPLE:** Ronnie's Pizzeria Inc. filed its 2021 Q1 Form 941 in April 2021 and received a $7,000 ERC Form 941 refund in May 2021. Ronnie's must reduce its 2021 deductions (wages) by $7,000. This will create a Schedule M-1 difference (increase taxable income). Ronnie's reports it as $7,000 in tax-free income (M-1 adjustment). According to IRS Notice 2021-20, question 61, the M-1 difference ($7,000) reduces taxable income and offsets the wage decrease. The net difference is $0.

If an entity missed claiming the ERC, it can file Form 941-X, according to IRS Notice 2021-20, question 57:

> Question 57: May an eligible employer that files quarterly federal employment tax returns take into account qualified wages paid in a past calendar quarter in which the eligible employer may have been entitled to claim the credit, but elected not to do so?
>
> Answer 57: Yes. An eligible employer may file a claim for refund or make an interest-free adjustment by filing Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*, for a past calendar quarter to claim the employee retention credit to which it was entitled on qualified wages paid in that past calendar quarter, following the rules and procedures for making those claims or adjustments.

STUDY QUESTIONS

2. Which of the following is excluded from gross receipts for purposes of the 80 percent test?

- **a.** Restaurant revitalization grants
- **b.** Royalties
- **c.** Annuities
- **d.** Dividends

3. Which of the following relatives is ***not*** covered by attribution?

- **a.** Descendant of a child
- **b.** Ancestor of the father
- **c.** Spouse
- **d.** Sister-in-law

MODULE 1: BUSINESS—Chapter 5: Partnership and S Corporation Tax Filing Issues

¶ 501 WELCOME

This chapter discusses general tax reporting by a pass-through entity, including ordinary and separately stated items; specific information that must be provided in each type of return, including new questions that must be answered; and the challenges presented by the 2017 Tax Cuts and Jobs Act provisions.

¶ 502 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify key reporting issues in pass-through entities
- Recognize how to provide the most useful information to the owner
- Determine the amount in which phaseout of the qualified business income deduction (QBID) ends for single and married taxpayers
- Describe correct statements regarding capital account reporting
- Recognize the four situations that require reporting S corporation shareholder basis
- Identify issues in tax basis capital reporting

¶ 503 INTRODUCTION

Currently, the majority of all businesses in the United States are pass-through entities. Therefore, a broad range of issues are associated with the preparation of pass-through entity tax returns.

Partnerships and S corporations, as pass-through entities, must report separately stated items of income or loss. These are items that may differentially impact the tax reporting of partners or shareholders based on the owners' specific tax positions. The 2017 Tax Cuts and Jobs Act (TCJA) continues a trend of adding more items that require additional information reporting by pass-through entities. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and Consolidated Appropriations Act (CAA) legislation add to this trend. Because many provisions of these acts remain unclear, professional advisers may reasonably disagree on the level of specificity to provide to partners and shareholders.

Professional tax advisers need to understand both the level of detail to provide to owners of pass-through entities as well as the specific information to be provided.

¶ 504 PAYCHECK PROTECTION PROGRAM LOAN ISSUES

The Paycheck Protection Program (PPP), administered by the U.S. Small Business Administration, offered loans to businesses to keep their workforce employed during the COVID-19 pandemic. Borrowers could be eligible for loan forgiveness if the PPP loan was used for eligible payroll costs, business mortgage interest payments, rent, or

utilities during either the 8- or 24-week period after loan disbursement. All the examples in this section will assume the PPP loan is used for permitted purposes and hence is forgiven.

Initially, there was quite a bit of debate about whether PPP-funded expenses could be deducted. One of the top issues that arose in early 2020 was whether taxpayers could deduct the expenses that are funded by a PPP loan. Many tax practitioners believed the expenses could be deducted. But the IRS presented three different arguments explaining why taxpayers could not deduct these expenses. The argument most commonly stated by practitioners was because the PPP loan forgiveness is not income. Consequently, these expenses are essentially funded with tax-exempt income (see Code Sec. 265).

This debate was resolved late in 2020 with passage of the CAA. However, the Act did something even more important—it stated that the forgiveness excluded from income was a Code Sec. 1366 or Code Sec. 705 tax-exempt income item, therefore increasing basis. The tax-exempt income basis adjustment would offset the negative basis adjustment for the deductions claimed.

PPP EXAMPLE: Assume the taxpayer is a single shareholder whose basis in S corporation stock (or partnership interest) is zero. The taxpayer obtained a PPP loan of $200,000 in 2020 and used it for deductible expenses in 2020. The loan is forgiven in 2020. What is the result?

The deductions are allowed to the S corporation (partnership). The forgiveness is not income; rather, the forgiveness is deemed an item of exempt income under Code Sec. 1366 (Code Sec. 705). Therefore, the result is:

- $200,000 stock (interest) basis is increased from exempt income.
- The pass-through deduction reduces the stock (interest) basis by $200,000.
- The end basis is zero. A (net) deduction is allowed with no basis effect.
- There is no economic outlay because the taxpayer is allowed $200,000 in deductions.

PPP EXAMPLE: VARIATION: Assume the same facts as in the previous example, but that Congress simply clarified that the deductions are allowed. The excluded forgiveness income is due to the CARES Act; it is not an item that affects the liability of the shareholder, and therefore it is not a Code Sec. 1366/705 (basis adjustment) item. The end result is that there are no allowed deductions, due to zero basis.

If we say the beginning basis is $200,000, deductions are allowed but the basis is reduced. So the taxpayer will have more income/fewer deductions in the future. It becomes a timing issue only (like depreciation).

PPP EXAMPLE: S CORPORATION WITH EARNINGS AND PROFITS: Assume an entity is a C corporation for 2020. It has accumulated earnings and profits of $200,000 and a cash balance of $200,000. The entity elects S status for 2021, and it wants to distribute $200,000 in 2021. Income and expenses in 2021 zero out. The entity has a 2020 PPP loan that is forgiven in 2021. Expenses are deducted in 2020, and forgiveness is not income in 2021.

The entity has earnings and profits, but its operations create no accumulated adjustments account (AAA); tax-exempt income goes into the other adjustments account (OAA). Does the entity then have $200,000 in 2021 distribution from earnings and profits, or can it use the PPP forgiveness as AAA?

The answer can be found in the Instructions to Form 1120-S, *U.S. Income Tax Return for an S Corporation*, which states that the PPP forgiveness (exempt) income *and* the expenses paid with the PPP loan proceeds both go through the OAA. When PPP-funded expenses are part of line 1, ordinary income or loss, they flow through to the AAA column. This means the entity must make a positive adjustment to the AAA in addition to running the expense and the exempt income through the OAA. Then the AAA and the OAA both zero out, just like the (net) basis.

¶ 505 SALT WORKAROUND ISSUES

As part of the 2017 TCJA, a $10,000 limitation for state and local tax deductions was created. Taxpayers in a high-tax jurisdiction or taxpayers that make $5 million a year, for example, will hit that $10,000 limitation fairly quickly. Consequently, a growing number of states allow a pass-through entity, rather than the owners, to pay state income taxes. The purpose is to take advantage of the IRS Notice 2020-75 state and local tax (SALT) workaround. Although the logic of this Notice may be flawed, the IRS does allow the workaround. Most states require an election by the pass-through entity.

If the workaround is used, pass-through entity owners may need to adjust their estimated payments. In addition, partner, or shareholder agreements to make the tax distributions may need adjustments to back out the state tax impact. Should the election be made? It may depend on knowledge of the owner's tax situation. Practitioners must help the entity decide whether to do the workaround. The workaround should work with both business and investment income.

¶ 506 QUALIFIED BUSINESS INCOME DEDUCTION: ISSUES AND REPORTING

Under Code Sec. 199A, beginning in 2018, a 20 percent deduction may be available for qualified business income. This is referred to as the *qualified business income deduction* (QBID), and it is not available to pass-through entities. Rather, the owner takes the deduction.

The pass-through entity reporting may affect the owner's ability to claim the deduction. A pass-through entity will need to make certain decisions that may affect the QBID of the owner and will need to provide the information needed to determine the owner's QBID. W-2 wages can impact the deduction, as can guaranteed payments to partners.

The U.S. Treasury Inspector General for Tax Administration (TIGTA) reviewed 12,480 2019 QBID claims and found that 95.3 percent were below the threshold set by IRS for review (the average QBID claimed was $2,370). Of the remaining claims, the IRS proposed adjustments in 85.3 percent. The taxpayer agreed to the proposed adjustment 98.3 percent of the time, and the average claimed QBID was $74,138.

TIGTA suggests that because of the high error rate, the IRS should set a lower threshold for examination and consider issuing "soft" notices about eligibility requirements, as well as caution statements on Form 8995, *Qualified Business Income Deduction Simplified Computation*.

NOTE: A "soft" notice from the IRS could be a notice provided to a taxpayer with a list of things that are required in order to claim the deduction. The IRS would relay that the taxpayer might want to examine the items a bit more carefully because many taxpayers are not providing the required information.

Because of problems in the way taxpayers are reporting the QBID, there will likely be a higher rate of IRS examinations going forward.

Pass-Through Reporting

Supplemental information should now be required to allow the owner of a pass-through business to determine the following:

- Qualified business income
- Share of W-2 wages
- Share of unadjusted basis of tangible business assets, which is called "UBIA"
- Classification of business as specified service activity or otherwise
- Income or loss by business

Code Sec. 751 ordinary income is qualified business income (QBI). Note that the QBID is not available for reasonable compensation, a guaranteed payment for services or capital, or a non-partner payment for services.

General QBID Reporting: Partnerships

The partnership itself does not claim the QBID. The entity may aggregate businesses; if so, it will attach Schedule B to the Schedule K-1. Therefore, all information is on the partners' Schedule K-1 forms.

- Box 20 (Other Information) includes certain information related to the QBID, such as W-2 wage share, unadjusted basis immediately after acquisition (UBIA) share, real estate investment trust (REIT) dividends, and publicly traded partnership (PTP) income.
- Partnership "special" allocations may allow optimal allocations of QBI, W-2 wage share, or UBIA share; however, the rules are complex. UBIA is allocated only to owners on the last day of the year and is based on "book" depreciation shares as determined under Section 704(b).

General QBID Reporting: S Corporations

The S corporation itself does not claim the QBID. The entity may aggregate businesses; if so, it will attach Schedule B to the K-1 form. Therefore, all information is on the shareholders' Schedule K-1 forms.

- Box 17 (Other Information) includes certain information related to the QBID, such as W-2 wage share, UBIA share, REIT dividends, and PTP income.
- "Special" allocations do not exist in an S corporation. However, as for partnerships, UBIA is allocated only among owners as of the last day of the tax year.

Income Limitations

For 2018, the threshold income for the QBID was $315,000 for married filing jointly taxpayers and $157,500 for other taxpayers. The limitations have been inflation adjusted to $340,100 for married filing jointly taxpayers and $170,050 for other taxpayers in 2022. The phaseout ends at $440,100 for married filing jointly and at $220,050 for other taxpayers (both 2022 figures). For service businesses, the deduction goes to zero. A separate limitation applies to other businesses based on wages or wage/capital.

For a non-service business, if the taxpayer's taxable income exceeds the threshold, the deduction may be limited to the greater of:

- 50 percent of W-2 wages for business
- 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of depreciable business assets.

If the business has W-2 wages or capital, there will be some deduction allowed without regard to the taxpayer's taxable income. For a service business, a separate limitation is determined by use of an "applicable percentage," which begins at 100 percent and goes to zero through the phaseout range. No deduction is allowed for a service business when income hits the end of the threshold income phase out range.

Reporting Issues: Threshold Taxpayers

Threshold income owners of a pass-through entity may need a share of W-2 wages or UBIA to maximize deductions. S corporation allocations are set by statute; UBIA, however, is only allocated to owners as of the last day of the year.

Partnership allocations have added flexibility, provided the allocations have substantial economic effect. The substantiality test is likely to cause the greatest concerns with special allocations to threshold-income partners. The economic effect of an allocation can be insubstantial when it does not affect the dollar amounts to be received by the partners from the partnership. This generally means the allocation does not affect the Code Sec. 704(b) capital accounts.

An allocation of an "excess" amount of W-2 wages or UBIA (depreciation) to one partner may be offset by an allocation of fewer other types of deductions to that partner. If the overall effect is to create the same capital accounts as if the allocations had not been (specially) made, there is a substantiality problem.

The "fix" for this problem could be an allocation of more gain to the partner who gets excess W-2 wages or depreciation in an earlier year. To protect substantiality, this is best done with gain from the sale of partnership property. This is protected by an assumption in Reg. § 1.704-1(b)(2)(iii) that the value of all partnership properties equals its basis. Thus, one can assume that there will be no gain to use as an offset for the prior allocation.

Ordinary and Separately Stated Items

Pass-through entities have ordinary income items and separately stated items that can impact the partner's liability separately or can impact a shareholder's liability. Over the years, there has been an increase in the number of separately stated items. Pass-through entity owners need separate reporting for anything that might impact their tax reporting. Page 1 of Form 1065/1120-S reports those items that are treated the same for all partners:

- Ordinary business income or loss
- Code Sec. 162 classification of a business
- Deduction for partner guaranteed payments

Guaranteed Payments and Preference Returns

Guaranteed payments are deductible by the partnership and separately stated income to the partner. They are also subject to self-employment tax if received for services. It is not always clear how to classify guaranteed payments, which can be for capital or for services. The key is that they are *not* determined by reference to income.

Preference distributions may mimic guaranteed payments, but they are different in that they are intended to be matched with an allocation of income. Some use the terms *guaranteed payment* and *preference return* interchangeably, but there are distinctions:

- A preference return is a priority that is intended to be matched with an allocation of income.
  - — The intent may not be realized, and the preference could carry over (cumulative).
  - — "Target" allocations make it easy to see the link between the preference (distribution) and the allocation of income.
- A guaranteed payment is not determined by reference to income.
- Guaranteed payments create their own income and deduction.
  - — The recipient of a guaranteed payment has separately stated income.
  - — A partnership has a deduction for guaranteed payments.

Aggregation and Segregation: QBID

The first thing a taxpayer must decide for the QBID is how many businesses it has, and that is not necessarily an easy determination. Doing so may involve the aggregation or segregation of operations. Reg. § 1.199A-4 allows aggregation and requires certain "segregation" of operations (although the term "segregation" is not used in the regulations, there are certain operations that must be kept separate). In both cases, Reg. § 1.199A-4 spells out the rules.

> **NOTE:** Keep in mind that aggregation *may* be done; it is not required (as can be true for Code Secs. 465, 469, and 1411). The Code Sec. 469 activity tests are not applicable.

The rules for aggregation under Reg. § 1.199A-4 are as follows:

- Each operation must be a business.
- There must be common ownership, meaning a majority ownership (direct and indirect with attribution).
- Service and non-service businesses cannot be aggregated other than through a *de minimis* rule (discussed below).
- The aggregated business must share two of three factors found in Reg. § 1.199A-5.
- Consistency and disclosure are required.

Service and non-service operations can be aggregated if the service business is incidental to the non-service business. There is a *de minimis* test based on gross receipts:

- If aggregate gross receipts are $25 million or less for the year, service income must be 10 percent or less of the total.
- If aggregate gross receipts are more than $25 million for the year, service income must be 5 percent or less of the total.

STUDY QUESTIONS

1. Which of the following statements regarding the SALT workaround is correct?

a. The workaround should work with both business and investment income.

b. A decreasing number of states allow a pass-through entity to pay state income taxes.

c. Only a few states require an election by the pass-through entity.

d. If the workaround is used, pass-through entity owners are required to adjust estimated payments.

2. Beginning in what year was a 20 percent deduction available for qualified business income?

a. 2017

b. 2018

c. 2019

d. 2020

3. TIGTA suggests each of the following improvements because of the large error rates with QBID, ***except?***

a. A lower threshold for examination

b. "Soft" notices about eligibility requirements

c. Preapproval clearance through Form 2154

d. Caution statements on Form 8995

¶ 507 REPORTING TAX BASIS CAPITAL

Beginning with the 2020 tax year, a partnership must report its partners' tax basis capital. The instructions to Form 1065, *U.S. Return of Partnership Income*, say to use "transactional" tax basis reporting, but this method is not well defined, and no examples are provided.

Taxpayers may have different ways of tracking transactional tax basis capital. It is not the same as the basis of the partner's interest. One thing that would make a distinction is if the partner share of liabilities is not included in the tax basis capital. Partners can acquire their interest in different ways. They can inherit an interest; in which case they have a fair market value basis. They could purchase the interest and have a cost basis. They could acquire the interest by contributing money or capital to the partnership in exchange for the interest. They could acquire the interest in a divorce, or they could acquire the interest by gift. In each case, they will have a different determination of the basis of their partnership interest that will not necessarily link to the capital account. The goal of tax basis capital reporting is to reflect, as best as is possible, the partner's "outside" basis exclusive of a share of partnership debt.

Shareholders may need to report a basis reconciliation on their own tax return. Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*, is now used for this purpose. The form provides a detailed and common format and replaces "white paper" reporting (basis reporting was previously required, but the taxpayer could adopt their own method of reporting). This reporting is required when:

- A distribution is received,
- Shareholder debt is repaid,
- A loss passes through, or
- Stock is disposed of.

¶ 508 CENTRALIZED PARTNERSHIP AUDITS

The tremendous growth in very large partnerships has caused a strain on Tax Equity and Fiscal Responsibility Act (TEFRA) partnership audits. Partnerships now have centralized audits, which means the audit actually takes place at the partnership level. For post-2017 tax years, the partnership itself is now responsible for payment of the tax

from audit adjustments. A partnership representative will handle the audit on behalf of the partnership. Note that adjustments may be paid by the partners by election.

Small partnerships may elect out if:

- They have 100 or fewer K-1s
- Partners are corporations, estates, or individuals—*not* partnerships or disregarded entities (e.g., single-member limited liability company, grantor trust).

Small partnerships may want to restrict transfers to ineligible partners. They must also provide a list of the partners and, if an S corporation is a partner, all S corporation shareholders.

NOTE: Partnership representatives have much more authority than tax matters partners have; they have the authority to bind the partnership. Partnership representatives also may:

- Elect to push out assessment to partners after the assessment
- Elect to have review year partners amend returns
- Show that one or more partners is subject to a lower statutory rate

¶ 509 SECTION 179 REPORTING

Schedule K summarizes the ordinary and separately stated items shown on the individual pass-through entity owner K-1s. But decisions must also be made, such as:

- Code Sec. 179 expense elections, and
- Grouping of activities for purposes of passive activities. (This also may affect the Medicare surtax.)

With regard to Code Sec. 179 reporting, the limitations apply to both the pass-through entity and the owner:

- Dollar limit ($1 million, inflation indexed, reduced if acquisitions exceed $2.5 million, inflation indexed)
- Taxable income limit

Thus, entities must be careful of electing where the pass-through entity owner has otherwise reached the limit, although this may be less of an issue now that the $1 million/$2.5 million limits (both have been adjusted for inflation) are permanent. The pass-through entity tax basis is reduced by claimed expense election, whether the expense is limited or not. If the expense was limited at the pass-through entity level (e.g., taxable income limitation), the basis reduction caused by the pass-through deduction is restored immediately before a taxable disposition. This protects the owner from a basis reduction when no benefit was received from the pass-through expense deduction.

Section 179 Reporting: S Corporation

The corporate taxable income limit is computed before any deduction for shareholder compensation is taken. The shareholder taxable income limitation includes salary from the S corporation. If the corporate taxable income limit applies, the excess Code Sec. 179 deduction carries forward at the corporate level.

Bonus Depreciation

Section 179 expensing is elected. The partnership or S corporation must elect its application. However, 100 percent bonus depreciation is not elected. Consequently, the default rule is bonus depreciation, which the taxpayer may elect out of (for qualifying

property). Bonus depreciation does not have a taxable income limitation, so the partnership or S corporation may choose bonus depreciation and fail to elect Section 179.

¶ 510 REPORTING PASSIVE ACTIVITY LOSS ACTIVITIES

A pass-through entity is not subject to the passive activity loss (PAL) rules. However, the pass-through entity must determine the number of "activities"—what the pass-through entity aggregates cannot be disaggregated by the owner. The pass-through entity must attach a statement showing the income/loss for each PAL activity/classification. The first page of the Forms 1065 and 1120-S, as well as each owner's K-1 form, have a box to check if there is more than one activity reported. The pass-through entity grouping may affect the owner in two ways:

- Passive loss application
- Code Sec. 1411 Medicare surtax application

It is generally best to disaggregate to allow owners the greatest flexibility in grouping at their level; however, pass-through entity groupings must satisfy the appropriate economic unit standard.

For pass-through entity activity reporting, the activity definitions of Code Sec. 469 (Reg. § 1.469-4) apply to both:

- The PAL rules of Code Sec. 469, and
- The net investment income tax (NIIT) rules of Code Sec. 1411.

However, the aggregation of a business for purposes of Code Sec. 199A is separate. The activity definition of Code Sec. 465 (at risk) is also different.

A partner's Schedule K-1 shows the allocable share of profit and loss and the reconciliation of the capital account for the partnership. It also shows the share of liabilities (beginning and end) for the partners: recourse, nonrecourse, and qualified nonrecourse debt. The reason it shows this level of detail is because when a partner has a loss pass through or gets a distribution, they need to decide what their basis is, and their basis includes their share of liabilities. So the basis of a partner's interest includes the partner's share of recourse debt and its share of nonrecourse debt, and both increase basis.

There is a distinction between recourse and nonrecourse at-risk basis. A partner gets basis for recourse debt. That is a liability that the creditor has the right to come after and enforce some type of payment obligation on the partner. And the partner also gets basis for what is called qualified nonrecourse debt.

On Schedule K-1, when there is a distinction between nonrecourse debt and qualified nonrecourse debt, it is there for the at-risk basis. The at-risk basis includes the qualified nonrecourse debt but not the regular nonrecourse debt. Qualified nonrecourse debt has to be issued by a party that is in the trade or business of lending money, and it has to be in connection with the activity of holding real property. In addition to the distinction in basis for nonrecourse debt, the at-risk basis is also determined activity-by-activity. The Treasury Department takes the position that the rules for aggregating at-risk basis are much more stringent than those for passive loss.

¶ 511 ALLOCATIONS OF PROFIT AND LOSS: PARTNERSHIP

Generally, partnership allocations of profit and loss may be made by agreement. However, allocations by agreement must have "substantial economic effect." These allocations are governed by Code Sec. 704(b). Allocations that lack substantial eco-

nomic effect, or allocations made in the absence of any specific agreement, must follow the partners' interests in the partnership.

Most partnerships prefer to include certain language in the partnership agreement that provides an economic effect safe harbor. As long as the partnership has such language in the agreement, the IRS will not challenge its allocation as having economic effect. This safe harbor language would provide that the partnership's capital accounts are maintained per the regulations, and liquidating distributions follow capital accounts. Typically, the partnership would have either (1) a deficit restoration obligation, or (2) a qualified income offset. The substantiality test is an overall-effect test and includes three "insubstantiality" tests.

A target allocation in the agreement does not prescribe allocations. It states how the partnership will make distributions, rather than how it will allocate profit and loss. The allocation section states that allocations will be made to create a "target" capital balance matching the distributions to be made at the end of each year if we pretend that the partnership is liquidated. This is referred to as a *hypothetical liquidation*.

A Code Sec. 704(b) safe harbor compliant agreement contains the following:

- Capital accounts per Reg. § 1.704-1(b)(2)(iv)
- Liquidating distributions follow ending capital
- One of the following:
  - — Deficit restoration obligation
  - — Qualified income offset
- Minimum gain chargeback

A target allocation agreement does not meet the safe harbor (liquidating distributions are not based on capital) but generally targets Code Sec. 704(b) capital. It is often characterized by a reference to target capital based on a hypothetical liquidation at book value. The preparer has to decide the target allocation. To identify a target allocation, look to the partnership agreement, which refers to "hypothetical" items: hypothetical distributions arising from a hypothetical sale of assets (at book value), followed by a hypothetical liquidation of the partnership. Allocations are those that allow us to reach a hypothetical "target" capital equal to the hypothetical distributions.

Other provisions governing allocations. Allocations that relate to pre-contribution gain or loss must be made to consider the built-in gain or loss at contribution—either at formation of the partnership or at the date that a new partner joins by a contribution. These allocations are governed by Code Sec. 704(c). If partners' interests change during the year, the "varying interest rule" of Code Sec. 706(d) applies.

Code Sec. 706(d) provides that if partners' interests change, distributive shares are to be determined using any method prescribed by the Secretary that considers the varying interests. The IRS has offered two methods:

- Interim closing: This is the preferred method (more accurate) and is the default rule.
- Proration: This is less accurate but administratively simple; it must be elected by agreement.

Although the interim closing method is the most accurate, it is also more difficult to apply. The exception is the proration rule, which requires an agreement among the partners. The agreement must be written, dated, and kept with the partnership books. It may be a general grant in a partnership agreement.

Comparison: S corporation changes in interest. The S corporation default rule is pro rata allocations. If interests change, those shareholders affected by the change may

agree to an interim close. On significant changes (20 percent or greater), shareholders may agree to an interim close.

Code Sec. 704(c) pre-contribution gains or losses. The basic premise of partnership allocations is that "partnership" allocations relate to items of gain and loss that arise while the owners are in a partnership form. This does not apply to S corporations, which follow an "entity" approach. Thus, gains and losses that arose before the owners became partners should not be shared by all owners. Instead, the partner who contributed the property should be allocated the gain or loss that arose outside of the partnership.

Code Sec. 704(c) also requires that depreciation or amortization with respect to contributed property considers the difference between fair market value and tax basis. This Code Section also applies to unrealized gains and losses of the partnership before a new partner is admitted by contribution.

¶ 512 DETERMINING SHARES OF LIABILITIES: PARTNERSHIPS

Increases and decreases in partners' "shares" of entity liabilities affect basis. A "share" of a liability is determined using the Reg. § 1.752 regulations. Recourse liabilities are shared using economic-risk-of-loss principles, whereas nonrecourse liabilities are shared in a three-step approach, which is somewhat arbitrary. In reporting liability shares, Schedule K-1 requires:

- Shares of recourse debt,
- Shares of nonrecourse debt, and
- Shares of qualified nonrecourse debt.

Qualified nonrecourse debt allows at-risk basis; it applies only to real property activities where the lender is in the business of lending.

STUDY QUESTIONS

4. Which of the following identifies the 2018 start of the QBID full phase-in amount for single filers?

a. $157,500
b. $207,500
c. $315,000
d. $415,000

5. Which of the following statements is correct regarding guaranteed payments and Code Sec. 199A?

a. Guaranteed payments are not QBID eligible.
b. S corporation shareholders cannot be employees.
c. W-2 wages are eligible for the QBID.
d. It is always clear how to classify guaranteed payments.

6. Which of the following is ***not*** required by a partner's Schedule K-1?

a. Share of recourse debt
b. Share of nonrecourse debt
c. Share of qualified nonrecourse debt
d. Share of nonqualified nonrecourse debt

MODULE 1: BUSINESS—Chapter 6: Highlights for Passthrough Entities

¶ 601 WELCOME

This chapter focuses on the qualified business income deduction and how it works for specific partnership, S corporation, and limited liability company clients. It also includes a discussion of qualified opportunity funds, the deduction for business interest expense, carried interest, and the employee retention credit.

¶ 602 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify how to advise pass-through clients on the Tax Cuts and Jobs Act and CARES Act
- Recognize and apply the new effective tax rates and 20 percent deduction for K-1 income
- Describe tax incentives provided
- Summarize court cases that found the rental real estate in question was in fact a business
- Describe the different types of qualified opportunity funds
- Identify the 2022 threshold amount for the qualified business income deduction (QBID) for married filing jointly taxpayers
- Recognize aggregation factors with respect to QBID
- Identify the number of ways a rental can produce qualified business income
- Identify the 2021 maximum employee retention credit per employee per quarter
- Recognize which form is used to claim the employee retention credit

¶ 603 QUALIFIED OPPORTUNITY FUNDS

Qualified opportunity funds (QOFs) were created by the 2017 Tax Cuts and Jobs Act (TCJA). Typically, QOFs are formed to invest in real estate in low-income census tracts known as qualified opportunity zones. A qualified opportunity zone must construct or substantially improve real estate. QOFs can be used to move stock market gains into real estate with some tax benefits.

The most important thing to understand is that if a taxpayer wants to use a QOF to defer taxes and also to obtain a permanent tax exclusion, it must have eligible gains in the preceding 180 days. A "qualifying investment" is limited to the amount of eligible gains—taxpayers only receive QOF benefits to the extent of eligible gain and qualifying investment. Eligible gains must meet the following requirements:

- The gain must be capital gain or Code Sec. 1231 gain.
  - — Taxpayers are not required to net against losses; they can make an election for the gross amount of gain.
  - — There is no "tracing requirement" to the proceeds of the sale.
- The gain must arise from a sale to an unrelated person (Treas. Reg. § 1.1400Z-2(a)(1)).

- The gain must be recognized before January 1, 2027.
- For nonresident aliens and foreign corporations, gains can qualify if they are effectively connected to a U.S. business or taxed under the Foreign Investment in Real Property Tax Act (FIRPTA).

QOF Tax Benefits

QOFs offer potential tax advantages. The first is a temporary deferral of the original gain (e.g., selling Amazon stock). This ends at earlier of the "inclusion event" or December 31, 2026. The second benefit is a partial exclusion of the original gain.

- If the taxpayer invested in a QOF on or before December 31, 2019 (seven-year hold), the partial exclusion is 15 percent.
- If it invested in a QOF on or before December 31, 2021 (five-year hold), the partial exclusion is 10 percent.

The third—and most important—benefit is a full exclusion of the economic gain on the QOF, if the taxpayer holds the investment for 10 or more years.

EXAMPLE: OPPORTUNITY ZONE: George has a $100,000 gain on a Microsoft stock sale on April 16, 2020. It is his only capital gain. He elects to defer the gain and invests in a QOF on August 3, 2020, for $100,000. He will not report the gain in 2020; he will push it back until 2026. Note that this is just a deferral. If George owns the interest on December 31, 2026, he will pay tax on $90,000 ($100,000 × 90%) "original" gain in 2026.

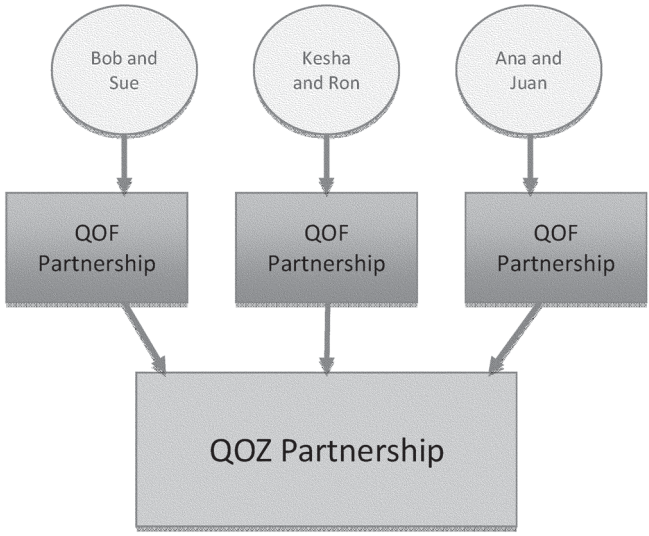
However, if George sells his investment for $1.1 million in 2031, he has met the 10-year holding period and the $1.1 million economic gain can completely be excluded.

Types of QOFs

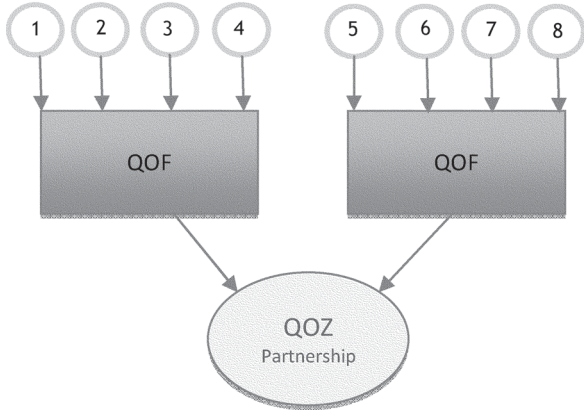
Qualified opportunity funds generally come in two types:

- **"Friends and family":** A local developer uses the tax benefits of a QOF to construct an apartment building or commercial office building in a low-income census track.
- **Widely held funds:** This type involves large projects with many properties in low-income census tract areas.

The following graphic illustrates two-tier developer QOFs. This is what it looks like in the context of a "friends and family" deal. Small partnerships are at the very top. Bob and Sue have a partnership, Kesha and Ron have a partnership, and Ana and Juan have a partnership. These three different partnerships own an interest in a lower-tier partnership. With a two-tier structure like this, it is much easier to qualify the fund. Technically, the lower-tier entity *could* be a corporation. However, this will likely be uncommon because the QOF itself will never qualify as an eligible S corporation shareholder.



Widely held two-tier QOFs are organized as shown below. It is still a two-tier deal, but it may have thousands of investors. The first tier of ownership in this case is just two QOFs. But they own part of a second pure partnership. In this example, there are four owners in each of the first-tier partnerships.



Suppose a client has a large capital gain. What is the first thing a practitioner should mention to the client? The following chart shows three hypothetical client situations, and recommendations for discussions with the client.

Event	Details	Discuss with the Client
A client calls	Client states it will have a large capital gain; it just signed a sales agreement for rental property.	Code Sec. 1031 exchange* or a QOF
A client calls	Client has a $3 million gain on the sale of a closely held business.	QOF
You receive a client's Form 1099-B	$1 million gain on Amazon stock	QOF
* Although you can use a QOF to defer gain, it typically is better to do a Code Sec. 1031 exchange for real estate.		

¶ 604 QUALIFIED BUSINESS INCOME DEDUCTION

With regard to the QBID, special income-dependent limits apply to high-income taxpayers. There is a wage or wage/property phaseout; that means the QBID phases out if the taxpayer has insufficient wages or tangible property.

There is also a QBID phaseout for high-income taxpayers who have specified service trade or business (SSTB) income. SSTB activity includes the following services: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or investing, trading, or dealing in securities, partnership interests, or commodities. Note that real estate agents and insurance brokers do not have SSTB income.

For purposes of the QBID, *high-income taxpayer* is defined by the thresholds outlined in the following chart:

	Threshold Amount (No Wages Required)	Phase-in Range	Full Phase-In (Need Wages/Property)
Married Filing Jointly	$340,100	$100,000	$440,100
Single, Head of Household	$170,050	$50,000	$220,050

EXAMPLE: A married filing jointly taxpayer has pre-QBID taxable income of $480,000. No QBID is allowed for the taxpayer's SSTB income. However, if the taxpayer has non-SSTB income, it will need enough wages and property to get the full QBID.

