Top Federal Tax Issues for 2024 | CPE Course

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MODULE 1: BUSINESS—Chapter 1: Overview of the SECURE 2.0 Act

¶ 101 WELCOME

Congress seemingly cannot stop tinkering with the rules governing retirement plans in an effort to further encourage taxpayers to save for retirement and to incentivize employers to offer savings opportunities to employees. The Securing a Strong Retirement Act, dubbed the "SECURE 2.0 Act," passed Congress in 2022 as part of the year-end omnibus spending bill. This chapter focuses on the main points of the act affecting retirement plans for small businesses and taxpayers' future withdrawal requirements from their retirement plans. It provides a history of this legislation, a summary of its main provisions, and planning ideas for clients affected by the act.

¶ 102 LEARNING OBJECTIVES

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

- Describe how the SECURE Act and SECURE 2.0 Act passed Congress and their primary provisions
- Explain the new increased catch-up contribution rules
- Identify the potential tax impacts related to IRA withdrawals by participants and beneficiaries under the legislation
- Recognize how to recommend tax planning to clients and beneficiaries affected by the SECURE Act and SECURE 2.0 Act
- Identify the changes affecting employer-sponsored plans, including automatic enrollment requirements and student loan repayment matching options

¶ 103 LEGISLATIVE HISTORY AND OVERVIEW

The Setting Every Community Up for Retirement Enhancement Act of 2019 (known as the SECURE Act) was introduced in the House on March 29, 2019 (H.R. 1994) and passed the House on May 23, 2019. It was eventually incorporated into the Further Consolidated Appropriations Act of 2020, which passed the House and Senate in December 2019 and was signed into law on December 20, 2019 (P.L. 116-94).

The Securing a Strong Retirement Act of 2021 (known as the SECURE 2.0 Act) was introduced in the House on May 4, 2021 (H.R. 2954) and passed March 29, 2022. This bill became part of the Further Consolidated Appropriations Act of 2023, which became law on December 29, 2022 (P.L. 117-328). The direct links to each act are as follows:

- SECURE Act: Contained in Division O of HR 1865 (pp. 604–649), https://www.congress.gov/116/bills/hr1865/BILLS-116hr1865enr.pdf
- SECURE 2.0 Act: Contained in Division T of HR (pp. 817–939), https://www.congress.gov/117/bills/hr2617/BILLS-117hr2617enr.pdf

Changes under the original SECURE Act included the following:

- Delayed required beginning date
- Part-time worker participation opportunities
- Small business retirement plan credits
- Repeal of IRA contribution age limit
- IRA beneficiary withdrawal period changes

The SECURE 2.0 Act changes include:

- Delayed (again) required beginning date
- Increased part-time worker participation opportunities
- Expanded catch-up contributions
- Mandatory automatic enrollment and escalation terms
- Roth matching opportunities
- Student loan matching
- Lost and found retirement account database

Most of the SECURE Act provisions became effective for tax years starting after December 31, 2019, whereas most of the SECURE 2.0 Act provisions are effective for tax years starting after December 31, 2022.

¶ 104 REQUIRED BEGINNING DATE CHANGES

The qualified plan withdrawal rules permit individuals to make tax-free contributions to qualified retirement plans during their working years up to stated annual limits. For example, an individual can contribute on a pretax basis up to $6,500 to a traditional retirement account (IRA) or $22,500 to a 401(k) account in tax year 2023.

If funds are withdrawn from these accounts before the account owner reaches age 59½, a 10 percent penalty applies to the amount withdrawn in addition to the income being included as part of the owner's taxable income. There are some exceptions for hardship, education, a home purchase, and other circumstances. After an individual reaches age 59½, they can take unlimited voluntary withdrawals (without a penalty). Mandatory withdrawals (required minimum distributions, or RMDs) start after the employee's "required beginning date."

Delayed Required Beginning Date

The required beginning date is defined by Internal Revenue Code Sec. 401(a)(9)(C) as follows:

> "(C) Required beginning date.—For purposes of this paragraph—
>
> (i) In general.—The term "required beginning date" means April 1 of the calendar year following the later of—
>
> (I) the calendar year in which the employee attains age 70½, or
>
> (II) the calendar year in which the employee retires."

> **NOTE:** Code Sec. 401(a)(9)(C)(i)(II) applies to a plan sponsored by the employee's current employer only, not to other retirement funds carried over from prior employers.

The SECURE Act delayed the required beginning date by replacing age 70½ with age 72, which was effective for tax years started after December 31, 2019. Subsequently, the SECURE 2.0 Act replaced age 72 with ages 73 and 75 based on the following timeline:

- Age 73 starting in 2023
- Age 75 starting in 2033

Previous versions of the SECURE 2.0 Act included an intervening increase to age 74 starting in 2030; however, the final legislation as confirmed by later commentary eliminated this interim increase.

The second increase is effective for taxpayers reaching age 73 after December 31, 2022. Since the effective date is based on when the taxpayer reaches the applicable required beginning date, there will be some taxpayers under ages 72 or 73 who need to take RMDs if they reached the applicable required beginning date prior to the effective date of the legislation. Those who already reached age 70½ were not grandfathered in. Based on year of birth, the following summarizes the birth dates associated with each required beginning date age:

- Those born before June 30, 1949, must start taking RMDs no later than April 2020 based on age 70½. (The CARES Act allowed participants to delay their first RMD until 2021.)
- For those born after June 30, 1949, but before January 1, 1951, RMDs start no later than April 2023 based on age 72.
- For those born in 1951–1957, RMDs start on April 1 of the year after they turn age 73.
- Those born in 1958 or later must start taking RMDs on April 1 of the year after they turn age 75.

The following charts illustrate how the SECURE Act affects taxable income and account growth.

Taxable Income and Account Growth Post–SECURE Act

RMD Begins at 70 1/2			
Life Expectancy	Age	Acct Value (5%) Growth	RMD
27.4	70	$500,000	$18,248
26.5	71	$505,839	$19,088
27.4	72	$511,089	$18,653
26.5	73	$517,058	$19,512
25.5	74	$522,423	$20,487
24.6	75	$527,033	$21,424
23.7	76	$530,889	$22,400
22.9	77	$533,913	$23,315
22	78	$536,128	$24,369
21.1	79	$537,347	$25,467
		Total Withdrawals	$212,964
Withdrawals + Account Value			$750,310

RMD Begins at 72			
Life Expectancy	Age	Acct Value (5%) Growth	RMD
27.4	70	$500,000	
26.5	71	$525,000	
27.4	72	$551,250	$20,119
26.5	73	$557,688	$21,045
25.5	74	$563,475	$22,097
24.6	75	$568,447	$23,108
23.7	76	$572,606	$24,161
22.9	77	$575,868	$25,147
22	78	$578,257	$26,284
21.1	79	$579,571	$27,468
		Total Withdrawals	$189,428
Withdrawals + Account Value			$768,999

RMD Begins at 73			
Life Expectancy	Age	Acct Value (5%) Growth	RMD
27.4	70	$500,000	
26.5	71	$525,000	
27.4	72	$551,250	
26.5	73	$578,813	$21,842
25.5	74	$584,819	$22,934
24.6	75	$589,979	$23,983
23.7	76	$594,296	$25,076
22.9	77	$597,681	$26,100
22	78	$600,161	$27,280
21.1	79	$601,525	$28,508
		Total Withdrawals	$175,723
Withdrawals + Account Value			$777,248

Missed RMD Withdrawal Penalty Reduction

Code Sec. 4974(a) imposes a penalty if an employee (or any beneficiary) withdraws less than the RMD. The penalty was historically 50 percent of the amount that should have been withdrawn; however, the SECURE 2.0 Act reduces the penalty to 25 percent. In addition, Code Sec. 4974(e) was added to allow a further penalty reduction to only 10 percent if the taxpayer withdraws the previously un-withdrawn amounts during a "correction window" and pays tax on those amounts. The correction window ends on the earlier of:

- The date a notice of deficiency is mailed relating to the Code Sec. 4974(a) penalty,
- The date the taxpayer addresses the Code Sec. 4974(a) penalty, or
- The last day of the second year after the penalty is imposed.

If the taxpayer does not act within the correction window, the 10 percent reduced penalty is no longer available. This addition is seemingly designed to incentivize taxpayers to address unwithdrawn RMDs instead of ignoring or waiting out the statute of limitations.

Currently, the IRS permits taxpayers to request a waiver of the penalty for reasonable cause. To do so, the taxpayer attaches a statement to Form 5329, *Additional Taxes on Qualified Plans (including IRAs) and Other Tax Favored Accounts*, explaining the circumstances surrounding the missed withdrawal and explaining how they are correcting it. Currently, it is unclear if the SECURE 2.0 Act reduced penalty provision will eliminate the IRS's voluntary penalty waiver process.

¶ 105 EXPANDED CATCH-UP CONTRIBUTIONS

The SECURE 2.0 Act introduces several new catch-up contribution opportunities. The catch-up contribution amount is now indexed for inflation, there is an additional catch-up for employees who are ages 60–63, there is an increased catch-up for SIMPLE plans, and Roth characterization is required for catch-ups to employer plans.

Pre-SECURE 2.0 Act IRA and 401(k) Plan Contribution Limits

For tax year 2022, the contribution limits were as follows:

- IRA and Roth IRA limits
  - Under age 50 = $6,000
  - Age 50 or over = $7,000 (includes the $1,000 catch-up)
- 401(k) plan limits
  - Under age 50 = $20,500
  - Age 50 or over = $27,000 ($6,500 catch-up)
- SIMPLE limits
  - Under age 50 = $14,000
  - Age 50 or over = $17,000 ($3,000 catch-up)

Expanded SECURE 2.0 Act IRA and 401(k) Plan Contribution Limits for 2023

- IRA and Roth limits
  - Under age 50 = $6,500
  - Over age 50 = $7,500 ($1,000 catch-up **will now be adjusted for inflation (AFI)**)
- 401(k) plan limits
  - Under age 50 = $22,500
  - Over age 50 = $30,000 ($7,500 catch-up)
  - **Ages 60–63 = $32,500 (starting in 2025, the catch-up is increased to the greater of $10,000 AFI or 150 percent of the regular catch-up)**
- SIMPLE limits
  - Under age 50 = $15,500
  - Over age 50 = $19,000 ($3,500 catch-up; **in 2024, this will increase 10 percent)**
  - **Ages 60–63 = $32,500 (starting in 2025, the catch-up increases to the greater of $5,000 AFI or 150 percent of the regular catch-up)**

Note that these amounts are subject to taxable compensation limits. The portions in bold above are the SECURE 2.0 Act changes. Any other revisions are related to normal inflation adjustments.

Catch-Up Contributions Characterized as Roth

The Act provides that catch-up contributions under Code Secs. 401(k), Code Sec. 403(b), or Code Sec. 457(b) plans are subject to mandatory Roth tax treatment, except those made by participants whose wages for the preceding calendar year do not exceed $145,000, as annually indexed for inflation. This rule does not apply to simplified employee pensions under Code Sec. 408(k), or to SIMPLE IRAs under Code Sec. 408(p).

Effective January 1, 2024, catch-up contributions to employer-sponsored plans (i.e., 401(k), 403(b), and 457(b) plans) must be made to a Roth account if the taxpayer earns more than $145,000 AFI.

EXAMPLE: The 401(k) plan limits are as follows:

- Under age 50 = $22,500 (all pre-tax)
- Over age 50
    - — $22,500 (pre-tax)
    - — $7,500 (post-tax Roth)
- Ages 60–63
    - — $22,500 (pre-tax)
    - — $10,000 (post-tax ROTH)

Amounts are subject to taxable compensation limits.

Excess IRA Contribution Penalty

Employees who contribute too much to their IRA must withdraw the excess contribution before the due date of their tax return. As mentioned earlier, withdrawals made prior to age 59½ are subject to a 10 percent early withdrawal penalty. The SECURE 2.0 Act exempts the earnings on the overcontribution from the 10 percent early withdrawal penalty.

When an overcontribution occurs, the taxpayer must file Form 5329 to report it. The SECURE 2.0 Act imposes a six-year statute of limitation for taxpayers who had an overcontribution to their account and failed to file Form 5329.

Early Withdrawal Penalty Exceptions Expanded

Code Sec. 72(t) allows taxpayers to withdraw retirement funds before age 59½ without paying the 10 percent penalty for a multitude of reasons (medical expenses, college, first-time homebuyer, disability, etc.). The SECURE 2.0 Act adds to this list of exceptions by allowing taxpayers to make a one-time withdrawal of up to $1,000 per year for an unforeseeable or immediate financial need related to personal or family emergency expenses. The taxpayer can repay the withdrawal within three years. If it is not repaid, the taxpayer cannot make further withdrawals based on the emergency exception during the three-year period. This provision is effective starting January 1, 2024.

Retirement "Savings" Accounts

Also effective January 1, 2024, retirement plans can offer linked emergency savings accounts to non–highly compensated employees. An employee can contribute 3 percent of their salary up to a total account balance of $2,500 on a post-tax (Roth) basis. The participant can withdraw up to $1,000 once per year for an emergency without triggering the 10 percent early withdrawal penalty.

The withdrawal can be repaid within three years of taking it, but if it is not repaid, the taxpayer cannot take further withdrawals from this savings account during the three-year term. This provision is intended to address lower income earners' worries that saving for retirement leaves them without an emergency fund.

EXAMPLE: 2024: Employee contributes $2,000 to an emergency savings account.

2025: Employee's car breaks down on the Fourth of July, and the employee withdraws $700 from the savings account.

2026: Employee recontributes $200 to the savings account.

2027: Employee recontributes $100 to the savings account

2028: Employee encounters a health event in January but cannot access the savings account because repayment has not occurred during the three-year repayment term.

2029: Employee can again access the remaining savings account.

"Saver's Match" Replacing "Saver's Credit"

The "saver's credit" currently provides a nonrefundable tax credit for lower-income taxpayers who take advantage of retirement savings opportunities. Starting in 2027, taxpayers earning between $41,000 and $71,000 for married filing jointly and $20,500 and $35,500 for single taxpayers will be eligible for a federal retirement savings "match" of up to 50 percent of the employee's own contributions (up to $2,000 per year). This new match will replace the saver's credit. Details on how taxpayers will receive this match or where it will be deposited have yet to be released.

New Options for Lower-Income Plan Participants

In summary, SECURE 2.0 implements three new options to incentivize lower-income taxpayers to participate in retirement saving opportunities including the new early withdrawal exception for emergency expenses up to $1,000; the retirement savings account, which is similarly accessible for emergency expenses up to $1,000; and the saver's match providing a federal match for lower-income savers. Time will tell whether these incentives actually encourage savings among the target group or whether the complexity and seeming red tape surrounding these opportunities will detract from taxpayers' participation.

STUDY QUESTIONS

1. Most SECURE 2.0 Act provisions are applicable for tax years starting on which of the following dates?

a. January 1, 2019

b. January 1, 2020

c. January 1, 2023

d. January 1, 2024

2. As a result of the SECURE 2.0 Act, the combined 401(k) plan deferral and catch-up contribution limit for those aged 60–63 for 2025 is which of the following?

a. $7,500

b. $22,500

c. $30,000

d. $32,500

3. The new saver's match, which will replace the saver's credit, will be effective starting in which of the following years?

a. 2026
b. 2027
c. 2030
d. 2033

¶ 106 AUTOMATIC ENROLLMENT AND ESCALATION RULES

The SECURE 2.0 Act added Code Sec. 414A, which requires new defined contribution plans to include provisions that will automatically enroll employees once they are eligible. The initial automatic savings rate must be at least 3 percent but no more than 10 percent. That rate must automatically increase by 1 percent annually up to at least 10 percent but no more than 15 percent. Employees may elect out of saving or reduce their saving rates at any time. This provision is effective for new plans beginning after December 31, 2024. The goal is to increase employee participation by requiring employees to opt-out of retirement savings instead of opting-in.