Aggregation

QBID is computed separately for each business. This creates limits if one business has income but insufficient wages, and another business has "surplus" wages (more than it needs). This business-by-business limit on aggregation is not an issue for taxpayers with taxable income below $340,100 (for married filing jointly); they get the full deduction even if they have no wages. Rather, it affects high-income taxpayers as defined earlier.

General Rule: Business-by-Business Limit		
	Business A	Business B
QBI	$500,000	$500,000
QBID rate	20%	20%
Tentative QBID	$100,000	$100,000
Wages*	$0	$400,000
Wage limit (50%)	$0	$200,000
QBID	$0	$100,000
*Assumes no tangible property, so the alternate formula does not help.		

Therefore, aggregation is good for high-income taxpayers who have one business that has excess wages and another business that lacks enough wages and property to qualify for the deduction. The regulations allow the aggregation of businesses. Aggregated businesses are treated as a single business under Treas. Reg. § 1.199A-2(a)(2).

When Aggregation Works			
	Business A	Business B	Aggregated
QBI	$500,000	$500,000	$1,000,000
QBID rate			20%
Tentative QBID			$200,000

When Aggregation Works			
	Business A	Business B	Aggregated
Wages*	$0	$400,000	$400,000
Wage limit (50%)			$200,000
QBID			$200,000
* Assumes no tangible property, so the alternate formula does not help.			

To aggregate, businesses must meet all of the following requirements:

- They must have common control (for the majority of days and on the last day of the year).
  - — Attribution under Code Secs. 267 and 707 applies.
- They must have the same taxable year.
  - — There is an exception for short taxable years.
- None of the aggregated businesses can be an SSTB.
- They must meet reporting requirements (on the tax return).
- They must meet at least two of the following three factors as outlined in Treas. Reg. § 1.199A-4(b)(1):
  - — They have the same products, property, or services (e.g., a restaurant and a food truck) or items "customarily provided together" (e.g., a gas station and a car wash).
  - — They must share facilities or significant centralized business elements (common personnel, accounting, legal, purchasing, human resources, etc.). They do not have to share an entire facility; if a catering business and a restaurant share a kitchen, for example, that is sufficient.
  - — The businesses must be operated in coordination with or reliance on other aggregated businesses (e.g., have supply chain interdependencies).

¶ 605 ENTITIES SUBJECT TO CODE SEC. 163(j)

Under Code Sec. 163(j), a taxpayer's deduction of business interest expenses paid or incurred for the tax year is generally limited to the sum of:

- The taxpayer's business interest income for the tax year for which the taxpayer is claiming the deduction (not including investment income);
- 30 percent of the taxpayer's adjusted taxable income (ATI), but not less than zero; and
- The taxpayer's floor plan financing interest.

The limit was increased to 50 percent of ATI for the 2019 or 2020 tax year for any taxpayer other than a partnership in response to the COVID-19 pandemic. In the case of partnership, the 50 percent limit applied only for the tax year beginning in 2020 with a special allocation of excess business interest expense to partners for the 2019 tax year unless the partner elected otherwise. A taxpayer may have elected not to use the 50 percent ATI limit in 2019 or 2020 but continued to use the 30 percent limit. In addition, a taxpayer may elect for any tax year beginning in 2020 to use its ATI from the 2019 tax year to calculate its Code Sec. 163(j) limit.

Any business interest not deductible as a result of the limit generally may be carried forward indefinitely to succeeding tax years. The limit applies to all taxpayers except a small business with average annual gross receipts for the three prior tax years that do not exceed a threshold amount ($26 million for 2019, 2020, and 2021, and $27 million for 2022). It also does not apply to certain excepted businesses including a trade

or business of providing services as an employee, an electing real property business, an electing farming business, and certain regulated utility businesses.

Tax Shelters

Uncertainty arises with respect to tax shelters. There are three types of tax shelters that can subject a taxpayer to most of the Code Sec. 163(j) limits (see the following chart). Most of the problems are associated with the second type, a syndicate, when more than 35 percent of its losses are allocated to limited partners or limited entrepreneurs (which can include LLC members).

Types of Tax Shelters	
	Explanation
1. Securities registration required (federal or state).	Broadly defined. Includes entities that must file notice of *exemption*. Ask the attorney who formed the entity if it is subject to securities registration.
2. "Syndicate"—35% of losses	More than 35% of losses are allocated to limited partners or limited entrepreneurs (not active in the business).
3. Code Sec. 6662(d)(2)(C)	Targeted to traditional tax shelters (almost none exist anymore).

The 35 percent loss rule was originally enacted in 1981, and the TCJA incorporated it into Code Sec. 163(j). An individual is not treated as a limited partner or a limited entrepreneur if the individual (1) actively participates at all times in management (participation of a close relative—spouse, children, parents—also satisfies the test), or (2) actively participated in management for at least five years in the past.

Individuals can be excluded from that 35 percent circle if they did not acquire their interest for tax avoidance. If the entity was not set up for tax avoidance, and if the individual LLC member, for example, did not acquire it for tax avoidance purposes, the IRS will consider that person a "deemed" active participant, and they can be pushed out of the 35 percent circle so they do not cause a tax shelter (Code Sec. 1256(e)(3)(C)). This is a significant provision.

> **EXAMPLE:** Bethe and Holly bought an apartment building in 2016. Each owns 50 percent of the LLC, and the apartment building has $15,000 per year in losses. Bethe is very active in management, but Holly is not involved at all. Neither Holly nor the LLC had a tax avoidance motive. In fact, Holly can't deduct losses (because she is a passive participant).
>
> On the surface, this should be a tax shelter because there is a 50 percent allocation to an inactive participant. In this author's view, the IRS is required to "deem" Holly to be "active," so the LLC is not a tax shelter. Code Sec. 163(j) does not apply, and the taxpayer is not required to use the accrual method.

If a business is subject to Code Sec. 163(j), the business interest expense is limited to the sum of:

- Business interest income
  - — This includes interest income on customer accounts receivable, but not working capital.
- 30 percent × adjusted taxable income
- Floor plan financing (e.g., for auto dealers, etc.)

"Siloed" Interest Expense

"Silos" only apply to Code Sec. 163(j) entities with more than $27 million (for 2022) trailing average annual gross receipts or a tax shelter. Only future excess taxable income (ETI) of that entity allows a deduction of "siloed" excess business interest expense (EBIE). Once that entity has ETI, siloed interest is treated as paid by the partner to that extent.

For a partnership, nondeductible interest expense is siloed at the partner level. For an S corporation, nondeductible interest expense is siloed at the S corporation level.

There is a two-step process for partnerships subject to Code Sec. 163(j):

- Determine if there is any nondeductible interest for the year.
  - — Apply the limit at the partnership level (Prop. Reg. § 1.163(j)-6(g)).
- Allocate nondeductible interest expense to the partners (Prop. Reg. § 1.163(j)-6(g)).
  - — Interest is siloed until there are future allocations of ETI or EBIE from the same partnership. Partners cannot deduct in the same year EBI (Schedule K-1, line 13, code K) passes through. (Prop Reg. 1.163(j)-6(o), example 1). They can deduct to the extent of allocated ETI or excess business interest income (EBII) in future years. (Prop. Reg. § 1.163(j)-6(g)(2)(i)).

Problem with silos. The Code Sec. 163(j) limit is entity-by-entity (and taxpayer-by-taxpayer). No aggregation is allowed. The following chart shows that ABC LLC has $90,000 in business interest expense before the limit. It is only able to use $30,000, so it has $60,000 in nondeductible interest. It had too much interest expense and was subject to Code Sec. 163(j). Even if DEF LLC has lots of income, and even if the other LLC is under common control, that does not help ABC. Unlike Code Sec. 199A, there is no aggregation when it comes to Code Sec. 163(j). The partners in ABC LLC will have to track that disallowed interest expense every year. And until ABC has income in the future, the partners will have to carry that forward.

	ABC LLC	DEF LLC	~~Combined~~
Business interest expense (before limit)	($90,000)	($0)	~~($90,000)~~
ATI	$100,000	$200,000	~~$300,000~~
ATI business interest limit (30%)	$30,000	$60,000	~~$90,000~~
Disallowed business interest (carryover)	($60,000)	$0	~~$0~~

EXAMPLE: SILOED INTEREST EXPENSE: In 2019, Forgey Consolidated LLC is subject to Code Sec. 163(j). It has $200 in ATI and $100 of business interest expense ($0 business interest income). Its interest expense is limited to $60 ($200 ATI × 30%). Its EBIE is $40 ($100 – $40).

Mary owns 50 percent of Forgey Consolidated LLC. Mary is allocated $20 of excess business interest expense (Schedule K-1, line 13, code K). This is "siloed." ETI from other entities will not help deduct it.

Remember that only partnerships silo at the owner level.

The CARES Act and Code Sec. 163(j)

Under the CARES Act, partners have a special EBIE deduction: they can deduct 50 percent of disallowed EBIE in 2020. They can elect to use 2019 ATI for their 2020 tax return. Partnerships and S corporation would multiply their ATI by the following percentages:

Year	Partnership	S Corporation
2019	30%	50%
2020	50%	50%

EXAMPLE: Lucas Fabrication is subject to Code Sec. 163(j). Its 2019 ATI is $200,000, and its 2020 ATI is ($125,000). In 2020, it may elect to use 2019 ATI for the business interest limit. If Lucas makes this election, it can deduct up to $100,000 in business interest expense. If it does not make the election, it will have no deduction for business interest expense.

¶ 606 THE QBID AND RENTAL REAL ESTATE

Do real estate rentals qualify for the QBID? The threshold question is whether the rental is a business. The most important word here is *business*. The regulations use the business definition in Code Sec. 162 (Treas. Reg. § 1.199A-1(b)(14)), with the exception that some "self-rentals" are deemed to be businesses.

EXAMPLE: SELF-RENTAL: A real estate broker is renting land on a triple net lease to a 100 percent owned S corporation. A self-rental to a pass-through entity like an S corporation or partnership is automatically eligible for QBI; it is automatically treated as a business and not tested under the Code Sec. 162 standard.

The courts, and sometimes the IRS, have different views of what constitutes a business. Although the Tax Court and Seventh Circuit (and sometimes the IRS) merely require "regular and continuous" activity, the Tax Court appears to impose a higher standard for:

- Prior personal residences held out for lease, but never actually leased.
- Land leases (if just one piece of land).

The Second Circuit (and sometimes the IRS) also require some degree of substantial activity. Real estate rentals qualify for the QBID if they are businesses, per the Code Sec. 162 definition of a business (Preamble, p. 9). The Tax Court has repeatedly held that the rental of a "single piece of real property [is] a . . . business" (*Curphey v. Commissioner*, 73 TC 766). *Curphey* involved Code Sec. 162. However, the Tax Court declined to hold that *all* real estate rentals are businesses. In a later decision (*Balsamo v. Commissioner*), the court said this did not signify a change in philosophy.

The Tax Court and most circuit courts have a relatively low bar, but the Second Circuit (covering New York, Connecticut, and Vermont) has a higher bar. The following tables highlight several cases, as well as some IRS guidance, involving real estate rentals.

Rental Real Estate: Good Cases			
Case	**Facts**	**Business?**	**Venue/Comments**
Murtaugh v. Commissioner	Two timeshares, management company had substantial activity.	Yes	Tax Court/manager's activity counts.
LaGreide v. Commissioner	Inherited, single-family residence.	Yes	Tax Court/rental of single property equals business.
Hazard v. Commissioner	Single-family, taxpayer lived in different city.	Yes	Tax Court/rental of single property equals business.

Rental Real Estate: Good Cases			
Case	**Facts**	**Business?**	**Venue/Comments**
Jephson v. Commissioner	Held for rent, but never rented. Paid maintenance.	Yes	Board of Tax Appeals (predecessor to Tax Court).
Reiner v. U.S.	Single-family, management company.	Yes	CA-7/cited *LaGreide*.

Tax Court: Rental Real Estate Is Not a Business			
Case	**Facts**	**Business?**	**Venue**
E.R. Fenimore	Rental of a small portion of residence formerly occupied as a residence.	No	Tax Court
Coykendall	Former residence, offered for sale of rent, never actually rented.	No	Tax Court
Horrmann	Former residence, attempted to rent, never actually rented.	No	Tax Court

Rental Real Estate: Land			
Case/IRS Guidance	**Facts**	**Business?**	**Venue/Comments**
Good v. Commissioner	Lease of land. Rented continuously for 20 years. Also owned other rental land.	Yes	Tax Court/followed *Hazard* case. Seemed to rely upon continuous rental of land.
Durbin v. Birmingham	Lease of land.	No	DC Louisiana.
Emery v. Commissioner	Lease of land.	No	Tax Court/failed to provide evidence.
IRS Private Letter Ruling 8350008	Triple net, owned land only, tenant owned and maintained building.	No	Non-precedential administrative guidance.
Anderson v. Commissioner	Leased single piece farmland.	No	Tax Court/tenant—all work.

Rental Real Estate: Second Circuit			
Case/IRS Guidance	**Facts**	**Business?**	**Venue/Comments**
Grier v. U.S.	Single-family, inherited, only one tenant, made repairs.	No	Second Circuit has least favorable position.
Balsamo v. Commissioner	Inherited, no repairs, sold three months after inheritance.	No	Tax Court used CA-2 law, bound by *Golsen*.
Union Bank of Troy	Triple net lease, tenant-maintained bldg.	No	District Court NY (cites *Grier*, appealable to CA-2)
IRS Private Letter Ruling 8350008	Triple net, owned land only, tenant owned and maintained building.	No	Non-precedential administrative guidance. This taxpayer in Second Circuit (see GCM 39126).

Rental Real Estate: Triple Nets			
Case/IRS Guidance	**Facts**	**Business?**	**Venue/Comments**
Fegan v. Commissioner	Rented hotel building to controlled corporation. Tenant maintained interior, landlord exterior ("2½ net").	Yes	Tax court/He also rented other part of same building.
Rev. Rul. 60-206	Rented equipment, no activity at all with respect to property.	Yes	Code Sec. 513. Sole activity was to receive rental income. Lessee maintained.
Neill v. Commissioner	Inherited property, tenant constructed building, paid triple net expenses.	No	Code Sec. 871 case. Similar to land lease (in that tenant constructed building).
Rev. Rul. 73-522	Supervised negotiation of long-term lease identical to prior lease, lessee paid all expenses, including landlord's mortgage.	No	Code Sec. 871 case. Appears taxpayer did not own underlying land (had to pay ground lease).

The IRS seems unsure of whether rental real estate is a business. The IRS's Revenue Rulings are contradictory. For example, Rev. Rul. 60-206 notes that if the only activity for the rental real estate business is collecting one check per month, it is a business. However, according to Rev. Rul. 73-522, it would not be considered a business. According to the Code Sec. 199A regulations, relevant factors for rental real estate businesses *might include* the following:

- Type of rental (residential vs. commercial)
- Number of properties rented
- Owner's or agents' day-to-day involvement
- Types/significance of ancillary services under the lease
- Terms of lease (net lease vs. traditional)

The regulations state this is a "facts and circumstances" test. The Treasury declines to rule that all rentals are businesses and does not want to imply that land leases are or are not businesses. There is arguably substantial authority (Rev. Rul. 60-206). Practitioners should consider using Form 8275 to disclose their position on this matter to avoid certain penalties; this drops the standard to reasonable basis. Of course, they should first discuss doing so with the client.

To summarize this discussion, the Tax Court's position is that almost all rental real estate is a business. Exceptions include:

- A former personal residence that was never actually rented, or a small portion of which was rented, and
- A single piece of land, where the owner is inactive.

The Second Circuit sets a higher bar: the owner needs to engage in more activity. The IRS has a contradictory position on the level of activity required to be a business. Rev. Rul. 60-206 states that no activity except collecting a check is indicative of a business, whereas Rev. Rul. 73-522 indicates that no activity except collecting a check indicates that there is *not* a business.

STUDY QUESTIONS

1. Which of the following is ***not*** one of the tax incentives with respect to designated opportunity zones?

a. Temporary deferral of original gain

b. Indefinite capital gain deferral for all QOF investments

c. Partial exclusion of original gain

d. Full exclusion of gain on QOF

2. The only way to receive benefits of a QOF is that you must have eligible gains in the preceding _____ days.

a. 30

b. 60

c. 120

d. 180

3. Which of the following identifies the full phase-in amount related to QBID for single filers for 2022?

a. $163,300

b. $220,050

c. $326,600

d. $426,600

¶ 607 REVENUE PROCEDURE 2019-38: SAFE HARBOR

Rev. Proc. 2019-38 has a safe harbor allowing certain interests in rental real estate, including interests in mixed-use property, to be treated as a trade or business for purposes of the QBID under Code Sec. 199A. To qualify for this safe harbor, taxpayers must meet the following requirements:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise.
- Rental real estate enterprises that have been in existence less than four years must have performed 250 or more hours of rental services per year. Other rental real estate enterprises must have performed 250 or more hours of rental services in at least three of the past five years.
- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents regarding hours of all services performed, descriptions of all services performed, dates such services were performed, and who performed the services.
- The taxpayer attaches a statement to the return filed for the tax year(s) the safe harbor used.

According to IRS guidance, there are three ways a rental property can produce QBI:

- Rise to level of a business (*Curphey* case, etc.),
- Meet the safe harbor, or
- Lease property to a commonly controlled S corporation or partnership.

¶ 608 CARRIED INTEREST

Rev. Proc. 93-27 provides that if a partner receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, that interest is tax-free. To be tax-free, the interest cannot be:

- Substantially certain income, such as a high-quality debt/net lease,
- Within two years of receipt the partner disposes of the interest, or
- Interest in publicly traded limited partnership.

The profits interest cannot be a capital interest (if the partnership liquidates immediately, there is no distribution).

EXAMPLE: A hedge fund invests in five stocks. Four stocks are sold after two years, resulting in a 20 percent gain to the hedge fund. The hedge fund has short-term capital gain (special three-year plus one-day holding period). The last stock is held after four years. The hedge fund has long-term capital gain (it meets the special holding period).

¶ 609 EMPLOYEE RETENTION CREDIT

The employee retention credit (ERC) is a broad refundable tax credit designed to encourage employers to keep employees on their payroll. The government pays a portion of the qualified wages of each employee. For small employers, all wages are paid during the affected periods. Large employers receive a restricted credit—only for wages paid while the employee is not providing services. Note that taxpayers cannot double-count the same wages for both the Paycheck Protection Program (PPP) and the ERC.

EXAMPLE: Susan's Salon has three employees and receives a PPP loan. First, it must allocate enough wages to obtain full loan forgiveness. Then, it should allocate the excess wages to the ERC.

Businesses can qualify for the ERC in two ways:

- It partially suspended its business due to a government shutdown.
- It suffered a significant decline in gross receipts due to COVID-19.

For 2021, the business's gross receipts must drop below 80 percent of gross receipts for the same quarter in 2019 for it to qualify for the ERC. The ERC can be substantial. For 2020, businesses can receive up to $5,000 per employee per year, and for 2021 up to $7,000 per employee per quarter (maximum $10,000 wages per employee per quarter times the 70 percent credit rate).

Taxpayers can claim the ERC by filing Form 941, *Employer's Quarterly Federal Tax Return*. If a business failed to take the credit on its Form 941, it can file Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*.

According to IRS Notice 2021-49, majority owners of S corporations are generally not eligible for the ERC. The ERC does not apply to majority owner wages, nor to the wages of certain family members.

STUDY QUESTIONS

4. A business with trailing three-year average gross receipts in excess of which of the following amounts must aggregate businesses under common control with respect to Code Sec. 163(j)?

a. $3 million

b. $12 million

c. $21 million

d. $27 million

5. Which of the following Tax Court cases found that the associated rental real estate was in fact a business?

a. *E.R. Fenimore*

b. *Coykendall*

c. *Murtaugh*

d. *Horrmann*

6. Regarding the safe harbor in Rev. Proc. 2019-38, one of the requirements is that there are at least _____ service hours performed each year.

a. 100

b. 250

c. 750

d. 900

CPE NOTE: When you have completed your study and review of chapters 1-6, which comprise Module 1, you may wish to take the Final Exam for this Module. Go to **cchcpelink.com/printcpe** to take this Final Exam online.

MODULE 2: TAX DEVELOPMENTS—Chapter 7: Tax Implications of Cryptocurrency

¶ 701 WELCOME

This chapter presents an overview of blockchain and the tax implications of cryptocurrency transactions. The IRS has provided some recent guidance on cryptocurrency, but potentially conflicting pronouncements by other regulatory agencies have created uncertainty on reporting issues. This chapter will help the practitioner understand when a taxable transaction has occurred, determine what reports to file to satisfy IRS requirements, and identify tax traps for the unwary.

¶ 702 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Describe what constitutes blockchain and the various types of cryptocurrencies it supports
- Determine whether a cryptocurrency transaction creates a taxable event
- Identify the IRS forms needed to report cryptocurrency transactions
- Develop a working knowledge of possible reports due to other regulatory agencies
- Recognize the traps cryptocurrency traders could encounter that could unexpectedly increase the trader's tax liability
- Identify current enforcement actions employed by the IRS

¶ 703 BACKGROUND

Cryptocurrency is a decentralized form of digital cash that functions as a medium of exchange. It is not issued or backed by a government and does not have legal tender status in most jurisdictions, although El Salvador has declared Bitcoin as legal tender. Cryptocurrency eliminates the need for traditional intermediaries like banks and governments to make financial transactions. Originally associated with the dark web, where people could buy or sell all types of goods or services that were, in most cases, illegal, cryptocurrency had a shadowy past. Cryptocurrency could not be easily traced because it was outside the normal banking system.

Many people think that cryptocurrency is Bitcoin, but that is not entirely true. Bitcoin was the first cryptocurrency and is a major player in this area—it broke the $67,000 per unit trading barrier in late 2021 but had fallen below $20,000 in a subsequent crash—but other cryptocurrencies are rapidly gaining ground. Bitcoin was created in 2008 by a group of individuals operating under the name Satoshi Nakamoto. The first Bitcoin transaction was in 2010 when, in a well-publicized stunt, someone bought two Papa John's pizzas for 10,000 Bitcoin, which would be equivalent to over $67 million at Bitcoin's trading peak.

Blockchain is the system that supports the trading of cryptocurrency like Bitcoin. Any two willing parties can directly transact peer-to-peer on the blockchain without the need for a trusted third party such as a bank. These virtual transactions are recorded in the blockchain, which is a digitized public ledger. Individual units of the currency are called *coins*.

The system is based on cryptographic proof and cannot be reversed. Designed to protect sellers from fraud, the system is secure "as long as honest nodes collectively control more CPU power than any cooperating group of attacker nodes."

Examples of cryptocurrency include the following:

- Dogecoin
- Ether
- Liteco
- Ripple

The use of cryptocurrency poses certain problems. For example, the anonymity could facilitate tax evasion or money laundering, and support other crimes. Because cryptocurrency operates in a decentralized manner and is unregulated, it is easy to transfer cryptocurrency between countries or between people. And it is more difficult to track down when compared to traditional currency.

Cryptocurrency is now mainstream, and its use is growing. PayPal and several investment banks (e.g., BNY Mellon) are providing services to clients in managing their cryptocurrency. Recent cryptocurrency launches include JPMorgan's JPMorgan Coin, Facebook's Libra, and Coinbase's USD Coin (which is a stablecoin, or a cryptocurrency whose value is fixed to another asset).

Definitions

Many terms are associated with cryptocurrency. The following definitions will help readers navigate the literature.

Address: Unique identifier where the cryptocurrency sits on the blockchain. The coin's ownership data is stored here. The address registers any changes when the cryptocurrency is traded.

Airdrop: A marketing ploy where tokens are sent into wallets for free or in return for a social media post in order to promote a new virtual currency.

Altcoins: All the other coins outside of Bitcoin are grouped together under the category of altcoins. Examples include Ethereum and Litecoin.

Block: A blockchain is made up of blocks. Each block holds a historical database of all cryptocurrency transactions made until the block is full. A block is a permanent record that can be reviewed.

Cold storage (also known as a *cold wallet*): An offline wallet provided for storing Bitcoins or other cryptocurrencies. The wallet is stored on a platform that is not connected to the Internet, protecting the wallet from unauthorized access, cyber hacks, and other vulnerabilities.

Ethereum: One of the top three cryptocurrencies in the world, based on capitalization. Ethereum differs from Bitcoin in that it allows developers to create applications on top of it and also write smart contracts.

Exchange: A platform where cryptocurrencies are exchanged with each other, with other traditional currencies (like U.S. dollars). and between entities. Examples of popular cryptocurrency exchanges include Coinbase, Binance, Gemini, Bittrex, Kraken, and KuCoin.

Fiat: Refers to money that is recognized as legal tender by governments, such as the U.S. dollar, British pound, Euro, and Australian dollar.

Fork: A new version of a blockchain that is created, resulting in two versions of the blockchain running side-by-side. A *hard fork* is a major update to this protocol. There is

no consensus about the changes that have been made, so a new blockchain is created to run in parallel with the original. The problem is that of backwards compatibility. A *soft fork* is a minor update that improves efficiency.

Initial coin offering (ICO): Occurs when a creator of a cryptocurrency puts an initial batch of its coins up for purchase in order to raise funds.

Private key: A string of numbers and letters that is used to access a user's "wallet." The private key acts as a password when someone is selling or withdrawing cryptocurrencies. It also acts as a digital signature.

Token: Acts as the "coin." It is actually a digital code that can be owned, bought, and sold.

Wallet: An app that allows cryptocurrency users to store and retrieve their digital assets. A user can store cryptocurrency in a wallet and from there use it to make transactions.

Where to Buy Cryptocurrency

Cryptocurrency can be purchased on exchanges (e.g., Coinbase) or from investment brokerages (e.g., Robinhood). One can also buy cryptocurrency peer-to-peer; this happens when someone downloads their cryptocurrency information on a flash drive and hands it over to someone else. Cryptocurrency ATMs are another option for purchasing crypto.

¶ 704 CLASSIFYING CRYPTOCURRENCY

How cryptocurrency is classified depends on the perspective of the government agency or entity doing the classification. The IRS classifies cryptocurrency as property, much like stock or real estate. Therefore, it does not give rise to foreign currency gain or loss for U.S. tax purposes.

The Commodity Futures Trading Commission (CFTC) classifies cryptocurrency as commodities, whereas the Financial Crimes Enforcement Network (FinCEN) categorizes substitutes for real currencies as "money transmitters." Regulators are motivated to bring virtual currency under their jurisdiction.

Cryptocurrency as Property

IRS Notice 2014-21 states that cryptocurrency is treated as property for federal tax purposes. Gain or loss based on the difference between the taxpayer's basis in the property and its fair market value must be recognized on the exchange of cryptocurrency for cash or for other property. The character of gain or loss is capital if it is a capital asset in the hands of the taxpayer; otherwise, the character is ordinary. Capital gains or losses are reported on Form 1040, Schedule D, and Form 8949, *Sales and Other Dispositions of Assets*. Ordinary gains or losses should be reported on Form 1040, line 21 (Other Income), or Schedule C.

Tax Planning Ideas

Taxpayers can defer, reduce, or eliminate taxes by investing cryptocurrency proceeds into businesses and personnel located in Opportunity Zones. Another option is to place cryptocurrency in a self-directed cryptocurrency individual retirement account (IRA). If cryptocurrency is placed in a Roth IRA, gains are tax-free. If placed in a non-Roth account, tax on the gains will be deferred.

¶ 705 TAXABLE TRANSACTIONS

According to IRS Notice 2014-12, a taxable event occurs when a taxpayer:

- Trades cryptocurrency to fiat currency like the U.S. dollar;
- Exchanges one cryptocurrency for another cryptocurrency;
- Uses cryptocurrency to pay for goods and services; or
- Earns cryptocurrency as income.

Wages paid by virtual currency must be reported on Form W-2. The wages are subject to federal income tax withholding, FICA, and FUTA. Virtual currency payments to independent contractors constitute self-employment income that is subject to self-employment tax. One thing to keep in mind if paying wages in cryptocurrency is that the payor should first obtain the contractor's tax ID since these payments are subject to the backup withholding rules.

As defined earlier, an airdrop is a random distribution of coins during a marketing campaign, typically to promote a new cryptocurrency. The IRS considers marketing giveaways to be ordinary income. They are valued on the date the cryptocurrency is received. The cost basis equals the value.

Hard forks can potentially be taxable events. Cryptocurrency that is being held by an individual goes through a hard fork, and the new forked cryptocurrency received is taxed as income. The cost basis in the newly received cryptocurrency is equal to the income recognized. Soft forks (minor upgrades), on the other hand, are not taxable.

In margin trading, funds are borrowed from an exchange to effect a trade and are repaid later. The borrowed funds are treated as the taxpayer's investment and will therefore establish cost basis. The margin trading profit and loss can be calculated using this cost basis. Gains or losses will be capital in nature (typically short-term). BitMex and other similar cryptocurrency exchanges have popularized margin trading. However, as of this writing, the IRS has not released guidance that specifically addresses cryptocurrency margin transactions.

¶ 706 MINING

Mining is a process in which an individual solves complex mathematical problems and donates "computing" power in order to add new transactions to the blockchain. Mining consists of the certification of the transactions on a blockchain. The person donating the computer power is granted new fractions of the cryptocurrency. The IRS asserts that if the taxpayer's "mining" activities rise to the level of a trade or business, the income is also subject to self-employment tax.

In a "mining rig," an individual owns the computers and equipment in order to reap all the mining rewards. Income received from the mining rewards offset by expenses should be reported on Schedule C. The income is also subject to self-employment taxes to be reported on Schedule SE. The taxpayer may qualify for the Code Sec. 199A 20 percent qualified business income deduction (QBID). If a taxpayer has a number of fixed assets, it can consider accelerating deductions through the Section 179 or bonus deprecation provisions.

"Cloud mining" is where the individual invests in another company that is operating the computers and mining equipment. In this case, the individual is paid out a portion of the mining rewards. The fair market value of the rewards is reported on Schedule B as dividend income.

EXAMPLE: MINING MISMATCH BETWEEN ORDINARY INCOME AND CAPITAL LOSS: Bob joins a mining pool. He spends $4,000 on electricity and is rewarded with a Bitcoin worth $7,500. Bob has to recognize $3,500 ordinary income on the date of the reward.

Bob shortly thereafter sells his Bitcoin, which had collapsed in value from $7,500 to $4,000. While it looks like he has broken even, Bob will probably owe tax. This is because he has $3,500 of ordinary income taxed at higher rates and now $3,500 of capital loss, some, or all of which will result in a lower tax benefit. This is due to the fact that the capital losses can only offset capital gains, which are taxed at a lower rate. Excess capital losses may be used to offset up to $3,000 of other ordinary income, but any excess amounts remaining after this offset are suspended.

EXAMPLE: MINING AND THE HOBBY LOSS RULES: Assume the same facts as in the previous example, except Bob had never intended for the mining to be a money-making enterprise and enjoyed mining merely for entertainment purposes.

If the IRS can prove Bob's mining was a hobby, then Bob will be required to report all of his $7,500 revenue as income but would not be able to deduct his $4,000 in costs.

STUDY QUESTIONS

1. In what year was Bitcoin created by a group of individuals operating under the name Satoshi Nakamoto?

a. 2006

b. 2008

c. 2012

d. 2013

2. A digitized public ledger is often called a(n) _____.

a. Block

b. Wallet

c. Blockchain

d. Exchange

3. Which of the following identifies a new version of a blockchain that is created, resulting in two versions of the blockchain running side-by-side?

a. Block

b. Fork

c. Altcoins

d. Fiat

¶ 707 GIFTS

Gifts of cryptocurrency to individuals follow the general gift exemption rules. Therefore, annual gifts of up to $16,000 of cryptocurrency per recipient are not subject to gift tax. The fair market value is established on the date of the gift. Multiple donors can possibly give to the same donee, gift tax-free. The recipient of the gift will inherit the donor's holding period and tax basis. Remember that according to the IRS, cryptocurrency is property, not currency.

What about gifts of cryptocurrency to charitable organizations? In this case, under Code Sec. 501(c)(3), the donor may be able to deduct the full fair market value of the

cryptocurrency given to a public or private charity or to governmental entities or political subdivisions thereof (e.g., a public school). The cryptocurrency gift is valued as of the date of the gift. Keep in mind that donations greater than $500 must be reported to the IRS on Form 8283, *Noncash Charitable Contributions*.

However, there is an exception to this rule when long-term capital gain assets are being held for investment in a trade or business. For cryptocurrency held for more than one year donated to charity, the taxpayer can deduct the fair market value up to 30 percent of adjusted gross income. The built-in gain is not taxed. If the cryptocurrency is held for less than a year, the taxpayer can deduct up to 50 percent of adjusted gross income and the lesser of (1) the cost basis or (2) the fair market value of the donated cryptocurrency.

Note that unused charitable contributions may be carried over to future years.

¶ 708 TRAPS FOR THE UNWARY

Traders of cryptocurrency traders could encounter several pitfalls that might unexpectedly increase their tax liability.

Wash Sale Rules

At the time this chapter was written, the wash sale rules do not apply to cryptocurrency; cryptocurrency is considered property and is not in the same category as stocks or bonds. The wash sale rules prohibit the claiming of a loss on the sale of a security purchased within 30 days before or after the loss is realized. Cryptocurrency traders can therefore harvest a loss and then immediately repurchase the cryptocurrency without losing the right to immediately claim the loss.

Form 1099-K

Coin exchanges are required to issue Form 1099-K, *Payment Card and Third-Party Network Transactions*, to customers who received $600 or more from payment card entities and third-party network transactions in one year. There is no minimum transaction threshold. Form1099-K does not provide cost basis for each coin. Traders also have to keep track of the fair market value of any cryptocurrency traded into, which can be challenging since trades can occur between platforms.

Form 1099-B

The 2021 Infrastructure Investment and Jobs Act makes it mandatory for all cryptocurrency exchanges that are considered "brokers" (i.e., cryptocurrency exchanges and other third parties that facilitate the transfer of digital assets) to provide forms 1099-B, *Proceeds from Broker and Barter Exchange Transactions*, starting with the 2022 tax year.

Problems may arise due to the fact that the blockchain may not have the cost basis. This level of reporting flies in the face of the "interoperability" inherent in blockchains.

Expanded Reporting in 2024

The Infrastructure Investment and Jobs Act also expands Code Sec. 6050I so that any person or entity that receives more than $10,000 in virtual assets must file a report with the IRS with the sender's personal information. This provision was initially created to discourage large, in-person cash transactions. If applied to digital assets, it will heavily discourage swaps due to the requirement to exchange the parties' sensitive information.

Ordinary Income Created by Forks

The IRS treats coin split-ups that occur when a blockchain forks into two chains as constituting current ordinary income equal to the value of the newly created coin, even

if it is not sold. The rationale is that the split creates a windfall to the holder, even though arguably it more resembles a stock split, which does not result in an immediate tax implication.

Code Sec. 1031 Like-Kind Exchanges

Cryptocurrency does not qualify as like-kind property, in part because it is not real estate. The Code Sec. 1031 tax deferral is not available for cryptocurrency since January 1, 2018. An exchange for one cryptocurrency for another is therefore a taxable event.

Cryptocurrency Futures and Code Sec. 1256 Contracts

As mentioned earlier, the CFTC ruled that virtual currencies are commodities. But do the "Section 1256 Contract" rules apply? Futures are subject to the following tax treatment:

- Positions are "marked to market" on December 31, with paper gains and losses recognized as if the futures position was sold and immediately bought back.
- The gains and losses are split 60 percent long-term, 40 percent short-term, irrespective of the actual holding period.

Code Sec. 475(f) Election for Traders

Cryptocurrency traders are considered to be carrying on a trade or business. Generally, traders must treat gains and losses as capital in nature, and they are reported on Schedule D. Dividend and interest income is treated as investment income and reported on Schedule B. A taxpayer can make a Code Sec. 475(f) election where gains or losses are treated as ordinary and reported on Form 4797, *Sales of Business Property.*

The Code Sec. 475(f) election permits taxpayers to use the mark-to-market rules. Traders can elect as having sold all their securities on the last day of the tax year at their fair market value, with gain or loss recognized and taxed as ordinary income or ordinary loss. Dealers' and traders' expenses are considered business expenses and are deductible. The wash sale rules will not apply if the election is made.

To make the Code Sec. 475(f) election, no special form is required to be filed. The taxpayer would file a statement with the following information:

- A description of Code Sec. 475 claiming the use of the mark-to-market method of accounting;
- The first tax year for which the election is effective; and
- The trade or business for which the taxpayer is making the election.

The statement must be filed by the unextended due date of the tax return.

Straddle Rules

The straddle rules apply to cryptocurrency. Losses are not permitted on closing a position in an actively traded investment if an open position is being maintained in the opposite direction. This situation can arise if an individual maintains multiple positions in cryptocurrency futures, options, puts, or calls.

FBAR and FATCA Reporting

Cash and securities held in offshore accounts are subject to the reporting requirements under Foreign Bank and Financial Accounts (FBAR) and Foreign Account Tax Compliance Act (FATCA). Failure to report can result in severe penalties. Since cryptocurrency is considered property and not cash or securities, FBAR and FATCA normally should not apply. However, an individual who trades cryptocurrency during the year into fiat currencies may cross a threshold and be required to comply with the reporting requirements.

FBAR reporting is required if the offshore account exceeds $10,000; the form is filed electronically. For FATCA, the threshold is $50,000 and Form 8938, *Statement of Specified Foreign Financial Assets*, must be filed.

FinCEN considers cryptocurrency administrators and exchanges to be engaged in a "money service business," which is regulated by the Bank Secrecy Act. Cryptocurrencies can arguably be reportable if they can be characterized as a "foreign" account (or similar asset). As of November 13, 2019, FinCEN officials at an AICPA conference stated that FBAR is not required to be filed for cryptocurrency assets.

According to FinCEN Notice 2020-2, current FBAR regulations do not define a foreign account holding virtual currency as a type of reportable account. However, FinCEN intends to amend the Bank Secrecy Act regulations to include virtual currency as a type of reportable account under FBAR.

Reporting Challenges

Exchanges of one cryptocurrency for another are typically not expressed in U.S. dollars (e.g., .034 Litecoin for 2.9 Ripple), so cost basis and fair market value may be hard to determine without diligent and contemporaneous record-keeping.

Traders typically trade and operate on a multitude of platforms where cryptocurrency is sent back and forth, and assets are comingled. This can cause fragmented data and difficulty in establishing cost basis and sale price.

Many traders are unaware of the tax reporting requirements and have not kept records of trades, purchases, and sales. This can make it difficult to accurately reflect complete and accurate basis.

FIFO versus Specific ID in Calculating Gain/Loss

Since cryptocurrency is considered a capital asset, the IRS's default method for determining basis for purposes of calculating gain or loss on a disposition is the first-in, first-out (FIFO) method of accounting. Traders may be tempted to use specific identification to reduce the recognized gain, especially when the value of the cryptocurrency is rapidly rising, and the trader has acquired multiples of the same cryptocurrency. This may be considered an aggressive approach.

Notice 2014-21 does not specifically refer to cryptocurrency as stock. It is also unlikely that an "adequate identification" can be made since it is merely an entry in a distributed ledger held by various parties. The cryptocurrency can be divided into an infinite number of parts and lacks any sort of lot number. It would be difficult to establish adequate identification.

No Banking Insurance Coverage

Because cryptocurrency is not currency, it is not covered by banking insurance. Securities Investor Protection Corporation (SIPC) insurance covering up to $500,000 of funds stolen from a brokerage or bank does not cover cryptocurrency. Cryptocurrency is not covered by FDIC insurance since it is not considered a bank account. The consequences of being uninsured can be devastating. For example, $40 million in cryptocurrency was hacked from Binance in 2019, and the loss was not covered by insurance.

¶ 709 IRS ENFORCEMENT

The IRS is beginning to ramp up its enforcement actions related to cryptocurrency. This includes sending out CP 2000 Notices for unreported/underreported 1099-K transactions. More than 10,000 warning and action letters were sent to noncompliant cryptocurrency investors in 2019. These include the following:

- Letter 6173 (Action Letter)
- Letter 6174 and 6174-A (No Action Letter)

Information Release 2022-61: Cryptocurrency Reporting

Issued on March 18, 2022, IR-2022-61 states that all filers of Forms 1040, 1040-SR, and 1040-NR must answer the forms' question regarding virtual currency. The question asks, "At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?" Taxpayers must check either the "yes" or "no" box regardless of whether they engaged in any transaction involving virtual currency during the tax year.

Transactions with cryptocurrency requiring a "yes" answer include the following:

- Paying or receiving cryptocurrency for goods or services
- The receipt or transfer of cryptocurrency for free that does not qualify as a bona fide gift
- Receiving cryptocurrency as a result of mining and staking activities
- Receiving cryptocurrency as a result of a hard fork
- Exchanging cryptocurrency for another virtual currency
- Selling cryptocurrency
- Any other disposition of a financial interest in virtual currency

Transactions that permit taxpayers to check the "no" box are as follows:

- Merely holding the cryptocurrency in the taxpayer's own wallet or account;
- Transferring virtual currency between wallets or accounts the taxpayer owns or controls; or
- Purchasing virtual currency using real currency, including purchases using real currency electronic platforms such as PayPal and Venmo

Any combination of holding, transferring, or purchasing virtual currency in the above three ways will not require a "yes" answer.

Cryptocurrency Reporting

The Infrastructure Investment and Jobs Act requires Forms 1099-B filed after December 31, 2023, to include certain cryptocurrency transactions. Although additional guidance on the scope of the requirement is still to come from the Treasury Department, early indications are that "ancillary parties" without access to relevant information about transactions but merely validating them, selling storage devices for private keys, or writing related software code will not likely be considered brokers.

The acquisition of virtual currency can require reporting as wages on the taxpayer's return if it was received as compensation for services. If cryptocurrency is held for sale to customers in a trade or business, it would be reported as inventory. If it is held as a capital asset, then any resulting capital gain or loss will be reported on Schedule D.

Operation Hidden Treasure

In 2021, the IRS announced the Operation Hidden Treasure initiative, a joint effort between the IRS's civil office of fraud enforcement and its criminal investigation unit, to catch unreported cryptocurrency transactions. Specially trained agents will review blockchains to identify tax evasion among users of cryptocurrency.

United States v. Kvashuk

In this case, a Microsoft engineer was sentenced to nine years in prison for stealing $10 million in digital currency while testing Microsoft's online retail sales platform. Kvashuk exchanged the currency for $2.8 million in Bitcoin and used a Bitcoin "mixing" service to hide the transactions. He then used the proceeds to buy a $160,000 Tesla and a $1.7 million lakefront home and filed fake tax return forms claiming that the Bitcoin was a gift from a relative.

United States v. Elmaani

This case involves cryptocurrency founder Elmaani (a.k.a. "Bruno Block"), who promoted Pearl tokens, a new cryptocurrency, which were part of a 2017 ICO. The U.S. Securities and Exchange Commission (SEC) asserted that the Pearl tokens were securities and the $1.3 million sale had not been properly registered.

Elmaani is alleged to have used a web of digital wallets to covertly mint approximately four million unauthorized Pearl tokens. He made millions in illicit gains through the minting and sale of Pearl tokens, spending more than $10 million to purchase several yachts, two homes, and other personal expenses. Elmaani did not report any income on his tax returns for 2017 or 2018, even though he received a 2018 Form 1099 reporting $12.5 million in cryptocurrency proceeds.

John Doe Summonses

A "John Doe" summons is a summons authorized by Code Section 7609(f). Unlike other IRS summonses, it does not list the name of the taxpayer under investigation because the taxpayer is unknown to the IRS. The IRS has issued a John Doe summons to Coinbase seeking information about taxpayers who conducted transactions in cryptocurrency from 2013 to 2015. So far, Coinbase has only provided information on transactions exceeding $20,000. It is evident that the IRS is aggressively pursuing enforcement of compliance in cryptocurrency transactions.

Links to IRS Resources

The following resources contain valuable information on cryptocurrency for both taxpayers and tax practitioners.

- Rev. Rul. 2019-24, which addresses the tax treatment of a cryptocurrency hard fork and virtual currency transactions for those who hold virtual currency as a capital asset: https://www.irs.gov/pub/irs-drop/rr-19-24.pdf
- Notice 2014-21, which contains frequently asked questions (FAQs) regarding how existing general tax principles apply to transactions using virtual currency: https://www.irs.gov/pub/irs-drop/n-14-21.pdf
- 2019 IRS FAQs on cryptocurrency: https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions

STUDY QUESTIONS

4. Which of the following statements is correct regarding the taxability of cryptocurrency transactions?

- **a.** Wages paid by virtual currency must be reported on a Form W-2.
- **b.** Virtual currency payments to independent contractors do not constitute self-employment income.
- **c.** Soft forks are taxable transactions.
- **d.** The IRS considers marketing giveaways to be passive income.

5. Which of the following identifies the process where an individual solves complex mathematical problems and provides "computing" power in order to add new transactions to the blockchain?

- **a.** Hacking
- **b.** Mining
- **c.** Phishing
- **d.** Smishing

6. Gifts of up to what amount of cryptocurrency per recipient are ***not*** subject to gift tax?

- **a.** $16,000
- **b.** $20,000
- **c.** $35,000
- **d.** $110,000

MODULE 2: TAX DEVELOPMENTS—Chapter 8: Federal Income Taxation of Trusts and Estates

¶ 801 WELCOME

As more clients are using trusts for estate planning, asset protection and wealth management purposes, and in reaction to planning issues prompted by the COVID-19 pandemic, it is essential that practitioners develop practical knowledge regarding income taxation of trusts and estates. This chapter provides a concise review of key issues and considerations that arise in connection with the income taxation of trusts and estates.

¶ 802 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Recognize how estate and trust income is taxed
- Identify how estate and trust income is defined, calculated, and reported
- Describe key compliance and planning issues as well as concerns related to fiduciary income taxation
- Identify when the decedent's taxable year ends
- Recognize which type of trust has an annual exemption of $300
- Describe trust accounting income
- Recognize the annual net capital loss deduction limitation against ordinary income
- Recognize how many months an automatic extension could be filed for Form 1041 (by using Form 7004) for an estate
- Identify the annual exemption for complex trusts
- Recognize what would apply if a fiduciary fee may be deducted

¶ 803 BASIC CONCEPTS AND ISSUES

Trusts and estates exist as creations established under state, not federal, law. The Internal Revenue Code determines how they are taxed for federal income tax purposes.

Estates

A decedent's estate is a separate taxable entity that comes into existence upon the death of an individual. The decedent's taxable year ends on his or her date of death, and the estate's year begins the same day. A separate tax identification number must be obtained for the estate by filing Form SS-4, *Application for Employer Identification Number*, with the IRS.

An estate typically has a relatively short duration. It lasts as long as it takes the fiduciary to complete the duties of administration, including marshaling and collecting the assets of the decedent and paying all of the legacies, bequests, debts, and taxes.

Income taxation. The basic concept of Subchapter J of the U.S. Code is to tax income once—either to the estate that receives it, or to the beneficiary to whom the estate

distributes it within the estate's taxable year. Distributions of income by an estate to its beneficiaries qualify the estate for an income distribution deduction.

For tax years except for 2010, the estate's basis in property acquired from a decedent is the fair market value of the property on the decedent's date of death (or on the alternate valuation date). Regardless of their actual holding period by the decedent or the estate, capital assets acquired from a decedent are considered to have been held by the estate for more than one year and thereby qualify for long-term gain or loss treatment. For deaths in 2010, if the estate elected out of the federal tax system, a modified carryover basis rule applies.

Accounting methods. An estate may utilize the cash or accrual method of accounting. It does not have to be the same method of accounting used by the decedent.

Taxable years. The estate may utilize a fiscal year; this must be elected on the first Form 1041, *U.S. Income Tax Return for Estates and Trusts*, filed for the estate.

Estimated tax payments. An estate is not required to make estimated tax payments unless it is open more than two years after the decedent's date of death. A short fiscal year counts as one tax year. The estate need not make estimated tax payments if:

- There was no tax liability for the preceding full twelve-month tax year; or
- The balance of tax due is less than $1,000.00.

Penalties are avoided if the estate makes estimated tax payments equal to either 90 percent of the tax shown on the return for the current year, or 100 percent of the tax shown on the return for the prior tax year. Where the adjusted gross income of the estate exceeds $150,000, a special rule applies, as follows:

- The required percentage of the preceding year's tax that must now be paid in a tax year to satisfy the safe harbor provisions is 110 percent for 2022 estimated payments.
- If there has been an underpayment of estimated taxes, the fiduciary should complete Form 2210, *Underpayment of Estimated Tax by Individuals, Estates and Trusts*, which calculates the underestimation penalty.

NOTE: Any estimated taxes paid by or on behalf of an individual prior to death may **not** be claimed on Form 1041.

In the final tax year of the estate, its estimated tax payments may be allocated to the beneficiaries per an election by the executor. Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries*, is used to make this allocation election, and it must be filed by the 65th day after the close of the estate's tax year.

Tax return filing requirements. A domestic estate must file Form 1041 if it:

- Has gross income in excess of $600 for the taxable year; or
- Has a beneficiary who is a nonresident alien.

If the estate meets either one of these requirements, it will receive a $600 exemption.

The due date for Form 1041 is the 15th day of the fourth month following the close of the tax year. The estate may obtain an automatic five-and-a-half-month extension of time to file Form 1041 by using Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns.*

Tax rates. The tax rates are the same for estates and trusts. For 2022, the top tax rate of 37 percent is reached at $13,450. Long-term capital gains and qualified dividends are taxed at the rate of zero percent if taxable income is $2,800 or less, or at the rate of 15 percent if taxable income is greater than $2,800 up to $13,700, or at the maximum tax rate of 20 percent when the entity's income exceeds $13,700 for 2022 subject to special

rules for the taxation of unrecaptured Code Sec. 1250 gain (25 percent) and gains realized on the sale or exchange of collectibles (28 percent).

Trusts

A trust may be created by a transfer made during the lifetime of its creator (an *inter vivos* transfer) or by transfers made taking effect upon the death of the creator (a *testamentary* transfer). Transfers made during the creator's lifetime may be either revocable or irrevocable, depending on the terms of the trust document. Each trust created by a decedent's will is a separate and distinct taxpayer that requires its own identifying number, record-keeping, annual income tax return, and so forth.

Trusts generally have a designated end date. When a trustee has discretion to distribute trust principal, the trust may end when the trustee, in the exercise of its discretion, distributes the balance of the principal, thus terminating the trust.

Income taxation. Trusts are taxed under Subchapter J of the Code, which taxes income once—either to the trust that receives it, or to the beneficiary to whom the trust distributes it within the trust's taxable year. Distributions of income by a trust to its beneficiaries qualify the trust for an income distribution deduction. Trusts may be classified generally as either *simple trusts*, *complex trusts*, or *grantor trusts*.

The terms of simple trusts (Code Secs. 651–652) require all income to be distributed currently and for the beneficiary to be taxed, whether the income is actually received or not. The trustees may not withhold or accumulate the trust income. The trust does not permit amounts to be paid, permanently set aside, or used for charitable purposes, and no trust principal is distributed in the current year. Simple trusts have an annual exemption of $300.

The terms of complex trusts (Code Secs. 661–663) allow the trustee in its discretion to either pay or to withhold or accumulate current trust income so that it is not required to pay income currently to the beneficiary. These trusts may have charitable beneficiaries. The "65-day rule" permits a trustee to elect to treat an amount paid or credited to a trust beneficiary within the first 65 days of the trust's taxable year as if distributed in the prior year. Complex trusts have an annual exemption of $100.

A grantor trust (Code Secs. 671–679) is an *inter vivos* trust, created by a person for his or her own use and benefit. A "living trust" is a grantor trust. The grantor will be taxed on all of the trust income, and the trust is disregarded as a separate taxable entity for federal income tax purposes. The grantor of a grantor trust must report all trust income on his or her own Form 1040. When the trust grantor dies, the trust typically becomes irrevocable, and the trust assets are administered according to the terms of the trust agreement.

Taxable years. In general, trusts must file returns on a calendar-year basis.

Estimated tax payments. General rules require a trust to file a declaration and make payments of estimated taxes if the trust is expected to owe $1,000 or more in tax liability. Form 1041-ES, *Estimated Income Tax for Estates and Trusts* is used for this purpose.

Underestimation penalties can be avoided if the trustee makes quarterly estimated tax payments equal in total to either:

- 90 percent of the tax shown on the return for the current taxable year, or
- 100 percent of the tax shown on the return for the prior year.

This is true unless the trust's adjusted gross income in the previous tax year exceeds $150,000, in which event the required percentage of the preceding year's tax liability that must be paid as estimated tax to satisfy the "safe harbor" provisions and

avoid a penalty for underestimating payments of estimated tax is 110 percent for 2022 estimated payments. No estimated tax payments are required from a trust if:

- The balance of tax due is less than $1,000, or
- The trust had no tax liability for the preceding full (12-month) tax year.

If excess estimated tax payments are made for a particular year, they can be either refunded to the fiduciary or applied against the tax liability for the next taxable year, or, by affirmative election, be distributed to the trust's beneficiaries via Form 1041-T. For trusts, this election may be made for any tax year. This election to allocate estimated tax payments to the trust's beneficiaries must be made on or before the 65th day following the close of the trust's taxable year.

Tax return filing requirements. Form 1041 must be filed for a trust if it has:

- Any taxable income for the tax year,
- Gross income of $600 or more regardless of taxable income, or
- A nonresident alien beneficiary.

Form 1041 must be filed on the 15th day of the fourth month following the end of the trust's taxable year. A trust can obtain an automatic five-and-a-half-month extension of time to file Form 1041 by making a timely filing of Form 7004—that is, file Form 7004 on or before the due date of Form 1041.

Tax rates. The income tax rates for ordinary income of estates and trusts are extremely compressed. Just as in the case of estates, long-term capital gains and qualified dividends will be taxed at the rate of 20 percent when the taxable income of the entity exceeds $13,700 for 2022. The net investment income tax of 3.8 percent will apply to the undistributed investment income of trusts and estates when the entity has taxable income in excess of $13,450 for 2022.

Election to treat a qualified revocable trust as part of the decedent's estate. Code Sec. 645 permits an election to be made for income tax purposes to enable a qualified revocable trust (QRT) to be treated and taxed as part of the estate, not as a separate trust. The election (referred to as the "Section 645 election") must be made by both the executor of the decedent's estate and by the trustee of the qualified revocable trust. Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*, must be filed by the due date for Form 1041 for the first tax year of the related estate.

A QRT is defined as a trust treated as owned directly by the grantor-decedent under the grantor trust rules of Code Sec. 676. The QRT election must be made no later than the due date for filing the income tax return for the first tax year of the combined electing trust and related estate, if there is an executor, or of the first taxable year of the electing trust if there is no executor.

The election is irrevocable. Once the election is made, the trust will be treated as part of and taxed as part of the estate for all tax years of the estate that end after the decedent's date of death and before the date that is the later of two years after the date of the decedent's death, or the date that is six months after the date of the final determination of the estate tax liability (the "election period").

When a Section 645 election is made for a QRT, the trustee is not required to file Form 1041 for the short taxable year of the trust beginning with the decedent's date of death and ending on December 31 of that year. Once the Section 645 election has been made, an electing trust may select a fiscal year rather than a calendar year. The electing trust may claim a $600 annual exemption, be entitled to deduct up to $25,000 in certain real estate passive losses and may deduct amounts paid or permanently set aside for charity.

Estimated taxes are due in accordance with the estate rules, not the trust rules.

The electing trust may hold S corporation stock in accordance with the broader rules allowing estates generally, but not all trusts, to be S corporation shareholders.

When the election period terminates, the combined estate and QRT are deemed to distribute all of their assets to a new trust.

Once the QRT election is made, only one Form 1041 need be filed, rather than separate returns for the trust and the estate. The executor of the related estate is responsible for filing Form 1041 for the estate and all electing trusts.

¶ 804 FUNDAMENTAL CONCEPTS

Trust Accounting Income

Trust accounting income, also known as *fiduciary accounting income*, is an accounting concept that determines how much the trustee may or may not distribute to the income beneficiaries. It is not strictly a tax law concept. Generally, trust accounting items include taxable interest, ordinary dividends, rental income, business (Schedule C) or partnership (Schedule E) income, and tax-exempt interest. Typically, capital gains are not included in trust accounting income.

Trust accounting principal items generally include the proceeds of the sale or exchange of an item of trust principal—capital gain property, generally.

Distributable Net Income

Distributable net income (DNI) is a tax concept utilized to make certain that an estate or trust acts as a conduit vehicle and avoids double taxation. The DNI concept serves several purposes:

- It establishes the maximum income distribution deduction that may be claimed by a trust or an estate.
- It establishes the maximum amount of the entity's annual income taxable to the beneficiaries.
- It determines the character of the items of income taxable to the beneficiaries.

DNI refers to taxable income, plus tax-exempt interest, reduced by allocable expenses. DNI may include capital gains when the trust instrument requires (or permits) the inclusion of capital gains in income and the distribution of capital gains to beneficiaries. State law may provide for a "power to adjust" to allow a trustee to distribute gains if not prohibited by the trust instrument. Capital gains are included in DNI in the year of termination of an estate or trust.

The basic tax concept of trusts and estates is that distributions from an entity to a beneficiary carry out DNI to that beneficiary to the extent of the entity's DNI. Exceptions to the basic DNI rule include the following:

- Specific bequests of property or specific bequests of a sum of money payable in not more than three installments do not carry out DNI.
- Payments of required bequests to charities do not carry out DNI.

If beneficiaries receive distributions in excess of the entity's DNI for the taxable year, the balance of any distribution is treated as a nontaxable principal payment to the beneficiary.

Definition of "Income" for Trust Purposes

IRS regulations have dramatically revised the definition of trust income and created situations where capital gains of a trust may be included in DNI. The "prudent investor rule" requires a trustee to invest for total return and to allocate items of principal to income, or vice versa, to treat income and remainder beneficiaries more equitably.

Increasingly popular and widespread state legislation would allow a trustee to pay a unitrust amount (on a "total return trust" concept) to the income beneficiary to satisfy that beneficiary's right to trust income. A "safe harbor" for a reasonable apportionment is stated to be a state law providing for a unitrust amount between 3 percent and 5 percent of the annual fair market value of the trust.

Reg. §1.643(a)-3(a) states the traditional rule that ordinarily capital gain will be excluded from DNI. However, Reg. §1.643(a)-3(b) addresses capital gains under Prudent Investor Act practices by providing that capital gains may be included in DNI to the extent they are allocated to income.

Taxable Income

As a general rule, the taxable income of a trust or an estate is calculated in the same manner as that of an individual. The most important difference between an individual return and a fiduciary return is that the fiduciary return permits a distribution deduction for amounts of income distributed to beneficiaries.

STUDY QUESTIONS

1. Which of the following types of trust is required to distribute all income annually and has an annual exemption of $300?

a. Grantor trust

b. Complex trust

c. Living trust

d. Simple trust

2. Which of the following types of trust is disregarded as a separate taxable entity for federal income tax purposes?

a. Simple trust

b. Grantor trust

c. Complex trust

d. Electing small business trust

3. Trusts are required to make estimated payments of taxes if the trust is expected to owe more than what amount in tax liability?

a. $10

b. $250

c. $500

d. $1,000

¶ 805 INCOME REPORTABLE BY FIDUCIARIES

Interest Income

Rules regarding reporting and taxation of interest income that apply to individuals also apply to estates and trusts. Tax-exempt interest must be accounted for and reported. It is not reported on Line 1 of Form 1041; instead, it is shown on page 3 of Form 1041 on Line 1 below "Other Information." Form 1041 does not require a separate listing of items generating the taxable or tax-exempt interest income.

Qualified Dividend Income

An allocation must be made between the beneficiary's allocable share of qualified dividends and the trust or estate's allocable share of such dividends. Qualified dividend income will be taxed at the same tax rates that apply to net long-term capital gains, that is, a 15 percent rate when the taxable income of the entity is up to $13,700 for 2022 and a 20 percent rate when the taxable income exceeds $13,700.

Business Income

If the fiduciary of an estate or trust is responsible for operating a business, the fiduciary completes Schedule C (of Form 1040) and attaches it to Form 1041. No self-employment tax on business income is reported or paid by the estate or trust. The fiduciary is not necessarily bound by the tax elections made by the preceding business owner.

Capital Gains and Losses

Generally, the capital gain and loss rules applicable to individuals apply to trusts and estates. Short-term and long-term gains and losses are reported separately. Capital losses offset capital gains in full. There is an annual net capital loss deduction limitation against ordinary income of $3,000, and any excess loss may be carried forward indefinitely. Schedule D of Form 1041 is used to report capital gains and losses, along with Form 8949, *Sales and Other Dispositions of Capital Assets*.

Income Reportable by Fiduciaries

The fiduciary must indicate on Form 1041 whether the capital gain or loss is to be allocated to the beneficiary or to the fiduciary. This will affect both DNI and the determination of whether the beneficiary or the entity will ultimately report the gain or loss.

Different income tax basis rules may be applicable to estate and trust situations. The decedent's estate receives a fair market value basis at the decedent's date of death (or alternate valuation date, if properly elected) under Code Sec. 1014, and a deemed long-term holding period (Code Sec. 1223 (11)) regardless of how long an asset was actually held by the decedent.

A trust that is a testamentary trust may receive a stepped-up basis from the decedent's death tax value. However, the assets of an *inter vivos* trust that was funded prior to the decedent's death, which has continued thereafter and the corpus of which was not included in the decedent's taxable estate, takes a carryover basis from the grantor-donor.

Rents, Royalties, Partnerships, Income from Other Estates and Trusts

If an estate or trust has income derived from rents, royalties, partnerships, S corporations, and other estates and trusts, a completed Schedule E of Form 1040 is attached to Form 1041, reporting the net aggregate gain or loss. In general, trusts and estates are

subject to the same at-risk rules and passive activity rules as are applicable to individuals. Material participation by trusts to avoid characterization as passive is controversial.

Unused fiduciary passive activity losses at the termination of the trust or estate lose their carryover potential and are not deductible by the beneficiaries. However, the benefit of the fiduciary's passive activity losses is not completely eliminated, as beneficiaries to whom a passive activity item is distributed may increase their basis in the activity by any unused (by the fiduciary) passive activity loss.

Planning Notes

Depreciation. The depreciation deduction is to be allocated between the fiduciary and the beneficiaries on the basis of the income allocated to each. If the fiduciary is required to maintain a reserve for depreciation by the governing instrument or by local law, then the fiduciary receives the depreciation deduction at least to the extent of the reserve.

Who pays income taxes on partnership or S corporation K-1 income? When a trust owns an interest in a pass-through entity, such as a partnership or an S corporation, the trust must report its share of the entity's taxable income each year, regardless of how much the entity distributes to the trust. The entity may distribute more than enough for the trustee to pay its tax on the entity's taxable income. Alternatively, the entity may distribute an amount less than the trust's tax on the entity's taxable income. Or the entity may distribute nothing.

Note that a partnership's capital gains allocated to a trust are included in the income of the trust, not as principal (see *Crisp v. United States*, 34 Fed. Cl. 112 (1995)). These rules can create a number of complex computational problems. If the pass-through entity owned by a trust or estate has taxable income and distributes nothing to the trust or estate, the trust must still report its full share of the entity's taxable income and pay the tax due. No Schedule K-1 for the taxable income is delivered to the beneficiaries of the trust or estate.

Where the entity distributes more than enough of its income to pay the income tax, but less than its total taxable income, how much is used by the trust to pay the income tax liability, and how much is distributed to the income beneficiaries? A complex algebraic calculation is required to address this.

When the pass-through entity distributes an amount equal to or greater than its taxable income, the trust or estate's tax attributable to the pass-through entity's taxable income is zero, because the deductible payments to the income beneficiary reduce the trust or estate's taxable income to zero.

Farm Income

The fiduciary completes Schedule F of Form 1040 and the required supporting schedules and reports the net amount on Form 1040. No self-employment tax on farm income is reported by an estate or trust. The fiduciary is not bound by tax elections made by the previous farm owner and is entitled to make new elections.

Ordinary Gain or Loss: Form 4797

A trust or an estate reports on Form 4797, *Sales of Business Property*, the net ordinary gain, or loss arising from the sale or exchange of property held by the trust (other than capital assets) used in a trade or business and from condemnations and other involuntary conversions, other than those arising from casualty or theft.

Other Income

This is an all-inclusive category of income items that must be reported by a trust or estate on Form 1041 not specifically included in the categories of income noted earlier. It includes the following:

- Compensation along with commissions and contingent fees due to the decedent and received by the decedent's estate after his or her death that constitutes income in respect of a decedent (IRD); and
- Distributions from pension plans, profit-sharing plans, and individual retirement accounts (IRAs), insurance contracts, etc., that constitute ordinary income.

¶ 806 DEDUCTIONS AVAILABLE TO FIDUCIARIES

General Rules

Trusts and estates are entitled to many of the same deductions as are allowed to individuals. For purposes of income taxation, there is no distinction between deductions allocated to principal and those allocated to income. A portion of some of the otherwise allowable deductions may have to be allocated to tax-exempt income received by the entity and are consequently rendered nondeductible.

A trust or an estate may not claim a standard deduction. They may claim an exemption, which is:

- $600 for an estate,
- $300 for a simple trust, and
- $100 for a complex trust.

As a general rule, deductions for expenditures that may be applicable to both a decedent's estate tax return (Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*) and the income tax return of a decedent's estate or trust (such as fiduciary and professional fees) may be claimed only once. The fiduciary must choose. Funeral expenses may not be deducted on Form 1041; they may only be claimed on Form 706.

An exception to the general rule is available for some items that constitute deductible debts of a decedent on Form 706 and also constitute deductible expenses on Form 1041 when paid by the fiduciary after the decedent's death. These items (such as business expenses, interest expenses, and state income taxes and real estate taxes owed at death and paid after death) are properly claimed as deductions in respect of a decedent or "double deductions."

Items of deduction that are directly attributable to a specific type of income must be deducted from that income. If there are deductions available that are not attributable to a specific class of income (such as fiduciary fees), these deductions may be allocated to any item of income included in the computation of distributable net income.

A decedent's unused income tax deductions at the time of death do not carry forward to the fiduciary income tax return of the decedent's estate.

Specific Items of Deduction

Interest expenses. Personal interest is nondeductible. Interest paid as qualified residence interest ($750,000 debt cap after December 15, 2017) is deductible. (The cap is $1 million if the debt was incurred before December 15, 2017.) Interest payments made arising from federal or state tax deficiencies are nondeductible.

Taxes. State and local income, real estate taxes, and personal property taxes are deductible subject to the 2017 Tax Cuts and Jobs Act (TCJA) imposing a $10,000 limitation on these deductions. State inheritance taxes and state estate and gift taxes are not deductible on Form 1041.

Fiduciary fees. Fiduciary fees may be deducted if they are reasonable in amount. To the extent such fees are allocable to tax-exempt income, the deduction for them must be reduced proportionately ("disallowance ratio" required).

Fiduciary, attorney, accounting, and preparer fees. Fiduciary, attorney, accounting, and return preparer fees may not be deducted on Form 1041 if they were previously deducted on Form 706. The decision as to where to claim a deduction generally turns on where it will do the most good, that is, where the deduction falls into the highest tax bracket. If fiduciary fees (and other estate administration expenses) are being claimed on Form 1041, a waiver must be filed affirming that amounts being deducted on Form 1041 were not claimed on Form 706.

Charitable deductions. Trusts and estates may claim an unlimited charitable deduction against their gross income. The governing instrument (will or trust) must provide specifically for the charitable contribution in order for the deduction to be available (Code Sec. 642(c)). If the fiduciary makes a voluntary payment to a charitable organization, such payment is not deductible.

Amounts contributed to a charity must be paid from gross income to be deductible on Form 1041. If the payment source is the corpus (principal) of the trust or estate, the payment to a charity is not deductible. Schedule A of Form 1041 should be completed by an estate or complex trust to compute the charitable deduction.

Payments to qualified charities made after the close of the current taxable year (Year 1) and before the end of the following taxable year (Year 2) may be treated as made in Year 1 if a special election is made as an attachment to Form 1041.

Other deductions allowed. General administration expenses, such as appraisal fees, probate fees, fiduciary bonds, judicially required accountings, asset protection and distribution fees, and so forth, are deductible on Line 15a of Form 1041. A U.S. Supreme Court case (*M.J. Knight v. Commissioner*, 552 U.S. 181 (2008)) allows estates and trusts a full deduction only for costs that individuals do not "commonly" incur (*not* investment management fees).

Miscellaneous itemized deductions suspended through 2025 by the 2017 TCJA. Ownership costs and investment advisory fees are not deductible; trustee fees must be "unbundled."

TCJA pass-through QBI deduction. The Code Sec. 199A 20 percent pass-through deduction for qualified business income (QBI) from taxable income may be claimed by trusts and estates if they have a business entity (or an interest in a real estate investment trust or publicly traded limited partnership) that qualifies for this deduction. The 2022 threshold is $170,050.

Income distribution deduction. The income distribution deduction is a unique feature of fiduciary income taxation. It permits the fiduciary to be treated as a separate taxable entity with pass-through characteristics. Income is received by the fiduciary entity. The entity deducts the income distributed to its beneficiaries, and the beneficiaries in turn report the income distributions on their own tax returns. This system prevents double taxation of the income received by the estate or trust.