> **EXAMPLE:** An employer plan automatically enrolls employees in a defined contribution plan at 4 percent after they reach one year of service. Employee A does not realize that she has been enrolled in the plan. After five years, Employee A is saving at a 9 percent rate (due to the automatic 1 percent increase annually). Employee A contacts her employer to reduce her contribution rate to 2 percent.

The potential savings from automatic enrollment is illustrated in the following chart:

Savings Opportunities for Automatic Enrollee				
	Employee's Wage	**Savings Rate**	**Annual Retirement Savings**	**Savings with 5% Growth**
Year 1	$50,000	3%	$1,500	$1,500
Year 2	$51,500	4%	$2,060	$3,635
Year 3	$53,045	5%	$2,652	$6,469
Year 4	$54,636	6%	$3,278	$10,071
Year 5	$56,275	7%	$3,939	$14,513
Year 6	$57,964	8%	$4,637	$19,876
Year 7	$59,703	9%	$5,373	$26,243
Year 8	$61,494	10%	$6,149	$33,705
Year 9	$63,339	11%	$6,967	$42,356
Year 10	$65,239	12%	$7,829	$52,304
Year 11	$67,196	13%	$8,735	$63,654
Year 12	$69,212	14%	$9,690	$76,527
Year 13	$71,288	15%	$10,693	$91,046
Year 14	$73,427	15%	$11,014	$106,613
Year 15	$75,629	15%	$11,344	$123,288

¶ 107 EMPLOYER MATCHING AND CODE SEC. 529 ROLLOVERS

SECURE 2.0 Act introduces some new ways for employers to match their employees' own retirement contributions and also recognizes the impact student loan debt could play on employees' ability to start saving for retirement. Employers will now be able to match employees' contributions on a Roth basis and provide matching contributions for employees paying down student debt. New options for rolling over unused educational savings funds to retirement accounts was also incorporated in the legislation.

Employer Roth Matching

Matching contributions by employers or nonelective contributions by employers currently are only made on a pre-tax basis. The SECURE 2.0 Act allows plans to permit employees to choose whether all or part of the employer's contribution will be added to a Roth account. The employer's plan must include this as an option. This provision is effective for any employer contributions made after December 29, 2022; however, the plan must incorporate this option, which may not be adopted by all employers.

> **EXAMPLE:** Employee B earns $100,000 per year and contributes 10 percent of his earnings to a pre-tax 401(k) plan and 10 percent of his earnings to a post-tax Roth 401(k) plan. His employer offers a match of an employee's contributions up to 6 percent of the employee's salary, so Employee B is eligible for a $6,000 contribution from his employer. If the employer's plan allows, Employee B may choose to have all of the contribution added to either the 401(k) plan or the Roth 401(k) plan, or part to each account.

Student Loan Matching

IRS Private Letter Ruling 201833012 permitted employers to provide a retirement plan matching contribution based on an employee's student loan payments (instead of actual retirement contributions). The SECURE 2.0 Act makes this ruling a permanent statutory fixture. Note that all other tests for the retirement plan must still be met, including antidiscrimination calculations.

> **EXAMPLE:** An employee earns $50,000 annually and pays $500 per month ($6,000 annually/12 percent of salary) toward student loans. The employee cannot afford to save for retirement on top of the student loan payments.
>
> The employer who has adopted this plan provision and who normally matches the employee's contributions up to 4 percent of the employee's salary, can now deposit $2,000 in the employee's retirement account even if the employee contributes nothing.
>
> The employee's payments toward their student loans count as retirement contributions for purposes of the employer's matching calculations.

529 Plan Rollovers

The SECURE 2.0 Act amends Code Secs. 408A and 529 to permit unused 529 savings to be rolled into Roth IRA accounts. This is beneficial for students who did not fully deplete their educational savings accounts and would have been subject to nonqualifying use penalties plus tax on any earnings withdrawn from the account. This provision is effective for tax years starting after December 31, 2023. Note the following considerations:

- Transfers must be done on a trustee-to-trustee rollover.
- The beneficiary of the 529 plan and the owner of the Roth IRA must be the same person.
- The 529 plan must be open for 15 years prior to the rollover.
- Total rollovers cannot exceed $35,000 during the beneficiary's lifetime.
- Annual Roth IRA contribution limits apply (without considering the taxpayer's income), which means the rollovers must occur over multiple years.

EXAMPLE: Maria's parents and grandparents contribute $200,000 to a 529 savings account for her educational expenses. Maria receives scholarships and has $30,000 remaining in her 529 account upon graduation. In 2024, Maria can roll over $6,500 AFI to a Roth IRA account. The next year, Maria can roll over another $6,500 AFI, and so on until the account is empty. Maria now has a solid start to retirement savings during years when her income levels may have been too low to contribute.

NOTE: Do not forget about the other opportunities to use 529 plan monies.

- The original SECURE Act created an option for students to use 529 plan balances to pay off up to $10,000 in student loans.
- The account owner (often a parent or grandparent) can change the beneficiary to a sibling, cousin, grandparent, aunt, uncle, or the account owner themselves to pay additional educational expenses.
- The account owner can also use up to $10,000 for elementary, middle, or secondary school. (Some states have restrictions, so check first.)

¶ 108 EXPANSION OF OPTIONS FOR PART-TIME EMPLOYEES

Along the lines of changes to employer-sponsored plans is a new rule that now requires employers to permit long-term, part-time employees to participate in a retirement plan if it is offered. Before the SECURE Act, an employer could limit plan participation to employees who are at least 21 years old and either (1) work 1,000 hours in 12 months or (2) have 12 months of service.

Under the SECURE Act, an employer using the "1,000 hours in 12 months" requirement must now also offer a "500 hours in three consecutive years" eligibility option. This rule is effective for plan years beginning after December 31, 2020. The three-year counting does not begin until January 2021.

EXAMPLE: UNDER THE ORIGINAL SECURE ACT: John has worked 600 hours per year for his employer since 2015. He is 45 years old. John's employer is now required to permit John to participate in the company's retirement plan if he works until January 1, 2024 (three consecutive years after the original effective date of January 1, 2021).

The SECURE 2.0 Act shortens the time period for part-time employee eligibility to 500 hours in two consecutive years, effective for plan years beginning after December 31, 2024. The two-year counting still begins on January 1, 2021, and the two-year period applies for both participation and vesting requirements. Top-heavy plans will be eligible for an exemption if they do not provide safe-harbor matching contributions to long-term, part-time employees. Since the two-year rule is only effective for plan years starting after December 31, 2024, part-time employees should still look to the original SECURE Act's three-year rule if they desire to participate sooner than 2025.

EXAMPLE: UNDER THE SECURE 2.0 ACT: John has worked 600 hours per year for his employer since November 1, 2022. He is 45 years old. John's employer will be required to permit John to participate in the company's retirement plan for the plan year that starts *after* December 31, 2024, if he works until November 1, 2024 (two consecutive years after the original effective date of January 1, 2021).

Employers of part-time employees should consider the following:

- If the employer used the 1,000-hour test, its plan must be amended to permit long-term, part-time employees to participate.
- Participation will start on January 1, 2024, under the original SECURE Act if the employee was employed back on January 1, 2021.
- Only employees who started more recently will benefit from the SECURE 2.0 Act since it applies only to plan years after December 31, 2024.

All employers will have until the end of the first plan year beginning on or after January 1, 2025 (instead of 2022) to amend their plan documents to comply with all of the new required provisions passed under the SECURE Act, SECURE 2.0 Act, CARES Act, and Taxpayer Certainty and Disaster Tax Relief Act of 2019. Employers can operate as though those future amendments are already made without violating the anti-cutback requirement applicable to all plans.

Current laws require a multitude of notices regarding the plan and plan activities to be sent to all employees (even if employees opted out of participation in the plan). The SECURE 2.0 Act reduces the scope of notices required to be sent to employees who opt out. Nonparticipants must now receive (1) an annual participation reminder and (2) any documents requested by the employee.

¶ 109 CHANGES FOR BENEFICIARIES

Lost and Found Retirement Account Database

By the end of 2024 (two years after passage of the SECURE 2.0 Act), the Department of Labor must create a "Retirement Savings Lost and Found" database. The goal is to prevent orphan retirement savings accounts from going unclaimed. This follows the trend begun by many states to create unclaimed fund search websites. A similar site is currently maintained by the National Association of Insurance Commissioners for life insurance policies and annuities.

Expanding on Surviving Spouse's Withdrawal Options

The SECURE 2.0 Act requires the IRS to amend Treas. Reg. § 1.401(a)(9)-5, Q&A 5(a), to allow the surviving spouse of an employee to use the uniform tables based on the employee's date of death to calculate required distributions as originally intended. Now, spouses inheriting both IRAs and employer-sponsored accounts can choose from all the available distribution options applicable to surviving spouses.

Post–SECURE Act IRA Beneficiary Withdrawal Options

After the passage of the original SECURE Act, there are now four categories of retirement plan distribution options: those for spouses, eligible designated beneficiaries, designated beneficiaries, and no designated beneficiary. The four categories are detailed in the following chart:

Post-SECURE Act Distribution Options	
Spouses	Menu of options—rollover, stretch IRA, etc.
Eligible designated beneficiary (disabled, ill, and minors)	Stretch IRA
Designated beneficiaries	10-year plan with or without RMDs depending on the age of the account owner
No beneficiary	5-year plan or decedent's life expectancy depending on whether the decedent died before or after their required beginning date

The payout options for surviving spouses remain unchanged compared to withdrawal options prior to the passage of the SECURE Act and SECURE 2.0 Act. Eligible designated beneficiaries receive the same withdrawal options practitioners historically applied to any named individual beneficiary. As described in the following section, the SECURE 2.0 Act, the proposed regulations, and notices from the IRS have recently clarified how designated beneficiaries and non-designated beneficiaries should calculate their withdrawal windows.

RMDs and the 10-Year Payout

The proposed regulations released after the passage of the SECURE Act clarify a widely misunderstood concept relating to whether beneficiaries subject to the 10-year withdrawal window must also withdraw RMDs if the account owner died after their required beginning date. As described in the regulations, if an account owner died before their required beginning date (under age 72 prior to the SECURE 2.0 Act or age 73 after the SECURE 2.0 Act), the beneficiary must simply empty the account by end of the 10th year after the death. However, if the account owner died *after* the required beginning date, the beneficiary must withdraw RMDs for the next 10 years *and* empty the account by end of the 10th year after the death.

The IRS acknowledges that the SECURE Act was not clear on the rule to take RMDs during the 10-year withdrawal period. IRS Notice 2022-53 suggests that in spite of pushback from practitioners concerned about the unwieldly nature of the regulations, the IRS intends to permanently adopt this bifurcated plan. In light of the original misunderstanding of the SECURE Act legislation, Notice 2022-53 offers relief to beneficiaries subject to the 10-year withdrawal window who failed to take RMDs during 2021 and 2022. If a taxpayer did not take an RMD for 2021 or 2022, the IRS will not assert any excise tax due under Code Sec. 4974 (2020 was an RMD holiday for all account owners under the CARES Act). If a taxpayer already paid an excise tax for a missed RMD, the taxpayer may request a refund of that excise tax.

> **EXAMPLE:** Mom, age 70, and Dad, age 75, each have a $500,000 IRA. Sadly, both pass away in a car accident. Their child is named as the sole beneficiary of both accounts. Since Mom had not yet reached her required beginning date, the child must withdraw her account by the end of the 10th year after her death. Since Dad had already reached his required beginning date, the child must withdraw annual RMDs from Dad's account and also withdraw the remainder of the account by the end of the 10th year after his death.

RMDs and the 5-Year Payout

If an account owner dies before the required beginning date (under age 72 prior to the SECURE 2.0 Act or age 73 after the SECURE 2.0 Act) and the account is payable to the owner's estate, a charity, or a nonqualifying trust, the beneficiary must empty the account by the end of the fifth year after the death. No RMDs are required during this five-year withdrawal period. But if the account owner died *after* the required beginning date, the estate/charity/nonqualifying trust can withdraw the account over the remaining life expectancy of the account owner reduced by one each year after death. This period is sometimes referred to as the *ghost life expectancy*.

The following table illustrates a sample withdrawal period for an account owner dying after their required beginning date at age 75. Curiously, as illustrated in this table, a non-designated beneficiary such as an estate can actually withdraw funds over a longer period of time if the owner dies after their required beginning date and has a life expectancy greater than 10 years under the Single Life Table.

		Age	Account Value (5%) Growth	RMD
	27.4	70	$100,000	
	26.5	71	$105,000	
	25.6	72	$110,250	
	24.7	73	$115,763	$4,687
	23.8	74	$116,630	$4,900
Death	22.9	75	$117,316	$5,123
Switch to Single Life Table	14.1	76	$117,802	$8,355
	13.1	77	$114,920	$8,773
	12.1	78	$111,455	$9,211
	11.1	79	$107,356	$9,672
	10.1	80	$102,568	$10,155
	9.1	81	$97,034	$10,663
	8.1	82	$90,689	$11,196
	7.1	83	$83,468	$11,756
	6.1	84	$75,297	$12,344

NOTE: Once the RMDs are "turned on," they cannot be turned off. That means if an account owner turned on RMDs (by reaching their required beginning date), the RMDs cannot be turned off after his death.

However, if the surviving spouse transfers the deceased spouse's account to their own account, RMDs can be turned off.

Although RMDs can't be turned off, the plan beneficiary can always increase the flow of distributions or fully deplete the account during the 10- or 5-year term.

¶ 110 PLANNING IDEAS FOR CLIENTS

The changes imposed by the SECURE Act and SECURE 2.0 Act are, in part, linked to the fact that life expectancy in the United States increased from age 73.7 in 1980 to age 79.1 in 2023. Delaying the required beginning date increases the size of RMDs from retirement savings plans and increases the likelihood of an employee dying with a larger retirement account.

Unfavorable beneficiary withdrawal provisions will tax more dollars at higher rates because (1) withdrawals are compressed into a shorter withdrawal period and (2) beneficiaries may still be working, subjecting withdrawals to higher tax brackets.

Delayed Required Beginning Date

As mentioned earlier in this chapter, the SECURE 2.0 Act replaces "age 72" in Code Sec. 401(a)(9)(C) with "ages 73 and 75" (based on a timeline). The following two charts compare withdrawals for an inherited IRA both before and after passage of the Act:

	Pre-Secure Act Inherited IRA						Post-Secure Act 2.0 Inherited IRA			
	Required Withdrawal Factor	Age	Acct Value (5%) Growth	RMD Pre-Secure Act			Required Withdrawal Factor	Age	Acct Value (5%) Growth	RMD Post-Secure Act
Parent	N/A	68	$100,000	$0		Parent	N/A	68	$100,000	$0
	N/A	69	$105,000	$0			N/A	69	$105,000	$0
	29.1	70	$110,250	$0			N/A	70	$110,250	$0
	28.2	71	$115,763	$4,105			N/A	71	$115,763	$0
	27.4	72	$117,446	$4,286			N/A	72	$121,551	$0
	26.5	73	$119,032	$4,492			26.5	73	$127,628	$4,816
	25.5	74	$120,491	$4,725			25.5	74	$129,193	$5,066
	24.6	75	$121,791	$4,951			24.6	75	$130,587	$5,308
Child	41	45	$122,929	$2,998		Child	41	45	$131,808	$13,181
	40	46	$126,078	$3,152			40	46	$125,217	$13,913
	39	47	$129,230	$3,314			39	47	$117,565	$14,696
	38	48	$132,377	$3,484			38	48	$108,748	$15,535
	37	49	$135,513	$3,663			37	49	$98,650	$16,442
	36	50	$138,626	$3,851			36	50	$87,141	$17,428
	35	51	$141,706	$4,049			35	51	$74,069	$18,517
	34	52	$144,743	$4,257			34	52	$59,256	$19,752
	33	53	$147,723	$4,476			33	53	$42,466	$21,233
	32	54	$150,633	$4,707			32	54	$23,357	$23,357
	Total Withdrawals			$60,509			Total Withdrawals			$189,245

Planning for Potentially Shortened RMD Period

Ever since the SECURE Act was introduced in March 2019, planners have been trying to come up with ideas to help clients avoid the unfortunate 10-year withdrawal period. Some of the most common tax-saving proposals are detailed in the sections that follow.