Distributions from the fiduciary entity to a beneficiary carry out DNI to the beneficiary to the extent of DNI. So long as there is DNI present and a distribution to a

beneficiary occurs, DNI is deemed carried out to the beneficiary to the extent of the available DNI. If distributions are made to beneficiaries in excess of the DNI for the taxable year, the beneficiaries only report as income their respective shares of the DNI. Schedule K-1 requires a breakdown by category of the income, deductions, and credits being allocated to the beneficiary: interest, dividend, rent, short and long-term capital gain, excess deductions in the year of termination, etc.

Trust and estate income retains the same character in the hands of the beneficiaries that it had in the hands of the entity.

Estate tax deduction: Including IRD items and certain generation-skipping taxes. If the estate or trust includes an item of income in respect of a decedent (IRD) in its gross income that was also included in the decedent's taxable estate for estate tax purposes, the estate or trust may deduct the portion of the estate tax attributable to the inclusion of the item of IRD in the decedent's estate. The IRD deduction is not considered a miscellaneous itemized deduction.

Distributions in the Year of Termination

For income tax purposes, an entity in its year of termination distributes to its beneficiaries a combination of current income, previously undistributed income, and all remaining principal. In such year, all of the entity's items of income pass directly to the beneficiaries and must be included on their respective income tax returns.

In the year of termination of a trust or estate, any unused net operating loss carryforwards and unused capital loss carryforwards are passed through to the beneficiaries and retain their character in the hands of the beneficiaries. The carryforward period for NOLs and capital losses is unlimited.

Those deductions that exceed the entity's income in the year of termination may or may not be passed through to beneficiaries as "excess deductions" (only) in the year of termination.

- Accounting, legal, trustee, probate, appraisal, and other such fees *are not* miscellaneous itemized deductions, so they may be passed through.
- Fees such as investment advisory fees and property maintenance fees *are* miscellaneous itemized deductions. Therefore, they may not be passed through.

¶ 807 TRUSTS AND ESTATES AND THE ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) rules have been applicable to trusts and estates since January 1, 1987. The rules are similar to those applicable to individuals, modified to take into account situations unique to fiduciary entities. The AMT exclusion is now indexed for inflation. It is $26,500 for 2022. If the trust or estate is required to complete Schedule B for regular tax computation purposes, then Schedule I of Form 1041 must be completed for AMT purposes.

STUDY QUESTIONS

4. A trust is required to file IRS Form _____ if gross income exceeds $600 for a taxable year.

a. 1023
b. 1040
c. 1041
d. 1065

5. Form 1041 is required to be filed on the 15th day of which of the following months after the end of the trust's taxable year?

a. Third month
b. Fourth month
c. Fifth month
d. Sixth month

6. Which of the following identifies the standard deduction amount for a trust?

a. $0
b. $100
c. $300
d. $600

MODULE 2: TAX DEVELOPMENTS—Chapter 9: Mid-Year Tax Update

¶ 901 WELCOME

This chapter provides highlights of recent tax legislation, new court cases and administrative guidance, IRS issues, and other developments through mid-2022.

¶ 902 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify important new tax cases
- Recognize how to apply important new IRS guidance
- Identify the impact of new legislation on clients

¶ 903 INFLATION ADJUSTMENTS

In IR 2022-70, released on March 29, 2022, the IRS announced that educators will be able to deduct up to $300 of out-of-pocket classroom expenses when they file their federal income tax return in 2023. For tax years 2002 through 2021, the limit was $250 per year. The limit will rise in $50 increments in future years based on inflation adjustments.

This change affects many types of kindergarten to 12th-grade educators, including teachers, instructors, counselors, principals, and aides, in both public and private schools (if they work at least 900 hours). The above-the-line deduction covers a variety of out-of-pocket expenses, such as:

- Books, supplies, and other materials used in a classroom;
- Equipment including computer equipment, software, and services;
- COVID-19 protective items; and
- Professional development courses related to the curriculum

¶ 904 GROSS INCOME

For Form 1099-K, *Payment Card and Third-Party Network Transactions*, the reporting threshold will drop. "Third-party platforms" such as Etsy, Uber, Lyft, eBay, VRBO, TaskRabbit, and Venmo must file Form 1099-K for 2021 if their gross payments are greater than $20,000 and they have more than 200 transactions. For 2022, they must file if their gross payments exceed $600, even if they have just one transaction.

NOTE: These new rules apply to sales of goods and services (Treas. Reg. § 1.6050W-1) but *not* to cash transfers to friends and family. Therefore, Venmo payments to friends and family will not require the filing of Form 1099-K.

These rules apply to eBay and similar third-party network transactions. For example, if a client sells a used portable heater on eBay on May 26, 2022, eBay will report this sale (if total sales for the year are greater than $600) in January 2023. Most sales on eBay have significant costs. The new rules will reduce or eliminate gain; however, personal losses are not deductible.

EXAMPLE: Barry sells a used laptop on eBay for $600. If Barry paid $800 for the laptop and did not depreciate it, he will not have any taxable income.

The IRS estimated this change will raise almost $8.4 billion over 10 years. Tax practitioners should expect many matching notices from the IRS. One platform expects to issue over 10 million 1099-Ks for the 2022 tax year. Practitioners also should expect many questions from clients early in 2023. The Forms 1099-K for 2022 transactions must be issued by January 31, 2023, so clients need to begin keeping records now. Keep in mind that the 1099-K is for the gross amount of transactions.

EXAMPLE 1: Keiko's VRBO rentals are for the gross amount of $14,000, so her Form 1099-K will be for $14,000. However, she only receives $12,000 after VRBO deducts fees. Keiko should report the $14,000 gross and deduct $2,000 in fees. She can get details about the fees on the VRBO website.

EXAMPLE 2: Phil drives for Uber. In 2021, he provided 180 rides and had $9,000 in receipts. Phil will not receive Form 1099-K. But if he receives $600 in 2022 for two rides, he *will* get a 1099-K.

EXAMPLE 3: Tamika rents out a vacation home in Miami through VRBO. She has 35 rentals per year and $45,000 in gross receipts. In 2021, Tamika will not receive Form 1099-K (her gross receipts are over $20,000, but she has fewer than 200 transactions). In 2022, she will receive a 1099-K if she has over $600 in gross receipts.

EXAMPLE 4: In 2022, Steve sells three items on eBay for $600. He will receive a Form 1099-K.

A study by the Independent Economy Council notes that trouble is brewing for independent contractors. Forty-nine percent of these workers are not making estimated tax payments, and 40 percent will not be able to pay their taxes. Coupled with lower Form 1099-K reporting for the 2022 tax year, this will likely result in a bit of a meltdown in the 2023 filing season.

Although there currently is a bill in Congress that would increase the 2022 threshold to $5,000, it is not clear whether this will pass.

¶ 905 CRYPTOCURRENCY

Traditional tax concepts are being tested by new technology, such as cryptocurrency. The lack of existing cases in this area is causing practitioners to draw analogies between prior cases and those involving new technology.

Keep in mind that no single company or person monitors and issues cryptocurrency. Rather, the activity is performed through a free-functioning software program. The software itself monitors cryptocurrency and issues new cryptocurrency. The software is not owned by any person.

Staking and Mining

One risk of cryptocurrency is that someone might spend the same bitcoin twice. To eliminate this risk of "double-spending," two common security methods are used: *staking* and *mining*. With staking (used by the blockchain Tezos and to be used by Ethereum 2.0), you pledge your cryptocurrency; you cannot sell it. You add information to the database to authenticate other transactions, so there is no double-spending. With mining (used by Bitcoin), you employ enormous amounts of computer power to solve complex math problems. If you solve the problem, you may submit information that is used to ensure there is no double-spending. To entice crypto owners to stake and mine, these exchanges offer users additional cryptocurrency.

EXAMPLE: Tezos will create new cryptocurrency and transfer it to Jerry *if* he helps validate transactions to ensure there is no double-spending of Bitcoin. Jerry

pledges cryptocurrency and agrees not to sell it for a period of time. In exchange for his pledge, Tezos issues Jerry new tokens. Is the new cryptocurrency Jerry received taxable?

The IRS's position is that mining is taxable when new cryptocurrency is received (Notice 2014-21, A-8). Although staking is not addressed in the Notice, staking bears many similarities to mining.

In *Jarrett v. United States* (DC MD TN), Mr. Jarrett argued that receipt of new cryptocurrency from staking is not taxable; it would only be taxable later when he sells the cryptocurrency he had received. Jarrett's refund claim was $4,000. Jarrett's arguments included the following:

- A gold miner does not have income when he finds gold; the miner does not pay tax until he sells the gold. Similarly, cryptocurrency "stakers" have no income when they receive cryptocurrency, so they should not have to pay tax until they sell it.
- Artists do not have income when they create art; they have income only when they later sell the art.
- Receiving cryptocurrency is not a payment for services. There is no third party (such as an employer) to pay for the services.

The IRS granted Mr. Jarrett his $4,000 refund, and the cryptocurrency community exploded in excitement. The assumption was the IRS was conceding this issue. Although the refund of Jarrett's $4,000 does not have any legal weight, it is very interesting. Possible IRS counterarguments to Jarret's analogies include the following:

- Jarrett: A gold miner does not have income when he finds gold.
  - — IRS: Staking is more like receiving rent (payment for the use of property). A staker agrees to pledge (not to sell) cryptocurrency, and their cryptocurrency data is used to verify other transactions. If a gold miner received rent for his use of the gold, he would have to pay tax on it.
- Jarrett: Artists do not have income when they create art.
  - — IRS: The staker did not create new cryptocurrency; the software did.
- Jarrett: Receiving cryptocurrency is not a payment for services. There is no third party (such as an employer) to pay for the services.
  - — IRS: Whether services are paid for by a person is irrelevant; Jarrett received property.

Cryptocurrency Reporting

Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, will be required for digital assets, including cryptocurrency. According to the IRS, a broker or barter exchange must file this form for each person:

- "For whom they sold stocks, commodities, regulated futures contracts, foreign currency contracts, forward contracts, debt instruments, options, securities futures contracts, etc., for cash,
- Who received cash, stock, or other property from a corporation that the broker knows or has reason to know has had its stock acquired in an acquisition of control or had a substantial change in capital structure reportable on Form 8806, or
- Who exchanged property or services through a barter exchange."

There are hefty penalties for failure to file Form 1099-B.

Cryptocurrency and FBAR

In its Notice 2020-2, the Financial Crimes Enforcement Network (FinCEN) indicated it would amend its regulations to require a Report of Foreign Bank and Financial Accounts (FBAR) for foreign cryptocurrency accounts. As of this writing, the regulations have not yet been amended, but the changes may be released in 2022 or 2023. Form 1099-B reporting for cryptocurrency transactions will begin on January 1, 2023, but this covers domestic exchanges. If FinCEN amends its regulations, foreign exchanges would be reported through the FBAR.

Cryptocurrency is property, if held on a foreign cryptocurrency platform. The IRS has hinted that cryptocurrency over the filing threshold should be reported on Form 8938, *Statement of Specified Foreign Financial Assets*. Practitioners should stay alert for any such reporting developments.

IRS Cryptocurrency Seizures

The IRS has acquired cutting-edge technologies to find and trace cryptocurrency, and its crypto seizures have skyrocketed. In 2019, the IRS seized $700,000 in cryptocurrency. That number rose to $100 million in 2020. In 2021, the IRS made its first ever $1 billion seizure of crypto, and in 2022, one seizure alone amounted to $3.6 billion.

NFT Artwork Taxation

A non-fungible token (NFT) is a digital asset stored in a blockchain that represents a real-world item such as artwork, music, videos, or pictures. NFTs use the same blockchain technology as Bitcoin. For example, the NFT (piece of digital artwork) "Everydays: The First 5000 Days" sold for $69.3 million. But how are these digital assets taxed?

Currently, there is only guidance that covers digital currencies, such as Bitcoin (Notice 2014-21). According to Treasury Secretary Janet Yellen's comments on April 7, 2022, the Treasury Department should apply the same approach to other digital assets, including artwork NFTs. For taxation purposes, digital currency (and presumably artwork NFTs) should be treated as property, usually creating a capital gain or loss.

EXAMPLE: Javier buys a digital asset as an investment for $1,000 and sells it two years later for $2,000. This should produce a $1,000 long-term capital gain, just as it would if Javier had purchased actual artwork (Notice 2014-21, A-4). The treatment would likely be different, however if Javier created an NFT or received it for services performed. This would be ordinary income, subject to self-employment tax if Javier is not an employee (Notice 2014-21, A-9 and A-10).

¶ 906 TAXES AND INFLATION

The annual inflation rate hit 8.3 percent in April 2022. Inflation is impacting federal taxes in several ways:

- Many tax ceiling limits are fixed (not indexed for inflation):
  - — Home sale exclusions are $250,000/$500,000. If they had been indexed for inflation, they would be $454,000/$908,000.
  - — Active participation for passive rentals—the phaseout begins at modified adjusted gross income of $100,000. If the phaseout had been indexed for inflation, it would be $263,785.
  - — $200,000/$250,000 net investment income tax (NIIT) threshold.

- The value of tax deferrals is increasing:
  - — At 8 percent, deferring tax for one year means a taxpayer is paying the equivalent of $.92 on the dollar.
- The IRS interest rate with regard to tax underpayments and overpayments rose to 5 percent beginning July 1, 2022 (Rev. Rul. 2022-11).

Strategies for Tax Ceilings

The $250,000/$500,000 limit excludes the gain on a sale of a residence. It is much more common to have gains on the sale of a principal residence that is over the limit. Strategies for dealing with this include the following:

- Make sure to pick up closing costs.
  - — Obtain the closing statements (for the purchase and the sale). If the client doesn't have these, check with the broker.
- Get the cost of capitalizable improvements.
  - — Give clients a list of common improvements to jog their memories.
  - — Have clients walk around the house and grounds to ensure they are picking up everything.
  - — If the client lacks exact numbers, make estimates. Estimates are generally acceptable under the Cohan rule. See *Estate of Gunther*, TC Memo 1954-181.
  - — Take pictures of improvements.
- Planning: Clients should set up a receipts folder for improvements.

Improvements increase the costs basis of the home. Examples of common basis increases (largely from IRS Publication 523, *Selling Your Home*) include:

- Grounds: Landscaping, driveway, walkway, fence, retaining wall, pool
- Exterior: windows, doors, new roof, new siding, satellite dish, driveway
- Insulation
- Systems: furnace, central air conditioning, sprinkler system, wiring
- Plumbing: septic system, water heater, water system, filtration system
- Interior: Built-in appliances, flooring, carpeting, fireplace
- Additions to home: new bedroom, garage, deck, porch, patio

Basis increases also include entryway upgrades, granite countertops, new cabinets, fire pits, remodels (including bathroom, kitchen, dining room, bedroom, basement, and other rooms), new blinds, a security system, flooring, and paneling.

Expenditures (repairs) that do not increase basis include painting, fixing leaks, replacing a faucet or toilet, etc. However, there is an exception for painting or other work done as part of a remodel (Treas. Reg. § 1.263(a)-3(g)(1)(ii)).

EXAMPLE: Stu and Kanesha remodel their kitchen. At the same time, they repaint the kitchen. They can capitalize the cost of painting.

Impact of Home Office in Principal Residence

Home office depreciation taken after May 6, 1997, is "unrecaptured Section 1250 gain." It is only treated as capital gain subject to the top tax rate of 25 percent.

EXAMPLE: Manuel is married and filing a joint return. His home office represents 10 percent of the floor space inside his home. He has taken $12,000 in depreciation expenses after May 6, 1997. Manuel meets the test to exclude the gain on the sale of his principal residence (use, ownership, no prior sale of residence on which there was excluded gain in the prior two-year period).

The gain on the sale of his residence is $400,000. Normally, the result would be entirely tax-free (but for the depreciation on the home office). The effect of the home office depreciation is that Manuel picks up $12,000 gain (the amount of depreciation he'd previously claimed), which is subject to the 25 percent capital gains tax rate. Manuel does not have to report any more gain; for example, he does not report gain on 10 percent of the sale of the property (Treas. Reg. § 1.121-1(e)(4), Example 5).

Tax Deferrals

Most practitioners regularly help clients defer income, but doing so takes on new importance with rising inflation. Traditional strategies for deferring tax are as follows:

- Defer income if the taxpayer expects to be in the same or a lower tax bracket next year.
  - — If the business is a cash method business, it should send out business invoices a bit later in December and should buy equipment and pay bills.
  - — Defer bonuses. These can be deferred before they are payable.
  - — Purchase equipment before year-end.
- Installment sales of real property.
- Contribute to deductible individual retirement accounts (IRAs) and/or retirement plans.
- Use health savings accounts if the taxpayer has a "high-deductible health plan."

IRS Interest Rates Increase

The IRS interest (late payment of taxes) and estimated tax penalty rates increased to 5 percent beginning July 1, 2022. Should clients put more of a cushion in extension payments since the cost of being wrong is increasing? Is the client more likely to utilize the 100 percent/110 percent safe harbors for estimated tax payments? Paying more tax in advance makes sense, especially if the client has a great deal of money in a checking account or in a low-interest rate money market account.

Recap: Taxes and Inflation	
Annual inflation	8.3 percent
Fixed limits *not* indexed for inflation	Principal residence gain exclusion. Strategies to reduce gain. Active participation for rentals. NIIT threshold.
Increase in IRS interest rates/ES underpayment rates	Put more "cushion" in extension estimates? Pay 100 percent/110 percent safe harbor ES?
Value of deferrals	Increased as result of inflation. Deferring taxes has greater value. Paying in future with less valuable $.

¶ 907 BUSINESS AND INVESTMENT DEDUCTIONS

Bonus Depreciation Changes

December 2022 marks the five-year anniversary of the Tax Cuts and Jobs Act (TCJA). That means 100 percent bonus depreciation will begin to phase out in 2023.

NOTE: If a recession occurs, 100 percent bonus depreciation may be extended.

Be aware that the Code Sec. 179 deduction and the *de minimis* safe harbor are not phasing out. In fact, they become more valuable as bonus depreciation begins to phase out. It is more important than ever to make a *de minimis* election.

Bonus Depreciation Percentages	
Placed in Service*	**Bonus Percentage****
9/28/17 to 2022	100 percent
2023	80 percent
2024	60 percent
2025	40 percent
2026	20 percent
2027	None
* Property must also be *acquired* after 9/27/17. ** Special rule applies to longer production period property and certain planes.	

Research Expenditures

The TCJA rule for research costs (Code Sec. 174) is effective for years beginning after 2021. For most clients, that is the 2022 calendar year. Taxpayers must amortize research over five years, or 15 years if it is foreign research. Research costs have historically been deductible, but this will change unless Congress acts. The Senate voted 90–5 to instruct conferees on another bill to fix this issue, so there is a chance Congress will eliminate or defer this rule.

In May 2022, Senator Ron Wyden, chair of the Senate Finance Committee, said he will push to retain the prior rule and allow the continuation of the deduction treatment. This rule affects more clients than one might initially think, because research expenditures include most software development.

Hobby Loss Case

In *Jessica Walters v. Commissioner*, TC Memo 2022-17, Walters and her parents were the owners of a real estate partnership, D&J Properties. D&J historically owned three buildings that were rented to La-Z-Boy stores. All partners had experience in environmentally friendly ("green") real estate. One partner, Jessica's father, studied LEED certification and lectured at a local college, and Jessica had a degree in environmental science.

D&J decided to transition to the green real estate business. They constructed a green home in an eco-friendly development that had a wine cellar, putting green, and greenhouse. D&J promoted and advertised the property and gave tours to prospective customers. It was also involved in discussions about other green projects, but those were not consummated.

However, there were also many personal aspects to the project, such as:

- Golf club memberships were purchased for Jessica, her parents, and her grandparents.
- Six personal cars (the daughter's, parents', and grandparents') were registered in the name of D&J.
- D&J had wine, bicycles, and DirecTV at the green house.
- The parents spent approximately 132 days at the green home in the first year.
- Expenses ($18,000) for Atlanta Braves season tickets and a PGA golf tournament were charged to the partnership.

In determining whether D&J's activity was a business or a hobby, the hobby loss rules were considered, and the results are outlined in the following chart:

Factor	Result	Winner
Businesslike manner	Good: Careful accounting records, advertising. Bad: Deducted lots of personal expenses.	Tie
Taxpayer/adviser expertise	Lots of knowledge about green real estate.	D&J
Time/effort spent	Good: Spent lots of time, did lots of maintenance. Bad: Part of the time was spent playing golf, etc.	D&J
Expectation that assets would increase in value	IRS agreed it was reasonable to expect real estate to increase in value.	D&J
Success in other activities	Had success in La-Z-Boy stores and other businesses.	D&J
History of losses in this activity	Lost money, but that was due to the "Great Recession."	D&J
Occasional profits earned?	Never had any income from green real estate.	IRS
Is the taxpayer wealthy?	Worth $3 million, but all in personal residence and green project. Income was $40,000/month.	Tie
Personal pleasure?	Good: Worked on maintenance at green property. Bad: Used the golf course and extensive cable TV package.	Tie

Surprisingly, the Tax Court ultimately sided with the taxpayers, stating, "The factors of this case support a conclusion that the partnership was engaged in a for-profit activity."

¶ 908 CANNABIS

There is a special rule for cannabis business taxation. Deductions and credits are disallowed; there is no tax benefit. This covers deductions "paid or incurred" (Code Sec. 280E). The cost of goods sold provides a tax benefit because it reduces income. Therefore, cannabis businesses should try to capitalize their cost of goods sold to obtain a tax benefit.

> **EXAMPLE:** Green Cross LLC is a cannabis retail business. As a tax strategy, Green Cross should capitalize as many expenditures as possible to cost of goods sold since deductions provide no tax benefit.

The case of *Alternative Therapies Group, Inc. v. Commissioner*, No. 266-22, makes an interesting argument. The TCJA allowed small businesses to use a new rule for tax inventories (Code Sec. 471(c)). The rule stated that if a business capitalizes its financial statement inventory, it can also use it for tax purposes. Unfortunately, the IRS issued regulations in 2021 that stated even if a taxpayer capitalizes nondeductible costs into its financial statements, it cannot capitalize for tax purposes. Alternative Therapies argued that this regulation is invalid due to failure to comply with the Administrative Procedures Act (which will be discussed later in this chapter). Alternative Therapies' strategy was that it is a "small business" and therefore can use its financial statement inventory for tax purposes. It capitalized all of its costs to inventory in its financial statements, so there are no deductions to disallow.

The Code Sec. 199A qualified business income deduction (QBID) may be allowable for cannabis businesses. Remember that only deductions "paid or incurred" are disallowed under Code Sec. 199A. The QBID does not require a payment of cash, nor does it require incurring a liability. In a recent case, *Lord v. Commissioner*, TC Memo 2022-14, the IRS and the taxpayer agreed that a Code Sec. 199 deduction needed to be computed. Code Sec.199 was the predecessor of the QBID. It appears that the IRS is allowing this, so it presumably would allow the QBID.

¶ 909 PASSIVE ACTIVITIES

Rogerson Case

In *Rogerson v. Commissioner*, TC Memo 2022-49, the IRS addressed the issue of material participation. Michael Rogerson started his first aerospace company while still in college. He is a micromanager, involved in all areas of his aerospace companies, and he appeared to be worth approximately $400 million. The IRS disallowed millions of dollars from his yacht chartering activity because, according to the IRS, it was a passive activity.

Rogerson intended to charter his yachts but never actually chartered them. The yachts were considered tangible property held for use by customers and therefore rental activities under Code Sec. 469(j)(8). Rental activities suffer from the "curse" of being automatically passive, even if a taxpayer materially participates in them. However, there are some exceptions to this "curse":

- Real estate professionals are excepted (not pertinent here).
- Average period of customer use of the rental is seven days or less.
- Average period of customer use of the rental is 30 days or less and involved significant personal services.
- The rental activity is grouped with a related activity.

Rogerson said he "intended" to lease the yachts for the short term. If he had leased them, the lease would have been for an average period of customer use of seven days or less. Therefore, he would not have met that exception to the curse. The activity would not have been automatically passive. Rogerson would still have to show he materially participated, even if he met the exception.

The Tax Court found that because there was no customer use of the yachts, it was impossible to determine what the average period of customer use was. Therefore, Rogerson did not qualify for the short-term rental exception to the "curse."

As mentioned earlier, Rogerson was very involved in his aerospace company. As a micromanager, he did the following:

- Monitored operations
- Was extensively involved in sales and customer relations
  - — He had to approve bids greater than $100,000. In one month alone, he had to approve 12 bids. He also traveled to meet with customers.
- Communicated with executives on weekends and holidays (at least 10 to 15 hours/month)
- Made decisions on staffing matters
- Had the last word on hiring new employees
- Approved capital improvements
- Provided input on accounting matters
- Set departmental budgets and had to approve all bonuses and hourly rate increases

Despite this, Rogerson claimed to be passive—that he did not materially participate in the aerospace company activities.

The tax principle regarding net passive income and losses is that only the net passive loss is nondeductible. For example, if a taxpayer has a net passive loss of $5 million, it cannot deduct it; it must suspend it and carry it over. Rogerson's objective was to make the aerospace company a passive income generator. If the aerospace company

was a passive activity, Rogerson's $5 million in passive income could offset his $5 million in passive losses from the yachts, resulting in a net passive loss of $0 and no tax due.

However, Rogerson was very active in the aerospace company. He owned an aerospace S corporation for decades. It was a single aerospace company from 2005 through 2013. He reported this activity as nonpassive, and the Tax Court considered this as one big activity. In 2014, Rogerson divided the single company into three separate companies and argued that one of these three divided companies was passive.

There are seven material participation tests, and meeting any one of them results in material participation. The IRS said Rogerson materially participated using the "5 out of 10 prior year" test. Because he treated the combined aerospace operations as a single activity through 2013, they would all be treated as a single activity in measuring his material participation.

Therefore, Rogerson did not have a passive income generator; the income of the aerospace companies was nonpassive and could not offset the passive losses from the yacht chartering business. Takeaways from this case include the following:

- If you are a micromanager, you almost certainly materially participate in your business. The income is nonpassive and cannot offset your passive losses.
- Rental activities (real and personal property) are automatically passive unless a special rule applies.

Real Estate Professionals

For qualified real estate professionals, there is an exception to the "curse" of rental activity being automatically passive. Real estate professionals can treat rentals as nonpassive activities if they materially participate. They demonstrate material participation by clearing two tests:

- **Test 1:** More than 50 percent of the personal services the real estate professional performs are in "real property businesses" in which the professional materially participates.
- **Test 2:** The real estate professional spends more than 750 hours per year providing personal services in "real property businesses" in which the professional materially participates (Code Sec 469(c)(7)(B)).

According to Code Sec. 469(c)(7)(C), real property businesses include development, redevelopment, construction, reconstruction, remodeling, acquisition, conversion, rental, operation, management, leasing, or brokerage businesses.

NOTE: For married real estate professionals, one spouse alone must meet the 750-hour and 50 percent material participation tests.

In the case of *Sezonov v. Commissioner*, TC Memo 2022-40, Christian and Francine Sezonov bought two rental properties in Florida in 2013. They deducted losses on the rentals. Remember that rental properties normally suffer from the "curse" of the rentals and are treated as automatically passive, even if the taxpayer materially participates.

The Sezonovs spent the following number of hours on their rentals: Mr. Sezonov—405 hours in 2013 and 26 hours in 2014; Mrs. Sezonov—476 hours in 2013 and 40 hours in 2014.

The Tax Court held that neither spouse met the 750-hour requirement for either year, and therefore the Sezonovs were not real estate professionals. The rentals were treated as passive activity (even if they materially participated). Their losses were suspended and carried over to future years.

¶ 910 PARTNERSHIPS AND S CORPORATIONS

When a limited liability company (LLC) elects to be taxed as an S corporation, it cannot have a second class of stock; S corporations are prohibited from having a second class of stock. Each share of stock must have identical rights to regular and liquidating distributions. In many cases, the LLC agreement was prepared by an attorney, thinking the LLC was a partnership. The agreement would have boilerplate language about "maintaining capital accounts" and "liquidating distributions in accordance with positive capital accounts." The IRS believes this language causes a second class of stock.

Therefore, if an LLC plans to make an S corporation election, *before* the first day it wants the S corporation election to be effective, it should strip out all partnership provisions from its operating agreement and have a simple distribution structure (always proportionate to ownership interest).

The safest course for an entity faced with this problem is to file a Private Letter Ruling request. Note that an issue may not exist if there is only one shareholder (PLR 202111010). Congress's reason for the "no second class of stock" rule was to avoid complexity (see *Portage Plastics Co., Inc.*, 31 AFTR 2d 73-864).

STUDY QUESTIONS

1. Which of the following is an example of an above-the-line deduction that was increased from 2021 to 2022?

- **a.** Charitable deductions
- **b.** State and local taxes paid
- **c.** Educator expenses
- **d.** Gambling losses

2. A Form 1099-K is required to be provided beginning in 2022 if payments from a third-party platform exceed what amount?

- **a.** $200
- **b.** $300
- **c.** $500
- **d.** $600

3. Which of the following statements is correct with respect to cryptocurrency?

- **a.** There is no single company or person that monitors and issues cryptocurrency.
- **b.** The concept of staking is used by Bitcoin.
- **c.** The IRS notes that mining is taxable when the process commences.
- **d.** Form 1099-B will be required for digital assets starting in 2022.

4. Under the _____ rule, the Tax Court has concluded that estimates are generally acceptable.

- **a.** Sampson
- **b.** Hefty
- **c.** Cohan
- **d.** Dougherty

¶ 911 CENTRALIZED PARTNERSHIP AUDIT REGIME

The IRS's Centralized Partnership Audit Regime (CPAR) enables the IRS to assess tax at the partnership level for any perceived deficiency in tax paid by a partner on a partnership item (referred to as an *imputed underpayment*). Partnerships can elect out of the CPAR by checking the "yes" box on page 3, line 29 of Form 1065, *U.S. Return of Partnership Income*. Electing out of the CPAR:

- Keeps the IRS from shifting work to tax preparers if the partnership is audited;
- Avoids the extreme difficulty of amending returns (CPAR requires Administrative Adjustment Requests, or AARs); and
- Eliminates "partnership representative" risk.

If a partnership does not elect out of the CPAR, it must designate a partnership representative (in line 29).

The first results of the CPAR system were released in 2022 in Tax Inspector General Report Number 2022-30-020. The report noted that 78 percent of partnerships audited received "no change" reports. The IRS accepted returns without proposing any changes to income. To be eligible to opt out of the CPAR, a partnership must:

- Have 100 or fewer Form K-1s. If it has an S corporation as a partner, it should count the K-1s the S corporation issues to shareholders.
- Only have the following as partners:
  - — Individuals
  - — Deceased partner's estates
  - — C corporations
  - — S corporations
  - — Foreign entity requesting to be a corporation if domestic (including "per se" corporations)

Partner types that prevent election out of the CPAR include:

- Trusts
- Partnerships
- Disregarded entities (Final Regulations issued on January 2, 2018, take the position that disregarded entities are not eligible partners.)
- A person who holds interests on behalf of another
- Estates other than those of deceased individuals

¶ 912 PENSIONS AND IRAs

SECURE Act Provisions

There are two versions of the Setting Every Community Up for Retirement Enhancement (SECURE) Act. SECURE Act 1.0 was passed in late 2019, and SECURE Act 2.0 has not yet been enacted as of this writing.

SECURE Act 1.0 eliminated "stretch" IRAs (defined contribution plans, and traditional and Roth IRAs). For most participants dying after December 31, 2019, the decedent's beneficiary must withdraw the entire account by the end of year containing the 10th anniversary of the decedent's death.

NOTE: For planning purposes, the beneficiary should withdraw the account in lower tax bracket years.

Five types of beneficiaries are not subject to this requirement: the surviving spouse, minor children of the deceased participant, the disabled, the chronically ill, and beneficiaries who are not more than 10 years younger than the decedent.

The proposed SECURE Act 1.0 regulations, released in 2022, contain an unpleasant surprise. Most thought that distributions could be delayed until the *end* of the 10th year. This is especially important for Roth IRAs as waiting until the last day of the 10-year period would allow as much non-taxable income as possible. However, the proposed regulations require distributions in each year of the 10 years after death if the decedent had already reached age 72 at the time of death. (Prop. Reg. § 1.401(a)(9)(5)(d)). The good news is that it is quite possible this will change in the final regulations. The regulations would be effective beginning January 1, 2022.

SECURE Act 2.0 (HR 2954) was passed by the House with overwhelming bipartisan support (414–5). It was then received by the Senate and referred to the Finance Committee. It is expected to be included as part of "must pass" legislation like the appropriations bill. As of this writing, the SECURE Act 2.0 provisions include the following:

- Changes to timing for required minimum distributions (RMDs). The law would delay the beginning date for RMDs until the taxpayer is 75 years old. The delay would be gradually phased in:
  - — In 2023, RMDs would commence at age 73; in 2030, age 74; and in 2033, age 75.
- Increased "catch-up" provision for those 50 or older by year-end.
  - — The current $6,500 provision would increase to $10,000 (401(k) and 403(b)).
  - — The current $3,000 provision would increase to $5,000 for SIMPLE plans.
- Employers would be able to contribute to 401(k) plans on behalf of an employee to pay off an employee's student loans.
- More part-time workers would be allowed to enter 401(k) plans.
- Enrollment would be automatic (unless an employee affirmatively opts out).
- There would be an increased credit for start-up businesses' administrative setup costs.

Cryptocurrency and Retirement Plans

In May 2022, NBC News reported that Fidelity Investments is giving companies the option to allow employees to invest up to 20 percent of their 401(k) plans in bitcoin. Aware of such developments, the U.S. Department of Labor issued Compliance Assistance Release No. 2022-01, warning that plan fiduciaries (including 401(k) plans) should exercise "extreme care" before adding cryptocurrency to the investment menu for plan participants. The release stated that fiduciaries have standards of professional care that are the "highest known in law."

¶ 913 ITEMIZED DEDUCTIONS

State and Local Taxes

Recent developments on the $10,000 tax limit for itemizers include the following:

- There are efforts to increase the limit. Although congressmen are pressing to attach an increase to the spending bill, this is probably not going to happen.
- The Supreme Court has decided not to hear a $10,000 limit tax case. Some states had challenged the constitutionality of the limit; see *New York v. Yellen*.
- Twenty-seven states have passed partnership/S corporation entity-level income taxes. These are deductible above the line (Notice 2020-75).

Charitable Contributions

In *Lafayette Nelson v. Commissioner*, Docket No. 892-19 (Bench Opinion), Mr. Nelson made over $3,000 in cash charitable contributions. All contributions were apparently in the amount of $250 or more. However, Nelson failed to get contemporaneous written acknowledgements (CWAs) acknowledging the amount of the gifts and including a statement that he did not receive goods or services in return. CWAs must be received by the earlier of the date the return is filed or the final due date of the return.

> **EXAMPLE:** Allie made a $250 charitable contribution in 2021. She extended the due date for filing her return until October 15, 2022, and then filed her return on May 26, 2022. Allie must have a CWA for her contribution by May 26, 2022.

Because Nelson did not have CWAs when he filed his return, he will get no deductions for the contributions, even if he can prove he made them. Note that the CWA requirement applies to both cash and noncash contributions. Some clients keep their contributions below $250 at one time to avoid the CWA requirement.

> **EXAMPLE:** Sue wants to make a cash contribution (to a food bank) and a noncash contribution (donation of clothing to Goodwill). She chooses to make more frequent small contributions to avoid the CWA requirement. She makes a $245 cash contribution to the food bank and a $240 noncash contribution to Goodwill. She is not required to get a CWA for either contribution.

¶ 914 IRS ISSUES AND DEVELOPMENTS

Free Electronic Tax Return Filing

For decades, the IRS has had an agreement with tax software providers to offer free electronic filing of tax returns to lower income taxpayers. However, there have been accusations that software providers have made it very difficult for taxpayers to free file, and that they tried to "steer" low-income taxpayers to pay for filing. Only about 4 percent of low-income taxpayers actually used free file, and two of the largest free-file providers have pulled out of the IRS agreement, no longer offering free-file services.

On May 4, 2022, Intuit settled a lawsuit, agreeing to pay $141 million to customers who paid for its software but should have received free return filing.

Will the IRS Prepare Tax Returns?

In dozens of countries, governments prepare tax returns. For example, in Portugal, the government partially fills out a taxpayer's tax return based on the information it has. The taxpayer provides the missing information (e.g., rental expenses) and then signs the return.

A new study indicates that the IRS could prepare close to half of all tax returns in the United States, especially those for low- and middle-income taxpayers. For accuracy, the IRS would need information about a taxpayer's dependents before preparing the returns. Bills have been introduced in the House and the Senate for the IRS to offer such free filing. The IRS would enter on the taxpayer's return the information it has (from Forms W-2, 1099, etc.) to make preparation easier. Practitioners should stay tuned for developments in this area.

IRS Crackdowns

The IRS has focused on cracking down on certain tax arrangements. These include:

- Abusive research and development credits
- Conservation easements
  - — Typically, a developer provides an easement to a conservation charity. It promises to never develop a portion of the property (charitable deduction).

- Microcaptive insurance arrangements
  - — A U.S. company sets up its own small insurance company. It deducts premiums, but the insurance company does not report that as income.

Recent developments related to these crackdowns are discussed below.

Research and development (R&D) credits. The *Houston Chronicle* reported that the IRS raided AlliantGroup's headquarters. AlliantGroup has performed many R&D credit studies. The raid reportedly occurred on May 20, 2022, but as of this writing further details have not yet been released. AlliantGroup stated that it is fully cooperating with the IRS.

Conservation easements. On March 1, 2022, the Department of Justice Office of Public Affairs announced the indictment of four CPAs and two appraisers in an abusive conservation easement contributions case. Allegations include the following:

- Easements were appraised at a very high fair market value—10 times more than the purchase price paid months before.
- The CPAs provided spreadsheets to the appraisers with pre-set values. The values helped deliver tax deductions that had been promised to investors.
- Sales documents were backdated to the prior year to allow tax deductions.

Microcaptive insurance. Microcaptive insurance companies are under attack by the IRS. IRS Notice 2016-66 has identified them as "Transactions of Interest," and it has formed 12 microcaptive auditing teams. Typically, under a microcaptive arrangement, a partnership or corporation sets up a related "insurance company" and deducts large premiums paid to that company. The microcaptive insurance company excludes the premiums from income by making an election under Code Sec. 831(b).

The IRS argues that such microcaptive insurance companies are not in reality insurance companies. They did not "adequately distribute risk"; the only insured customers were related parties. Microcaptive insurance companies often do not charge arm's-length premiums. Instead, they charge higher premiums than a real insurance company would charge.

In *Reserve Mechanical Corp. v. Commissioner* (CA-10), the Tenth Circuit denied tax benefits to a microcaptive insurance company. The court found the following:

- There was no distribution of risk.
  - — The same people owned the mining company (the insured) and the microcaptive (the insurer).
  - — Insurance is not really insurance unless risk is distributed among many people; the microcaptive entered into a pool to make it appear it was distributing risk.
- The microcaptive did not charge arm's-length premiums. The original insurance company (an unrelated third-party) charged $94,000 in premiums, whereas the microcaptive (which the business owned) charged $438,000.

As a result, the microcaptive insurance company paid a 30 percent tax on the premiums.

Congressional Hearings on the IRS

Members of Congress on both sides of the aisle have urged President Biden to replace IRS Commissioner Charles P. Rettig. Although some members of Congress still support Commissioner Rettig, others have attacked the IRS on many fronts, including its destruction of documents, backlog of paperwork, low rate of answering phone calls, and its audit selection process.

Paper Documents

A recent report by the Treasury Inspector General for Tax Administration (TIGTA) noted that in March 2021, the IRS purposely destroyed 30 million paper documents, mainly Forms 1099—including documents that it had not yet processed. The IRS's explanation for the destruction of these documents included that it needed a system update prior to the 2021 filing season, that it has antiquated technology, and that it is focusing on reducing its backlog of tax returns. The IRS stated that only 1 percent of all paper information returns were destroyed.

The IRS also said it will not impose a failure-to-file penalty on Forms 1099 if a client says they sent in the forms. The IRS point out that many of the forms have been shredded.

Phone Call Workaround

The IRS answers only about 11 percent of the phone calls it receives. Its incoming phone call volume increased 400 percent between 2019 and 2021. EnQ, a private company, has developed a solution to this problem. Its software "gets in line" on the IRS switchboard and sells time-saving slots close to being answered.

To address this problem, the IRS is also using voice "chatbots" to cover some phone calls. Powered by artificial intelligence, the chatbots mainly help with inquiries about how to make payments, answers to frequently asked questions, and IRS collection notice clarification. However, taxpayers can still talk to a real person if necessary (IR-2022-56).

Backlog

The IRS normally has a backlog of less than 1 million documents, but as of April 8, 2022, its backlog was 26.2 million documents. Reasons for this accumulation of unprocessed documents include COVID-19 issues, the processing of economic impact payments, and ongoing staffing issues.

In response, the IRS has formed a surge team by shifting 800 employees to help it catch up. It will also shift another 700 employees to the team. Overtime is now mandatory for 6,000 employees and optional for another 10,000 employees. The IRS also stated that it will not close its Austin, Texas, service center.

Hiring Blitz

The IRS plans to add 10,000 employees to its ranks, using funds left over from pandemic appropriations. Its prior efforts to hire employees have been unsatisfactory. The IRS had previously tried for months to hire 5,000 call center employees, but through January 26, 2022, only 179 of these positions had been filled. The IRS recently received "direct hiring authority," which should reduce the time needed to onboard new employees from seven months to one month.

IRS Employees Returning to Offices

In March 2020, the IRS had 26,000 employees teleworking. In December 2021, that number had grown to 60,000. Ashton Trice, IRS deputy associate chief counsel, said in May 2002 that the IRS leadership had been in the office since April 24, 2022, and that in-person operations would resume on June 25, 2022. However, some IRS employees will still have the option to work remotely.

IRS Audit, Appeals, and Other Developments

IRS audit rates dropped by more than 70 percent from 2010 to 2019. The IRS is auditing lower-income taxpayers at very high audit rates; approximately 70 percent of all closed individual audits are for taxpayers with annual income below $50,000. The most common issue in IRS audits is the earned income tax credit. Collecting tax from lower-income taxpayers has been challenging. Almost half are classified as "currently not collectible," so the IRS will not be pursuing collections.

Congress has questioned whether the IRS is using its audit resources wisely. Commissioner Rettig blames disproportionately higher low-income audit rates on the Improper Payments Elimination and Recovery Act (IPERA). The Commissioner also noted that the IRS has increased its audit rate of very high-income taxpayers (those with income greater than $10 million) and that its most experienced auditors are working on higher-income taxpayer audits.

Holly Paz, deputy commissioner of the IRS Large Business Group, stated that the IRS is trying to hire more auditors to audit more partnerships. Its goal is to hire experienced tax personnel from accounting and law firms.

With regard to appeals, in 2021, it took the IRS twice as long to close appeals cases as it did in 2018. The average time to close an appeals case is now more than one year. Andrew Keyso, the chief of the IRS Independent Office of Appeals, has vowed to turn this around.

In March 2022, the IRS established the Taxpayer Experience Office. It will focus on taxpayer expectations, customer service best practices, and developing agency-wide customer experience expectations (IR-2022-50).

Circular 230

Circular 230 defines the ethics rules for CPAs and enrolled agents (EAs). A practitioner who breaches these rules may not be able to represent taxpayers before the IRS in audits, appeals, collection proceedings, and so forth.

However, Circular 230 is extremely out of date; it still purports to govern the preparation of tax returns. And according to some courts, the IRS cannot use Circular 230 to regulate tax return preparation (*Loving v. IRS*, 742 F.3d at 1022); it is only used for purposes of controlling "practice before the IRS." The IRS has stated it will update Circular 230, "possibly" in 2022.

¶ 915 ADMINISTRATIVE PROCEDURE ACT

During the New Deal era in the 1930s, numerous new agencies were formed. But there was concern that these agencies could issue regulations and run roughshod over citizens. In response, the Administrative Procedure Act (APA) was enacted in 1946 so new regulations would get public input. The act, which governs the procedures of administrative law, states that agencies must:

- Give notice of a proposed rule;
- Provide a "notice and comment" period (to obtain public input on the proposal);

- Consider comments and respond to significant comments; and
- Make a concise general statement of its findings.

The IRS believed it was not subject to the APA. For decades, the IRS failed to follow procedural rules for issuing regulations. Temporary regulations typically did not follow the APA rules, and final regulations sometimes followed them and other times did not. Consequently, the IRS has a problem with many of its older regulations.

Under the APA, if issuing regulations is urgently required, an agency can bypass the regular rules, but it must issue a "statement of good cause." For example, the Paycheck Protection Program regulations issued by the Small Business Administration were urgently needed and contained a "statement of good cause." Therefore, those regulations did not have to garner public input prior to issuance. However, the IRS has issued temporary regulations for decades without notice-and-comment—and without a statement of good cause.

In 2011, in *Mayo Foundation*, 131 S Ct 704, the Supreme Court said the IRS must follow the APA rules, calling into question some (but not all) regulations issued decades before. The IRS was slow to respond to *Mayo* and continued to publish temporary regulations without a statement of good cause. It also neglected to clean up older final regulations that did not go through the public input phase.

Gradually, however, the IRS did respond. It noted there would be a "hazard of litigation" if regulations did not follow the APA (CCA 201747005). On March 5, 2019, the IRS issued a policy statement noting that it will include a statement of good cause for all future temporary regulations and notice and comment for all final regulations.

The major disputes surrounding this issue have ended. The IRS is required to follow public input (notice-and-comment) procedures, just like every other federal agency. The 2022 cases on this matter (discussed in the following sections) focus on very narrow points: If IRS regulations properly go through public input and the regulations state they can be updated by IRS notices, will that work? Or does the new notice have to go through public input (notice-and-comment)?

Case Law in 2022

One of the 2022 cases on this issue is *Mann Construction Inc. v. United States*, No. 21-1500 (6th Cir. 2022). The Internal Revenue Code provides required reporting of "listed" and "reportable" transactions. Reportable transactions are those with the "potential for [illegal] tax avoidance or evasion." Listed transactions are the "same as or substantially similar to a transaction the IRS has *identified* as tax avoidance transactions." Penalties for failure to disclose these are severe.

In Notice 2007-83, the IRS stated that reporting is required for certain cash value life insurance policies. The IRS chose not to issue regulations on this rule, and the rule did not go through the public input process. Mann Construction did not report such transactions to the IRS, so the IRS assessed penalties. At issue was the following:

- Did Mann Construction owe severe penalties for failure to report?
- Or did the IRS's failure to get public input invalidate the penalties?

The IRS said its prior regulations with public input allowed the update through notices. However, the court held that the IRS cannot avoid public input by providing in notice-and-comment regulations that more guidance can come from notices or other guidance. The court stated that if the IRS wanted to provide additional listed transactions, a notice was not the proper way to do so—it must issue new regulations with public input.

CIC Services LLC, 129 AFTR 2d 2022-119 (ED TN), is very similar to the *Mann Construction* case; it just involves a different type of "reportable transaction." However, the court's holding is the same: the IRS cannot identify reportable transactions by notice unless it (1) goes through the notice-and-comment process, or (2) has a "statement of good cause" for not going through public notice and explains the reason why the change was urgent. The court held that the IRS's notice was invalid.

In *Hewitt v. Commissioner,* 128 AFTR 2d 2021-7033 (CA-11), David and Tammy Hewitt donated a conservation easement and took a charitable contribution deduction of $2.78 million. The Tax Court said no deduction was allowed because the taxpayers did not meet the requirements of the regulations.

The Hewitts argued that the regulations are invalid. Although the regulations went through the public input process, the IRS failed to respond to significant comments about them. The 11th Circuit reversed the Tax Court, and the deduction was allowed. The regulations were found to be invalid because they failed to meet APA requirements. In this case, the IRS met most of the procedural requirements of the APA:

- The regulations were issued in proposed form.
- There was a notice-and-comment period.
- The IRS had a public hearing.
- The IRS made a concise general statement of its finding.

However, the IRS failed to consider all significant taxpayer comments. The IRS must respond to significant comments to comply with the APA. The IRS has decided not to appeal this case to the Supreme Court.

The court found the opposite in a similar case, *Oakbrook Land Holdings LLC v. Commissioner*, No. 20-2117 (6th Cir. March 14, 2022). It held the comment that what the IRS ignored was not significant and the regulation is valid. However, this is a fine point that does not save final regulations that failed to go through public input, or temporary regulations that failed to include a statement of good cause.

The U.S. District Court for the District of Colorado, in *Liberty Global Inc. v. United States*, held that temporary regulations must also meet APA requirements, including the notice-and-comment rule. However, there is an exception: If the IRS can show it has a good reason to issue temporary regulations, it does not need to go through the public notice and comment process.

Liberty Global challenged the IRS's Section 245A temporary regulations issued in 2019. The IRS had included a "good cause" statement in the temporary regulations, but the court said the IRS's reasons were not good enough. Although the IRS argued that immediate guidance was required to avoid a tax abuse loophole, the court responded that the IRS had plenty of time to go through notice-and-comment.

The IRS May Be Introducing a New Tax Environment

IRS revenue rulings, notices, and revenue procedures do not go through notice-and-comment procedures. Consequently, many commentators question whether these are binding. The Tax Court long ago indicated these sub-regulatory documents are not binding on taxpayers (*Rauenhorst v. Commissioner,* 119 TC 157 (2002)). Taxpayers can, however, rely on such guidance if it supports their positions.

The IRS seems to be embracing the new tax environment. It has indicated new guidance would "be a regulation if this is something that has to be followed" (Representative of IRS Chief Counsel Office, May 13, 2022).

IRS and the APA: The Big Picture

Courts do not dispute the IRS's ability to issue "force of law" regulations; they just want the IRS to go through the public notice provisions and not abuse its discretion. The IRS must articulate why it made its choice, and this should be tied to Congress's wishes. The fallout, however, is that many IRS temporary regulations and final regulations are invalid; see the following chart.

Examples of Regulations with APA Issues		
Topic	**Regulation Section**	**APA Issue**
Interest expense tracing rules	1.163-8T	No statement of "good cause"
Passive material participation	1.469-5T	No statement of "good cause"
Home mortgage interest	1.163-10T	No statement of "good cause"
Inventory capitalization	1.471-3	No concise statement, only summary discussion of comments
Self-employment tax—real estate rentals	1.1402(a)-4	No concise statement, only summary discussion of comments
Portions of partnership regulations	Subchapter K	No concise statement, only summary discussion of comments
Portions of Code Sec. 1231 regulations		No concise statement, only summary discussion of comments

A summary of this section's discussion of the APA is provided in the following chart.

APA Recap	
Federal agencies must follow APA to issue regulations.	Issue proposed regulations. Public has opportunity to comment. IRS considers and responds to significant comments. Summary of purpose and policy.
Federal agencies can avoid "notice-and-comment."	If they have a strong reason to issue immediately *and* provide "statement of good cause."
IRS thought the APA rules did not apply to it.	Some regulations lacked "notice and comment." Temporary regulations did *not* provide statement of good cause.
Supreme Court decided the rules did apply to the IRS.	*Mayo* (2011)
IRS agreed to follow APA rules to issue regulations.	"Policy Statement on the Tax Regulation Process" issued March 5, 2019.
IRS admits "hazards of litigation" if it did not meet APA requirements	CCA 201747005
Mann Construction	IRS designation of listed transaction. Invalid—needed new public input regulations; notice not sufficient.
Hewitt	Even though public input was obtained, the regulation was invalid. The IRS didn't address significant comment.
Oakbrook	Same regulation as in *Hewitt*, but court said the regulation was valid, comment was not significant.
Liberty Global	2019 IRS temporary regulation was invalid even though it included "statement of good cause." The matter wasn't so urgent that the IRS couldn't have gone through the notice-and-comment process.

¶ 916 CREDITS

Code Section 30D provides a credit for qualified plug-in electric drive motor vehicles, including passenger vehicles and light trucks. The total amount of the credit allowed for a vehicle is limited to $7,500. Cars eligible for the new plug-in credit include the following:

- 2022 Audit e-tron ($7,500)
- 2022 BMW i4 – eDrive40, M50 ($7,500)
- 2022 ELMS Urban Delivery ($7,500)
- 2022 Jeep Grand Cherokee PHEV ($7,500)
- 2022 Ford E-Transit ($7,500) and F-150 Lightning
- 2022 McLaren Artura ($4,855)

For a full list of eligible vehicles and more details about the credit, see https://www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit.

The phaseout of the credit begins after a manufacturer sells more than 200,000 eligible cars. At the time of this writing Tesla and GM are both phased out. If a car is for personal use, the credit is nonrefundable. Taxpayers can claim the credit on Form 8936, *Qualified Plug-in Electric Drive Motor Vehicle Credit*, by providing the vehicle identification number (VIN) and other information.

¶ 917 GIFT AND ESTATE TAX ISSUES

A surviving spouse is technically not required to file a 2022 estate tax return (Form 706) if the estate's gross fair market value of assets is less than $12.06 million. However, the surviving spouse may consider filing it anyway. A "portability" election, sometimes referred to as a DSUE (deceased spouse's unutilized exemption) must be made on a timely filed Form 706. The Form 706 is due nine months after the decedent's date of death. The extension period is an additional six months.

For 2022, each spouse gets $12.06 million in taxable gifts and estate tax exclusion. If a "portability" election is made, the surviving spouse gets the deceased spouse's unused portion of the $12.06 million for their own gifting/estate purposes.

EXAMPLE: Bob passes away in 2022. His assets have a fair market value of $7 million. All of Bob's property is left to Kanesha, his surviving spouse. Bob doesn't use the $12.06 million lifetime exemption (there are no prior taxable gifts). Since bequests to a spouse are not taxable (due to the unlimited marital deduction), if Bob's executor makes a timely portability election on Form 706, his unused $12.06 million exemption is "ported" or inherited by Kanesha. Kanesha can add that to her own lifetime exemption.

There are three different ways to make a portability election:

- Timely file a properly completed Form 706 (estate tax return) by nine months after the date of the decedent's death (six months extra if the taxpayer gets an extension).
- File a properly completed Form 706 after the due date, but within two years of the date of death (Rev. Proc. 2017-34). This is automatic if the taxpayer properly completes Form 706 and writes on it, "Filed Pursuant to Rev. Proc. 2017-34 to Elect Portability Under § 2010(c)(5)(A)."
- File a properly completed Form 706 more than two years after date of death, but only if the taxpayer gets a Private Letter Ruling from the IRS.

The second and third options above apply only if the taxpayer is not required to file Form 706 due to the size of the estate.

EXAMPLE: Robert passed away on April 26, 2022. His gross estate and adjusted taxable gifts are less than $12.06 million. In other words, he was not required to file Form 706. His surviving spouse files a properly completed Form 706 to elect portability late on March 1, 2024 (within two years of his date of death). The surviving spouse does not need to file a request for a Private Letter Ruling to get portability; she can get automatic approval.

Approximately 200 private letter rulings are requested per year to get permission for the late portability election. The portability election is becoming crucial for two reasons:

- The lifetime exclusion is to be cut by 50 percent for deaths after December 31, 2025.
  - — So while a taxpayer may not have estate tax today (due to the $12.06 million exclusion for each spouse), if the second spouse passes away after December 31, 2025, this could be important.
- Real estate and stock market gains.

The final regulations issued by the IRS in 2019 (IR-2019-189) provide a "no clawback" rule: If one spouse passes away by December 31, 2025, and makes a portability election, and the other spouse passes away after December 31, 2025 (when the exemption is cut in half), the surviving spouse will get the benefit of original double exemption.

EXAMPLE: Bob passes away in 2020 (his lifetime exemption is $11.4 million). Bob has never made taxable gifts and he leaves all his property, totaling $8 million, to his spouse Cassie. Because his estate qualified for the unlimited marital deduction, Bob did not use any of the lifetime exemption. He did not make a portability election. Cassie passes away in 2026 (her post-TCJA lifetime exclusion is $6.8 million). She has $17.8 million in assets (she has Bob's assets plus her own). The estate tax is $4.4 million.

If Bob had made a portability election, there would be no estate tax at all, and Cassie's exemption would have been $18.2 million: her $6.8 million plus Bob's ported amount of $11.4 million (Treas. Reg. § 20.2010-1(c)(2)(iii)).

Even though Cassie's lifetime exemption is now $6.8 million, Bob's "ported" higher exemption when he passed away is not "clawed back." Because Bob made a portability election, Cassie gets the full $11.4 million that Bob did not use.

The following is a tax checklist for a surviving spouse:

- Notify Social Security of the death, and check the "survivor" benefits.
- Check IRA and other retirement plan beneficiaries, and notify the custodian/administrator.
  - — Consider changing the IRA to the surviving spouse's IRA.
  - — The surviving spouse should check their own beneficiary designation.
- The surviving spouse may wish to begin gifting (since a step-up has occurred).
- The surviving spouse should update their own will.
- Check with the estate planning attorney.
  - — Probate?
  - — Who will prepare Form 1041 and 706 (and the state tax return, if any)?
  - — File to make a "portability" election?

- File an estate tax return just to get portability?
- Get an EIN for the estate (unless all assets are in a living trust).
- Get stepped-up tax basis (Code Sec. 754 for partnerships, brokers for stocks, real estate, etc.).
- Notify banks, brokers, partnerships and S corporations, and insurance providers of the death.

STUDY QUESTIONS

5. Which of the following is an example of an expenditure that does ***not*** increase basis?

a. Entryway upgrades
b. Replacing a faucet
c. Granite countertops
d. New bedroom

6. Which of the following represents an untraditional strategy for deferring tax?

a. Defer income if one expects to be in the same or lower tax rate next year
b. Installment sales of real property
c. Deposit cash received for services in December in the following year
d. Contribute to deductible IRAs

7. Which of the following identifies the bonus depreciation rate for the year 2027?

a. 0 percent
b. 40 percent
c. 60 percent
d. 80 percent

8. A taxpayer materially participates in a rental activity if they had material participation for any ___ taxable years during the immediately preceding ___ years.

a. 4, 6
b. 5, 10
c. 4, 8
d. 3, 10

9. To be classified as a real estate professional, more than _____ of personal services must be performed in real property business in which the professional materially participates (assuming that the taxpayer performs more than 750 hours of services in which they materially participate in a real property business).

a. 15 percent
b. 20 percent
c. 35 percent
d. 50 percent

10. If an entity wants to elect out of the Centralized Partnership Audit Regime (CPAR) requirements entirely, it should check the box on which of the following IRS forms?

a. Form 1120-S
b. Form 1065
c. Form 1120
d. Form 7036

11. In which of the following areas does the APA provide only summary discussion of comments (i.e., no concise statement)?

a. Home mortgage interest

b. Inventory capitalization

c. Interest expense tracing rules

d. Passive material participation

12. The electric drive motor vehicle tax credit begins to phase out for a manufacturer's vehicles when at least _____ qualifying vehicles manufactured by that manufacturer are sold for use in the United States.

a. 200,000

b. 225,000

c. 350,000

d. 475,000

MODULE 2: TAX DEVELOPMENTS—Chapter 10: Getting Rid of Tax Penalties

¶ 1001 WELCOME

Those late-night TV commercials may make it sound easy, but how do you get rid of tax penalties? This chapter covers the various penalties applied by the IRS and the ways practitioners can seek to have them removed. It discusses the First Time Penalty Abatement, abatement for reasonable cause, and how to challenge the liability legally. The chapter also reviews strategies for handling abatement from the start of the exam through documenting reasonable cause.

¶ 1002 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify the various penalties applied by the IRS
- Recognize ways practitioners could have penalties removed
- Describe First Time Penalty Abatement
- Describe failure to file/pay based on reasonable cause
- Identify an indicator of responsibility with respect to trust funds
- Recognize the penalties for failure to pay

¶ 1003 PENALTY POLICY CONSIDERATIONS

In order to understand tax penalties, you first need to understand the policy behind the penalties. Why does the IRS charge penalties? There are several reasons. Penalties:

- Encourage taxpayers' voluntary compliance,
- Conserve IRS resources (and help offset the cost of enforcement),
- Provide clear guidance to taxpayers and practitioners,
- Ensure consistent and fair treatment of the issues, and
- Ensure noncompliant behavior is penalized.

IRS penalties are imposed for various reasons, including if a taxpayer fails to file their tax return on time, fails to pay the tax owed, or prepares an inaccurate return.

¶ 1004 FIRST TIME ABATEMENT

The IRS allows a first-time penalty abatement for the failure to file and failure to pay penalties (Internal Revenue Manual [IRM] 20.1.1.3.3.2.1). It provides administrative relief from the following penalties if the qualifying criteria contained in the IRM subsection are met:

- Failure to file (FTF) penalty under Code Secs. 6651(a)(1), 6698(a)(1), or 6699(a)(1);
- Failure to pay (FTP) penalty under Code Sec. 6651(a)(2) and/or Code Sec. 6651(a)(3); and
- Failure to deposit (FTD) penalty under Code Sec. 6656.

This administrative waiver, implemented in 2001, is referred to as First Time Abate (FTA) and is available for penalty relief the first time a taxpayer is subject to one or more of the referenced penalties for a single return. When the FTA criteria have otherwise been met, they do not provide penalty relief under the FTA waiver unless the following are true:

- The taxpayer has filed, or filed a valid extension for, all required returns currently due, *and*
- The taxpayer has paid, or arranged to pay, any tax currently due.

A taxpayer may qualify for the FTA for a penalty if they have been and are currently tax compliant. They are considered compliant if they (1) filed the same return type for the past three tax years before the tax year for which they received the penalty, and (2) did not receive any penalties during the prior three years. Therefore, tax practitioners should always pull transcripts to check a client's three-year prior history.

NOTE: The FTA does not apply to anything *prior* to 2001.

¶ 1005 STRATEGIES FOR THE AUDIT

To prepare for a client's audit, tax practitioners should gather all the relevant records, visit the business location, and essentially do all the work that the IRS auditor is going to do. Laying this groundwork will make the practitioner aware of any issues with the client's return and help him or her determine how to handle them. Practitioners should also:

- Build credibility with the IRS examiner through cooperation, timeliness, and transparency;
- Assume penalties will be imposed and build a defense throughout the audit; and
- Seek to discuss the examiner's position and negotiate before a 30-day letter is issued.

The 30-day letter notifies the taxpayer of their right to appeal the IRS's proposed changes to their return within 30 days. If an appeal is filed, keep in mind that the IRS Independent Office of Appeals will not simply concede the issue. The practitioner must prepare for the Appeals hearing by laying out all information and making arguments. This preparation can be used as a bargaining chip for the penalty abatement. Timing, the taxpayer's history, and specific circumstances must be reviewed. Make sure the story "fits."

¶ 1006 ABATEMENT FOR REASONABLE CAUSE

Reasonable cause is based on all the facts and circumstances of a taxpayer's situation. The IRS states that it will consider "any sound reason for failing to file a tax return, make a deposit, or pay tax when due." Such reasons include the following:

- Fire, casualty, natural disaster, or other disturbances
- Inability to obtain records
- Death, serious illness, incapacitation, or unavoidable absence of the taxpayer or a member of his or her immediate family
- Other reasons that establish the taxpayer used all ordinary care to meet their tax obligations but was unable to do so

Therefore, for an abatement for reasonable cause, the practitioner should show that his or her client did everything that was possible. Here are some questions to consider:

- Does the taxpayer's explanation relate to the penalty?
- Do dates and times coincide?
- Could the noncompliance have been anticipated/prevented?
- Was it an honest mistake?
- Has the taxpayer presented sufficient detail to determine if ordinary business care/prudence was used?
- Is the taxpayer a financial professional?
- What is the taxpayer's history with compliance?
- Has the taxpayer had this issue before?
- Have there been prior abatements?

To request a reasonable cause abatement, Form 843, *Claim for Refund and Request for Abatement*, must be filed—one form for each period. That means if a taxpayer is seeking a reasonable cause abatement for 2018, 2019, and 2020, three Forms 843 must be filed. The tax practitioner should also write a cover letter explaining the circumstances, discussing penalty considerations and the theory behind them in the IRM, and why those provisions don't apply to the client. Documentation that supports the arguments should be included, such as medical issues, loss, or theft losses, etc. The following examples illustrate two abatement cases with different outcomes.

EXAMPLE 1: Taxpayer A filed eight years of late returns (2003–2010). His daughter had brain cancer in 2005 at age 16, had surgery, and recovered in 2006. In 2012, the taxpayer's son and daughter have both graduated from college and moved out of the family home.

Taxpayer A owes $145,000 in taxes for the unfiled years, plus penalties and interest. He contacts a tax professional, seeking help with penalty relief, which he believes should be easy to obtain.

Taxpayer A sends his tax practitioner medical documentation that supports the story of his daughter's illness. But that information does not explain why the taxpayer failed to file the 2004 and 2004 tax returns timely, or why returns for 2007–2009 were not filed on time. An IRS revenue officer had to visit the taxpayer's home to get the unfiled returns from him, leaning on the taxpayer with enforcement.

Ultimately, the IRS Independent Office of Appeals refused to abate the penalties imposed on Taxpayer A.

EXAMPLE 2: Taxpayer B is a self-employed financial professional, He and his wife have two small children. His wife was suffering from bipolar disorder and became suicidal after their second child was born in 2004. Taxpayer B failed to file and pay his taxes for 2004–2005, and he now owes $62,000 of tax plus penalties and interest

He contacts a tax practitioner, providing medical documentation for his wife, who is now stable.

In this case, the taxpayer failed to file and pay taxes for a brief period of time due to an extreme family medical situation and has the appropriate medical documentation to support his situation. His noncompliance started immediately after the medical crisis and ended when the situation was under control. The penalties were therefore abated by the IRS.

Relying on Tax Advice

Relying on a tax opinion by a tax advisor may serve as a defense to the accuracy-related penalty. The reliance must be objectively reasonable and based upon all pertinent facts,

and the advice must not be based upon unreasonable factual or legal assumptions. Note that the reliance does not cover the filing of a return that is missed.

STUDY QUESTIONS

1. In what year was the administrative waiver available for penalty relief the first time a taxpayer is subject to one or more penalties for a single return?

a. 1998
b. 2001
c. 2005
d. 2020

2. Each of the following represents a best practice for an IRS exam, ***except?***

a. Build credibility with the examiner
b. Assume penalties will be imposed
c. Propose a settlement during the exam
d. Seek to discuss the examiner's position

3. Which form is used to claim a refund and request for abatement?

a. Form 843
b. Form 5695
c. Form 7023
d. Form 9000

¶ 1007 PREPARER/PROMOTER PENALTIES

Tax preparers must lead by example. This means taking care of their own tax filing compliance—after all, they can't claim ignorance when it comes to tax rules. The number-one reason tax professionals end up in front of the IRS Office of Professional Responsibility (OPR) is their failure to file returns and pay their taxes due.

Internal Revenue Code Sections related to tax return preparer/promoter penalties include the following:

- Code Sec. 6694(a)—Unreasonable position
- Code Sec. 6694(b)—Willful conduct or intentional or reckless disregard of rules/regulations
- Code Sec. 6695—Miscellaneous preparer misdeeds
- Code Sec. 6695A—Appraisers
- Code Sec. 6700—Promoters of abusive tax shelters
- Code Sec. 6701—Aiding/abetting understatement of tax
- Code Sec. 6702—Frivolous returns
- Code Secs. 6707 and 6707A—Information returns for reportable/listed transactions
- Code Sec. 6708—List of advisees
- Code Sec. 6713—Improper disclosure/use of return info by preparer

When an IRS examiner proposes assessing penalty on a tax professional under Code Secs. 6694(b), 6700, or 6701, there is a mandatory referral to the OPR. If the examiner

proposes assessing a penalty under Code Secs. 6694(a) or 6695, referral to the OPR is discretionary.

The IRS may also file an injunction suit against a tax preparer for not meeting due diligence requirements. The injunction can temporarily or permanently prohibit the preparer from preparing tax returns. Generally, the IRS does this only when earlier compliance efforts have failed.

The IRS issues a 30-day letter to the preparer proposing the penalty under Code Sec. 6694(a) and/or (b). Appeals will consider the preparer's case, but an assessment is not made until a final administrative determination is issued (Reg. § 1.6694-4(a)(2)). After the assessment, the IRS will send a Notice and Demand letter.

Preparers/promoters can defend themselves in these situations by asserting that:

- Their position is not unreasonable (Code Sec. 6694(a)),
- They had reasonable cause and acted in good faith (Code Sec. 6694(a)(3)), or
- Their conduct was not willful or reckless (Code Sec. 6694(b)).

NOTE: A tax professional should always challenge tax penalties, as failing to do so can be seen as an admission of guilt. When it comes to challenging preparer penalties, it's not about the dollars—it's about the fight. The tax preparer's license is on the line.

¶ 1008 PAYROLL TAX

There are two sides of payroll taxes: the fiduciary portion and the employer's share. The fiduciary portion includes the income tax withheld, and the FICA taxes withheld (Social Security and Medicare) from the employee's pay. These are referred to as "trust fund taxes" because the employer is holding them in trust for the government.

Taxpayers must deposit payroll taxes on a schedule. If they do not meet the schedule, a failure to deposit penalty is assessed as follows:

- 2 percent penalty for depositing within 5 days late
- 5 percent penalty for depositing 5 to 15 days late
- 10 percent penalty if depositing more than 15 days late
- 15 percent penalty if the deposit is not made within 10 days after the first delinquency notice

The failure to file penalty applies to Form 941, *Employer's Quarterly Federal Tax Return*. Under Code Sec. 6651, the penalty is 5 percent of the tax due per month for failing to file, up to a 25 percent maximum.