Withdrawing funds during one's lifetime. Withdrawing funds over the owner's lifetime may very well be the best option for a client who is in a lower income tax bracket. Of course, analysis should be done to ensure this is the best option. Some clients are in lower tax brackets than their children. There are also many clients who incur significant medical expenses later in life, especially after they move into assisted living. Withdrawing taxable funds in years with excess medical deductions should be considered over using investments that will receive a basis adjustment at the client's death.

Making qualified charitable distributions (QCDs). Clients who are already charitably inclined should consider using these funds and make qualified charitable distributions instead of writing checks or cashing in nonqualified funds. After age 70½, taxpayers can make charitable contributions of up to $100,000 per year directly from an IRA (not a 401(k) plan). The age 70½ for purposes of QCD withdrawals was not impacted by either the SECURE Act or SECURE 2.0 Act. These QCDs are not includable in income. Under the SECURE 2.0 Act, the $100,000 limit is now indexed for inflation. The inflation index will start for tax years beginning after 2023.

New Code Sec. 408(d)(8)(F) allows up to $50,000 to be directed to a split-interest entity in the form of a QCD. The $50,000 limit is similarly indexed for inflation. Qualifying split-interest entities include charitable remainder annuity trusts, charitable remainder unitrusts, and charitable gift annuities. In comparison to most sums transferred to these types of entities, the $50,000 limit is relatively inconsequential and will likely cost more in administrative expenses than would be worth the tax savings.

Naming a charitable remainder trust as beneficiary. Charitable remainder trusts can be useful, though, if the charitable remainder trust (CRT) is named as the beneficiary of a client's retirement account. The client can achieve tax deferral similar to that with a stretch IRA and can maintain control over the monies, so the beneficiaries don't receive everything at once. The following steps can be taken to accomplish this:

- Have testamentary CRT language included in the participant's estate plan.
- Name a CRT as beneficiary of the plan.
- The CRT claims the account at the participant's death.
- The CRT can withdraw the account now but pays no tax as a charitable entity.
- Distributions are made over the participant's lifetime or a period of years to named beneficiaries who pay tax as the funds are received.

Naming multiple nonspouse beneficiaries. Another relatively simple consideration is dividing the account among multiple beneficiaries. By doing this, the taxpayer is spreading out the 10-year withdrawal payments among multiple taxpayers instead of conglomerating all the income onto one beneficiary's tax return.

> **EXAMPLE 1:** The taxpayer's son is the beneficiary of the taxpayer's $500,000 IRA. At a minimum, the son's income is increased by $50,000 per year if the IRA is withdrawn proportionately over the 10-year withdrawal period.

> **EXAMPLE 2:** The taxpayer's three grandchildren are the beneficiaries of the taxpayer's $500,000 IRA. Each grandchild's income is increased only by $16,666 per year if the IRA is withdrawn proportionately over the 10-year withdrawal period. The grandchildren may also be in lower tax brackets.

Converting an IRA to a Roth IRA. Lastly, clients might consider converting their traditional IRAs to Roth IRAs. Of course, this may not be ideal for every client depending on their current income tax bracket, but with tax rates at historical lows right now, it may be an idea that some clients want to consider. This requires income tax analysis similar to medical expenses, tax rates, losses, etc.

> **PLANNING POINTER:** When recommending tax planning to clients and beneficiaries affected by the SECURE Act and SECURE 2.0 Act, remember that one size does not fit all. The following are among the many factors that must be taken into account:
>
> - Relative ages of the taxpayer and beneficiary
> - Relative income tax brackets
> - Estate tax liability
> - Beneficiary immaturity or disability
> - Creditor issues (lawsuits/divorce)
> - Charitable intentions

STUDY QUESTIONS

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4. With respect to 529 plan rollovers, the maximum amount of 529 plan assets permitted to be rolled over to a Roth IRA during a beneficiary's lifetime is which of the following amounts?

a. $22,500
b. $32,500
c. $35,000
d. $40,000

5. Employers have until the end of the first plan year beginning on or after January 1, ______ to amend their plan documents to comply with the SECURE Act, the SECURE 2.0 Act, the CARES Act, and the Taxpayer Certainty and Disaster Tax Relief Act.

- **a.** 2021
- **b.** 2022
- **c.** 2023
- **d.** 2025

6. After age 70½, taxpayers are permitted to make charitable contributions of up to _______ per year directly from an IRA without recognizing taxable income for such distributions.

- **a.** $100,000
- **b.** $125,000
- **c.** $200,000
- **d.** $250,000

MODULE 1: BUSINESS—Chapter 2: Tax Rules for Vehicles

¶ 201 WELCOME

This chapter covers the tax rules for vehicles—cars, light trucks, and vans used by individuals and businesses. It discusses write-offs for using vehicles, and new green energy incentives for buying clean vehicles. It also addresses vehicle-related tax rules, such as those associated with donating vehicles to charity.

¶ 202 LEARNING OBJECTIVES

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

- Describe the limitations on deducting depreciation for business vehicles
- Identify the situations in which personal use of a vehicle is tax deductible
- Explain the tax incentives for purchasing certain types of vehicles
- Recognize which expenses are taken into account when deducting the costs of a business vehicle purchased in 2023
- Identify which elements must be substantiated when a taxpayer uses the standard mileage rate
- Recognize which method to use to figure an employee's personal use of a company vehicle

¶ 203 INTRODUCTION

Vehicle usage in the United States—by both individuals and businesses—is widespread, and the costs are significant. In 2022, nearly 15 million new cars and light trucks were purchased,[1] and more than 290.8 million cars were registered in the United States.[2] As of November 2022, the average cost of a new car was $45,872.[3] Approximately one-fifth of all vehicle transactions were leases.[4]

Different tax rules apply, depending on whether the vehicle is owned or leased, whether it's used for business or personal driving, and whether it's a clean vehicle, a plug-in electric vehicle, or fuel cell vehicle versus one powered by fossil fuel.

Because of the complexity of some of the rules, this chapter only provides an overview, with references to additional resources on particular matters.

[1] MarkLines, "USA—Automotive Sales Volume," https://www.marklines.com/en/statistics/flash_sales/automotive-sales-in-usa-by-month#:~:text=Light%20vehicle%20seasonally%20adjusted%20annualized,million%20units%20a%20year%20ago.

[2] Hedges & Company, "US Vehicle Registration Status," https://hedgescompany.com/automotive-market-research-statistics/auto-mailing-lists-and-marketing/.

[3] Business Wire, "U.S. Automotive Forecast for November 2022," https://www.businesswire.com/news/home/20221123005156/en/J.D.-Power-and-LMC-Automotive-U.S.-Automotive-Forecast-for-November-2022.

[4] Statista, "Percentage of New Vehicles on Lease in the United States from 3rd Quarter of 2017 to 3rd Quarter of 2022," https://www.statista.com/statistics/453122/share-of-new-vehicles-on-lease-usa/#:~:text=Nearly%20one%20fifth%20of%20new,the%20rest%20being%20sold%20outright.

¶ 204 BUSINESS USE

The use of cars, vans, pickup trucks, and panel trucks is common for business. Taxpayers who use a vehicle for business are generally permitted to write off the costs. In fact, the deduction for car and truck expenses for sole proprietors is one of the top two deduction categories each year. The deduction includes acquisition and most operating costs. However, various limitations apply and there are different ways to handle annual write-offs.

There are two ways to figure the deduction for business use of a vehicle: the *actual expense method* and the *standard mileage rate*. Usually, a taxpayer may choose which method to use. However, the standard mileage rate may *not* be used if the taxpayer:

- Operates five or more vehicles at the same time,
- Claimed depreciation using any method other than straight-line,
- Claimed a Code Sec. 179 deduction,
- Claimed a bonus depreciation allowance, or
- Deducted actual expenses after 1997 for a vehicle the taxpayer leases.

Note that if you claim the standard mileage rate in the first year of vehicle ownership, you may choose to deduct actual expenses or use the standard mileage rate in later years. In the case of a *lease*, once you claim the actual expense method, you cannot choose to use the standard mileage rate in a future year.

If the standard mileage rate is chosen by reporting it on a timely filed return, this choice cannot be changed for the year it was used.

> **EXAMPLE:** Taxpayer A bought a business car in December 2022 and filed her 2022 income tax return on April 18, 2023, using the standard mileage rate method to determine the deduction for the vehicle. She cannot amend this return to change to the actual expense method.

Using the actual expense method, the expenses factored into the standard mileage rate include:

- Depreciation or lease payments (depending on whether the vehicle is owned or leased)
- Gas and oil
- Insurance
- Registration fees and licenses
- Repairs and maintenance
- Tires

This list is not exclusive. Other costs, such as car washes—another maintenance expense—are deductible. Parking and tolls are separately deductible. Interest on a car loan is handled separately; it is not part of actual expenses deducted for car and truck expenses.

Depreciation of a Vehicle

While most of the expenses are self-explanatory, we should discuss depreciation and lease payments. Vehicles are five-year property, but a six-year recovery period applies due to the half-year convention under the Modified Accelerated Cost Recovery System (MACRS). The normal depreciation rates applied to the unadjusted basis (usually cost) of the vehicle are:

- 20 percent for the first year (half of the 40 percent double-declining balance factor for year 1)
- 32 percent for the second year

- 19.20 percent for the third year
- 11.52 percent for the fourth and fifth years
- 5.76 percent in the sixth year

There are various limitations that may alter or limit the deduction amount resulting from these percentages. Before discussing these limitations and their impact on the annual depreciation allowance, we should discuss the basis to use to compute the depreciation.

If the taxpayer buys a vehicle, the basis for depreciation is the vehicle's cost. This includes sales tax on its purchase. It cannot separately deduct the sales taxes on the vehicle in the year of purchase. It does not matter whether the taxpayer pays cash or finances the purchase in whole or in part. The borrowed funds are part of the cost basis.

> **EXAMPLE:** A business buys a $40,000 pickup truck for its business, putting $5,000 down and financing the balance. The cost basis is $40,000, even though the business only paid $5,000 cash.

Using a Personal Vehicle for Business

If a taxpayer begins to use a personal vehicle for business purposes, the basis for depreciation is the lesser of the vehicle's fair market value (FMV) on the date of conversion to business use or its adjusted basis on that date. Because a vehicle typically declines in value annually, the taxpayer will likely be using FMV for depreciation purposes because it would be lower than the adjusted basis.

Whether the taxpayer buys the vehicle for business use or converts it from personal use and uses it for both business and personal driving, the taxpayer must allocate basis to business and personal use.

> **EXAMPLE:** A taxpayer buys a vehicle for $40,000 and uses it 75 percent for business. The taxpayer figures depreciation on $30,000, the portion of basis allocable for business use.

Trade-Ins

If the taxpayer acquires the vehicle through a trade-in of another one, the taxpayer must report gain or loss on the transaction (the trade-in). Usually, gain results because of having depreciated the vehicle. In the past, trade-ins didn't necessarily trigger tax because they were treated as like-kind exchanges, but this tax treatment is now restricted to realty, so vehicle transactions are taxable. The good news is that the full cost of the new vehicle (including the trade-in allowance) is the tax basis for depreciation.

Listed Property

The depreciation percentages mentioned earlier in this chapter only apply if business use of the vehicle is more than 50 percent of the miles driven for the year. These percentages reflect the MACRS factors for 5-year property. A vehicle is listed property (Code Sec. 280F). This means that if business use is below 50 percent, only straight-line depreciation may be claimed.

Depreciation deductions for listed property must be reported in Part V of Form 4562, *Depreciation and Amortization*.

If business use is more than 50 percent but declines below this threshold in a later year, the taxpayer must change to the straight-line depreciation method. This is so even in the year of disposition, other than in the case of the owner's death. The MACRS deduction—the amount in excess of straight-line depreciation—must be recaptured.

The dollar limits apply to so-called luxury vehicles weighing under 6,000 pounds (the unloaded gross vehicle weight) (Code Sec. 280F). The IRS can adjust the dollar limits annually, and the limits to use are those applicable for the year in which the vehicle is placed in service. The dollar limits for depreciating luxury vehicles bought and placed in service in 2023 are as follows:

2023 Dollar Limits for Depreciating Luxury Vehicles	
Tax Year	**Placed in Service in 2023 (Rev. Proc. 2023-14)**
First year	$20,200*
Second year	$19,500
Third year	$11,700
Each succeeding year	$6,960
* If the vehicle does not use the additional first-year depreciation deduction under Code Sec. 168(k), the limit is $12,200.	

In the past, there were different limits for passenger cars versus trucks and vans. Now, light trucks and vans are treated the same as passenger cars.

Looking Ahead and Back

Bonus depreciation begins phasing out in 2023, reducing the applicable amount by 20 percent each year until it expires at the end of 2026. For vehicles placed in service prior to 2023, different dollar limits may apply. These dollar limits are listed in IRS Publication 463, *Travel, Gift, and Car Expenses*. The percentage is different if the fourth quarter convention applies.

Safe Harbor Rule

If a vehicle is placed in service in 2022 and the taxpayer used 100 percent bonus depreciation, then the taxpayer must figure depreciation going forward using a safe harbor rule (Rev. Proc. 2019-13). To apply the safe harbor method, the taxpayer must use the applicable depreciation table in Appendix A of IRS Publication 946, *How to Depreciate Property*. The safe harbor method does not apply to a vehicle placed in service after 2022 because bonus depreciation is no longer 100 percent.

The safe harbor method also does not apply if the taxpayer elected out of the 100-percent additional first-year depreciation deduction or elected under Code Sec. 179 to expense all or a portion of the cost of the vehicle. To use the safe harbor method, no special form or election is needed; the taxpayer simply applies it to the depreciation allowance on the first taxable year following the year in which the vehicle was placed in service.

Allocating the Dollar Limit

If a taxpayer buys an expensive vehicle but doesn't use it entirely for business, the taxpayer must allocate the dollar limit.

> **EXAMPLE:** A vehicle bought and placed in service in 2023 cost $100,000 and is used 75 percent for business. The full dollar limit would ordinarily be $20,200, taking into account the additional first-year depreciation deduction (bonus depreciation). In this situation, the deduction cap is $15,150, or 75 percent of $20,200.

Heavy SUVs

Passenger vehicles are not subject to the dollar limit when rated at more than 6,000 pounds unloaded gross vehicle weight (Code Sec. 280F(d)(5)). For trucks and vans, the threshold is more than 6,000 pounds gross vehicle weight. There are dozens of such "heavy" sports utility vehicles (SUVs), ranging from the Audi Q7 to the Toyota Sequoia.

For heavy SUVs, the usual dollar limits and the full first-year expensing limit—$1,160,000 in 2023—do not apply. Instead, there is a special first-year expensing deduction of up to $25,000, adjusted for inflation, so the amount is $28,900 in 2023. There is an additional write-off:

- In 2023, with 80 percent bonus depreciation applicable, the full purchase price is not immediately deductible.
- The only requirement for using bonus depreciation for a heavy SUV is that the vehicle must be used more than 50 percent for business.

Vehicles Exempt from Dollar Limits and Substantiation Requirements

Certain vehicles are exempt from the dollar limits, including:

- Vehicles with an interior cargo bed length of less than 6 feet
- Passenger vans seating fewer than ten people behind the driver's seat
- Cargo vans
- Non–personal use vehicles (Reg. § 1.274-5T(k)), which include:
  — Ambulances
  — Delivery trucks with seating only for the driver (or with a fold-out jump seat)
  — Farm vehicles (e.g., tractors)
  — Flatbed trucks
  — Hearses
  — Specialized vehicles (e.g., tow trucks, moving vans, dump trucks)

To repeat, they are exempt from both substantiation requirements and the dollar limits that would otherwise apply. The IRS makes it very clear that merely putting a business sign on a vehicle does not transform it into a non–personal use vehicle.

Leased Vehicles—Actual Expense Method

If a leased vehicle is used 100 percent for business, then 100 percent of the lease payments are deductible, subject to an adjustment (discussed below). If the vehicle is used partly for personal driving, the taxpayer must allocate the lease payments; only the business portion is deductible.

If the vehicle is considered a luxury vehicle, then an *inclusion amount* reduces the deductible lease payment. More specifically, the inclusion amount is taken from an IRS table for this purpose. The taxpayer should use the table for the year in which the lease begins. For 2023, this means a vehicle first leased on or after January 1, 2022, and having a FMV at the start of the lease of over $60,000.

First Year	Second Year	Third Year	Fourth Year	Fifth Year and Later
$0	$0	$1	$3	$5

EXAMPLE: Assume a vehicle is leased in January 2023 with a fair market value of $75,000. The inclusion amount for the first year of the lease is $91. If the total vehicle lease payments for 2023 are $7,200, the deductible amount is $7,109 ($7,200 – $91).

The inclusion amounts for vehicles leased before 2023 are in IRS Publication 463.

Standard Mileage Rate for Business Driving

The IRS can adjust the standard mileage rate annually, and twice it has made two adjustments for a year when gas prices skyrocketed. The standard mileage rate cannot be used for business driving if:

- The taxpayer uses five or more cars at the same time, such as fleet operations;
- The taxpayer previously claimed accelerated depreciation, including first-year expensing and bonus depreciation for the vehicle; or
- The taxpayer is a rural mail carrier who is reimbursed for driving.

The standard mileage rate can be used regardless of business status, meaning it can be used by employees who are still eligible to deduct their work-related expenses, self-employed persons, and business entities.

Keep in mind that most employees can't deduct their mileage costs because of the suspension of miscellaneous itemized deductions subject to the 2 percent-of-AGI (adjusted gross income) floor. However, some employees deduct their business expenses in other ways and can still take their mileage deduction. These include:

- Reservists in the Armed Forces who deduct their travel costs as an adjustment to gross income
- State or local government officials paid on a fee basis who deduct their business expenses as an adjustment to gross income
- Performing artists who are eligible to deduct their business expenses as an adjustment to gross income

The standard mileage rate can also be used to reimburse employees on a tax-free basis using an accountable plan, which will be discussed later in this chapter. Also, note that the standard mileage rate can be used whether the vehicle is owned or leased.

For 2023, the standard mileage rate for business driving is 65.5¢ per mile (Notice 2023-03). In 2022, there were two standard mileage rates: 58.5¢ per mile for the first half of the year, and 62.5¢ per mile for the second half of the year. Rates for these and other years are shown in the following chart:

Year	Business Cents per Mile
2023	65.5¢
January – June 2022 July – December 2022	58.5¢ 62.5¢
2021	56¢
2020	57.5¢
2019	58¢
2018	54.5¢

The standard mileage rate deduction is figured by multiplying the number of business miles driven during the year by the rate.

> **EXAMPLE:** If the taxpayer drives 13,468 miles for business in 2023, the deduction for car usage figured with the standard mileage rate is $8,822 (13,468 × 65.5¢).

Sole proprietors claim their vehicle use deduction in Part IV of Schedule C (Form 1040 or 1040-ES), assuming they are not required to file Form 4562 for depreciation purposes.

Deemed Depreciation

When the taxpayer sells or trades in a vehicle for which the standard mileage rate was used, it must adjust the basis of the vehicle by a deemed depreciation rate for each year of service. Like the standard mileage rate, this is a rate that is also set annually by the IRS. The adjustment is necessary because depreciation is factored into the standard mileage rate.

The deemed depreciation rate for 2023 is 28¢ per mile. It was 26¢ per mile in 2022. Apply the deemed depreciation rate for each year based on the applicable rate and the number of miles driven. The following chart lists the deemed depreciation rates since 2015. The deemed depreciation rate hasn't varied too much over the years.

Year	Deemed Depreciation Rate
2023	28¢
2021–2022	26¢
2020	27¢
2019	26¢
2017–2018	25¢
2015–2016	24¢

EXAMPLE: A taxpayer bought a car in 2020 and used it 10,000 miles each year, using the standard mileage rate. The car is sold at the end of 2023. The basis of the car is reduced by $10,700.

Year	Rate	Mileage	Deemed Depreciation
2020	$0.27	10,000	$2,700
2021	$0.26	10,000	2,600
2022	$0.26	10,000	2,600
2023	$0.28	10,000	2,800
Total			$10,700

Rural Letter Carriers

There are special rules for rural letter carriers and their reimbursements. For rural letter carriers, qualified reimbursements from the government are tax-free. However, these carriers may have higher vehicle costs than the amount reimbursed. Unfortunately for them, the additional costs cannot be deducted from 2018 through 2025 because of the suspension of miscellaneous itemized deductions for individuals.

In prior years, rural letter carriers deducted their driving costs and figured this unreimbursed employee business expense on Form 2106, *Employee Business Expenses*, using the actual expense method (the standard mileage rate method was not permitted) and then claimed them as a miscellaneous itemized deduction on Schedule A of Form 1040.

Substantiation

Claiming a deduction for business vehicles is predicated on substantiation. The tax law is very specific about this requirement. Failure to have adequate substantiation has led to much litigation, and the taxpayer often loses deductions to which he or she would otherwise be entitled. Substantiation means keeping a contemporaneous record noting the following:

- Dates of driving
- Business destination
- Purpose of each drive
- Total mileage for the year for allocation between business and personal use
- Cost of each separate expense

PLANNING POINTER: Using the standard mileage rate method relieves the taxpayer of recordkeeping for costs, but not for substantiation of other elements.

Recordkeeping can be simplified with smartphone apps, some of which use GPS and note the date and destination of each trip. However, it's still up to the user to note the purpose of the trip and any other necessary details, including costs when using the actual expense method.

Schedule C filers must note in Part IV whether they have evidence to support their deduction and whether this evidence is written. The IRS has not stated in any formal or informal way whether apps are treated as written, but they do enable users to make printouts.

Accountable Plans

Reimbursing employees for business driving in their personal vehicles can be done through an accountable plan or a non-accountable plan. An accountable plan is a win-win for both employees and employers. The employer effectively deducts all the reimbursements as write-offs for business driving. Thus, the reimbursements avoid income and employment taxes.

Accountable plan payments are more important than ever for employees since they cannot deduct their unreimbursed employee business expenses as miscellaneous itemized deductions until after 2025. An accountable plan is an arrangement established by the employer. It must contain all of the following elements:

- **There must be a business connection for the expenses.** This is easy to show when employees use their personal vehicle for company business.
- **The employee must adequately account to the employer for the expenses incurred within a reasonable time.** An accountable plan with a 60-day deadline following either (1) advance payments to employees or (2) incurring the expense is treated as reasonable, but the employer can set a shorter period. Substantiation means supplying all the required information outlined earlier. If the employer reimburses the employee at no more than the standard mileage rate, no substantiation of the actual expenses is needed.

EXAMPLE: If the employer reimburses the employee for business driving in 2023 at 65.5¢ per mile, the employee does not need receipts for gas fill-ups. The employee must still substantiate the business purpose of the travel as outlined earlier.

The employee must account for and return to the employer any excess advances (monies not used for a business purpose) within a reasonable period of time. For this purpose, returning excess advances to the employer within 120 days of the advance of funds to the employee is treated as reasonable.

EXAMPLE: If an employer advances an employee $400 for driving during a quarter of the year, but the employee's mileage entitles her to only $375, she must return the $25 to the employer within this time period.

PLANNING POINTER: Although there is no requirement in the tax law that the accountable travel reimbursement plan be written or formalized, it is highly advisable for the employer to put the terms of the plan in writing and communicate them to employees.

Closely held corporations may want to adopt an accountable plan in their annual board meeting and note the adoption in the corporate minutes.

If the plan is not in writing, there must be some proof that a plan exists.

In one case, a couple who owned an S corporation could not show any proof, such as collecting documentation, to substantiate the purported expenses and the amount actually reimbursed (*Kyle D. Simpson*, TC Memo 2023-4). As a result, they were taxed on the reimbursements.

Nonaccountable Plans

If an employer has an accountable plan but an employee fails to meet all of the requirements, then expenses are treated as having been paid under a nonaccountable plan. Under a nonaccountable plan, reimbursements are treated as taxable compensation, which means they are:

- Taxable as compensation to the employee,
- Subject to income tax withholding and FICA and FUTA taxes, and
- Reportable on an employee's Form W-2.

The employee cannot deduct the cost of business driving on his or her personal income tax return due to the suspension of miscellaneous itemized deductions.

Fixed and Variable Rate Rule

Another rule relative to car usage is the fixed and variable rate rule, or FAVR. FAVR is used to figure reimbursements to employees who drive their own vehicles on company business. It's an alternative to the standard mileage rate for purposes of accountable plans and obviating the need to substantiate costs to the employer. The amount reflects fixed and variable costs (e.g., lease payments, which are fixed, and gas expense, which is variable). The burden is on the employer to make the necessary calculations for the FAVR.

The rule can only be used if the vehicle's cost does not exceed a set amount. For 2023, the cost limit is $60,800 (Notice 2023-03).

A complete explanation of FAVR can be found in Rev. Proc. 2010-51.

STUDY QUESTIONS

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1. Which of the following statements regarding the deduction for business use of a vehicle is correct?

a. Usually, a taxpayer is permitted to choose which method they use to calculate the deduction.
b. There are three possible methods of calculating the deduction.
c. The standard mileage rate method may be used if a taxpayer operates five or more vehicles at the same time.
d. Parking and tolls are expenses factored into the standard mileage rate.

2. Regina, a real estate agent, buys an expensive luxury vehicle with an unloaded gross vehicle weight that is less than 6,000 pounds. The car cost $120,000, and she uses it for business 60 percent of the time. The car is placed in service in 2023. Assuming that Regina uses bonus depreciation in year 1, what is the amount of her deduction for 2023?

a. $7,320
b. $12,120
c. $20,200
d. $72,000

3. The standard mileage rate for 2023 is which of the following?

a. 54.5 cents per mile
b. 57.5 cents per mile
c. 62.5 cents per mile
d. 65.5 cents per mile

¶ 205 PERSONAL USE

A person may use his or her vehicle for various activities other than business. This nonbusiness use may nonetheless give rise to a deduction.

Commuting

Generally, commuting to and from work is a nondeductible personal expense (Code Sec. 262). This is true regardless of the distance of the commute or other special factors. The only exception is any additional cost incurred for bringing work-related tools along (***Fausner***, S.Ct., 73-2 USTC ¶ 9515).

Once at work, driving to a second work location is not commuting; it is business driving. Even so, it can't be deducted by an employee but may be reimbursed through an accountable plan.

Driving for Medical Purposes

Personal driving for medical purposes is deductible. This includes driving to the following:

- Doctors and dentists
- Hospitals and clinics
- Pharmacies
- Therapists
- Any other deductible medical treatment (e.g., acupuncturists)

The cost of driving for medical purposes is based on either (1) the total of actual expenses incurred or (2) applying the IRS-set standard rate for this purpose. For 2023, the standard rate is 22¢ per mile, plus parking and tolls. The rate for 2022 was 18¢ per mile for the first half of the year and 22¢ for the second half of the year.

Even if a taxpayer itemizes, the AGI limit on itemizing medical expenses may bar a deduction for medical driving. Total medical expenses must exceed 7.5 percent of AGI.

PLANNING POINTER: Substantiation is required for medical driving, just as it is for business driving.

Driving for Moving Purposes

In the past, driving for a work-related move was part of an above-the-line deduction for moving expenses. For 2018 through 2025, this deduction is limited to members of the military who relocate to a permanent station of duty pursuant to orders (Code Sec. 217). A taxpayer who qualifies for a moving expense deduction may include driving in this write-off, which is figured on Form 3903, *Moving Expenses* (line 2), and is an above-the-line deduction (no itemizing is required).

Driving for this purpose includes taking yourself, members of your household, and personal effects to your new home. It does not include driving associated with house-hunting trips or returning to a previous location to close on a former residence.

The cost of driving for moving purposes is also based on either (1) the total of actual expenses or (2) the IRS-set standard rate. For 2023, the standard rate is 22¢ per mile. The rate for 2022 was 18¢ per mile for the first half of the year and 22¢ for the second half of the year. Parking and tolls should be added to the deduction.

PLANNING POINTER: As in the case of business and medical driving, substantiation is required.

Driving for Charity

Driving related to charity can also be deductible. This type of driving entails using a personal vehicle on behalf of a charitable organization.

> **EXAMPLE:** If a taxpayer volunteers for Meals on Wheels and uses his vehicle to deliver meals to homebound individuals, the taxpayer may deduct the driving.

The taxpayer may deduct the actual expenses or rely on a mileage rate fixed by the tax law: 14¢ per mile. (The same rate has been in effect since 1997.) The taxpayer can add parking and tolls to the deduction. Charitable driving must be substantiated and is then claimed as an itemized deduction.

Personal Use of Company Vehicle

The personal use of a company vehicle is generally treated as taxable compensation. This requires the employer to figure the value of personal use. There are several ways to do this.

Under the actual FMV rule, FMV is determined by looking at the cost of leasing a comparable vehicle at a comparable price at a comparable time. Essentially, this is the cost of a vehicle in an arm's-length transaction. There are two safe harbors under this method:

- Use the manufacturer's sticker price, plus 4 percent.
- Use the manufacturer's suggested retail price, minus 8 percent.

Then the portion of annual use for personal driving is reported as taxable compensation on the employee's Form W-2.

Another method for valuing personal use of a company vehicle is the car's annual lease value (ALV). The amount of the ALV used to determine personal use depends on the fair market value of the vehicle on the date it is first used for personal purposes.

> **EXAMPLE:** A company car's FMV on the date the employee began to use it for personal purposes is $25,000. The ALV is $6,850. The ALV is multiplied by the percentage of personal miles to total miles driven by the employee for the year. Thus, if the employee drives 5,000 miles for personal driving and 15,000 miles on company business, the amount of reportable income resulting from personal use of the company car is $1,713 ($6,850 × 25%).

ALVs are listed in IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*. The ALV does not include fuel costs, regardless of whether the employer provides fuel, reimburses its cost, or charges the employee for it. Employers must add a fuel charge of 5.5¢ per mile to the value of personal use figured under ALV, for personal driving (Reg. § 1.61-21(d)(3)(ii)(D)).

> **EXAMPLE:** If an employee drives a company car 3,000 miles in the year for personal use, the additional taxable amount reported is $165.

Another valuation rule is the fleet-average valuation rule. This rule applies to employers with a fleet of at least 20 vehicles (Reg. § 1.61-21(d)). This valuation method is a variation on the ALV. The employer averages the FMV of its vehicles. The FMV must be recalculated every two years.

The maximum value of employer-provided vehicles first made available to employees for personal use for an entire year cannot exceed a set amount. For 2023, that amount is $60,800 (Notice 2023-03); for 2022, it was $56,100 (Notice 2022-03).

Another method for valuing personal use is the cents-per-mile rule. This rule is based on the standard mileage rate. More specifically, the employer values personal use based on the number of miles the company vehicle was driven for personal purposes.

EXAMPLE: Continuing with the facts in the previous example, $5,000 personal miles in 2023 would be valued at $3,275 ($5,000 × 65.5¢).

This method can be used only if the vehicle is also used in the employer's business; it can't be used if the vehicle is only used for personal purposes. The value of the vehicle when first made available to the employee must not exceed a set limit (see the "Fleet-Average Valuation Rule" section).