The IRS has become much more aggressive regarding enforcement of payroll taxes. The Trust Fund Recovery Penalty (TFRP) is now mandatory, and there has been an upswing in criminal employment tax prosecutions.

Code Sec. 6672 allows the IRS to recover "trust funds" withheld from an employee's pay from "any person required to collect, truthfully account for and pay over any tax imposed" and "who willfully fails to collect such tax or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof."

The definition of a "responsible person" in this case is broad, encompassing anyone responsible for collecting, accounting, and paying over taxes to the government. The responsibility is a matter of status, duty, and authority. There is a functional test to make this determination. Indicators of responsibility for payroll taxes include the following:

- Holding corporate office
- Ownership
- Authority in the bylaws
- Hiring and firing authority
- Check signing authority
- Authority to sign and file payroll returns

However, keep in mind that these are merely indicators. Just because someone has signature authority doesn't mean they are "responsible."

IRS Letter 1153, *10-Day Notification Letter, Trust Fund Recovery Penalty Proposed*, notifies a taxpayer that the IRS is proposing a TFRP assessment against them. The individual assessed against will have 60 days to file a protest and obtain an Appeals hearing.

If the taxpayer does not think they are responsible for payment of the trust fund taxes, they should file a protest and gather supporting documentation, including affidavits from people who were witnesses that they were not involved in the business's finances and copies of the canceled checks to show they didn't sign them. The taxpayer and/or their representative should seek to obtain copies of the interview forms as well.

STUDY QUESTIONS

4. Relying on a tax opinion by a tax advisor _____ serve as a defense to the accuracy related penalty.

a. Should

b. Cannot

c. May

d. Will never

5. Which of the following identifies a type of enforcement action that can temporarily or permanently prohibit a tax professional from preparing tax returns?

a. Accuracy related penalty

b. Injunction suit

c. Frivolous tax returns or submissions

d. Understatement of liability due to unreasonable position

6. Code Section _____ allows the IRS to recover trust funds withheld from employee's pay.

a. 6053

b. 6103

c. 6223

d. 6672

MODULE 2: TAX DEVELOPMENTS—Chapter 11: 2022 Tax Legislation: Inflation Reduction Act and CHIPS Act

¶ 1101 WELCOME

The Inflation Reduction Act of 2022 was passed in short order after secret negotiations were revealed in late July 2022. This chapter provides a concise look at the seismic tax changes in this new legislation. Also discussed is the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act of 2022. Both acts were signed into law in August 2022.

¶ 1102 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify the newest tax developments contained in the Inflation Reduction Act of 2022
- Describe the new and extended credits available for green energy initiatives
- Recognize which taxpayers and assets qualify for credits for purchasing electric personal vehicles and clean commercial vehicles
- Recognize the implications of increased IRS funding
- Identify the newest tax developments contained in the CHIPS Act of 2022

¶ 1103 BACKGROUND

The 2022 Greenbook, which summarized the administration's tax proposals contained in the budget, gave insight into President Joe Biden's tax priorities. In the Build Back Better Act, the current administration proposed an ambitious $3.5 trillion social spending and taxing plan. Many dramatic twists and turns ensued, however, leading to the bill's defeat in December 2021.

The Inflation Reduction Act of 2022 (P.L. 117-169), effective on August 16, 2022, is a landmark U.S. law that aims to curb inflation by reducing the deficit, lowering prescription drug prices, and investing in domestic energy production while promoting clean energy. The law resulted from secret negotiations between Senator Joe Manchin (D–WV) and Senate Majority Leader Chuck Schumer. Modifications were made by Senator Kyrsten Sinema (D–AZ) before the act cleared the Senate in early August. The spend dropped to $428 billion, with $725 billion raised in new taxes.

Among its many provisions, the IRA:

- Spends $80 billion on new workers and technology at the IRS,
- Caps insulin costs for Medicare recipients and puts Medicare on course to negotiate drug prices,
- Funds hundreds of billions in tax subsidies intended to combat climate change, and
- Is scored to reduce the federal deficit by $90 billion.

¶ 1104 NEW CORPORATE ALTERNATIVE MINIMUM TAX

The IRA imposes a new 15 percent corporate alternative minimum tax (AMT) on certain corporations. The IRA's alternative minimum tax can be thought of as a "book minimum tax" (BMT) because the starting point of the calculation is a corporation's average annual adjusted financial statement income (AFSI) per generally accepted accounting principles (GAAP).

This is a departure from the previous calculation of the corporate alternative minimum tax ("old AMT") rules, in place prior to the Tax Cuts and Jobs Act of 2017 (TCJA), where the starting point was taxable income.

The financial statement that must be used as the starting point for the AMT is defined by Code Sec. 451(b)(3), which sets forth the following sources listed by priority:

1. Form 10-K filed with the Securities and Exchange Commission (SEC)
2. GAAP-certified audited financial statement used for non-tax purposes
3. GAAP-certified financial statement filed with a federal agency for non-federal tax purposes
4. An International Financial Reporting Standards (IFRS) financial statement filed with the equivalent of the SEC
5. Any other financial statement permitted by regulations

"Appropriate adjustments" must be made when the financial statement year covers a period other than the taxable year.

The new 15 percent AMT is imposed on corporations with average annual AFSI that exceeds $1 billion over any consecutive three-taxable-year period. The AFSI is equal to book income subject to certain adjustments. Tax (instead of book) depreciation deductions will reduce AFSI. This will aid businesses that invest in equipment and facilities (such as manufacturers).

Foreign Tax Credits, General Business Credits, and Carryforwards

The BMT is reduced by the corporate AMT foreign tax credit, defined as:

- The taxpayer's creditable foreign income taxes that are stated on its adjusted financial statement (AFS) and paid or accrued by the taxpayer, and
- The taxpayer's pro rata share of the aggregate creditable foreign income taxes paid or accrued by its controlled foreign corporation, stated on the controlled foreign corporation's AFS for the taxable year.

The IRA does not provide for a limitation on the utilization of "direct" taxes paid by the U.S. taxpayer. However, the act does limit the aggregate amount of taxes paid by controlled foreign corporations to 15 percent of the taxpayer's controlled foreign corporation net income. Any excess controlled foreign corporation taxes may be carried forward for five years.

General business credits may reduce BMT subject to the limitations of Code Sec. 38(c). Any BMT paid before the general business credits may be credited against regular tax and base erosion and anti-abuse tax (BEAT) payable in future periods.

The corporate AMT will not apply to companies that reach the $1 billion threshold when their income is combined with unrelated businesses under the shared ownership of an investment fund or partnership. Note that a $100 million threshold applies to certain foreign-backed corporations.

Delegated Authority to Treasury Department

The IRA delegates the following determinations to the Treasury:

- When a corporate taxpayer is no longer subject to the AMT
- Dividends and income from subsidiaries not included on the taxpayer's consolidated return is excluded from AFSI
- Which entities should be included in a foreign-parented multinational group
- Application of a simplified test for determining what qualifies as an "applicable corporation"
- When foreign taxes should be disregarded in determining AFSI and the treatment (including timing) of current and deferred taxes
- When AFSI should be adjusted so that depreciated property "is accounted for in the same manner as it is accounted for" for federal tax purposes
- Other AFSI adjustments: guidance on corporate liquidations, reorganizations, and partnership contributions and distributions

Applicable Corporation: Domestic

A corporation meets the income test if its average AFSI for the three-taxable-year period (determined without regard to prior loss carryovers) ending with the tax year exceeds $1 billion.

Net Operating Losses for Years in Testing Period

Financial statement income may be reduced by the financial statement net operating loss (NOL) for the taxable year. This NOL is capped at 80 percent of the taxpayer's AFSI, with the remainder carried over to the following year.

Unused financial statement NOLs may be carried forward indefinitely but do not include any NOLs arising in taxable years before 2020 for purposes of determining whether a taxpayer is an applicable corporation.

Three-Year-Test—Inclusion of Affiliates

Taxpayers must include the AFSI of any affiliates treated as a single employer under Code Sec. 52(a) or (b). They also must include the AFSI of any corporations that are members of its controlled group under Code Sec. 1563.

The AFSI of affiliated insurance companies, attributable to any U.S. trade or business of affiliated foreign corporations, and the pro rata share of the AFSI of a controlled foreign corporation would all be included in AFSI.

Rules Applicable to Related Groups of Entities

For affiliated corporations not included on a consolidated return, AFSI includes dividends except for amounts included as subpart F or global intangible low-taxed income (GILTI). AFSI also includes the AFSI of any of the taxpayer's disregarded entities. It is adjusted only to take into account the taxpayer's distributive share of AFSI of the partnership.

Solely for purposes of determining whether a corporation meets the three-year test, the net income or loss reflected on the partnership's AFS is included, rather than the partner's distributive share.

Applicable Corporation: Foreign Multinational Groups

A two-part test applies to U.S. subsidiaries or branches of a foreign-parented group reporting on a consolidated financial statement:

- The three-year average AFSI of the U.S. subsidiaries or branches must exceed $100 million in the aggregate.
- The three-year average AFSI for the foreign-parented group—including all worldwide income (not limited to income of U.S. subsidiaries, U.S. branches, or controlled foreign corporations)—must exceed $1 billion.

Rules Applicable to Foreign Income

For U.S. shareholders of controlled foreign corporations, AFSI includes the taxpayer's pro rata share of the net income or loss stated on the controlled foreign corporation's financial statements. Net losses from controlled foreign corporations do not reduce AFSI but can be carried forward to the next taxable year.

For purposes of the three-year test, the AFSI of the entire foreign group includes all worldwide income of the group, not limited to the pro rata share of controlled foreign corporation income or effectively connected income. A foreign corporation with a U.S. trade or business is treated as a separate domestic corporation owned by the foreign corporation for purposes of the BMT.

The foreign tax credit generally must be added back to income in calculating AFSI. For taxpayers that do not claim foreign tax credits for regular tax purposes, Treasury regulations will provide that foreign income taxes are taken into account to determine AFSI. Treasury regulations will also provide for the proper treatment of current and deferred taxes, including timing.

The impact of tax treaties on the IRA provisions is currently unclear.

Retaining Status as an Applicable Corporation

A corporation that is an applicable corporation retains that status in perpetuity unless:

- It has a change in ownership, or it no longer meets the three-year average AFSI test; and
- The Treasury determines it would be inappropriate.

This exception does not apply if the corporation meets the AFSI threshold for any future three-year period.

Computing AFSI

Instead of using the GAAP rules, AFSI is adjusted by taking the tax deductions and income with respect to:

- A covered benefit
- Tax depreciation deductions allowed under Code Sec. 167 on Code Sec. 168 tangible property
- Amortization adjustments under Code Sec. 197 relating to the qualified wireless spectrum used in the trade or business of a wireless telecommunications carrier where the property was acquired after December 31, 2007, and before the enactment of these rules; and
- Eighty percent of the adjusted financial statement NOL with the remainder carried forward

AMT Credit Limitations

The general business AMT credit is limited to 25 percent of the taxpayer's net income tax exceeding $25,000. Where regular tax is higher than the minimum tax, a corporation may carry forward a credit for the net minimum tax for all prior tax years beginning after 2022 to reduce the taxpayer's regular tax, including BEAT. Credits are creditable against AMT liability.

The AMT will not apply to S corporations, regulated investment companies (RICs), and real estate investment trusts (REITs).

For corporations that have been in existence for less than three taxable years, the income threshold will be based on the period during which the corporation was in existence. The provision is effective for tax years beginning after December 31, 2022.

The IRS will need to provide much guidance on these IRA provisions by year end. Practitioners should anticipate notices and then changes to the regulations.

Revenue Raised

The Joint Committee estimates that about 150 Fortune 500 taxpayers would be subject to the corporate minimum tax annually. These 150 companies will be responsible for raising $313 billion of the anticipated $450 billion required to cover go-green decarbonization expenditures of the IRA.

¶ 1105 ELECTRIC VEHICLE CREDITS

The IRA includes billions of dollars in electric vehicle (EV) incentives, including credits for both new and used vehicles.

Credits for New EVs

Under the IRA, buyers of new EVs will be eligible for up to a $7,500 credit for EVs placed in service after 2022 but before 2033. The manufacturer's limit is eliminated for EVs sold after 2022.

To be eligible for the credit, the EV manufacturer's suggested retail price (MSRP) cannot exceed $55,000 for sedans and $80,000 for sport utility vehicles (SUVs), trucks, and vans. The credit will be unavailable to single tax filers with modified adjusted gross income (MAGI) above $150,000. The income limit is $300,000 for married taxpayers filing jointly and $225,000 for heads of households.

Credits for Used EVs

The IRA makes available a credit of the lessor of $4,000 or 30 percent of the purchase price on purchases of previously owned EVs. No credit is allowed if the taxpayer's MAGI exceeds $150,000 for a joint return or surviving spouse, $112,500 for a head of household, or $75,000 for others. The income limitation is determined by the MAGI of the year of purchase or the preceding year.

Qualified Buyers

The IRA identifies a qualified buyer of an electric vehicle as an individual who:

- Purchases the vehicle for use and not for resale,
- Is not a tax dependent of another taxpayer, and
- Has not been allowed a credit for a previously owned clean vehicle during the three-year period ending on the sale date.

Qualified Commercial Clean Vehicles

The maximum credit per vehicle is $7,500 for vehicles with gross vehicle weight ratings of less than 14,000 pounds, or $40,000 for heavier vehicles. The credit per vehicle is the lesser of:

- 15 percent of the vehicle's basis (30 percent for vehicles not powered by a gasoline or diesel engine) or
- The "incremental cost" of the vehicle over the cost of a comparable vehicle powered solely by a gasoline or diesel engine.

NOTE: For purposes of this credit, the vehicle must be acquired for use or lease by the taxpayer, and not for resale.

¶ 1106 EXCISE TAX ON STOCK BUYBACKS

The IRA calls for a new excise tax on stock buybacks. In a stock buyback, a company can buy back its shares using surplus cash either from shareholders via a tender offer or on the open market. The company reduces the total number of outstanding shares available for purchase and increases its per-stock value for shareholders.

The IRA imposes an excise tax on domestic publicly traded corporations that repurchase their stock directly (or through a more than 50 percent owned subsidiary corporation or partnership). This tax is equal to 1 percent of the fair market value of the repurchased stock and is not deductible.

The tax applies to repurchases of stock of certain foreign corporations and is effective for repurchases that occur after December 31, 2022.

Buybacks present several advantages. They are often compared to dividend payouts. Ordinary dividends are taxed when the company distributes them to shareholders and are taxed as normal income. Qualified dividends, which meet the criteria to be taxed as capital gains, are taxed at rates of 20 percent, 15 percent, or 0 percent depending on income. Unlike dividend payouts, however, shareholders can choose whether to sell their stock back to the company in a repurchase, allowing a deferral of tax.

The Treasury Department can also apply this tax to any "economically similar" transaction. Code Sec. 4501 applies to a covered corporation's specified affiliate, a subsidiary or partnership of which the covered corporation directly or indirectly owns 50 percent or more of the stock, capital interests, or profit interests held directly or indirectly. It also applies to certain U.S. subsidiaries of foreign-parented firms and surrogate foreign corporations.

Exceptions to the Excise Tax

The tax does not apply for repurchased stock in the following situations:

- The transaction is part of a Code Sec. 368(a) reorganization
- The stock is contributed to an employer-sponsored retirement plan, employee stock ownership plan (ESOP), or similar plan
- The total value of stock repurchased does not exceed $1 million during the taxable year
- The repurchase is by a dealer in securities in the ordinary course of business
- The repurchase is made by a RIC or a REIT, or
- The repurchase is treated as a dividend

¶ 1107 EXCESS BUSINESS LOSSES

The IRA extends the limitation on the deductibility of excess business losses (EBLs) by noncorporate taxpayers under Code Sec. 461(l) for another two years, through December 31, 2029. EBLs are calculated as follows:

> Excess Business Losses = Total Business Deductions less (Total Business Income and Gains + $270,000 Not Married/$540,000 Married Filing Jointly (2022))

STUDY QUESTIONS

1. Which of the following statements is correct regarding the Inflation Reduction Act of 2022?

a. It provides $40 billion in new IRS funding.

b. It is scored to reduce the deficit by over $150 billion.

c. It caps insulin costs for Medicare recipients.

d. It funds hundreds of billions in tax subsidies for offshore drilling.

2. The new corporate alternative minimum tax is a _____ AMT on corporations with average annual AFSI that exceeds _____ billion over any consecutive _____ taxable period.

a. 15 percent / $1 / three-year

b. 20 percent / $1 / five-year

c. 15 percent / $2 / three-year

d. 20 percent / $2 / five-year

3. Which of the following statements is correct with respect to the new corporate AMT and the IRA of 2022?

a. It is a new 25 percent tax on certain corporations.

b. Book depreciation deduction reduces AFSI.

c. The IRA does not limit the aggregate amount of taxes paid by controlled foreign corporations to 15 percent of the taxpayer's controlled foreign corporation net income.

d. Any BMT paid before the general business credits may be credited against regular tax.

¶ 1108 CLEAN ENERGY TAX CREDITS

The IRA extends and expands existing energy-related tax credits and adds several new tax credits related to clean electricity, manufacturing, fuel, and vehicles. Approximately $374 billion is allocated to climate and energy spending.

The new legislation extends and expands existing tax credits to increase domestic production and the sale of components used in wind, solar, fuel cell, hydropower, waste energy, and other clean energy projects (including storage), as well as individual clean energy incentives (including energy rebates and consumer tax credits for energy-efficient homes and vehicles).

The act extends the renewable electricity production credit of 1.5 cents per kilowatt hour. Per Code Sec. 45(a), the electricity must be:

- Produced by the taxpayer from qualified energy resources at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service, and
- Sold by the taxpayer to an unrelated person during the tax year.

The IRA expands the Code Sec. 48 credits previously permitted for power-generating property using solar sources, fiber-optic distributed sunlight, geothermal deposits, microturbines, qualified fuel cells, small wind energy sources, cogeneration property, waste energy or groundwater heating and cooling property.

The new legislation adds the following qualifying types of property: energy storage technology, qualified biogas property, and microgrid controllers. Construction of the three types of property must begin before January 1, 2025. Code Sec. 48 also provides for phaseouts of the credit.

Bonus credits are available for eligible property located on Indian lands, a qualified low-income residential building project, or a qualified low-income economic benefit project.

The Code Sec. 45Q(d)(1) credit is extended to qualified carbon capture facilities that begin construction between December 31, 2022, and January 1, 2033.

The IRA extends the credit for sales and use of biodiesel and renewable diesel fuel, biodiesel fuel mixtures, alternative fuel, and alternative fuel mixtures on or before December 31, 2024. It increases the credit for a tax year to an amount equal to 30 percent of the sum of (a) the amount paid or incurred for qualified energy efficiency improvements installed, and (b) the amount of the residential energy property expenditures paid or incurred by the taxpayer during that year (Code Sec. 25C(a)).

New Energy-Efficient Home Credit

Under the IRA, credit is extended for qualified new energy-efficient homes acquired before January 1, 2033 (Code Sec. 45L(g)). The amount of the credit is increased to $500, $1,000, $2,500, or $5,000, depending on which energy-efficiency requirements the home satisfies.

Qualifying Advanced Energy Project Credit

Code Sec. 48C provides up to 30 percent of the qualified investment in the eligible property that re-equips, expands, or establishes a manufacturing facility for the production of:

- Property to produce energy from the sun, wind, or geothermal deposits or other renewable resources
- Fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles
- Electric grids or storage to support the transmission of intermittent sources of renewable energy
- Property to manufacture equipment used for carbon capture or sequestration
- Property to refine or blend renewable fuels to produce energy conservation technologies
- Plug-in electric drive motor vehicles or components; or
- Other advanced energy property designed to reduce greenhouse gas emissions

New Credits

Several new credits are introduced in the IRA. These include the following:

- A sustainable aviation fuel credit of $1.25 per gallon of "qualified mixture," plus, where the greenhouse gas emissions reduction percentage for the qualified mixture exceeds 50 percent, an increase resulting in a credit of up to $1.75 per gallon
- Clean hydrogen production—available for the first 10 years that a qualified clean hydrogen production facility is in service (Code Sec. 45V(a)(1))
- Clean Energy Production Credit
- Clean Energy Investment Credit
- Clean Fuel Production Credit

NOTE: Certain credits for energy property and electricity produced from certain renewable resources can be transferable.

Accelerated Depreciation for Green Building Property

Code Sec. 179D provides an accelerated cost recovery deduction for energy-efficient commercial building (EECB) property for the year placed in service. The maximum amount of the deduction allowed for a year was calculated by multiplying a statutory dollar amount ($1.80), adjusted for inflation ($1.88 for 2022), by the square footage of the building. There is a reduction for the total EECB property deductions taken related to the building in all prior years to arrive at the applicable limitation.

¶ 1109 RESEARCH CREDIT FOR SMALL BUSINESSES

The IRA increases the amount of research tax credit that can be applied by a qualified small business under Code Sec. 41(h) against payroll tax liability, from $250,000 to $500,000 for tax years beginning after December 31, 2022. The first $250,000 of the credit limitation will be applied against the employer portion of the FICA payroll tax liability. The second $250,000 would be applied against the employer portion of the Medicare payroll tax liability.

¶ 1110 CARRIED INTEREST RULES

The IRA would have revised Code Sec. 1061 to extend, from more than three to more than five years, the holding period required for carried interest income to be taxed at favorable long-term capital gains rates. The longer holding period would have applied to taxpayers with an adjusted gross income (AGI) of $400,000 or more. However, the carried interest provision was removed at the insistence of Senator Kyrsten Sinema (D–AZ).

¶ 1111 EXCISE TAXES ON FOSSIL FUELS

The IRA reinstates the Hazardous Substance Superfund tax. Crude oil received at a U.S. refinery and petroleum products entered into the United States for consumption, use, or warehousing, are subject to a 9¢-per-barrel environmental excise tax, which funds the Oil Spill Liability Trust Fund. For tax years 2023 through 2025, these products are subject to both: (a) the 9¢-per-barrel oil spill liability tax; and (b) a 16.4¢-per-barrel tax. After 2025, such crude oil and petroleum products are subject to only the inflation-adjusted Hazardous Substance Superfund tax.

Under the IRA, coal excise tax rates apply at $1.10 per ton for coal from underground mines and 55¢ per ton for surface-mined coal, not to exceed 4.4 percent of the sales price. Prior to the IRA, producers paid reduced rates to fund the Black Lung Disability Trust Fund: 50¢ per ton for coal and 25¢ per ton for coal from surface mines, not to exceed 2 percent of the sales price.

¶ 1112 DEPRECIATION

The IRA adds three categories of green energy property to the MACRS five-year property classification:

- Clean Electricity Production Facility Property defined under Code Sec. 45Y(b) (1) (A)
- Qualified Investment Property for Clean Electricity Investment defined under Code Sec. 48E(b) (2)
- Energy Storage Technology property defined under Code Sec. 48(c) (6)

Qualifying property includes property placed in service after December 31, 2024.

¶ 1113 FUNDING FOR THE IRS

The IRA appropriates $3.18 billion for the IRS to provide taxpayer and other services, and $45.6 billion for necessary expenses for the IRS to:

- Determine and collect taxes
- Provide legal and litigation support
- Conduct criminal investigations (including investigative technology)
- Provide digital asset monitoring and compliance activities
- Enforce criminal statutes related to violations of the Internal Revenue Code and other financial crimes
- Purchase and hire passenger motor vehicles, and
- Provide other services

IRS Spending Plans

Many of the 87,000 new IRS staffers to be hired will replace more than 50,000 employees set to retire over the next decade and will serve in a variety of roles, not just tax collection. The intention is to crack down on tax avoidance by wealthy taxpayers, with higher expected revenue used to pay down the deficit and fund healthcare and climate programs.

The act provides approximately $80 billion of additional IRS funding over the next nine years for the following:

- Taxpayer service
- Enforcement, including legal and litigation support, conducting criminal investigations, digital asset monitoring, and compliance and financial crimes
- Operations support; and
- Business systems modernization

More than half of the additional funds will be allocated to enforcement efforts. Funds will also be allocated to an e-file task force.

COMMENT: The increased IRS funding may have several implications for taxpayers, including an increase in audits of wealthy individuals. It remains a question as to whether lower- to middle-class taxpayers will also be affected. Other developments might include:

- Better IRS computer systems
- More automated matching and letter audits
- Better taxpayer service, resulting from the IRS's ability to staff positions
- Increased Criminal Investigation Division activity

Increased audits of taxpayers with income over $400,000 would result in approximately $20 billion in tax revenue. The IRA is scored to generate $220 billion in additional revenue from increased IRS enforcement. It is unclear where the $200 billion difference will come from.

¶ 1114 CHIPS ACT

President Biden signed the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act into law on August 9, 2022. The act authorizes more than $280 billion in federal funding to promote domestic semiconductor production. Only $53.7 billion will be immediately appropriated, with the remaining funds requiring further congressional action. The act also creates a 25 percent tax credit to incentivize investments in semiconductor manufacturing.

CHIPS Investment Tax Credit

The credit is 25 percent of qualified investments in advanced manufacturing facilities per Code Sec. 48D. Qualified Code Sec. 48D property placed in service may be equipment, buildings, or structural components of a building used for manufacturing semiconductors or equipment that will be used to manufacture semiconductors. Taxpayers can opt a "direct pay" election to treat the Code Sec. 48D credit to offset their tax liability in the year the qualified facility is placed in service.

The credit is available for facilities that are placed in service after December 31, 2022, and for which construction begins before January 1, 2027.

CHIPS Grants

The CHIPS Act also contains more than $50 billion of incentives in the form of new grants, which are intended to fund:

- Workforce development,
- Security of the domestic supply chain for semiconductors, and
- Programs for developing semiconductor technology from lab prototypes to fabrication through university collaboration and research and development.

STUDY QUESTIONS

4. Which of the following statements is correct regarding the rules applicable to foreign income?

a. The foreign tax credit generally must be added back to income in calculating AFSI.

b. For U.S. shareholders of controlled foreign corporations, AFSI excludes the taxpayer's pro rata share of the net income or loss stated on the controlled foreign corporation's financial statements.

c. Net losses from controlled foreign corporations reduce AFSI.

d. Treasury regulations will provide for proper treatment of deferred taxes only.

5. Which of the following statements is correct regarding the new electric vehicle (EV) credits?

a. Buyers of new EVs are eligible for up to a $4,500 credit.

b. The credit is unavailable to single tax filers with modified adjusted gross income above $150,000.

c. The manufacturer's limit is eliminated for EVs sold after 2026.

d. The MSRP cannot exceed $45,000 for sedans.

6. Which of the following statements is correct regarding the CHIPS Act?

a. It authorizes only $75 billion in federal funding to promote domestic semiconductor production.

b. It creates a 50 percent tax credit to incentivize investments in semiconductor manufacturing.

c. Taxpayers can opt a "direct pay" election to treat the Code Sec. 48D credit.

d. The credit is available for facilities that are placed in service after December 31, 2019.

CPE NOTE: When you have completed your study and review of chapters 7-11, which comprise Module 2, you may wish to take the Final Exam for this Module. Go to **cchcpelink.com/printcpe** to take this Final Exam online.

¶ 10,100 Answers to Study Questions

¶ 10,101 MODULE 1—CHAPTER 1

1. a. ***Incorrect.*** This section requires that, under certain circumstances, including failure of payee to provide a TIN, the payer must perform backup withholding.

b. ***Incorrect.*** This section relates to the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans.

c. ***Correct.*** **Note that the Internal Revenue Code requires that payers of certain types of payments issue information returns (i.e., Forms 1099-MISC).**

d. ***Incorrect.*** This section requires that a payee provide a TIN to the payer when the payment will be reportable on an information return (i.e., Form 1099-MISC).

2. a. ***Incorrect.*** This is the incorrect amount. Reporting is made to someone who is not your employee (note that this includes payments made by government agencies and nonprofit organizations to service providers).

b. ***Incorrect.*** This is the incorrect amount. Reporting is made for services in the course of your trade or business. This includes parts and materials used in conjunction with these services.

c. ***Incorrect.*** This is the incorrect amount. Reporting is made to an individual, partnership, estate, attorney, or, in some cases, a corporation.

d. ***Correct.*** **An example of a payment that must be reported is professional service fees to professional service providers.**

3. a. ***Incorrect.*** This is not a box 1 issue. Instead, this is an issue related to box 2 of Form 1099-MISC.

b. ***Correct.*** **Note that boxes 1, 2, 3, 6, and 10 are the main boxes on Form 1099-MISC.**

c. ***Incorrect.*** This is not a box 1 issue. Instead, this is an issue related to box 3 of Form 1099-MISC.

d. ***Incorrect.*** This issue relates to box 6. Note that box 6 reportable medical payments versus 1099-NEC box 1 services payments is the big issue.

4. a. ***Incorrect.*** A W-2 form, also known as the Wage and Tax Statement, is the document an employer is required to send to each employee and to the IRS at the end of the year.

b. ***Incorrect.*** The Form W-3 tells the IRS information about the individual taxpayer, including what they made during the tax year (including tips, Social Security wages, and Medicare wages).

c. ***Incorrect.*** Employees fill out a W-4 form to let employers know how much tax to withhold from their paycheck based on filing status, dependents, anticipated tax credits, and deductions.

d. ***Correct.*** **Form W-9 is used in the U.S. income tax system by a third party who must file an information return with the IRS. It requests the name, address, and taxpayer identification information of a taxpayer.**

5. a. ***Correct.*** **It's important to note that the TIN Matching Program is not part of the IRS B-Notice program.**

b. ***Incorrect.*** IRS2Go is the official mobile app of the IRS. You can use the app to check your refund status, make a payment, and find free tax preparation assistance, sign up for helpful tax tips, and more. IRS2Go is available in both English and Spanish.

c. ***Incorrect.*** Tax-exempt organizations may be searched online at IRS.gov to verify that charitable contributions to them are tax deductible. The search results will identify the organizations eligible to receive tax-deductible charitable contributions.

d. ***Incorrect.*** The IRS Fresh Start Program is a program that is designed to allow taxpayers to pay off substantial tax debts affordably over the course of six years. Each month, taxpayers make payments that are based on their current income and the value of their liquid assets.

6. a. ***Incorrect.*** This is an incorrect statement. Instead, LLCs can be a single-member similar to a sole proprietor.

b. ***Correct.*** **They can be owned by another entity and be a disregarded entity (i.e., disregarded as being separate from the owner).**

c. ***Incorrect.*** This is an incorrect statement. LLCs are not exempt from 1099 reporting as they are not corporations.

d. ***Incorrect.*** This is an incorrect statement. They can file to be treated as corporations for reporting purposes. However, this is rare.

¶ 10,102 MODULE 1—CHAPTER 2

1. a. ***Incorrect.*** This is the incorrect term. Note that Schedule K-2 relates to the partners' total international distributive share items.

b. ***Incorrect.*** This is the incorrect term. One of the returns referenced to is the Form 1065 (*U.S. Return of Partnership Income*).

c. ***Correct.*** **Note that international relevance is broadly defined. These schedules replace the often-cursory information formerly required to be entered on Schedule K-1, which then often necessitated an attached document, but with no specified format or items of information.**

d. ***Incorrect.*** This is the incorrect term. Note that Schedule K-3 relates to the partner's share of international income, deductions, credits, etc.

2. a. ***Correct.*** **Another Part of Schedule K-2 is Part I, related to "Partnership's Other Current Year International Information."**

b. ***Incorrect.*** Instead, Part III relates to "Other Information for Preparation of Form 1116 or 1118."

c. ***Incorrect.*** Instead, Part IV relates to "Information on Partner's Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)."

d. ***Incorrect.*** Instead, Part V relates to "Distributions From Foreign Corporations to Partnership."

3. a. ***Incorrect.*** Schedule 1 is used to report types of income that aren't listed on Form 1040, such as capital gains, alimony, unemployment payments, etc.

b. *Incorrect.* This is the incorrect schedule. This is the schedule that reports your share of the partnership's income, deductions, credits, etc.

c. *Incorrect.* This is the incorrect schedule. Schedule K-2 is an extension of Form 1120-S, Schedule K, and is used to report items of international tax relevance from the operation of an S corporation.

d. *Correct.* Note that instructions to Schedules K-2 and K-3 reference "the international tax provisions of the Internal Revenue Code."

4. a. *Incorrect.* This is the incorrect year when these schedules are required. Instead, they are required in a year beginning after 2020.

b. *Correct.* The Internal Revenue Service expects taxpayers to begin filing Schedules K-2 and K-3 for the 2021 tax year.

c. *Incorrect.* This is the incorrect year. Note that S corporations with international tax relevance, as well as certain Form 8865 filers, will have similar Schedules K-2 and K-3 filing obligations.

d. *Incorrect.* This is the incorrect year when these schedules are required. Instead, they are required in a year beginning prior to 2023.

5. a. *Correct.* For tax year 2021, no penalties will be assessed if a taxpayer could demonstrate a good-faith effort to comply. However, merely not filing the K-2 and K-3 would not be acting in good faith to attempt to comply.

b. *Incorrect.* This is one of the factors considered by the IRS in determining whether the taxpayer has made a good-faith effort to comply with the rules.

c. *Incorrect.* Note that merely not filing the K-2 and K-3 would not be acting in good faith to attempt to comply.

d. *Incorrect.* This is one of the factors considered by the IRS. Another consideration is if the taxpayer applied reasonable assumptions when this information could not be obtained.

6. a. *Incorrect.* This is the incorrect organization. The organization in question called for the Treasury Department and the IRS to delay implementation of the Schedules K-2 and K-3 to the 2022 tax year and to suspend any assessment of penalties for failing to file or failing to timely provide Schedules K-2 and K-3 for the 2021 tax year.

b. *Correct.* The AICPA sent comments to the IRS strenuously objecting to requiring Schedules K-2 and K-3 to be filed for the 2021 tax year.

c. *Incorrect.* This is the incorrect organization. The organization in question posits that the lack of a timely available Modernized e-File (MeF) filing option for these forms in electronic format will cause unnecessary hardship to all affected parties.

d. *Incorrect.* This is the incorrect organization. The organization in question also cited as a reason for the delay in implementation the fact that the taxpayer's reporting obligations are unresolved and the fact that the IRS is unable to accept electronically filed returns via the Modernized e-File (MeF) system until March 20, 2022 (partnerships) and until mid-June 2022 (S corporations returns).

¶ 10,103 MODULE 1—CHAPTER 3

1. a. ***Incorrect.*** Of the individuals surveyed, only 15 percent indicated that this factor had a great deal of influence.

b. ***Incorrect.*** Your ability to pay taxes due ranked as the third highest factor regarding voluntary compliance.

c. ***Correct.*** **Avoiding paying interest/penalties is one of the factors which drive voluntary influence. This factor had the second highest amount of influence with respect to voluntary compliance.**

d. ***Incorrect.*** While taxpayers' desire to help the government take care of citizens and national interests was a factor, it was only the fifth highest factor with the greatest influence.