Another rule that can be used is the commuting rule. Under this rule, the value of personal use is $1.50 per day each way, or $3.00 per day for a round-trip commute. This method of valuation can only be used if personal use is restricted to commuting or *de minimis* use and a written policy reflects this. The commuting rule cannot be used for a "control employee." For 2023, this includes any of the following:

- A board or shareholder-appointed, confirmed, or elected officer whose pay is $130,000 or more
- A director
- An employee whose pay is $265,000 or more
- An employee who owns a 1 percent or more equity, capital, or profits interest in the business

Instead of using the definition of a *control employee* for purposes of the commuting rule, the taxpayer can choose to use the definition of a *highly compensated employee*. A highly compensated employee is someone who meets either of the following tests for 2023:

- The employee was a 5 percent owner at any time during the current or preceding year, or
- The employee received more than $135,000 in pay in the preceding year.

The second test can be ignored if the taxpayer/employee wasn't also in the top 20 percent of employees when ranked for pay in the preceding year.

¶ 206 ENERGY-RELATED CREDITS

Over the years, various tax incentives existed for buying vehicles. For example, during the Great Recession in 2008 and 2009, the sales tax on the purchase of vehicles up to a set price and within a set period was deductible, regardless of whether the taxpayer itemized deductions. In the past, there were tax credits for buying hybrid vehicles. Now, tax incentives relate to so-called clean vehicles. These are plug-in electric vehicles (EVs) or fuel cell vehicles (FCVs).

The Inflation Reduction Act of 2022 made numerous changes to incentivize the purchase of electric vehicles (EVs) by consumers and businesses. The IRS provides answers to frequently asked questions about the clean vehicles credit at https://www.irs.gov/newsroom/frequently-asked-questions-about-the-new-previously-owned-and-qualified-commercial-clean-vehicles-credit.

Clean Vehicle Credit for Consumers Beginning in 2023

After 2022, there are different EV credits: two that apply for consumers and one that can be used by businesses for certain vehicles and movable equipment. Let's start with the one for consumers who buy a *new* EV.

The clean vehicle credit applies to the purchase of a plug-in EV or a fuel cell electric vehicle. This credit is up to $7,500 and is set to run through 2032. The 200,000-vehicle limit no longer applies. However, there are new eligibility requirements.

Like the pre-2023 credit, the amount is limited to $7,500, but the way in which it's figured is different. There's a crucial minerals portion of the credit up to $3,750 and a battery component portion up to $3,750. The critical minerals and battery components must be extracted or processed in the United States, by a U.S. free-trade agreement partner, or recycled in North America. The Department of Energy has a list of the percentages (https://bit.ly/3CQWVvg) to meet these requirements; they increase each year.

The clean vehicle credit is nonrefundable, with no carryforward. To claim the credit, the taxpayer's modified adjusted gross income (MAGI) may not exceed:

- $300,000 for married filing jointly,
- $225,000 for head of household, or
- $150,000 for other filers.

A taxpayer can use MAGI from the year in which he or she takes delivery of the vehicle or from the year before, whichever is less. If the taxpayer's MAGI exceeds the threshold amount in one year, it can still be claimed if it is below the threshold in the other year.

Additional clean vehicle credit rules include the following:

- The EV must be new.
- The seller must report information to the buyer—and to the IRS—at the time of sale. This information includes the buyer's name and taxpayer identification number (SSN).
- The vehicle's manufacturer suggested retail price (MSRP) cannot be greater than:
  - — $80,000 for vans, SUVs, and pickup trucks
  - — $55,000 for other vehicles

NOTE: The MSRP includes options, accessories, and trim, but doesn't include destination fees.

Credit for previously owned EV. Starting in 2023, there is a separate credit for previously owned clean vehicles (Code Sec. 25E). This credit applies to the same type of vehicle covered by the clean vehicle credit, meaning vehicles that weigh no more than 14,000 pounds. The credit is 30 percent of the sale price, up to a maximum credit of $4,000. Like the new EV credit, this credit is nonrefundable and can only be claimed once every three years. It can't be claimed if the taxpayer claimed another used clean vehicle credit in the three years before the purchase date. The credit also may not be claimed by a person who is a dependent on another taxpayer's return.

There is an income limit for the previously owned EV credit. The taxpayer's MAGI may not exceed:

- $150,000 for married filing jointly and qualifying surviving spouse,
- $112,500 for head of household, or
- $75,000 for other filers.

As with the credit for a new EV, a taxpayer can use MAGI from the year in which he or she takes delivery of the vehicle or the year before, whichever is less. If the taxpayer's MAGI exceeds the threshold amount in one year, the credit can still be claimed if it is below the threshold in the other year.

To qualify for the previously owned EV credit, the vehicle must:

- Have a sale price of $25,000 or less
- Have a model year at least two years earlier than the calendar year when it is purchased (e.g., a vehicle purchased in 2023 would have to be a model year of 2021 or older)

- Not have already been transferred after August 16, 2022, to a qualified buyer
- Have a gross vehicle weight rating of less than 14,000 pounds
- Be an eligible FCV or plug-in EV with a battery capacity of at least 7 kilowatt hours
- Be for use primarily in the United States

Also, the vehicle must be purchased from a dealer who reports the following required information at the time of the sale to the purchaser and to the IRS:

- Dealer's name and taxpayer ID number
- Buyer's name and taxpayer ID number
- Sale date and sale price
- Maximum credit allowable under Code Sec. 25E
- Vehicle identification number (VIN), unless the vehicle is not assigned one
- Battery capacity

The previously owned clean vehicle credit is claimed on Form 8936.

> **PLANNING POINTER:** Starting in 2024, the clean vehicle credit and the previously owned clean vehicle credit can effectively be "sold" to the dealer to reduce the purchase price of the vehicle. Opting to sell the credit to the dealer means the taxpayer does not have to wait to file a return in order to reap the tax savings from the credit.

Commercial clean vehicle credit. Starting in 2023, there is a credit for commercial clean vehicles that may be claimed by businesses as well as tax-exempt organizations (Code Sec. 45W). This credit applies to vehicles similar to the ones covered by the clean vehicle credit for consumers as well as to heavier motor vehicles and mobile machinery (vehicles not designed to perform a function of transporting a load over a public highway).

The credit is the lesser of 15 percent of the vehicle's basis, or 30 percent if the vehicle isn't powered by gas or diesel, or the incremental cost of the vehicle. The maximum credit amount depends on the weight of the vehicle:

- Up to $7,500 for vehicles weighing under 14,000 pounds
- Up to $40,000 for vehicles weighing 14,000 pounds or more

Incremental cost is the excess of the purchase price of such vehicle over the price of a comparable vehicle. A comparable vehicle with respect to any qualified commercial clean vehicle is any vehicle that is powered solely by a gasoline or diesel internal combustion engine and is comparable in size and use to such qualified commercial clean vehicle.

The IRS stated that it reviewed the incremental cost for all street vehicles in calendar year 2023 (Notice 2023-9). The analysis shows that the incremental cost of all street vehicles, other than compact car plug-in electric hybrids, with a gross vehicle weight of less than 14,000 pounds is greater than $7,500 in calendar year 2023. The incremental cost won't limit the available credit amount for these street vehicles placed in service in calendar year 2023.

For compact car plug-in electric hybrids for which the incremental cost was calculated to be less than $7,500, the IRS will accept the incremental cost published by the Department of Energy.

> **PLANNING POINTER:** There is no limit on the number of credits a business may claim. A business that replaces a fleet of cars or buys multiple trucks can

claim a credit for each vehicle that qualifies. The depreciable basis of the vehicle or machine must be reduced by the amount of the credit claimed.

The commercial vehicle or machinery must also either be:

- A plug-in EV that draws significant propulsion from an electric motor with a battery capacity of at least:
  - 7 kilowatt hours if the gross vehicle weight rating (GVWR) is under 14,000 pounds
  - 15 kilowatt hours if the GVWR is 14,000 pounds or more; or
- A FCV that satisfies requirements listed in Code Sec. 30B

The business will have to include the VIN number on the tax return to claim the credit. At present, there is no draft form for this purpose.

Alternative fuel refueling property credit (Code Sec. 30C). Another green energy measure related to vehicles is the tax credit for installing a charging station. This credit applies for installing a charging station and runs through 2032. Different rules apply to individuals who install charging stations at their residences versus businesses that install charging stations on their premises. However, in both situations, the credit beginning in 2023 can only be claimed if property is located in low-income census tracts or non-urban areas.

Individuals who install an EV charging station in their residence may claim a tax credit of the lesser of 30 percent of the property's cost or $1,000. Various credits must be used to reduce the regular tax before this credit for a charging station may be claimed. The unused portion of the credit may not be carried forward; it is simply lost.

Although an individual may not owe alternative minimum tax (AMT), the taxpayer must still figure the tentative minimum tax (TMT) to figure the credit. The taxpayer should attach Form 6251, *Alternative Minimum Tax—Individuals* to Form 8911, *Alternative Fuel Vehicle Refueling Property Credit*.

For charging stations for businesses, the credit limit is as follows:

- For 2022: the lesser of 30 percent of the property's cost or $30,000
- For 2023 and beyond: the lesser of 6 percent of the property's cost or $100,000

Beginning in 2023, prevailing wage and apprenticeship requirements must be satisfied in order to claim the credit for property placed in service after December 31, 2022. The IRS provides some guidance on these requirements (IR-2022-208), which reflect proposed regulations that took effect on January 30, 2023 (87 FR 73580). The IRS noted that it would issue additional guidance, so watch for any developments, which would impact 2023 returns to be filed in 2024.

The credit is figured on Form 8911. Partnerships and S corporations must file this form to claim the credit. All other taxpayers are not required to complete or file this form if their only source for this credit is a partnership or S corporation. Instead, they report this credit directly on Form 3800, *General Business Credit*.

State-level green energy tax incentives. Taxpayers should check their state tax rules, as there may be incentives for buying EVs and/or installing charging stations in their state. State-level tax incentives can be found at https://www.dsireusa.org/ (enter a zip code or click on the state on the map).

¶ 207 OTHER VEHICLE-RELATED MATTERS

This section addresses some other matters that may arise because they relate to vehicles.

State and Local Taxes

Today, if taxpayers purchase a vehicle solely for personal use, they may still obtain a tax break. The state and local sales taxes on the vehicle—new or pre-owned—are deductible by individuals if they itemize deductions and forego the deduction for state and local income taxes. The total write-off is subject to the $10,000 cap on state and local taxes (SALT cap).

The taxpayer should figure the sales tax deduction from an IRS table and then to this amount, add the sales taxes on the vehicle purchase.

NOTE: Businesses add the sales tax to basis.

Registration Fees by Individuals

In addition to sales taxes on vehicle purchases, registration fees are deductible by taxpayers, but only those who itemize. To deduct state and local car registration fees as a state personal property tax (subject to the SALT cap), the fee must be:

- An ad valorem tax, which means it is based on a percentage of the car's value (e.g., 1% of value);
- Imposed on an annual basis, whether it is collected more or less frequently; and
- Imposed on personal property.

A tax based on weight, model, year, or horsepower is not a deductible ad valorem tax. If a tax is based on both value and some other factor or factors, then the portion of the registration fee based on value is deductible.

Interest on Car Loans

Interest on a loan to buy a vehicle for personal driving is not deductible. However, interest on a loan by a self-employed person to buy a vehicle used for business driving is a deductible business expense. However, this "business interest" is subject to the interest expense limitation. Small businesses—those that meet the gross receipts test—are automatically exempt from this interest limitation, so all of their interest payments are deductible. Farming businesses and real property businesses that elect out of the limitation may deduct all of the interest on a vehicle loan.

PLANNING POINTER: The loan to purchase a vehicle is carried as a liability on the balance sheet for a business.

Donating Vehicles to Charity

If an individual donates a car or truck to an IRS-recognized charity, it may be tax deductible if the taxpayer itemizes deductions and does not claim the standard deduction amount. Generally, the amount of the deduction is limited to 30 percent of the taxpayer's AGI. It is claimed as a charitable contribution on Schedule A of Form 1040 or 1040-SR.

Special substantiation rules apply to donations of vehicles valued at over $500. The organization must issue Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, within 30 days of the date of the contribution or the date the organization sells the vehicle without using it in any significant way. If the organization sells the vehicle without using it in a significant way in its charitable activities or making any improvements to the vehicle, the donor's deduction is limited to the amount of the sales proceeds.

If the value of the vehicle is $250 or more but not over $500 and the organization sells it, the donor can deduct the actual value and isn't limited to the sales proceeds. If the vehicle's value is over $500 but the organization sells it for $500 or less, the maximum deduction the donor can claim is $500.

EXAMPLE: A taxpayer donates a clunker worth $750 to a charity, and the charity sells it for $450. The donor can deduct $500.

It's up to the donor to substantiate the value of the donation (using such resources as Kelley Blue Book values at www.kbb.com). The donor should also retain a written acknowledgment of the gift.

Car Accidents and Thefts

Car accidents and thefts are all too common occurrences. For 2018 through 2025, no deduction for loss related to a personal-use vehicle can be claimed as a personal casualty or theft loss; this write-off has been suspended.

Federal Disasters

If a vehicle is damaged or destroyed in a federally declared disaster, the loss may be deductible.

Involuntary Conversions

If insurance or other reimbursements exceed the adjusted basis of the vehicle, then there is a tax gain (an involuntary conversion). The taxpayer may be able to defer reporting the gain by buying replacement property (Code Sec. 1033); this is property that is similar or related in service or use.

To postpone reporting all the gain, the taxpayer must buy replacement property costing at least as much as the amount realized for the old vehicle. If the cost of the replacement property is less than the amount realized, the taxpayer must report the gain up to the unspent part of the amount realized.

The replacement must be timely (buying another vehicle to replace the old one usually within two years of the end of the year of the casualty). For involuntary conversions resulting from federally declared disasters, there's an additional one year to replace the vehicle. Disaster areas are listed at https://www.irs.gov/newsroom/tax-relief-in-disaster-situations.

The basis of the new or repaired vehicle ("replacement property") is reduced by the amount of gain not recognized.

Disaster Losses for Vehicles

If a taxpayer suffers a loss on a business vehicle, it's fully deductible. If the vehicle is used for personal driving, it may be deductible as a disaster loss on Schedule A of Form 1040 or 1040-SR. To claim the deduction:

- **The taxpayer must prove that the loss arose from an event declared to be a federal disaster.** Having an insurance report or newspaper articles on the disaster is helpful. Pictures of the vehicle are also helpful.
- **The taxpayer must establish the amount of the loss.** If the vehicle is damaged, the taxpayer should measure the loss by comparing the value before and after the event, and then reduce this amount by any insurance or other reimbursement. The taxpayer can use the cost of repairs as a measure of loss, provided it is not excessive and merely restores the vehicle to its pre-casualty event condition.
- **The taxpayer must reduce the loss by $100.** The $100 reduction applies to each casualty or theft loss event in the same year. The $100 reduction applies only to personal vehicles; it does not apply to business vehicles.
- **The taxpayer must reduce the loss by 10 percent of AGI**. Only the amount of total losses for the year in excess of 10 percent of AGI is deductible.

EXAMPLE: In 2023, the taxpayer's vehicle was totally destroyed in a flood declared to be a federal disaster. The vehicle's value before the incident was $18,100, or $18,000 after the $100 reduction. Insurance paid the taxpayer $6,000, so its loss is $12,000. The taxpayer's AGI is $48,000. The deductible loss is $7,200 ($12,000 – [10% of $48,000]).

A disaster loss can be deducted on the tax return prior to the year of the disaster. This can generate a tax refund if the prior year return has already been filed. To obtain the refund, the taxpayer must file an amended return.

If the disaster occurs before the prior year return has been filed, the taxpayer should simply report the loss on that return to reduce their tax bill. There is a time limit for electing to report the loss on a prior-year return. The due date for making the election is six months after the due date for filing the tax return for the disaster year (determined without regard to any filing extension). The deadline for revoking an election is on or before the date that is 90 days after the due date for making the election.

STUDY QUESTIONS

4. Which of the following statements regarding driving for medical purposes is correct?

a. Driving to pharmacies is not considered driving for medical purposes.

b. The cost of driving for medical purposes is based only on the total of actual expenses incurred.

c. If a taxpayer itemizes deductions, total medical expenses must exceed 2 percent of adjusted gross income to be deductible.

d. For 2023, the amount that can be deductible is the standard rate (22 cents per mile), plus parking and tolls.

5. The maximum amount of the 2023 credit for the purchase of a new qualified electric vehicle is which of the following?

a. $2,500

b. $5,000

c. $7,500

d. $10,000

6. The amount of the state and local tax cap for individuals who itemize deductions is which of the following?

a. $7,500

b. $10,000

c. $12,500

d. $15,000

MODULE 1: BUSINESS—Chapter 3: Tax Implications in a Remote Work Environment: State Tax Nexus and Income Tax Issues

¶ 301 WELCOME

The COVID-19 pandemic prompted a drastic shift to remote work, and many people are still working remotely. Employers have been allowing employees to work remotely in different states. Allowing employees to work remotely from states in which they do not normally work can create a host of issues for employers, but the two big tax issues relate to nexus and income tax.

First, will the presence of an employee working from home create taxable nexus for the employer in that state? Second, for income tax purposes, which state is owed income tax when an employee is working remotely from an out-of-state location? Is it possible that states could have contradictory rules, creating a double tax situation for many employees? (Spoiler alert: yes).

This chapter explains how states have responded to the new remote work environment and identifies potential issues for both individuals working remotely and their employers.

¶ 302 LEARNING OBJECTIVES

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

- Describe the corporate tax implications of having employees working in different states
- Recognize where (in which states) an employer may have corporate income tax nexus
- Identify the number of states that have a "convenience rule"
- Explain how to advise clients on sourcing of wages received while working remotely
- Identify how the primary domicile factors are considered for residency
- Explain what counts as a workday, and what does not, for wage allocation purposes

¶ 303 RESIDENCY RULES REFRESHER

Let's begin with a quick refresher on residency rules since, of course, the state tax consequences of remote employees depend on the employee's resident status. In general, states use three types of residency tests:

- **Domicile.** *Domicile* is generally defined as the location or area that a person intends to be their permanent home. This is the place they intend to return to whenever they might be absent. This test is often referred to as the "home is where the heart is" test. It's more of a subjective inquiry that looks at different factors to determine where the person intends their home to be.
- **Statutory residency.** The most widely used test for statutory residency defines the term *resident* to include an individual who is not domiciled in the state, but

who maintains a permanent place of abode there *and* is in the state for more than 183 days in a given taxable year. This test is sometimes called the "183-day rule." Implicit in this test is that a person can be a resident of more than one state. There are other variations of statutory residency. For example, a variation used in Ohio takes into account "contact periods," where a person is treated as a statutory resident only if they have more than 212 contact periods in Ohio during the year.

- **Rebuttable presumption of residency.** Other states, like California, use a rebuttable test. Under California's test, a person who spends more than 9 months in California during any tax year is presumed to be a resident, but that presumption is rebuttable. The following examples discuss residency in particular states.

EXAMPLE: RESIDENCY IN NEW YORK STATE: Residency is generally established by looking at:

- Domicile: Determined using five primary factors—home, time, business, family, and the "near and dear" factor, which is essentially the location of one's prized possessions.
- Statutory residency: A person not domiciled in New York in a particular year, but who spends more than 183 days (including part days) and maintains a "permanent place of abode" in New York.

In New York, income tax is based on resident status:

- New York State (NYS) residents are subject to tax on their worldwide income.
- NYS nonresidents are subject to tax on NYS-source income only.
- New York City (NYC) tax applies to residents only, so a nonresident working in NYC will be subject to NYS tax but not to the NYC personal income tax.
- The tax for the city of Yonkers applies to residents and nonresidents alike.

EXAMPLE: RESIDENCY IN CALIFORNIA: Residency is generally established by determining:

- Whether the taxpayer is present in California for other than a temporary or transitory purpose
- Whether the taxpayer is domiciled in California, but outside California for a temporary or transitory purpose

California also has a rebuttable presumption of residency if the taxpayer spends at least nine months of the year in California. Income tax is based on resident status:

- California residents are subject to tax on their worldwide income.
- California nonresidents are subject to tax on California-source income only.

There are no local individual income taxes.

¶ 304 ALLOCATING EMPLOYEE COMPENSATION

If an employee is a resident of the state where they work, then generally 100 percent of their compensation income is subject to that state's income tax, and the employer must withhold tax on 100 percent of their compensation. If an employee is a nonresident, state tax generally is still due to the extent of the taxpayer's workdays in the state. The formula for determining the workday percentage is:

[In-State Workdays] ÷ [Total Workdays] = [Workday Percentage]

The employer generally must withhold state tax based on that workday percentage, and the employee reports allocable income based on that workday percentage.

Allocating "Regular" Wages/Salary

Allocation is required when a nonresident's in-state workdays/compensation exceeds the state's applicable threshold (if any). The standard allocation formula is as follows:

$$\frac{In - State\ Workdays}{Total\ Workdays} \times Total\ Wages$$

A *workday* typically includes days worked in the employee's office, travel days, days worked from home, and days worked on weekends. It typically excludes holidays, vacation days, sick days, and weekends. The following chart shows how workdays may be counted:

Counting Workdays		
Total Days in Year		365
Nonworking Days		
Saturdays/Sundays	104	
Holidays	10	
Vacation Days	14	
Sick Days	5	
Other nonworking days	2	
Total Nonworking Days		135
Total Days Worked in Year		230
Total Days Worked Out-of-State		55
Total Days Worked In-State		175

EXAMPLE: You were employed in Colorado and were a resident of that state. Your employer required you to spend 15 days during 2022 at the company's main office in Wisconsin. Your annual salary was $40,000, which was compensation for 260 days. The amount of wages allocable to Wisconsin is $2,307.69, computed as follows:

15⁄260 × $40,000 = $2,307.69

Source: Wisconsin Pub. 122 (3/2023).

State Withholding Guidance During COVID-19

During the COVID-19 pandemic, there were three general approaches to state guidance regarding withholding for teleworkers:

- The state issued no guidance, so normal withholding rules presumably applied;
- The state issued guidance that specifically confirmed that the pre-pandemic rules remained in full force and effect; and
- The state adopted temporary laws, regulations, or other guidance that changed the normal pre-pandemic withholding rules.

As far as the temporary pandemic rules are concerned, the guidance generally fell into one of two categories.

- States that sought to maintain the status quo for their outbound residents, or
- States that allowed inbound residents who worked out of state pre-pandemic to continue sourcing their wages to their out-of-state pre-pandemic location.

The "start" and "end" dates varied by state and were tied to:

- The federal government's state-of-emergency,
- The state's state-of-emergency (e.g., Pennsylvania),
- The employer's mandatory work-from-home order (e.g., New Jersey), or
- A specific date (i.e., starting on March 13, 2020, and ending on July 1, 2021) (e.g., Connecticut, Massachusetts, South Carolina)

The states' responses to telecommuting during the pandemic are summarized in the following chart:

State Responses to Telecommuting and COVID-19		
State	**Sourced to Employer's Home State**	**Sourced to Employee's Home State**
Alabama	X	
Arkansas	X (until 12/1/20)	X (as of 1/1/21)
California		X
Colorado		X
Connecticut		X (2020 only)
Delaware		X
Georgia	X	
Illinois*		X
Iowa		X
Kansas	X (both until 12/31/20)	X (only as of 1/1/21)
Kentucky		X
Maine	X (until 6/30/21)	
Maryland		X
Massachusetts	X (until 9/13/21)	
Minnesota		X
Mississippi	X	
Missouri	X (for some employers if elected until 7/19/21)	X
Montana		X
Nebraska	X (until 7/30/21)	
New Jersey**	X	X
New York	X	
North Carolina		X
Ohio (municipal income tax)	X (until 12/31/21)	
Oregon		X
Pennsylvania		X (until 6/20/21)
Rhode Island	X	
South Carolina	X (until 9/30/21)	
Vermont		X
Wisconsin		X
* Withholding required if employee is telecommuting from IL for more than 30 days. ** Rules of employer's home state dictate which state gets the tax.		

Note that nearly all of this guidance was limited to the pandemic period and is no longer in effect.

The "Convenience of the Employer" Rule

This is a rule that applies to a small number of states, and it reflects an issue that has come to the forefront in recent years. A small number of states apply this rule. With respect to those states, in general, an employee's days worked from home are deemed to be days worked at their assigned work location to the extent that the employee is working remotely for their own convenience, broadly defined, rather than for the employer's necessity. Applications of this rule include:

- Nonresident income allocation,
- Employer withholding, and
- Resident credit purposes.

Six states—New York, Connecticut, Pennsylvania, Delaware, Nebraska, and New Jersey—currently have a "convenience rule." Connecticut and New Jersey's rules only applies if the other state is a convenience state. Several states (Georgia, Massachusetts, Maine, Mississippi, Nebraska, New York, Pennsylvania, Rhode Island, and South Carolina) issued guidance or temporary legislation during the pandemic requiring that days worked at home to continue to be treated as if worked at the employee's regular place of work.

Convenience Rule States	
Connecticut Conn. Gen. Stat. § 12-711(b)(2)(C)	"For purposes of determining the compensation derived from or connected with sources within this state, a nonresident . . . shall include income from days worked outside this state for such person's convenience if such person's state of domicile uses a similar test."
Delaware 2020 Schedule W 30 Del. C. § 1124(b).	For nonresidents, non-Delaware workdays "must be based on necessity of work outside . . . Delaware in performance of duties for the employer, as opposed to solely for the convenience of the employee. Working from [a home office] does not satisfy the requirements of 'necessity' of duties for your employer and is considered for the convenience of the employee unless working from home is a requirement of employment with your employer."
Nebraska 316 Neb. Admin. Code 22-003.01C(1)	"If the nonresident's service is performed without Nebraska for his or her convenience, but the service is directly related to a business, trade, or profession carried on within Nebraska and except for the nonresident's convenience, the service could have been performed within Nebraska, the compensation for such services shall be Nebraska source income."
New Jersey N.J. Stat. § 54A:5-8(e) P.L. 2023, c. 125 (effective 1/1/2023)	Similar to Connecticut's rule: "If an employee's state of residence uses a 'convenience of the employer' test when determining the source of income of a nonresident, income or wages earned by a nonresident are allocated to the employer's location, unless the nonresident works from an out-of-state location due to the necessity of the employer, rather than the convenience of the employee."

Convenience Rule States	
New York 20 NYCRR 132.18(a) TSB-M-06(5)I	"Any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer"
Pennsylvania 61 Pa. Code § 109.8	If a nonresident employee (including corporate officers but generally excluding salesmen) performs services both within and without PA, their PA-sourced income includes the ratio of PA workdays over total workdays. For this ratio, Non-PA workdays include days worked out-of-state performing services "which, of necessity, obligate the [employee] to perform out-of-State duties in the service of his employer."

New York's "Convenience of the Employer" Rule

In 2020, New York began sending desk audit notices to taxpayers who previously allocated most or all of their W-2 income to New York, and who began filing nonresident income tax returns allocating a lower percentage of their wages to New York. Some of the 2020 notices stated:

> We have determined that you were unable to access your office located in New York due to a temporary office closure resulting from COVID-19. If an employee's assigned or primary work location was New York prior to COVID-19 temporary office closure, and the employer continues to maintain the New York office for the employee, the employer's assigned and primary work location is still New York. The fact that the New York office is not used during the COVID-19 office closure does not affect the conclusion.

EXAMPLE: The July 2020 New York State FAQ on COVID Telecommuting included the following:

My primary office is inside New York State, but I am telecommuting from outside of the state due to the COVID-19 pandemic. Do I owe New York taxes on the income I earn while telecommuting?

If you are a nonresident whose primary office is in New York State, your days telecommuting during the pandemic are considered days worked in the state unless your employer has established a bona fide employer office at your telecommuting location.

There are a number of factors that determine whether your employer has established a bona fide employer office at your telecommuting location. In general, unless your employer specifically acted to establish a bona fide employer office at your telecommuting location, you will continue to owe New York State income tax on income earned while telecommuting.

https://www.tax.ny.gov/pit/file/nonresident-faqs.htm#telecommuting

The Convenience Rule After COVID-19

Telecommuting is likely here to stay and may become even more prevalent. Therefore, convenience rule issues will take center stage. But what happens if an employer no longer has a physical office? Employers need to be careful about nexus and convenience rule issues if they continue to allow employees to work from home.

Options to avoid New York's convenience rule include the following:

- **Option 1:** Assign the employee to a non–New York office.
- **Option 2:** Establish a bona fide home office under the TSB-M-06(5)I factors (see the chart that follows).
- **Option 3:** No New York workdays.

<table>
<tr><th colspan="2">The TSB-M-06(5)I Factors</th></tr>
<tr><td colspan="2">Step 1: Primary Factor: Employee's duties require the use of special facilities that cannot be made available at the employer's place of business, but those facilities are available at or near the employee's home.
If the home office does NOT satisfy the primary factor, proceed to Step 2.</td></tr>
<tr><td colspan="2">Step 2: The Secondary and "Other" Factors: The home office may still qualify as a "bona fide employer office" if it meets four out of the six Secondary Factors plus three out of the ten "Other" Factors.</td></tr>
<tr><td>Secondary Factors (4 out of 6 required)
1. Home office is a requirement or condition of employment.
2. Employer has a bona fide business purpose for the employee's home office location.
3. Employee performs some core duties at the home office.
4. Employee meets with clients, patients, or customers at the home office.
5. Employer does not provide the employee with office space or regular work accommodations.
6. Employer reimburses expenses for the home office.</td><td>"Other" Factors (3 out of 10 required)
1. Employer maintains a separate telephone line and listing for the home office.
2. Employee's home office address and phone number are on the employer's business letterhead and/or cards.
3. Employee uses a specific area of the home exclusively for the employer's business.
4. Employee keeps inventory of products or samples in the home office.
5. Employer's business records are stored at the home office.
6. Employer signage at the home office.
7. Home office is advertised as employer's place of business.
8. Home office covered by a business-related insurance policy.
9. Employee properly claims a deduction for home office expenses for federal income tax purposes.
10. Employee is not an officer of the company.</td></tr>
</table>

Reassignment to a Non–New York Office

There is no written guidance as to what constitutes an individual's primary office. On audit, New York has looked at facts such as:

- Which office does the individual visit more than any other?
- Where is the employee's administrative support?
- Where does the employee's supervisor, managers, or "team" sit?
- Does the employee still have designated office space in New York?
- What do the employer's HR records designate as the primary office?

There must be evidence other than geographical proximity to reassign an employee to another office.

EXAMPLE: NEW YORK TO FLORIDA MOVE: Facts

Matt lives and works in New York City, but he has decided to give up his NYC lease and move to Florida for good. Matt's employer is based in NYC and doesn't have a Florida office, but is okay with Matt doing remote work indefinitely, with occasional visits to the NYC office.

So, Matt telecommutes from his home office in Florida.

Issues

This is an easy domicile case, and there are NYC tax savings. But Matt's wages will still be subject to NYS tax based on the "convenience rule." Matt's employer is still required to withhold 100 percent NY tax.

EXAMPLE: DOUBLE TAX ON REMOTE WORK?: Facts

James (a NY resident) historically worked in his employer's NYC office. Since March 2020, he has been working remotely from his ski home in Colorado. James expects to return to NY by the end of 2022.

Issues

James is a NY resident, so NY withholding must continue. Colorado's rules require James to source his wage income to Colorado based on his physical work location in Colorado.

New York, on the other hand, calls those Colorado physical presence workdays "New York workdays" under its convenience rule.

James's employer may also have Colorado withholding obligations.

Multiyear Allocations

Multiyear allocations are triggered when a taxpayer receives compensation attributed to services performed in a different tax year. Common sources of deferred compensation include deferred bonuses, equity awards (restricted stock units/stock options), and termination/severance pay.

Deferred bonuses. Deferred bonuses are bonuses received by a nonresident for services performed in a previous taxable year. For example, a bonus received on April 1, 2023, for performance in 2022 is allocated based on the 2022 (not 2023) allocation percentage. This can be particularly important when a bonus is received in the year of one's change in residence.