2. a. ***Incorrect.*** Income subject to information reporting and withholding does not contribute the largest to the small business tax gap. This type of income includes wages and salaries.

b. ***Correct.*** **This type of income contributes the substantial majority to misreporting by income category. This includes income such as nonfarm proprietor income, rents, and royalties.**

c. ***Incorrect.*** This type of income includes pensions and annuities, unemployment compensation, dividend income, interest income, and taxable social security benefits.

d. ***Incorrect.*** This type of income includes partnership/S corporation income, capital gains, and alimony income. It is not the largest contributor to the tax gap.

3. a. ***Incorrect.*** Form 1040 is used by U.S. taxpayers to file an annual income tax return.

b. ***Correct.*** **Form 1120 (officially the *U.S. Corporate Income Tax Return*) is one of the IRS tax forms used by corporations (specifically, C corporations) in the United States to report their income, gains, losses, deductions, credits and to figure out their tax liability.**

c. ***Incorrect.*** Form 1065 is used for partnerships. Regarding the percentage of small businesses, 2.7 million are LLCs and 20 percent are domestic general partnerships.

d. ***Incorrect.*** Form 1120-S, called the *U.S. Income Tax Return for an S Corporation*, is a tax document that is used to report the income, losses, and dividends of S corporation shareholders.

4. a. ***Correct.*** **You should not miss the 30- and/or 90-day letters. If you do, you should request reconsideration.**

b. ***Incorrect.*** Responding on time is one of the best practices regarding mail audits. Another best practice is to fax your response if you're within a week of the deadline.

c. ***Incorrect.*** Following up by phone for status is a best practice with respect to mail audits. Another best practice is that you should include one complete response.

d. ***Incorrect.*** You should always request an appeal if the IRS disagrees. Furthermore, if you miss the 30-day or 90-day letters, you should request a reconsideration from the IRS.

5. a. ***Incorrect.*** This is the error rate found in IRS construction audits related to gross receipts for Form 1120-S, not Form 1065.

b. ***Correct.*** **This is the error rate found in IRS construction audits related to gross receipts for Form 1065. Also note that for depreciation, the error rate is 100 percent.**

c. ***Incorrect.*** This is the error rate found in IRS construction audits related to cost of sales for Schedule C, not for Form 1065.

d. ***Incorrect.*** This is the error rate found in construction audits with respect to depreciation on Form 1065. The error rate for other deductions on Form 1065 was 86 percent.

6. a. ***Incorrect.*** This is one of the fraud red flags. Another fraud red flag is attempts to hinder the investigation by failing or refusing to answer questions, canceling appointments, or refusing to supply records.

b. ***Incorrect.*** This is one of the fraud red flags. Another fraud red flag is false statements about material facts in an examination.

c. ***Correct.*** **This is not one of the identified fraud red flags. Instead, one of the red flags is transfers of assets for purpose of concealment.**

d. ***Incorrect.*** If the issues and IDRs are related to unreported income, and multiple years are under examination, this may be a sign that the IRS agent is looking for fraud.

¶ 10,104 MODULE 1—CHAPTER 4

1. a. ***Incorrect.*** This is one of the three ways to qualify for the employee retention credit. This includes the period where both the operations are partially or fully suspended, and a government order is in effect.

b. ***Correct.*** **This is not one of the three ways to qualify for the employee retention credit. Instead, the three ways include a government shutdown, significant decline in gross receipts, and a recovery startup business.**

c. ***Incorrect.*** This is one of the three ways to qualify for the employee retention credit. A business can use current quarter's gross receipts or elect to use prior quarters.

d. ***Incorrect.*** This is one of the three ways to qualify for the employee retention credit. However, note that this only applies in Q3 and Q4 of 2021.

2. a. ***Correct.*** **This is excluded for purposes of determining gross receipts. Additionally, PPP loan forgiveness is also excluded from the gross receipt's calculation.**

b. ***Incorrect.*** Royalties are included within the gross receipts. All amounts received for services are also included within gross receipts.

c. ***Incorrect.*** Annuities are included when determining the gross receipts. Also note that rents and royalties are also included when calculating gross receipts.

d. ***Incorrect.*** Dividends should be included when determining the gross receipts. However, note that sales tax should be excluded if legally imposed on the purchaser, and the taxpayer merely collects and remits.

3. a. ***Incorrect.*** A child or a descendant of a child is covered by attribution. Another relative covered is a sister or stepsister.

b. *Incorrect.* The ancestor of a father is covered by attribution. Another relative covered is a niece or nephew.

c. *Correct.* Spouses are not relatives for purposes of this rule. However, notice 2021-49 provides wages paid to spouses of majority shareholders are not eligible.

d. *Incorrect.* A sister-in-law is covered by attribution. Another relative covered is an individual (other than a spouse) who for the taxable year has the same principal place of abode as the taxpayers.

¶ 10,105 MODULE 1—CHAPTER 5

1. a. *Correct.* Regarding whether the election should in fact be made, it may depend on knowledge of the owner's tax situation.

b. *Incorrect.* Instead, note that a growing number of states allow a pass-through entity to pay state income taxes rather than the owners.

c. *Incorrect.* This is an incorrect statement. Instead, most states require an election by the pass-through entity.

d. *Incorrect.* Instead, if the workaround is used, pass-through entity owners may need to (but are not required to) adjust estimated payments.

2. a. *Incorrect.* The deduction is limited to the greater of (1) 50 percent of the W-2 wages with respect to the trade or business, or (2) the sum of 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property (generally, tangible property subject to depreciation under Code Sec. 167).

b. *Correct.* Section 199A allows taxpayers other than corporations a deduction of 20 percent of qualified business income earned in a qualified trade or business, subject to certain limitations.

c. *Incorrect.* Qualified business income is the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business that are effectively connected with the conduct of a business in the United States.

d. *Incorrect.* It was available for years prior to 2020. Note that the deduction is available to any taxpayer other than a corporation.

3. a. *Incorrect.* This is one of the suggestions made by TIGTA with respect to the large error rates. Note that TIGTA reviewed over 12 million QBID claims.

b. *Incorrect.* This is one of the suggestions made by TIGTA with respect to the large error rates. The average QBID claimed was $2,370.

c. *Correct.* This is not one of three points noted by TIGTA with respect to large error rates. Instead, one of the suggestions relates to having a lower threshold for IRS examination.

d. *Incorrect.* This is one of the suggestions made by TIGTA with respect to the large error rates. Of the more than 12 million QBID claims reviewed by TIGTA, 95.3 percent were below the threshold set by the IRS for review.

4. a. ***Incorrect.*** This is not the 2018 full phase-in amount for QBID for those individuals filing as single. Instead, this represents the threshold amount for single filers.

b. ***Correct.*** **This is the full phase-in amount for QBID for those individuals filing as single. Alternatively, for taxpayers filing as married jointly, the full phase-in amount is $415,000.**

c. ***Incorrect.*** This is not the full phase-in amount for QBID for those individuals filing as single. Instead, this represents the threshold amount for taxpayers filing as married jointly.

d. ***Incorrect.*** This is not the full phase-in amount for QBID for those individuals filing as single. Instead, this represents the full phase-in amount for taxpayers filing as married jointly.

5. a. ***Correct.*** **Also note that it may be possible, in many partnerships, to increase QBID by substituting priority distributions for what may otherwise be reported as a guaranteed payment.**

b. ***Incorrect.*** S corporation shareholders may be employees. Additionally, note that partners cannot be employed by the partnership.

c. ***Incorrect.*** This is an incorrect statement. Instead, note that W-2 wages are not eligible for the QBID.

d. ***Incorrect.*** It is not always clear how to classify guaranteed payments. The key is not determined by reference to income.

6. a. ***Incorrect.*** This is required to be reported on Schedule K-1. Schedule K-1 is a federal tax document used to report the income, losses, and dividends of a business' or financial entity's partners or an S corporation's shareholders.

b. ***Incorrect.*** This is required to be reported on Schedule K-1. Also note that the share of recourse debt should also be reported on Schedule K-1.

c. ***Incorrect.*** This is required to be reported on Schedule K-1. Note that qualified nonrecourse debt allows at-risk basis.

d. ***Correct.*** **This is not required to be reported on Schedule K-1. Instead, the share of recourse debt, share of nonrecourse debt, and share of qualified nonrecourse debt is required to be reported on Schedule K-1.**

¶ 10,106 MODULE 1—CHAPTER 6

1. a. ***Incorrect.*** The ability to reduce the deferred gain to be recognized by 10 percent of that deferred gain if the investment is held for five years before December 31, 2026, is one of the potential benefits of QOFs.

b. ***Correct.*** **This is not one of the tax incentives available with respect to QOFs. Note that the gain must be a capital gain or a Section 1231 gain.**

c. ***Incorrect.*** This is one of the potential benefits of QOFs. Another benefit is that you can get full gain exclusion if it is held for 10 or more years.

d. ***Incorrect.*** This is one of the tax incentives available as a result of the TCJA. The TCJA created new Section 1400Z-2 to create tax incentives to invest in designated opportunity zones.

2. a. ***Incorrect.*** The partnership investment is not required to be within 30 days of the gain recognition event. Instead, a longer time period is afforded to the partnership in order to elect a qualified opportunity fund deferral of an entity-level gain.

b. ***Incorrect.*** Note that no election is available for a gain triggered by Section 752(b) debt share reduction that results in a deemed distribution greater than the basis.

c. ***Incorrect.*** A partnership (or S corporation) may elect a qualified opportunity fund deferral of entity-level gain. It's important to note that if the partnership does not elect, a partner may elect.

d. ***Correct.*** **The partnership investment must be within 180 days of the gain recognition event. If the partnership does not elect, a partner may elect, and the 180-day period begins at the close of the partnership tax year.**

3. a. ***Incorrect.*** This is not the full phase in amount for QBID for those individuals filing as single. Instead, this represents the threshold amount for single filers in 2020.

b. ***Correct.*** **This is the full phase in amount for QBID for those individuals filing as single. Alternatively, for taxpayers filing as married jointly, the full phase in amount is $440,100.**

c. ***Incorrect.*** This is not the full phase in amount for QBID for those individuals filing as single. Instead, this represents the threshold amount for taxpayers filing as married jointly in 2020.

d. ***Incorrect.*** This is not the full phase in amount for QBID for those individuals filing as single. Instead, this represents the full phase in amount for taxpayers filing as married jointly in 2020.

4. a. ***Incorrect.*** This is not the correct amount. When calculating the amount, you use average gross receipts for preceding three years.

b. ***Incorrect.*** This is not the correct amount. It's also important to note that you don't include sales tax if it is imposed on the purchaser and the seller just collects.

c. ***Incorrect.*** This is not the correct amount. Instead, the amount of trailing three years average annual gross receipts must be higher than this amount in order for the requirement of aggregation to be applicable.

d. ***Correct.*** **It's important to note that you should aggregate commonly controlled businesses. This amount is also indexed for inflation. The other requirement is that the entity is not a tax shelter.**

5. a. ***Incorrect.*** In this case, the Tax Court concluded that the rental real estate was not a business. This case involved a rental of a small portion of a residence formerly occupied as a residence.

b. ***Incorrect.*** In this case, the Tax Court concluded that the rental real estate was not a business. This case involved a former residence, offered for sale, or rent, that was never actually rented.

c. ***Correct.*** **In this case, the Tax Court concluded that the rental real estate was in fact a business. This case involved two timeshares and a management company that had substantial activity.**

d. ***Incorrect.*** In this case, the Tax Court concluded that the rental real estate was not a business. By contrast, the case of *Hazard v. Commissioner* was one where the tax court concluded the rental real estate was a business.

6. a. ***Incorrect.*** This is the incorrect number of service hours. Another requirement when applying this safe harbor relates to having contemporaneous timekeeping.

b. ***Correct.*** **For rental real estate enterprises that have been in existence less than four years, the requirement is 250 or more hours of rental services are performed per year. For other rental real estate enterprises, the requirement is that 250 or more hours of rental services are performed in at least three of the past five years.**

c. ***Incorrect.*** This is the incorrect number of service hours. Another requirement when applying this safe harbor is that a statement is required to be attached to the respective tax return.

d. ***Incorrect.*** This safe harbor allows certain interests in rental real estate, including interests in mixed-use property, to be treated as a trade or business for purposes of the qualified business income deduction under Code Sec. 199A.

¶ 10,107 MODULE 2—CHAPTER 7

1. a. ***Incorrect.*** This is the incorrect year. Note that Bitcoin was a novelty technology for the first several years of its existence.

b. ***Correct.*** **The first Bitcoin transaction was in 2010. It involved two Papa John's pizzas for 10,000 Bitcoin, which would be equivalent to $200 million at current trading value.**

c. ***Incorrect.*** This is the incorrect year. Note that Bitcoin was given away or traded for almost nothing in the beginning.

d. ***Incorrect.*** Bitcoin inspired additional blockchain and cryptocurrency technologies. Some of these technologies (e.g., Litecoin) were released to compete with Bitcoin, but others (e.g., Ethereum) were developed to fill a different need in the marketplace.

2. a. ***Incorrect.*** A block is not a digital ledger of transactions. Instead, a block is essentially the pages of the blockchain ledger. Each block holds a historical database of all cryptocurrency transactions made until the block is full.

b. ***Incorrect.*** A wallet is not a digital ledger of transactions. A wallet is an app that allows cryptocurrency users to store and retrieve their digital assets.

c. ***Correct.*** **With this arrangement, any two willing parties can directly transact peer-to-peer without the need for a trusted third party such as a bank.**

d. ***Incorrect.*** An exchange is not a digital ledger of transactions. Instead, an exchange is the location where users can exchange traditional currency (fiat) for cryptocurrencies.

3. a. ***Incorrect.*** Each block holds a historical database of all cryptocurrency transactions made until the block is full. Also note that a block is a permanent record that can be reviewed.

b. ***Correct.*** **Note that hard forks represent a major update to this protocol. On the other hand, a soft fork is a minor update that improves efficiency.**

c. ***Incorrect.*** This is all the other coins outside of Bitcoin that are grouped together. One example of an altcoin is Ethereum.

d. ***Incorrect.*** Fiat refers to money recognized as legal tender by governments, such as the U.S. dollar, British pound, Euro, and Australian dollar.

4. a. ***Correct.*** **Wages paid by virtual currency must be reported on a Form W-2. These wages are also subject to federal income tax withholding, FICA, and FUTA.**

b. ***Incorrect.*** Virtual currency payments to independent contractors constitute self-employment income. As a result, this income is subject to self-employment tax.

c. ***Incorrect.*** Note that when cryptocurrency that is being held by an individual goes through a hard fork, the new forked cryptocurrency received is taxed as income.

d. ***Incorrect.*** The IRS considers marketing giveaways to be ordinary income. It is valued on the date the cryptocurrency is received.

5. a. ***Incorrect.*** This is not the term to describe this process. Hacking is an attempt to exploit a computer system or a private network inside a computer.

b. ***Correct.*** **In this situation, the person donating the computer power is granted new fractions of the cryptocurrency.**

c. ***Incorrect.*** Phishing is the fraudulent attempt to obtain sensitive information or data, such as usernames, passwords, credit card numbers, or other sensitive details by impersonating oneself as a trustworthy entity in a digital communication.

d. ***Incorrect.*** This is the fraudulent practice of sending text messages purporting to be from reputable companies in order to induce individuals to reveal personal information.

6. a. ***Correct.*** **Note that when giving gifts to charitable organizations, the donor may be able to deduct the full fair market value of cryptocurrency given to public or private charities under Code Sec. 501(c)(3) or to governmental entities or political subdivisions thereof (e.g., a public school).**

b. ***Incorrect.*** This is the incorrect amount that is not subject to gift tax. Remember that cryptocurrency is property, not currency.

c. ***Incorrect.*** This is the incorrect amount that is not subject to gift tax. Additionally, note that the donor may be able to deduct the full fair market value of cryptocurrency given to public or private charities under Code Sec. 501(c)(3) or to governmental entities or political subdivisions thereof.

d. ***Incorrect.*** This is the incorrect amount that is not subject to gift tax. Instead, the amount is $16,000 in 2022.

¶ 10,108 MODULE 2—CHAPTER 8

1. a. ***Incorrect.*** For a grantor trust, all income is purposefully taxed to the grantor (creator) of the trust. This is usually because the grantor wants to further deplete his own assets by paying tax while leaving the assets inside the trust free to continue to grow.

b. ***Incorrect.*** This is a trust that does not require the distribution of all income annually. It could be a trust that requires the distribution or income but also makes some distributions of principal during the year to beneficiaries or makes distributions to charities during the year.

c. ***Incorrect.*** A living trust is a trust that is created during your lifetime. In other words, while you are still alive, you transfer title to your property from your name to that of the trustee of the living trust. This type of trust is not required to distribute all income annually.

d. *Correct.* A simple trust is any trust which, under the actual terms of the trust document, is required to distribute all income and may not distribute any principal or monies to charities during the current tax year.

2. a. *Incorrect.* A simple trust is one that is required to distribute all of its income currently to its beneficiaries with no transfers to charities allowed.

b. *Correct.* A grantor trust remains in the control of the grantor while the grantor is alive. Most trusts (except grantor trusts) are separate taxpayers.

c. *Incorrect.* A complex trust is one that authorizes the trustee to either distribute or accumulate the trust's income. For this type of trust, transfers to charities are allowed.

d. *Incorrect.* An ESBT is an Electing Small Business Trust created for the purpose of holding S corporation shares. The most significant drawback of the ESBT lies in the income tax rules to which it is subject. Any portion of an ESBT that consists of S corporation stock must be treated as a separate trust taxable at the highest individual tax rate with no distribution deduction allowed.

3. a. *Incorrect.* Also note that trusts and estates do not exist as creations established under federal law; they are governed by state law provisions. The Internal Revenue Code determines how they are taxed for federal income tax purposes.

b. *Incorrect.* This is the incorrect amount with respect to estimated taxes. However, when estimated taxes are required, then Form 1041-ES is used for this purpose.

c. *Incorrect.* This is the incorrect amount with respect to estimated taxes. Underestimation penalties can be avoided if certain conditions are met.

d. *Correct.* Note that if excess estimated tax payments are made for a particular year, they can be either refunded to the fiduciary, or applied against the tax liability for the next taxable year, or, by affirmative election, be distributed to the trust's beneficiaries via Form 1041-T.

4. a. *Incorrect.* IRS Form 1023 is known as the *Application for Recognition of Exemption Under 501(c)(3) of the Internal Revenue Code* and is filed by nonprofits to get nonprofit exemption status.

b. *Incorrect.* Form 1040 is used by U.S. taxpayers to file an annual income tax return. It is not used to file the tax return for estates and trusts.

c. *Correct.* IRS Form 1041 is required if the estate generates more than $600 in annual gross income. The decedent and their estate are separate taxable entities. The due date of Form 1041 is the 15th day of the fourth month following the close of the tax year.

d. *Incorrect.* Form 1065 is not used to file the tax return for estates and trusts. Instead, this form is used to report partnership income, gains, losses, deductions, credits, etc. A partnership does not pay tax on its income but passes through any profits or losses to its partners.

5. a. *Incorrect.* This is not the due date for the Form 1041 tax return. Note that Form 1041 must be filed for a trust if it has any taxable income for the tax year, gross income of $600 or more regardless of taxable income, or a nonresident alien beneficiary.

b. *Correct.* The Form 1041 tax return for a calendar-year filer is due on April 15. For a taxpayer that has elected the fiscal year option, it is due three and a half months after the end of the tax year.

c. *Incorrect.* This is not the due date for the Form 1041 tax return. It's important to note that a trust can obtain an automatic five-and-one-half-month extension of time to file Form 1041 by making a timely filing of Form 7004.

d. *Incorrect.* This is not the due date for the Form 1041 tax return. Also note that income tax rates for ordinary income of estates and trusts are extremely compressed.

6. a. *Correct.* A trust or an estate may not claim a standard deduction. However, trusts and estates may claim an exemption, which is $600 for an estate, $300 for a simple trust, and $100 for a complex trust.

b. *Incorrect.* This is not the standard deduction amount for a trust or an estate. Instead, this represents the exemption amount for a complex trust. Note that trusts and estates are entitled to many of the same deductions allowed for individuals.

c. *Incorrect.* This represents the exemption amount for a simple trust. This is not the standard deduction amount for a trust or an estate. It's also important to note that the limitation of many deductions by the 2017 TCJA also applies to trusts and estates.

d. *Incorrect.* This is not the standard deduction amount for a trust or an estate. Instead, this represents the exemption amount for an estate. Furthermore, there is no distinction for tax purposes between deductions allocated to principal and those allocated to income.

¶ 10,109 MODULE 2—CHAPTER 9

1. a. *Incorrect.* Charitable deductions are not a type of above-the-line deduction. Instead, they are included within itemized deductions.

b. *Incorrect.* State and local taxes paid are not a type of above-the-line deduction. Instead, they are included within itemized deductions.

c. *Correct.* Educator expenses are an example of an above-the-line deduction. Another example of an above-the-line deduction is health saving account deductions.

d. *Incorrect.* Gambling losses are not a type of above-the-line deduction. An example of an above-the-line deduction is alimony paid.

2. a. *Incorrect.* This is the incorrect amount. Note that the threshold amount was reduced from 2021.

b. *Incorrect.* This is the incorrect amount. Note that the new rules apply to sales of goods and services.

c. *Incorrect.* This is the incorrect amount. Note that the new rules apply to sales of goods and services but not cash transfers to friends and family payments.

d. *Correct.* The IRS estimates that the lowering of the threshold will raise almost $8.4 billion over 10 years.

3. a. *Correct.* This is a correct statement. Note that activity is performed through a free-functioning software program.

b. *Incorrect.* Instead, Bitcoin uses the concept of mining. In this situation, you employ enormous amounts of computer power to solve complex math problems.

c. *Incorrect.* Instead, the IRS notes that mining is taxable when new cryptocurrency is actually received.

d. *Incorrect.* Form 1099-B will be required for digital assets (which includes cryptocurrency) and will include transactions in 2023 (not 2022).

4. a. *Incorrect.* This is not the correct rule. Note that courts bear heavily "upon the taxpayer whose inexactitude is of [her] own making."

b. *Incorrect.* This is not the correct rule. Note that estimates are not allowed in some areas, though.

c. *Correct.* Even if the taxpayer lacks receipts, a deduction is allowed if, among other requirements, there is a reasonable basis to support the estimate.

d. *Incorrect.* This is not the correct rule. However, estimates are not allowed for travel, gifts, listed property (business autos), and charitable contributions.

5. a. *Incorrect.* This is an example of an expenditure that would increase basis. Another example of an expenditure that would increase basis is adding a pool.

b. *Correct.* This is an example of an expenditure that doesn't increase basis. Painting is another expenditure that doesn't increase basis (unless it is performed as a part of a remodel).

c. *Incorrect.* This is an example of an expenditure that would increase basis. Another example of an expenditure that would increase basis is adding a new water heater.

d. *Incorrect.* This is an example of an expenditure that would increase basis. Another example of an expenditure that would increase basis is adding a new garage, porch, or patio.

6. a. *Incorrect.* This is a traditional method of deferring tax. Another traditional way of deferring tax is to delay bonuses.

b. *Incorrect.* This is a traditional method of deferring tax. Another traditional way of deferring tax is to contribute to certain tax-deferred retirement plans.

c. *Correct.* Instead, for a cash method business, a traditional strategy for deferring tax is to send out business invoices a bit later in December.

d. *Incorrect.* This is a traditional method of deferring tax. Another traditional way of deferring tax is to contribute to health savings accounts if you have a high-deductible plan.

7. a. *Correct.* The bonus depreciation rate for the year 2027 is 0 percent. This compares to 40 percent for the year 2025 and 60 percent for the year 2024.

b. *Incorrect.* 40 percent is not the bonus depreciation rate for the year 2027. Instead, 40 percent is the bonus depreciation rate for the year 2025.

c. *Incorrect.* 60 percent is not the bonus depreciation rate for the year 2027. Instead, 60 percent is the bonus depreciation rate for the year 2024.

d. *Incorrect.* 80 percent is not the bonus depreciation rate for the year 2027. Instead, 80 percent is the bonus depreciation rate for the year 2023.

8. a. *Incorrect.* Note that one of the seven tests of material participation is the "500-hour" test. There are seven tests for material participation that should be considered.

b. *Correct.* This is commonly referred to as the "5 of 10 preceding years" test. Based on Treas. Reg. §1.469-5T(k), Example 6, the taxpayer should consider whether they have materially participated for any five taxable years during the immediately preceding 10 years.

c. *Incorrect.* Also note that one of the other seven tests of material participation is the "substantially all participation" test.

d. *Incorrect.* This is the incorrect parameter for this test. In this example, the taxpayer would not meet this test of material participation. Instead, if they materially participated in significantly more years in the preceding 10 years, they would meet this test requirement.

9. a. *Incorrect.* In this situation, the taxpayer would not be considered to be a real estate professional because they did not clear the first hurdle with respect to personal services.

b. *Incorrect.* The taxpayer would not be considered to be a real estate professional in this situation even though they cleared the second hurdle regarding the 750 hours.

c. *Incorrect.* The taxpayer would not be considered to be a real estate professional in this situation even though they cleared the second hurdle regarding the 750 hours. A higher percentage of their personal services must be attributed to real estate business.

d. *Correct.* The determination of whether a taxpayer is a real estate professional involves a two-part test. It includes both the consideration of the percentage of their time spent on the activity as well as the number of hours.

10. a. *Incorrect.* The election out of CPAR is not made on Form 1120-S. Form 1120-S is a tax document used to report the income, losses, and dividends of S corporation shareholders.

b. *Correct.* The election out of CPAR is made annually on Form 1065. The election is valid only if made on a timely filed return, so it puts pressure on a preparer to prove the return and extension is valid and filed on time.

c. *Incorrect.* The election out of CPAR is not made on Form 1120. Form 1120 is the U.S. Corporation Income Tax Return form.

d. *Incorrect.* The election out of CPAR is not made on Form 7036. Instead, the IRS allows election into the CPAR regime early for 2017 on Form 7036. Form 7036 is probably the loneliest form in America as it is not recommended.

11. a. *Incorrect.* This is an area where the APA provides no "statement of good cause." Note that there are several areas where the APA provides no "statement of good cause."

b. *Correct.* Another area where the APA provides only summary discussion of comments (i.e., no concise statement) is portions of partnership regulations (e.g., Subchapter K).

c. *Incorrect.* This is an area where the APA provides no "statement of good cause." Instead, an area where there is only summary discussion of comments relates to self-employment tax on real estate rentals.

d. *Incorrect.* This is an area where the APA provides no "statement of good cause." Instead, an area where there is only summary discussion of comments relates to portions of Section 1231 regulations.

12. a. *Correct.* This is the correct amount. Note that it is determined on a cumulative basis for sales after December 31, 2009.

b. *Incorrect.* This is the incorrect amount. Note that the IRS added the 2022 Audi, BMW, and Lincoln vehicles to the list qualifying for the Code Sec. 30D plug-in electric drive motor vehicle credit.

c. *Incorrect.* This is the incorrect amount. For a list of qualified vehicles and additional information, you should visit the IRS.gov website.

d. *Incorrect.* This is the incorrect amount. Instead, when a lower number of manufacturer's vehicles are sold, that is when the credit begins to phase out.

¶ 10,110 MODULE 2—CHAPTER 10

1. a. *Incorrect.* This is the incorrect year. Instead, note that this administrative waiver was not available until after 1998.

b. *Correct.* This administrative waiver, implemented in 2001, is referred to as First Time Abatement (FTA) and is available for penalty relief the first time a taxpayer is subject to one or more of the referenced penalties for a single return.

c. *Incorrect.* This is the incorrect year. When the FTA criteria have otherwise been met, it does not provide penalty relief under the FTA waiver unless certain conditions are met.

d. *Incorrect.* This is the incorrect year. Instead, note that this administrative waiver was available well before 2020.

2. a. *Incorrect.* This is a best practice with respect to an exam. You should build credibility with the examiner through cooperation, timeliness, and transparency.

b. *Incorrect.* This is a best practice with respect to an exam. You should assume penalties will be imposed and build defense throughout the exam.

c. *Correct.* Instead, one of the best practices for an exam is to build credibility with the examiner through cooperation, timeliness, and transparency.

d. *Incorrect.* This is a best practice with respect to an exam. You should seek to discuss the examiner's position and negotiate before it goes to a 30-day letter.

3. a. *Correct.* You should use Form 843 to claim a refund or request an abatement of certain taxes, interest, penalties, fees, and additions to tax.

b. *Incorrect.* This is the incorrect form. Form 5695 is used to figure and take your residential energy credits.

c. *Incorrect.* This is the incorrect form. Form 7203 is used to figure potential limitations of your share of an S corporation's deductions, credits, and other items that can be deducted on your return.

d. *Incorrect.* This is the incorrect form. Taxpayers with print disabilities can use Form 9000 to elect to receive written communications from the IRS in an accessible format.

4. a. *Incorrect.* This is the incorrect term. If you claim this defense, it must be based upon all pertinent facts.

b. *Incorrect.* This is the incorrect term. Also note that the advice must not be based upon unreasonable factual or legal assumptions.

c. *Correct.* Also note that in order to claim this defense, it must be objectively reasonable.

d. *Incorrect.* This is the incorrect term. Note that this reliance does not cover the filing of a return that is missed.

5. a. *Incorrect.* Accuracy related penalties are not a type of penalty that is required to be referred to the OPR. Instead, this is an example of a type of penalty that has discretionary referral to the OPR.

b. *Correct.* The IRS may file an injunction suit against a tax preparer for not meeting due diligence requirements. The injunction can ban the preparer from preparing tax returns either permanently or temporarily.

c. *Incorrect.* Penalties related to frivolous tax returns or submissions is not a type of penalty that is required to be referred to the OPR. Instead, this is an example of a type of penalty that has discretionary referral to the OPR. A type of preparer penalty that is required to be referred is aiding and abetting understatement of a tax liability.

d. *Incorrect.* An understatement of liability due to unreasonable position is not a type of penalty that is required to be referred to the OPR. Instead, this is an example of a type of penalty that has discretionary referral to the OPR.

6. a. *Incorrect.* This Code Section does not relate to the IRS recovering trust funds. Instead, it relates to the reporting of tips.

b. *Incorrect.* This Code Section does not relate to the IRS recovering trust funds. Instead, it relates to confidentiality and disclosure of returns and return information.

c. *Incorrect.* This Code Section does not relate to the IRS recovering trust funds. Instead, it relates to partners bound by actions of the partnership.

d. *Correct.* This Code Section allows the IRS to recover "trust funds" withheld from employee's pay from "any person required to collect, truthfully account for and pay over any tax imposed" and "who willfully fails to collect such tax or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof."

¶ 10,111 MODULE 2—CHAPTER 11

1. a. *Incorrect.* Instead, the IRA of 2022 provides $80 billion for new workers and technology at the Internal Revenue Service.

b. *Incorrect.* Instead, the new act is scored to reduce the deficit by only $90 billion, not $150 billion.

c. *Correct.* Also note that the IRA of 2022 puts Medicare on course to negotiate drug prices.

d. *Incorrect.* Instead, the new act funds hundreds of billions in tax subsidies intended to combat climate change.

2. a. *Correct.* Note that AFSI is equal to book income subject to certain adjustments.

b. *Incorrect.* This is the incorrect AMT percentage amount. Instead, the percentage is less than 20 percent. This answer choice also is incorrect with respect to the consecutive taxable year period.

c. ***Incorrect.*** This is the incorrect AFSI threshold. Instead, the AFSI threshold is less than $2 billion.

d. ***Incorrect.*** This is the incorrect AFSI threshold, the incorrect percentage amount, as well as the incorrect consecutive taxable period.

3. a. ***Incorrect.*** Instead, it is a 15 percent AMT on corporations with average annual AFSI that exceeds $1 billion over any consecutive three taxable year period.

b. ***Incorrect.*** Tax (instead of book) depreciation deductions would reduce AFSI. This will aid businesses that invest in equipment and facilities (such as manufacturers).

c. ***Incorrect.*** Instead, the IRA does limit the aggregate amount of taxes paid by controlled foreign corporations to 15 percent of the taxpayer's controlled foreign corporation net income.

d. ***Correct.*** **Also note that it may be credited against BEAT payable in future periods.**

4. a. ***Correct.*** **For taxpayers that do not claim foreign tax credits for regular tax purposes, Treasury regulations will provide that foreign income taxes are taken into account to determine AFSI.**

b. ***Incorrect.*** Instead, for U.S. shareholders of controlled foreign corporations, AFSI includes (not excludes) the taxpayer's pro rata share of the net income or loss stated on the controlled foreign corporation's financial statements.

c. ***Incorrect.*** Net losses from controlled foreign corporations do not reduce AFSI but can be carried forward to the next taxable year.

d. ***Incorrect.*** Treasury regulations will provide for proper treatment of current and deferred taxes, including timing.

5. a. ***Incorrect.*** Buyers of new electric vehicles (EVs) will be eligible for up to a $7,500 credit for EVs placed in service after 2022 but before 2033.

b. ***Correct.*** **The income limitation is determined by the MAGI of the year of purchase or the preceding year.**

c. ***Incorrect.*** Instead, it's important to note that the manufacturer's limit is eliminated for EVs sold after 2022 (not 2026).

d. ***Incorrect.*** Instead, the MSRP cannot exceed $55,000 for sedans and $80,000 for SUVs, trucks, and vans.

6. a. ***Incorrect.*** Instead, the act authorizes more than $280 billion in federal funding to promote domestic semiconductor production.

b. ***Incorrect.*** Instead, it created a 25 percent tax credit (not 50 percent) to incentivize investments in semiconductor manufacturing.

c. ***Correct.*** **Taxpayers can opt a "direct pay" election to treat the Code Sec. 48D credit to offset their tax liability in the year the qualified facility is placed in service.**

d. ***Incorrect.*** Instead, the credit will be available for facilities that are placed in service after December 31, 2022, and for which construction begins before January 1, 2027.

Index

References are to paragraph (¶) numbers.

J

L

M

N

O

P

Q

R

S

T

¶ 10,200 Glossary

Address: Unique identifier where cryptocurrency sits on the blockchain. The coin's ownership data is stored here. The address registers any changes when the cryptocurrency is traded.

Airdrop: A marketing ploy where tokens are sent into wallets for free or in return for a social media post in order to promote a new virtual currency.

Altcoins: All the other coins outside of Bitcoin are grouped together under the category of altcoins. Examples include Ethereum and Litecoin.

Beneficiary: A natural person or other legal entity who receives money or other benefits from a benefactor.

Bitcoin: A type of digital currency in which a record of transactions is maintained, and new units of currency are generated by the computational solution of mathematical problems, and which operates independently of a central bank.

Block: A blockchain is made up of blocks. Each block holds a historical database of all cryptocurrency transactions made until the block is full. A block is a permanent record that can be reviewed.

Blockchain: A collaborative, tamper-resistant ledger that maintains transactional records. It is a system in which a record of transactions made in bitcoin, or another cryptocurrency, are maintained across several computers that are linked in a peer-to-peer network.

C corporation: Refers to any corporation that is taxed separately from its owners. A C corporation is distinguished from an S corporation, which generally is not taxed separately.

Capital gain: A profit from the sale of property or an investment.

CHIPS Act of 2022: The Creating Helpful Incentives to Produce Semiconductors Act of 2022, which establishes a new tax credit for investments in semiconductor manufacturing facilities in the United States.

Cohan Rule: Allows taxpayers, when unable to produce records of actual expenditures, to rely on reasonable estimates provided there is some factual basis for them.

Cold storage: An offline wallet provided for storing bitcoins or other cryptocurrencies.

Complex trust: Any arrangement that does not meet the requirements of a simple trust.

Controlled foreign corporation: A corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners.

Corporate AMT: Places a floor on the percentage of taxes that a corporation must pay to the government.

Covered corporation: For purposes of the Inflation Reduction Act of 2022, a domestic corporation with stock traded on established securities market.

Cryptocurrency: A digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank.

Decedent: A person who has died.

Depreciation: A measurement of the useful life of a business asset to determine the multiyear period over which the cost of that asset can be deducted from taxable income.

Employee retention credit (ERC): Refundable tax credit that encourages businesses to keep employees on their payroll. The ERC is 50 percent of up to $10,000 in wages paid by an eligible employer whose business has been financially impacted by the COVID-19 pandemic.

Ethereum: One of the top three cryptocurrencies in the world, based on capitalization. Ethereum differs from Bitcoin in that it allows developers to create applications on top of it and also write smart contracts.

Exchange: The location where the user can exchange traditional currency (fiat) for cryptocurrencies.

Executor: A person or institution appointed by a testator to carry out the terms of their will.

Failure to file penalty: A penalty assessed by the IRS against a taxpayer for failure to file a required tax return. It is 5 percent of the tax you owe for each month or part of a month your return is late, with a maximum penalty of 25 percent.

Failure to pay penalty: A penalty assessed by the IRS against a taxpayer for failing to pay required taxes. It is one-half of one percent for each month, or part of a month, up to a maximum of 25 percent of the amount of tax that remains unpaid from the due date of the return until the tax is paid in full.

Fiat: Refers to money that is recognized as legal tender by governments, such as the U.S. dollar, British pound, Euro, and Australian dollar.

FICA: The federal law that requires an employer to withhold three separate taxes from the wages it pays its employees.

First-time abatement: An administrative waiver that the IRS may grant to relieve taxpayers from failure-to-file, failure-to-pay, and failure-to-deposit penalties if certain criteria are met.

Foreign tax credit: A U.S. tax credit used to offset income tax paid abroad.

Fork: A new version of a blockchain that is created, resulting in two versions of the blockchain running side-by-side. A *hard fork* is a major update to this protocol. There is no consensus about the changes that have been made, so a new blockchain is created to run in parallel with the original. The problem is that of backwards compatibility. A *soft fork* is a minor update that improves efficiency.

Form 1099: One of several IRS tax forms used in the United States to prepare and file an information return to report various types of income other than wages, salaries, and tips.

Form 1120: An IRS document that American corporations use to report their credits, deductions, losses, gains, and income.

Form 1120-S: A form used to report the income, losses, and dividends of S corporation shareholders.

Gig work: Certain activity individuals do to earn income, often through an app or website (digital platform).

Gross receipts: Total sales (net of returns and allowances), all amounts received for services, as well as income from investments and from incidental or outside sources.

Independent contractor: A person, business, or corporation that provides goods or services under a written contract or a verbal agreement.

Inflation Reduction Act of 2022: A landmark U.S. law that aims to curb inflation by reducing the deficit, lowering prescription drug prices, and investing in domestic energy production while promoting clean energy.

Initial coin offering (ICO): Something to raise funds including to launch a token or cryptocurrency.

Injunction: A legal and equitable remedy in the form of a special court order that compels a party to do or refrain from specific acts.

Internal Revenue Service (IRS): The revenue service of the U.S. federal government, which is responsible for collecting taxes and administering the Internal Revenue Code, the main body of the federal statutory tax law.

Limited liability company (LLC): The U.S.-specific form of a private limited company. It is a business structure that can combine the pass-through taxation of a partnership or sole proprietorship with the limited liability of a corporation.

Net operating loss (NOL): An excess of deductions (for expenses from the operation of a business) over income from the operation of a business.

Non-fungible token (NFT): A financial security consisting of digital data stored in a blockchain, a form of distributed ledger.

Paycheck Protection Program (PPP): A $669-billion business loan program established by the Coronavirus Aid, Relief, and Economic Security (CARES) Act to help certain businesses, self-employed workers, sole proprietors, certain nonprofit organizations, and tribal businesses continue paying their workers.

Payroll taxes: Taxes imposed on employers or employees and usually calculated as a percentage of the salaries that employers pay their staff.

Private key: A string of numbers and letters that is used to access a user's "wallet." The private key acts as a password when someone is selling or withdrawing cryptocurrencies. It also acts as a digital signature.

Qualified business income: Ordinary, non-investment income of a business.

Qualified business income deduction (QBID): Provides for a deduction of up to 20 percent of qualified business income, applied at the individual level, and subject to certain limitations.

Reasonable compensation: Compensation that is consistent with the normal compensation for such employee for the work performed or duties entailed.

S corporation: A closely held corporation (or, in some cases, a limited liability company (LLC) or a partnership) that makes a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code.

Safe harbor: A legal provision to sidestep or eliminate legal or regulatory liability in certain situations, provided that certain conditions are met.

Schedule K-1: The form that reports the amounts that are passed through to each party that has an interest in the entity. It reports the party's share of the partnership's income, deductions, credits, etc.

Schedule K-2: An extension of Form 1120-S, Schedule K; used to report items of international tax relevance from the operation of an S corporation.

Schedule K-3: Reports a partner's distributive share of items of international tax relevance and is an extension of the Form 1065, Schedule K-1.

Shareholder: An owner of shares in a company.

Smart contract: An event-driven program, with state, that runs on a distributed, decentralized, shared, and replicated ledger and that can take custody over and instruct transfer of assets on that ledger.

Stablecoin: A type of digital asset generally designed to maintain a stable value relative to the U.S. dollar.

Tax gap: The difference between taxes that are owed and those that are collected.

Taxpayer identification number (TIN): An identification number used by the IRS in the administration of tax laws.

TIN Matching Program: A free web-based tool offered by the IRS through e-services that was established for payers of reportable payments subject to the backup withholding provisions of Section 3406 of the Internal Revenue Code.

Token: Acts as the "coin." It is actually a digital code that can be owned, bought, and sold.

Treasury Inspector General for Tax Administration (TIGTA): An office established under the IRS Restructuring and Reform Act of 1998 to provide independent oversight of IRS activities.

Trust: An arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries.

Wallet: An app that allows cryptocurrency users to store and retrieve their digital assets.

¶ 10,300 Final Exam Instructions

To complete your Final Exam go to **cchcpelink.com/printcpe,** click on the title of the exam you wish to complete and add it to your shopping cart (you will need to register with CCH CPELink if you have not already). Click **Proceed to Checkout** and enter your credit card information. Click **Place Order** to complete your purchase of the final exam. The final exam will be available in **My Dashboard** under **My Account**.

This Final Exam is divided into two Modules. There is a grading fee for each Final Exam submission.

Online Processing Fee:
$264.00 for Module 1
$288.00 for Module 2
$552.00 for both Modules

IRS Program Numbers:
Module 1: 4VRWB-T-04634-22-S
Module 2: 4VRWB-T-04635-22-S

CTEC Program Numbers:
Module 1: 1075-CE-2828
Module 2: 1075-CE-2829

Recommended CPE:
11 hours for Module 1
12 hours for Module 2
23 hours for both Modules

Federal Tax Law Hours:
11 hours for Module 1
12 hours for Module 2
23 hours for both Modules

Instructions for purchasing your CPE Tests and accessing them after purchase are provided on the **cchcpelink.com/printcpe** website. **Please note, manual grading is no longer available for Top Federal Tax Issues. All answer sheets must be submitted online for grading and processing.**

Recommended CPE credit is based on a 50-minute hour. Because CPE requirements vary from state to state and among different licensing agencies, please contact your CPE governing body for information on your CPE requirements and the applicability of a particular course for your requirements.

Expiration Date: September 30, 2024

Evaluation: To help us provide you with the best possible products, please take a moment to fill out the course Evaluation located after your Final Exam.

Wolters Kluwer, CCH is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: www.learningmarket.org.

Additional copies of this course may be downloaded from **cchcpelink.com/printcpe.** Printed copies of the course are available for $8.00 by calling 1-800-344-3734 (ask for product 10024491-0010).

¶ 10,301 Final Exam Questions: Module 1

1. The tax gap is most attributed to the underreporting of _____ income by individuals and sole proprietors.

a. Hobby
b. Personal
c. Business
d. Passive

2. Which of the following Internal Revenue Code Sections requires that, under certain circumstances, including failure of payee to provide a taxpayer identification number (TIN), the payer must perform backup withholding?

a. Code Sec. 3406(a)
b. Code Sec. 3978(d)
c. Code Sec. 6041(a)
d. Code Sec. 6109(a)(2)

3. Which of the following information should be included in box 6 of Form 1099-MISC?

a. Rents
b. Medical payments
c. Royalties
d. Other income

4. For a valid trust, estate, or pension plan, you should give the name and employer identification number (EIN) of which of the following on Form W-9?

a. Owner
b. Legal entity
c. Broker
d. Nominee

5. One method of encouraging a payee to give their taxpayer identification number (TIN) is to inform them that refusal means cash paid is less what percent?

a. 17 percent
b. 19 percent
c. 24 percent
d. 35 percent

6. For a limited liability company (LLC) to be treated as a corporation, it needs to file which of the following forms?

a. Form 1065
b. Form 4562
c. Form 7100
d. Form 8832

7. The TIN Matching program is a tool that is especially valuable for reducing corrections and which of the following notices?

a. A-Notices
b. B-Notices
c. C-Notices
d. D-Notices

8. B-Notices are generally issued in the spring and/or fall, and payers with _____ or more problematic files receive a CD.

a. 10
b. 75
c. 125
d. 250

9. If there is no response to a second B-Notice, a payer should begin backup withholding within how many days?

a. 30
b. 45
c. 60
d. 90

10. Each of the following identifies a best practice for a second B-Notice, ***except?***

a. Check IRS information against your records
b. Send a second B-Notice if the information matches
c. Begin backup withholding if there is no response within 30 business days
d. Send a new W-9

11. Schedules K-2 and K-3 replace the often-cursory information formerly required to be entered on Schedule _____, which then often necessitated an attached document, but with no specified format or items of information.

a. K-1
b. K-4
c. S-4
d. T-5

12. Which Part of Schedule K-2 relates to distributions from foreign corporations to partnership?

a. Part II
b. Part III
c. Part IV
d. Part V

13. Which Part of Schedule K-3 includes information on a partner's Code Sec. 250 deduction?

a. Part I
b. Part II
c. Part III
d. Part IV

14. The concept/term of international relevance is _____ defined.

a. Not
b. Broadly
c. Consistently
d. Narrowly

15. In what year did the IRS issue draft versions of Schedules K-2 and K-3?

a. 2017
b. 2018
c. 2019
d. 2020

16. The IRS provides relief through Notice 2021-39 that eligible pass-through entities will not have to file new Schedules K-2 and K-3 for which of the following tax years?

a. 2021
b. 2022
c. 2023
d. 2024

17. If a direct or indirect partner is eligible to claim a foreign tax credit, Schedules K-2 and K-3, Parts II and III, _____ be completed if the partners are not completing Form 1116 or 1118.

a. Should
b. Must
c. Does not need to
d. May

18. If an international provision is impacted and is not otherwise specifically identified, the taxpayer should check box _____ on Schedule K-2, Part I, and Schedule K-3, Part I, and attach a statement to both Schedules K-2 and K-3 (for distributive share).

a. 12
b. 13
c. 14
d. 16

19. A penalty of _____ is assessed for each insufficient Schedule K-1 for the 2020 tax year for failure to provide all required information.

a. $230
b. $280
c. $350
d. $490

20. Which of the following organizations wants the IRS to clarify that the exception to filing Form 1116, *Foreign Tax Credit*, refers to the requirements provided in Code Sec. 904(j)?

a. AICPA
b. FASB
c. ASB
d. IASB

21. It is estimated that the U.S. Treasury loses _____ a year due to non-compliance.

a. $126 million
b. $264 million
c. $630 billion
d. $945 billion

22. Which type of taxpayer accounts for the largest percent of the tax gap?

a. Sole proprietors
b. C corporations
c. Partnerships
d. Individuals

23. Which of the following is a common verification that the IRS does ***not*** conduct at the beginning of a small business audit?

a. Return to trial balance
b. Cash-T
c. Bank deposit analysis
d. Review of accounts receivable

24. Determining whether the history of the activity shows that it is generating any profit in any years is one of the six litmus test questions to ask with respect to which of the following considerations?

a. Business versus hobby
b. Compliance reporting
c. Unexplained depreciation
d. Domicile factors

25. In audits of Forms 1040 with pass-through losses from Form 1120-S between 2006 and 2008, what percentage of S corporation returns done by paid preparers had errors?

a. 14 percent
b. 33 percent
c. 71 percent
d. 94 percent

26. The older edition of the *Construction Industry Audit Technique Guide* noted that residential construction is of particular interest because this group of taxpayer accounts for 73 percent of the return filings but reports only _____ of the gross receipts.

a. 4 percent
b. 10 percent
c. 21 percent
d. 56 percent

27. How many factors does the IRS use to determine control with respect to the employee versus independent contractor assessment?

a. 2
b. 3
c. 5
d. It is not disclosed

28. The IRS instituted mandatory audit techniques for businesses that have e-commerce activity beginning in what year?

a. 2009
b. 2012
c. 2017
d. 2018

29. Which of the following identifies the maximum failure to deposit penalty with respect to Form 1099s and misclassification of workers?

a. 10 percent
b. 25 percent
c. 35 percent
d. 50 percent

30. In small businesses, most fraud cases stem from which of the following?

a. Worker misclassification
b. Stock options
c. Unreported income
d. Petty cash

31. To qualify for a significant decline in 2021 for purposes of the employee retention credit (ERC), a business's gross receipts must drop below _____ of gross receipts for the same quarter in 2019.

a. 45 percent
b. 55 percent
c. 75 percent
d. 80 percent

32. For purposes of gross receipts, PPP loan forgiveness is _____ and annuities are _____.

a. Excluded, included
b. Included, excluded
c. Excluded, excluded
d. Included, included

33. Recovery startup businesses are limited to an employee retention credit (ERC) of _____ per quarter.

a. $20,000
b. $45,000
c. $50,000
d. $75,000

34. Which of the following establishments would be subject to partial suspension of employee retention credit (ERC) caused by government order?

a. Take-out only restaurant
b. Retail store—density in store is limited, but there is a short wait outside for customers
c. Essential business (stays open), but customers are not coming in
d. Workplace is closed, but continues business at a comparable level as before COVID-19

35. Which of the following forms should be filed if a business missed claiming the employee retention credit (ERC)?

a. Form 815-A
b. Form 894-K
c. Form 941-X
d. Form 964-A

36. A _____ number of states allow a pass-through entity to pay state income taxes rather than the owners.

a. Growing
b. Decreasing
c. Low
d. Negligible

37. The state and local tax (SALT) workaround should work with which of the following?

a. Business income only
b. Investment income only
c. Both business and investment income
d. Neither business nor investment income

38. Beginning in 2018, a _____ deduction is available for qualified business income.

a. 10 percent
b. 15 percent
c. 20 percent
d. 25 percent

39. Of the 12,480 2019 QBID claims reviewed by the U.S. Treasury Inspector General for Tax Administration (TIGTA), what percentage were below the threshold set by the IRS for review?

a. 12.2 percent
b. 26.4 percent
c. 55.4 percent
d. 95.3 percent

40. Regarding the qualified business income deduction (QBID), if the business has W-2 wages or UBIA, there will be _____ deduction allowed without regard to the taxpayer's taxable income.

a. Some
b. A 50 percent
c. No
d. A significant

41. A _____ distribution is a priority that is intended to be matched with an allocation of income.

a. Suggestive
b. Preference
c. Synthetic
d. Phantom

42. Beginning with the _____ tax year, a partnership must report all partners' tax basis capital.

a. 2020
b. 2021
c. 2022
d. 2023

43. One of the small partnership requirements for electing out of partnership-level audits is to have _____ or fewer Schedule K-1s.

a. 100
b. 125
c. 150
d. 200

44. Which of the following identifies the number of "insubstantiality" tests with respect to substantial economic effect?

a. 2
b. 3
c. 4
d. 5

45. Allocations that relate to pre-contribution gain or loss _____ be made to consider the built-in gain or loss at contribution.

a. Should
b. May
c. Cannot
d. Must

46. In order to qualify for favorable qualified opportunity fund (QOF) treatment, the gain must be recognized before which date?

a. January 1, 2024
b. January 1, 2025
c. January 1, 2026
d. January 1, 2027

47. Qualified opportunity funds generally come in how many of the following different types?

a. 2
b. 3
c. 4
d. 5

48. What is the 2021 threshold amount for the qualified business income deduction (QBID) for married filing jointly taxpayers?

a. $50,000
b. $100,000
c. $164,900
d. $340,100

49. Which of the following is ***not*** one of the aggregation factors with respect to the qualified business income deduction (QBID)?

a. Common control
b. Similar profit margins
c. Same taxable year
d. Not an SSTB

50. When a company is subject to Code Sec. 163(j), business interest expense is limited to the sum of business interest income, _____ × adjusted taxable income, and floor plan financing.

a. 20 percent
b. 25 percent
c. 30 percent
d. 45 percent

51. Which of the following Tax Court cases concluded that the rental real estate was ***not*** a business?

a. *Hazard*
b. *Murtaugh*
c. *LaGreide*
d. *Horrman*

52. Based on the author's view, which of the following areas related to real estate includes substantial authority that is unclear?

a. Single piece of land leased, owner has little/no activity
b. Lease more than one piece of land
c. Apartment building or duplex
d. Triple net lease, landlord involved in maintenance

53. Which of the following identifies the number of ways a rental can produce qualified business income?

a. 1
b. 2
c. 3
d. 4

54. What is the 2021 maximum employee retention credit per employee per quarter?

a. $5,000
b. $7,000
c. $10,000
d. $14,000

55. Which of the following forms is used to claim the employee retention credit?

a. Form 941
b. Form 1020
c. Form 1065
d. Form 8200

¶ 10,302 Final Exam Questions: Module 2

1. Each of the following is a characteristic of cryptocurrency, ***except?***

- **a.** It functions as a medium of exchange
- **b.** It is a centralized form of digital cash
- **c.** It is not issued or backed by a government
- **d.** It does not have legal tender status in any jurisdiction

2. In what year did the first Bitcoin transaction occur?

- **a.** 2008
- **b.** 2009
- **c.** 2010
- **d.** 2015

3. Which of the following is a string of numbers and letters that are used to access a cryptocurrency wallet?

- **a.** Private key
- **b.** Smart contract
- **c.** NFT
- **d.** Secure ID

4. Which of the following is an app that allows cryptocurrency users to store and retrieve their digital assets?

- **a.** Wallet
- **b.** Fork
- **c.** Cold storage
- **d.** Token

5. The IRS currently views cryptocurrency as which of the following?

- **a.** Property
- **b.** Cash
- **c.** Securities
- **d.** A commodity

6. Which of the following is a nontaxable cryptocurrency event?

- **a.** Trading cryptocurrency to fiat currency like the U.S. dollar
- **b.** Using cryptocurrency to pay for goods and services
- **c.** Trading one cryptocurrency for another cryptocurrency
- **d.** Engaging in a soft fork

7. Regarding the giving of gifts to charitable organizations, donations greater than _____ must be reported on Form 8283.

- **a.** $50
- **b.** $100
- **c.** $250
- **d.** $500

8. Wash sale rules prohibit the claiming of a loss on sale of a security purchased within ____ days before or after.

a. 30
b. 45
c. 60
d. 75

9. The Infrastructure Investment and Jobs Act expands Section 6050I so that any person or entity who receives more than what amount in virtual assets must file a report with the IRS with the sender's personal information?

a. $500
b. $1,000
c. $5,000
d. $10,000

10. Which of the following types of transactions with cryptocurrency requires a "yes" answer on Form 1040?

a. Receiving crypto as a result of a "hard fork"
b. Merely holding the cryptocurrency in a taxpayer's own wallet or account
c. Transferring virtual currency between wallets the taxpayer owns
d. Purchasing virtual currency using real currency

11. A decedent's estate is a separate taxable entity that comes into existence upon the death of an individual. The decedent's taxable year ends on which of the following?

a. His or her date of death
b. January 31
c. March 31
d. December 31

12. The basic concept of Subchapter _____ is to tax income once—either to the estate that receives it, or to the beneficiary to whom the estate distributes it within the estate's taxable year.

a. C
b. D
c. J
d. P

13. For tax years except for ____, the estate's basis in property acquired from a decedent is the fair market value of the property on the decedent's date of death (or on the alternate valuation date).

a. 2010
b. 2011
c. 2015
d. 2021

14. An estate is ***not*** required to make estimated tax payments unless it is open at least more than _____ years after the decedent's date of death.

a. 2
b. 3
c. 4
d. 5

15. An estate may obtain an automatic extension of how many months to file Form 1041 (by using Form 7004)?

a. 3½ months

b. 4½ months

c. 5½ months

d. 7½ months

16. Which of the following identifies the annual exemption for complex trusts?

a. $0

b. $100

c. $500

d. $1,000

17. Underestimation penalties can be avoided if the trustee makes quarterly estimated tax payments equal in total to either _____ of the tax shown on the return for the current taxable year or _____ of the tax shown on the return for the prior year.

a. 80% / 90%

b. 90% / 90%

c. 80% / 100%

d. 90% / 100%

18. Once the Code Sec. 645 election has been made, an electing trust _____ select a fiscal year rather than a calendar year.

a. May

b. Should

c. Must

d. Cannot

19. A "safe harbor" for a reasonable apportionment is stated to be a state law providing for a unitrust amount between ____ and ____ of the annual fair market value of the trust.

a. 3% / 5%

b. 5% / 7%

c. 8% / 10%

d. 10% / 20%

20. Fiduciary fees may be deducted if which of the following applies?

a. They represent less than 1% of the estate value.

b. They are less than $10,000.

c. They are preapproved by the IRS.

d. They are reasonable in amount.

21. Which of the following identifies the 2022 above-the-line deduction for educators?

a. $250

b. $300

c. $350

d. $450

22. The IRS estimates that the new Form 1099-K reporting threshold for third-party platforms will raise almost which amount over 10 years?

a. $3.2 billion

b. $4.6 billion

c. $6.1 billion

d. $8.4 billion

23. The referenced Independent Economy Council study indicates that what percentage of independent contractors are ***not*** making estimated tax payments?

a. 4 percent

b. 22 percent

c. 49 percent

d. 84 percent

24. Form 1099-B will be required for digital assets (including cryptocurrency) for transactions beginning in what year?

a. 2023

b. 2024

c. 2025

d. 2026

25. Which of the following identifies the annual inflation rate as of April 2022?

a. 4.3 percent

b. 6.8 percent

c. 7.5 percent

d. 8.3 percent

26. In what year will bonus depreciation begin to phase out?

a. 2023

b. 2024

c. 2025

d. 2026

27. Which of the following identifies the number of tests that must be cleared to be classified as a real estate professional?

a. 1

b. 2

c. 3

d. 4

28. To elect out of the Centralized Partnership Audit Regime (CPAR), an eligible entity must have _____ or fewer K-1s.

a. 100

b. 125

c. 200

d. 430

29. Based on the first results of the Centralized Partnership Audit Regime (CPAR) system released in 2022, what percentage of partnerships audited received "no change" reports?

a. 14 percent
b. 38 percent
c. 62 percent
d. 78 percent

30. Based on the SECURE Act 1.0, for most participants dying after December 31, 2019, the beneficiary must withdraw the entire account by the end of year containing the _____ anniversary of death.

a. 8th
b. 9th
c. 10th
d. 11th

31. Which of the following identifies the number of states that have passed partnership/S corporation entity-level income taxes?

a. 2
b. 11
c. 27
d. 48

32. Each of the following is a type of tax arrangement the IRS has been cracking down on, ***except?***

a. Opportunity zones
b. Abusive research and development credits
c. Conservation easements
d. Microcaptive insurance arrangements

33. Based on recent statistics, the IRS answers what percentage of phone calls it receives?

a. 4 percent
b. 11 percent
c. 33 percent
d. 69 percent

34. Which of the following identifies the average amount of time it took in 2021 to close IRS appeals cases?

a. 3 months
b. 6 months
c. 9 months
d. More than a year

35. Which Circular defines certified public accountant (CPA) and enrolled agent (EA) ethical rules?

a. Circular 210
b. Circular 220
c. Circular 230
d. Circular 240

36. In what year did the Supreme Court conclude that the IRS must follow the Administrative Procedure Act (APA) rules?

a. 2009

b. 2011

c. 2015

d. 2022

37. In which of the following areas does the Administrative Procedure Act (APA) provide no statement of "good cause"?

a. Inventory capitalization

b. Self-employment tax on real estate rentals

c. Interest expense tracing rules

d. Portions of Code Sec. 1231 regulations

38. Which of the following identifies the number of ways to make the portability election?

a. 2

b. 3

c. 4

d. 5

39. The final regulations issued in _____ provide a "no clawback" rule.

a. 2018

b. 2019

c. 2020

d. 2021

40. Which of the following tax forms is used to claim the plug-in credit?

a. Form 1040

b. Form 3245

c. Form 6658

d. Form 8936

41. The IRS allows a first-time penalty abatement for failure to file and failure to _____ penalty.

a. Communicate

b. Disclose

c. Pay

d. Document

42. The First Time Abate (FTA) does ***not*** apply to anything prior to what year?

a. 2001

b. 2003

c. 2008

d. 2010

43. One of the strategies for an IRS audit is to build credibility with the examiner through cooperation, timeliness, and _____.

a. Kindness

b. Compassion

c. Transparency

d. Negotiation

44. You should use Form _____ with respect to a request for abatement.

a. 843

b. 4545

c. 6489

d. 7715

45. Relying on a tax opinion by a tax advisor may serve as a defense to the accuracy related penalty. However, it must be objectively _____.

a. Sourced

b. Estimable

c. Valued

d. Reasonable

46. Which of the following Code Sections relates to preparer/promoter penalties for promoters of abusive tax shelters?

a. Code Sec. 6694(a)

b. Code Sec. 6695

c. Code Sec. 6700

d. Code Sec. 6708

47. The _____ portion of payroll taxes includes the income tax withheld, and the FICA taxes withheld (Social Security and Medicare) from the employee's pay.

a. Fiduciary

b. Employer

c. Payable

d. Matching

48. Related to payroll taxes, a failure to deposit penalty of _____ percent is assessed if more than 15 days past due.

a. 2

b. 5

c. 10

d. 15

49. Code Sec. 6672 allows the IRS to recover _____ funds withheld from an employee's pay.

a. Trust

b. Payroll

c. Debt

d. Lien

50. Once assessed, an individual assessed against will have _____ days to file their protest and obtain an appeals hearing with respect to payroll taxes.

a. 45

b. 60

c. 90

d. 120

51. The Inflation Reduction Act of 2022 spends how many billions on new workers and technology at the Internal Revenue Service?

a. $15 billion

b. $26 billion

c. $31 billion

d. $80 billion

52. The Inflation Reduction Act of 2022 is scored to reduce the deficit by how much?

a. $90 billion

b. $340 billion

c. $780 billion

d. $1.4 trillion

53. The Inflation Reduction Act of 2022's alternative minimum tax can be thought of as a "book minimum tax" (BMT) because the starting point of the calculation is a corporation's average annual adjusted financial statement income (AFSI) per GAAP. Which of the following identifies the first source with respect to the financial statement that must be used as the starting point for the AMT?

a. GAAP-certified audited financial statement used for non-tax purposes

b. Form 10-K filed with the Securities and Exchange Commission

c. GAAP-certified financial statement filed with a federal agency for non-federal tax purposes

d. An IFRS financial statement filed with the equivalent of the Securities and Exchange Commission

54. The Inflation Reduction Act of 2022 limits the aggregate amount of taxes paid by a controlled foreign corporation to what percentage of the taxpayer's controlled foreign corporation net income?

a. 5 percent

b. 10 percent

c. 15 percent

d. 20 percent

55. Unused financial statement net operating losses (NOLs) may be carried forward _____ but do not include any NOLs arising in taxable years before 2020 for purposes of determining whether a taxpayer is an applicable corporation.

a. 5 years

b. 10 years

c. 20 years

d. Indefinitely

56. Buyers of new electric vehicles (EVs) will be eligible for up to a _____ credit for EVs placed in service after 2022 but before 2033.

a. $5,000

b. $7,500

c. $10,000

d. $12,500

57. The Inflation Reduction Act of 2022 imposes an excise tax on domestic publicly traded corporations that repurchase their stock directly. The tax is equal to _____ percent of the fair market value of the repurchased stock.

a. 0.5

b. 1.0

c. 1.5

d. 2.0

58. The Inflation Reduction Act of 2022 extends the limitation on the deductibility of excess business losses by non-corporate taxpayers under Code Sec. 461(l) for another _____ years through December 31, 2029.

a. Two

b. Three

c. Four

d. Five

59. The Inflation Reduction Act of 2022 adds three categories of green energy property to the MACRS five-year property classification. This is effective for property placed in service after which of the following dates?

a. December 31, 2021

b. December 31, 2022

c. December 31, 2023

d. December 31, 2024

60. The Inflation Reduction Act of 2022 appropriates _____ billion for the IRS to provide taxpayer and other services.

a. $3.18

b. $9.13

c. $23.4

d. $66.7

¶ 10,400 Answer Sheets

¶ 10,401 Top Federal Tax Issues for 2023 CPE Course: MODULE 1

Go to **cchcpelink.com/printcpe** to complete your Final Exam online for instant results.

A $264.00 processing fee will be charged for each user submitting Module 1 to **cchcpelink.com/printcpe** for online grading.

Module 1: Answer Sheet

Please answer the questions by indicating the appropriate letter next to the corresponding number.

1. ____	12. ____	23. ____	34. ____	45. ____
2. ____	13. ____	24. ____	35. ____	46. ____
3. ____	14. ____	25. ____	36. ____	47. ____
4. ____	15. ____	26. ____	37. ____	48. ____
5. ____	16. ____	27. ____	38. ____	49. ____
6. ____	17. ____	28. ____	39. ____	50. ____
7. ____	18. ____	29. ____	40. ____	51. ____
8. ____	19. ____	30. ____	41. ____	52. ____
9. ____	20. ____	31. ____	42. ____	53. ____
10. ____	21. ____	32. ____	43. ____	54. ____
11. ____	22. ____	33. ____	44. ____	55. ____

Please complete the Evaluation Form (located after the Module 2 Answer Sheet). Thank you.

¶ 10,402 Top Federal Tax Issues for 2023 CPE Course: MODULE 2

Go to **cchcpelink.com/printcpe** to complete your Final Exam online for instant results.

A $288.00 processing fee will be charged for each user submitting Module 2 to **cchcpelink.com/printcpe** for online grading.

Module 2: Answer Sheet

Please answer the questions by indicating the appropriate letter next to the corresponding number.

1. ____	13. ____	25. ____	37. ____	49. ____
2. ____	14. ____	26. ____	38. ____	50. ____
3. ____	15. ____	27. ____	39. ____	51. ____
4. ____	16. ____	28. ____	40. ____	52. ____
5. ____	17. ____	29. ____	41. ____	53. ____
6. ____	18. ____	30. ____	42. ____	54. ____
7. ____	19. ____	31. ____	43. ____	55. ____
8. ____	20. ____	32. ____	44. ____	56. ____
9. ____	21. ____	33. ____	45. ____	57. ____
10. ____	22. ____	34. ____	46. ____	58. ____
11. ____	23. ____	35. ____	47. ____	59. ____
12. ____	24. ____	36. ____	48. ____	60. ____

Please complete the Evaluation Form (located after the Module 2 Answer Sheet). Thank you.

¶ 10,500 Top Federal Tax Issues for 2023 CPE Course: Evaluation Form

(10024491-0010)

Please take a few moments to fill out and submit this evaluation to Wolters Kluwer so that we can better provide you with the type of self-study programs you want and need. Thank you.

About This Program

1. Please circle the number that best reflects the extent of your agreement with the following statements:

		Strongly Agree				**Strongly Disagree**
a.	The Course objectives were met.	5	4	3	2	1
b.	This Course was comprehensive and organized.	5	4	3	2	1
c.	The content was current and technically accurate.	5	4	3	2	1
d.	This Course content was relevant and contributed to achievement of the learning objectives.	5	4	3	2	1
e.	The prerequisite requirements were appropriate.	5	4	3	2	1
f.	This Course was a valuable learning experience.	5	4	3	2	1
g.	The Course completion time was appropriate.	5	4	3	2	1

2. What do you consider to be the strong points of this Course?

3. What improvements can we make to this Course?

THANK YOU FOR TAKING THE TIME TO COMPLETE THIS SURVEY!

CCH® CPELink

Meeting your continuing professional education requirements every year is time consuming enough without spending extra time hunting for relevant courses and keeping track of what you need to take. **CCH® CPELink** gives you your required CPE to maintain your license without giving you a headache. Hundreds of courses over a broad range of topics make it easy to find CPE relevant to your professional development, while the Compliance Manager makes it easy to actively monitor your CPE deadlines and mandatory subject requirements so you don't have to. Take a look at our offerings and feel good about the time you put into your CPE.

- **Webinars.** We offer more than 400 live, online interactive sessions every year, hosted by some of the industry's leading experts.
- **Self-Study.** Learn at your own pace with our online self-study courses. More than 800 courses cover everything from tax and accounting basics to niche topics to help you in your specified field.
- **Print CPE.** This convenient self-study learning is a great way to earn the required CPE credit you need. Download the complimentary course content PDF from CCHCPELink.com/printcpe. When you're ready, return to the website to take the test and earn your CPE.
- **Compliance Manager.** Never miss another CPE deadline! The Compliance Manager includes CPE tracking and compliance monitoring for CPAs in every state (including Puerto Rico) plus many other regulators. Let the Compliance Manager track your CPE so you don't have to.
- **Subscription packages.** Take care of all your CPE needs and save money doing it. View unlimited webinars, save on self-study and webinar hours, or get unlimited CPE for your whole firm. Visit **CCHCPELink.com** for details.

Wolters Kluwer