Equity awards. Several key dates are associated with equity awards:

- **Grant date:** When the employee is granted an option to purchase stock from the employer at a fixed price within a set period.
- **Vest date:** When the employee satisfies all employment-related conditions, making the options exercisable.
- **Exercise date:** When the employee actually buys the stock.
- **Sale date:** When the employee sells the stock.

Restricted stock. Restricted stock units (RSUs) are generally taxable for federal purposes as ordinary income in the year of vesting. The taxable amount equals the difference between the amount paid (if any) and the fair market value at the time of vesting (unless a Code Sec. 83(b) election is made).

The amount taxable as ordinary income for federal tax purposes can represent taxable compensation to a nonresident for state income tax purposes. It is generally allocable to the extent that the compensation is taxable for federal income tax purposes and where it is earned.

Example: New York RSU allocation. Employee A works in Employer's Florida office and is a New York nonresident every year. In 2022, Employer informs Employee A that he'll receive an RSU award valued at $1,000,000, which was granted on April 1, 2022, and would vest over the next five years on the following schedule:

- 10 percent on the first anniversary of the grant date (April 1, 2023)—$100K
- 10 percent on the second anniversary of the grant date (April 1, 2024)—$100K
- 20 percent on the third anniversary of the grant date (April 1, 2025)—$200K

- 30 percent on the fourth anniversary of the grant date (April 1, 2026)—$300K
- 30 percent on the fifth anniversary of the grant date (April 1, 2027)—$300K

From 2022 through 2027, Employee A has 240 workdays for Employer each year and he works in New York on 10 percent of those days (24 days/year), except that he works an extra six days in New York in March 2024 (30 days total for 2024).

In 2023, Employee A will receive W-2 compensation based on his 10 percent vesting ($100K) in wages, plus any appreciation that has occurred between the grant and vest dates, which will be allocated to New York based on the number of workdays between the date of the grant (April 1, 2022) and the date of vest (April 1, 2023). Thus, in 2023, $10,000 (or 10 percent of the $100K, plus appreciation) will be sourced to and taxable by New York.

The 2024 allocation will be computed as follows:

	New York		Total
Workdays 4/1/2022 – 3/31/2023	24		240
Workdays 4/1/2023 – 3/31/2024	30		240
Total Workdays Grant-to-Vest Period	**54**		**480**
	NY Allocation % (54 ÷ 480) = 11.25%		
	Total vested in 2024 (assume no appreciation) = $100K (10% of $1M)		
	Amount sourced to/taxable by NY = $11,250 (11.25% of $100K that vested in 2024)		

The 2025 allocation will be computed as follows:

	New York	Total
Workdays 4/1/2022 – 3/31/2023	24	240
Workdays 4/1/2023 – 3/31/2024	30	240
Workdays 4/1/2024 – 3/31/2025	24	240
Total Workdays Grant-to-Vest Period	**78**	**720**
NY Allocation % (78 ÷ 720) = 10.83%		
Total vested in 2025 (assume no appreciation) = $200K (20% of $1M)		
Amount sourced to/taxable by NY = $21,660 (10.83% of $200K that vested in 2025)		

Stock options. Statutory/qualified options (e.g., incentive stock options or ISOs) are generally taxed only once (when sold), and the character of the gain is capital in nature. Nonstatutory/nonqualified stock options are taxed twice: at the exercise date (ordinary income on the W-2) and when sold (capital gain).

Allocation methodologies for stock options vary. Most (but not all) states tax a nonresident on option income when and where it was earned versus when it was received. It doesn't matter if the individual was a resident of the state when it was earned.

- Workdays from grant-to-vest—e.g., New York, Georgia, Idaho
- Workdays from grant-to-exercise—e.g., Arizona, California, Connecticut, New Jersey, Pennsylvania
- Exceptions:
  - — Five-year—Illinois
  - — Location of grant rule—North Carolina

The difference between the option price and the fair market value on the exercise date represents compensation for services to a nonresident. The compensation is generally taxable for state tax purposes when it is recognized for federal income tax purposes. For qualified/ISOs, this is the date of sale; for nonqualified stock options (NQSOs), it is the date of exercise.

For qualified/ISOs, the compensation element is limited to the appreciation in stock between the grant and exercise dates. Any further appreciation between the exercise and sale dates is investment/intangible income and is not included in New York taxable income for a nonresident.

Termination/severance pay. This is generally allocated based on prior in-state services, but with varying periods. In New York, termination/severance pay is allocated based on the year of termination and three prior years. Note that New York uses a "comp-to-comp" method for this period.

> **EXAMPLE:** If Julia separates from employment in 2021 and receives a severance, she measures total New York compensation and total everywhere compensation in 2018, 2019, 2020, and 2021 and computes the allocation percentage using a total New York compensation over total everywhere compensation fraction over that period.

In Minnesota, termination/severance pay is allocated based on the percentage of time worked in the state in total.

> **EXAMPLE:** Andy worked for nine years in Minnesota and one year in Florida. He is a Florida resident when receiving his severance payment. He must allocate 90 percent of his severance pay to Minnesota.

Allocating Director's Fees

Director's fees are generally allocated based on the location of board meetings. New York requires nonresidents to allocate board compensation like a W-2, salaried employee (days in/out during the current year). However, generally only the days when there are board meetings are counted, and not the time spent preparing for the board meetings.

There is some inconsistency in audit treatment here, but it seems that most auditors do not count out-of-state attendance by telecommuting as a New York day. California has also issued Chief Counsel Ruling 2019-03, which expresses a similar view. Director's fees are non-wage income, so there are no convenience rule issues. By contrast, Pennsylvania has issued guidance stating that director's fees should be allocated "based upon working days within and outside the Commonwealth." *See* PA Department of Revenue, Answer ID 3570 (updated 6/29/2018).

> **EXAMPLE:** Kayla is on the board of a multinational company and received director's fees totaling $100,000 in 2021. The board held eight meetings in 2021: four in New Jersey, three in New York, and one in California.
>
> Kayla's director's fees are allocated as follows: $50,000 (50%) to New Jersey; $37,500 (37.5%) to New York; and $12,500 (12.5%) to California.

Proposed Federal Legislation to Address Remote Work Tax Issues

In 2021, two bills addressing remote work tax issues were introduced in Congress: the Remote and Mobile Workforce Relief Act of 2021 and the Multi-State Worker Tax Fairness Act of 2021. Both had goals of establishing some sort of nationwide uniformity so that tracking the changing rules and thresholds for remote work tax issues will not be a compliance nightmare.

The Remote and Mobile Worker Relief Act addresses "State and Local Tax Certainty During the 'Covered Period,'" including topics such as nexus hold harmless and remote work location versus primary work location. It broadly applies to a number of state and local taxes. The Multi-State Worker Tax Fairness Act calls for federal preemption of the convenience of the employer test.

STUDY QUESTIONS

1. Each of the following is one of the five primary domicile factors, ***except?***

a. Business

b. Forwarding address

c. Near and dear items

d. Time

2. In response to telecommuting during the pandemic, which of the following states is sourced to the employer's home state?

a. California

b. Mississippi

c. Oregon

d. Minnesota

3. In response to telecommuting during the pandemic, which of the following states does an employee have to work in for their income to be sourced to their home state and not necessarily their employers?

a. Wisconsin

b. New York

c. Rhode Island

d. Mississippi

¶ 305 RESIDENT TAX CREDIT ISSUES

When sourcing income, for residents, taxable income includes everything. For nonresidents, income from in-state sources is taxable. Income from in-state sources includes:

- Wages for services performed in-state
- Income/loss from real property
- Income/loss from in-state business

Note that not all income has a source. For example, "unearned income" or income from investments/intangibles is generally not taxable for nonresidents. Note that double taxation is possible for dual residents.

Resident Tax Credits

States generally allow their residents a credit for taxes paid to other states. The credit cannot exceed the tax due in the home state. There are two general approaches:

- The most common approach is to allow a credit for the tax paid to the other state on income sourced to that state, typically based on the home state's allocation rules (i.e., if we would tax a nonresident on the income, we will give the resident credit on taxes paid to the other state on that income). New York and Rhode Island use this approach.
- The less common approach is to allow a credit for tax paid to the other state on income not sourced to the home state (intangible income). New Jersey is an example of a state that uses this method.

Resident Tax Credit Statutes

In some states, the credit is limited to tax paid on income sourced to the taxing state. According to New York's statute:

> A resident shall be allowed a credit against the tax otherwise due . . . for any income tax imposed on such individual for the taxable year by another state of the United States, a political subdivision of such state, the District of Columbia or a province of Canada, *upon income both derived therefrom* and subject to tax under this article." [N.Y. Tax Law § 620(a) (emphasis added)].

Connecticut's statute reads as follows:

> Any resident . . . of this state shall be allowed a credit against the tax otherwise due under this chapter in the amount of any income tax imposed on such resident . . . for the taxable year by another state of the United States or a political subdivision thereof or the District of **Columbia *on income derived from sources therein*** and which is also subject to tax under this chapter." [Conn. Gen. Stat. § 12-704(a)(1) (emphasis added)].

California's statute is similar:

> The credit shall be allowed only for taxes paid to the other state . . . *on income derived from sources within that state* which is taxable under its laws irrespective of the residence or domicile of the recipient." [Cal. Rev. and Tax Code § 18001(a)(1) (emphasis added)].

In New Jersey, the resident credit is only limited to the extent that (1) the income is not from New Jersey sources and (2) the income is actually taxed by the other jurisdiction. The result is that New Jersey allows a resident credit for tax paid to another jurisdiction on intangible income. Michigan, Montana, and Oregon offer similarly structured resident credits.

Resident Tax Credit Challenges: The Convenience Rule

This would be a non-issue if all states used the same methods to source income. Most states limit the resident credit to taxes paid on income derived from the taxing state. Whether income is derived from sources in the state is determined under the rules of the state offering the credit.

If New York, for example, would tax nonresidents on that income, then New York would provide a New York resident a credit for taxes paid on that income to another state. There can be overlap and conflict in these situations. There are varying definitions of "in-state workday" in convenience and non-convenience states.

Resident Credit Examples: Working and Living in Different States

EXAMPLE 1: Employee A lives in New Jersey and receives wages from her New York employer. Employee A also received $1 million in dividends.

New York taxes all of Employee A's wage income.

New Jersey taxes all of Employee A's income (wages and dividends) but gives her a credit for the tax paid to New York on her wage income.

EXAMPLE 2: Employee B is domiciled in New York and telecommutes from California during the COVID-19 pandemic.

California taxes all of Employee B's wage income.

New York taxes all of Employee B's wage income but doesn't allow a credit for the tax paid to California since the employee's days commuting from California are deemed New York workdays under New York's convenience rule.

Resident Credit Examples: Dual-Resident (Resident of Two States)

EXAMPLE 1: Executive C is domiciled in New Jersey and is a statutory resident of New York City where she works and has an apartment. Executive C received $1 million in dividends.

New York taxes all of Executive C's income (wages and dividends). New York State and New York City personal income tax is imposed.

New Jersey taxes all of Executive C's income (wages and dividends) but gives her a credit for the tax paid to New York on all non–New Jersey income (which covers wages and dividends).

EXAMPLE 2: Executive D is domiciled in Connecticut and is a statutory resident of New York City, where she works and has an apartment. Executive D received $1 million in dividends.

New York taxes all of Executive D's income (wages and dividends). New York State and New York City personal income tax is imposed.

Connecticut taxes all of Executive D's income (wages and dividends) but gives her a credit for the tax paid to New York on New York–sourced income (which covers wages only). No credit is allowed for tax paid to New York on her dividend income.

Reciprocal Tax Agreements

If an employee works in State A but lives in State B, a reciprocal tax agreement between States A and B may provide that the employer need only withhold for, and the employee need only file in, State B.

However, reciprocal tax agreements typically exist only between neighboring states, and not all neighboring states have them. Such agreements are applicable to local taxing jurisdictions. They do not apply to income earned in a third state that is not party to the agreement.

States with reciprocal agreements allow a resident to work in another state without being subject to wage withholding or personal income taxes in the worksite state. The following chart provides a state-by-state list of reciprocity states:

State	Reciprocity States
Arizona	California, Indiana, Oregon, and Virginia
Illinois	Iowa, Kentucky, Michigan, and Wisconsin
Indiana	Kentucky, Michigan, Ohio, Pennsylvania, and Wisconsin
Iowa	Illinois
Kentucky	Illinois, Indiana, Michigan, Ohio, Virginia, West Virginia, and Wisconsin
Maryland	Pennsylvania, Virginia, Washington, D.C., and West Virginia
Michigan	Illinois, Indiana, Kentucky, Minnesota, Ohio, and Wisconsin
Minnesota	Michigan and North Dakota
Montana	North Dakota
New Jersey	Pennsylvania
North Dakota	Minnesota and Montana
Ohio	Indiana, Kentucky, Michigan, Pennsylvania, and West Virginia
Pennsylvania	Indiana, Maryland, New Jersey, Ohio, Virginia, and West Virginia

State	Reciprocity States
Virginia	Kentucky, Maryland, Pennsylvania, Washington, D.C., and West Virginia
Washington, D.C.	Maryland and Virginia
West Virginia	Kentucky, Maryland, Ohio, Pennsylvania, and Virginia
Wisconsin	Illinois, Indiana, Kentucky, and Michigan

¶ 306 STATE WITHHOLDING TAX CONSIDERATIONS FOR EMPLOYERS

States generally require employers to withhold personal income taxes on behalf of their employees. However, employer withholding requirements differ widely among the states. Many states have no thresholds (e.g., require withholding on the first dollar earned or the first day worked in the state). These states include Colorado, Indiana, Massachusetts, Maryland, Michigan, North Carolina, Ohio, Pennsylvania, and Virginia.

Among states that impose personal income taxes, more than half require employers to withhold tax from a nonresident employee's wages beginning with the first day the nonresident employee travels to the state for business purposes. Other personal income tax states provide for a threshold before requiring tax withholding for nonresident employees.

Employer Withholding Audits

States are becoming increasingly aggressive in enforcing withholding requirements, which are viewed as a new revenue source. There are multiple difficulties associated with withholding for a mobile workforce, including:

- Insufficient payroll system capabilities
- Burdens placed on employees to document travel
- No uniformity across states and cities

¶ 307 TELECOMMUTING AND NEXUS

Issues to consider when examining the tax impact of telecommuting include nexus, withholding changes, the "convenience of the employer" rule, and before stay-at-home orders and after.

Nexus means that there must be a link, some "minimum connection between a state and the person, property or transaction," for a state to impose tax. Does the presence of a telecommuter create nexus for a company? In most states and in "normal" circumstances, the answer is yes. This could mean nexus for employment, income, sales, and other taxes.

Nexus Considerations

Physical presence, or more specifically the presence of employees, in a state generally provides the state with jurisdiction to impose corporate income and franchise taxes. There have been cases holding that the presence of a single, telecommuting employee creates nexus (*see, e.g., Telebright Corp. v. New Jersey Division of Taxation,* 25 N.J. Tax 333 (Tax 2010), *aff'd* 424 N.J. Super. 384 (2012)).

Many states have adopted an economic nexus factor presence standard asserting nexus on a taxpayer if its sales, property, or payroll in the state exceed a certain threshold. The question is whether temporarily remote employees cause corporate taxpayers (employers) to exceed any of these thresholds.

Taxpayers with P.L. 86-272 positions should also consider whether the activities of temporarily remote employees exceed the scope of P.L. 86-272. During the pandemic, a handful of states released guidance providing that the presence of remote employees due to COVID-19 would not alone cause a taxpayer to establish nexus in the state. In certain cases, nexus relief was only available during the official state of emergency period.

Nexus Thresholds for Business Taxes

Approaches to nexus standards for business activity taxes include economic presence and factor presence. The Multistate Tax Commission (MTC) factor presence standard thresholds are:

- $50,000 of property;
- $50,000 of payroll;
- $500,000 of sales; or
- 25 percent of total property, total payroll, or total sales

State economic presence thresholds are detailed in the following chart:

State	Economic Presence
Connecticut	$500,000 in annual gross receipts
Maine	(1) $250,000 of property; (2) $250,000 of payroll; (3) $500,000 of sales; or (4) 25% of taxpayer's property, payroll, or sales (starting with tax years beginning on/after January 1, 2022)
Massachusetts	$500,000 (Presumption of corporate excise tax nexus if annual sales in MA exceed)
Michigan	$350,000 in annual gross receipts and "actively solicits" sales in Michigan
New York	$1,138,000 in annual receipts (threshold was $1 million until January 1, 2022)
Ohio (CAT)	$500,000 in annual taxable gross receipts; also uses MTC factors
Oregon	$750,000 in annual commercial activity
Hawaii	$100,000 in gross income in current/prior year or at least 200 transactions
Pennsylvania (CNIT)	$500,000 threshold (rebuttable presumption for pass-through entities held by a corporate entity)
Texas (franchise tax)	$500,000 in annual gross receipts
Washington (B&O)	More than $53,000 of in-state property or payroll; more than $267,000 of in-state receipts; or at least 25% of total property/payroll/sales

NOTE: Twenty-eight states and Washington, D.C., have adopted market-based sourcing to date.

State	Factor Presence
Alabama	MTC factors (adjusted for inflation; currently $54,000 property, $54,000 payroll, $538,000 sales, or 25% of total P/P/S)
California	MTC Factors (adjusted for inflation; currently $61,040 property, $61,040 payroll, $610,395 sales, or 25% of total property/payroll/sales)
Colorado	MTC factors
Ohio (CAT)	MTC factor
Tennessee	MTC factors

STUDY QUESTIONS

4. Which of the following states is one of the six states to have a “convenience rule”?

- **a.** Pennsylvania
- **b.** Florida
- **c.** Hawaii
- **d.** Missouri

5. Which of the following is excluded within the scope of “income from in-state sources”?

- **a.** Income/loss from real property
- **b.** Income from mutual funds
- **c.** Wages for services performed in-state
- **d.** Income/loss from in-state business

6. An employee works in State X but lives in State Y. If there is an agreement between States X and Y that provides that the employer need only withhold for, and the employee need only file in State Y, then this is an example of a _______ agreement.

- **a.** Mutual
- **b.** Reciprocal
- **c.** Common
- **d.** Jurisdictional

MODULE 1: BUSINESS—Chapter 4: Partnership Tax Filing Issues

¶ 401 WELCOME

Practitioners often encounter partnership tax filing issues regardless of their area of specialty. Increased information reporting and the complex nature of partnership tax transactions make compliance with the filing requirements particularly challenging. This chapter provides a practical review of the issues that most commonly arise in preparing partnership tax returns. It also addresses how to tackle partnership tax return complexities during the extended filing season.

¶ 402 LEARNING OBJECTIVES

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

- Describe essential reporting issues and obligations in partnership taxation
- Identify planning opportunities with partnership tax returns
- Recognize how to apply best practices for preparing partnership returns
- Identify correct statements with respect to guaranteed payments
- Describe capital account reporting
- Describe characteristics of Schedule K-1s

¶ 403 INTRODUCTION

In 2022, 4.3 million partnership returns were filed in the United States, and the IRS conducted 7,800 audits of partnerships. That is an incredibly low rate, so it's no surprise that the IRS plans to significantly increase the audit rate of partnerships. One of the ways the IRS will accomplish this is by using expert systems and artificial intelligence (AI).

Some of the questions on the partnership return are fairly new, so when practitioners answer those questions, they must consider how the IRS will use that information in an audit. Chances are that, in the future, the IRS will be using AI to identify those partnerships that are most likely to be audited based on the way preparers respond to these questions.

> **NOTE:** A preparer would be well advised to consider how the responses to the new information items (most first appeared in 2020) on Form 1065 and its related schedules will be used in audits.

Other topics addressed in this chapter include allocation of profit and loss, partner shares of debt, entity-level elections, centralized audits, capital accounting, unrecognized Code Sec. 704(c) reporting, distributions, and guaranteed payments.

¶ 404 ORGANIZATION OF THE FORM 1065 AND RELATED SCHEDULES

Form 1065, *U.S. Return of Partnership Income*, and its related schedules contain many questions. Some of these questions are simple, but others are designed to highlight areas of controversy. The following chart identifies certain types of partnership transactions and matches them to the questions asked on the partnership tax return.

Examples of Form 1065 Questions		
1	1065, page 1, Item K	Code Secs. 465, 469 groupings done by partnership
2	1065, page 2, Q6	Cancellation of debt (COD) event(s)
3	1065, page 2, Q10	Sec. 754 election
4	1065, page 3, Q11	Swap-and-drop
5	1065, page 3, Q12	Drop-and-swap
6	1065, page 3, Q25	Qualified opportunity fund (QOF) status
7	1065, K-1, item I2	Partner is a retirement plan
8	1065, K-1, Item J	Shares of capital, profit, and loss (P&L)
9	1065, K-1, Item K	Shares of debt (three types)
10	1065, K-1, Item L	Tax basis capital reconciliation
11	1065, K-1, Item M	Contributed Sec. 704(c): Yes/No
12	1065, K-1, Item N	Unrecognized Sec. 704(c)
13	1065, K-1, Boxes 22 and 23	Check if more than one passive activity loss (PAL) or at-risk activity statement attached

When preparing an individual return, if a taxpayer has not experienced a particular event, that does not have to be indicated. But in preparing a partnership return, the practitioner generally has to indicate whether certain events happened to the taxpayer during the year. A partnership has ordinary and separately stated items because a partnership is a pass-through entity; partnership income flows through and retains its character. Partners need separate reporting for anything that might impact their tax reporting.

Page 1 of Form 1065 reports those items that are treated the same for all partners, such as:

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

Recent tax law changes have greatly increased the required information to be reported on Form 1065. This information includes:

- Code Sec. 199A reporting (aggregation; unadjusted basis of assets [UBIA]; W-2 wages)
- Code Sec. 1400Z-2 opportunity zone deferrals
- Activity reporting
- Code Secs. 469, 465, and 1411 reporting, including grouping decisions
- Specific Schedule K-1 questions

All of this information must be separately detailed. In fact, the first substantive question on Form 1065 is exactly the first question on Form 1120-S (*U.S. Income Tax Return for an S Corporation*), that is, check this box if the taxpayer aggregated activities for purposes of Code Sec. 465 or grouped activities for Code Sec. 469. The Schedule K-1 asks a similar question for each partner.

¶ 405 CODE SEC. 199A REPORTING

Taxpayers can aggregate businesses, but they do not have to. Reg. § 1.199A-6 provides fairly detailed rules as to when taxpayers can aggregate businesses and what types of businesses they are allowed to aggregate. However, the decision to aggregate is entirely up to the taxpayer.

The decisions that are made at the partnership level are then binding on the partners because anything that is aggregated cannot be disaggregated. The partnership also has to make the following decisions:

- How many businesses does the partnership have?
- Of these businesses, which are specified service trades or businesses (SSTBs)?
- What is the qualified business income (QBI) three-step process for each business?
- What are the W-2 wages for each business?
- What is the UBIA for each business?
- What is the amount, if any, of real estate investment trust (REIT) dividends?

NOTE: REIT dividends are subject to the 20 percent deduction, but they are also unique in that they are not subject to the high-income taxpayer rule.

¶ 406 GUARANTEED PAYMENTS

Guaranteed payments are determined without regard to income; that is, they are not entrepreneurial risk–type payments. However, it is not always clear what constitutes a guaranteed payment.

The payments are treated as if made to a non-partner. They are deductible to the partnership and separately reported (ordinary) income to the partner. Guaranteed payments may be for capital or services, which can affect self-employment tax treatment (and the 0.9 percent Code Sec. 1411 surtax).

It is not always clear how to classify a guaranteed payment, so there is actually quite a bit of flexibility in determining the classification.

Preference versus Guarantee

Preferences may mimic guaranteed payments, and although some people use the terms *preference* and *guarantee* interchangeably, there are distinctions. A preference return is a priority that is intended to be matched with an allocation of income (per the disguised sale regulations). The intent may not be realized, and the preference could carry over. "Target" allocations, discussed later in this chapter, 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 the guarantee has separately stated income, and the partnership has a deduction for the guaranteed payment.

If a partner is asked, "Do you want a guaranteed payment?" the answer is presumably yes for economic purposes. However, can the "guarantee" be replaced with a priority distribution matched with "target" income allocations? This will allow for an increased Code Sec. 199A deduction. Note that if the partnership is generating business income, guaranteed payments are not eligible for the qualified business income deduction (QBID). Priority distributions do not impact the QBID.

¶ 407 ENTITY-LEVEL ELECTIONS

Page 2 of Form 1065 asks what type of entity the partnership is. Generally, this is based on the classification ("check-the-box") regulations. Reg. § 301.770-3 states that if an unincorporated business entity, such as a general partnership, limited partnership, limited liability company (LLC), limited liability partnership (LLP), or unincorporated business entity, has two or more owners, by default, it is a partnership. If it has one owner, by default, it is a disregarded entity. The regulations also state that if the taxpayer does not agree with the default rules, it can elect to treat the entity as something else. The taxpayer can choose the "Other" classification to classify the entity as a joint venture, for example.

There is a great deal of flexibility in reporting in community property states. Rev. Proc. 2002-69 provides that a married couple who own all of the interests can elect to treat that entity as a disregarded entity or a partnership if the husband and wife are the only owners and hold interests as community property.

In all states, if a husband and wife own a joint venture and both spouses materially participate in the trade or business, they have the same flexibility in choosing disregarded entity or partnership status (Code Sec. 761(f)).

> **EXAMPLES:** Assume Husband A and Wife B establish an LLC. If they are in a community property state, they can elect that the LLC be treated as a partnership or a disregarded entity by administrative fiat (Rev. Proc. 2002-69). If they are in a separate property state, their LLC likely will be treated as a partnership.
>
> Assume Husband C and Wife D run a joint venture (not an LLC). Their joint venture is treated the same whether they are in a community property or separate property state. If they have a trade or business, and both materially participate in it, they have the choice of partnership or disregarded entity status by statute.

Consider a partnership LLC with one equity partner and several carried interests. Is it a partnership or a disregarded entity? Assume one partner has contributed capital and the others have profits interests only. If it is a partnership, a partnership tax return must be filed to avoid penalties.

But is this actually a partnership? Although most people will treat the entity as a partnership, the answer is unclear. Under old IRS guidelines (prior to 1997), this entity would not be considered a partnership because only one person has a capital interest. However, the IRS has taken other positions more recently.

Determining whether an entity is a partnership can sometimes be a challenge (e.g., especially with a joint venture or co-tenancy; see Rev. Proc. 2002-22). It is unclear what minimum interest triggers partner status, and if the taxpayer incorrectly believes it is not a partnership, it could face penalties for failure to file a partnership return. There could also be missed elections and reporting issues, such as the following:

- Opportunity zone deferral
- Code Sec. 1031 deferral
- Charitable deduction appraisals

Typically, an entity does not want partnership status; it is easier not to have to file Form 1065. The entity can also avoid foot faults on entity-level elections. In some cases, it can be helpful to have a separate entity, such as for deliberate controlled-entity sales.

More recently, the state and local tax (SALT) workaround may be available only for a partnership (or other pass-through entity) tax filing. Some states allow Schedule C to qualify, but most require a separate entity filing a return. This could create a need for a partnership filing.

Schedule B Questions

Schedule B of Form 1065 asks a set of questions, some that are merely informative and others that are potential audit traps. The first question is whether the taxpayer has made a Code Sec. 754 election in the past or is first making the election now. It may be helpful for practitioners to ask this question of a new client.

The next question is whether something happened this year that would cause an adjustment triggered by the Code Sec. 754 election, such as a distribution, a sale, or a change of an interest. The next question asks if the partnership has distributed undivided interests in its property. This is to identify a “drop and swap” transaction. The IRS may question whether the partners held the property in a manner that allows a Code Sec. 1031 exchange. Then it asks if the partnership has distributed property acquired in an exchange. This is meant to target “swap and drops.” A swap and drop occurs when a taxpayer makes a like-kind exchange at the partnership level and then distributes one or more of the properties that it receives. This question is likely included in the partnership return because the IRS could then argue that the partnership did not hold that property for investment or trade or business purposes but rather held it for the purpose of distributing it to the partners.

More commonly seen is the “drop and swap” noted above. If the partnership wants to sell some real estate it owns, and one or more of the partners want to cash out while the others want to do a Sec. 1031 exchange, the partnership first distributes the property as tenant-in-common interest to the partners, and then has them individually make Sec. 1031 exchanges or not, as they see fit. Often the partnership has already negotiated the terms of the sale. This may throw the sale of distributed property back to the partnership.

Partnership Code Sec. 754 Elections

The Code Sec. 754 election is an entity-level election that affects two transactions:

- The sale or exchange of an interest (Code Sec. 743). This affects the basis of the purchasing partner only, but the partnership must track the adjustment (if notified).
- Distributions of money or property from the partnership (Code Sec. 734). An adjustment may be made to the basis of partnership properties.

NOTE: The Sec. 754 election is important because once made, it is binding on all future years.

Code Sec. 743 adjustments are designed to equate the “inside” and “outside” basis. The outside basis refers to the partner’s basis in the interest. This is cost if purchased; it may also be the fair market value for an inherited interest, carryover basis for a gifted interest, or substituted basis for an interest acquired in an exchange. The inside basis is a percentage share of the partnership’s basis attributable to the partner’s interest. The partnership uses it to report entity transactions to the partner.

The Code Sec. 743 adjustment arises outside the partnership and creates no capital account adjustments because it is triggered by one partner buying an interest from another partner. That does not involve the partnership; it happens outside the partnership. Therefore, it is absolutely clear that Sec. 743 adjustments do not affect tax or book capital.

The Sec. 743 adjustment is allocated among assets using a hypothetical sale of assets. This allocation may need to follow Code Sec. 1060 principles where the partnership is operating a trade or business or where goodwill could reasonably attach to the assets. However, the taxpayer is not required to file Form 8594, *Asset Acquisition Statement Under Section 1060*, even if Code Sec. 1060 applies. It must follow the principles of Form 8594 but does not have to actually file it.

Code Sec. 734 adjustments are triggered by a distribution to a partner. This occurs “inside” the partnership and impacts capital accounts. These adjustments do affect the book and tax capital because they affect the partnership’s balance sheet, and the basis of assets of the partnership.

There are four scenarios when an adjustment occurs. A partner usually takes a carryover basis in distributed property. It may be less if the basis of the interest is insufficient to allocate the full carryover, or it may be more if the distribution liquidates the partner's interest. There are positive and negative adjustments, both of which are triggered by what happens to the partner.

- Positive adjustments
  - Gain is recognized by the distributee.
  - The distributee's basis in the property is less than the carryover.
- Negative adjustments
  - Loss is recognized by the distributee.
  - The distributee's basis in the property is more than the carryover.

Both negative adjustments occur only when a partner's interest is liquidated; the partnership must continue after the one partner's interest is liquidated to book an adjustment, so negative adjustments are less common than positive adjustments.

Generally, Code Sec. 734 and 743 adjustments are not made unless a Code Sec. 754 election is in effect. If an adjustment was not made already, it would not be made for a negative adjustment. However, a mandatory adjustment occurs if the adjustment is negative and exceeds $250,000. This applies to both Code Sec. 734 and 743 adjustments.

STUDY QUESTIONS

1. Which of the following statements is correct regarding guaranteed payments?

a. It is always clear how to classify them.
b. They are determined without regard to income.
c. They are not deductible to a partnership.
d. They are treated as if made to a partner.

2. Which of the following appropriately describes the type of election a Code Sec. 754 election represents?

a. Account-level election
b. Partner-level election
c. Entity-level election
d. Transaction-level election

3. A mandatory adjustment occurs when the adjustment is both negative and exceeds what amount?

a. $50,000
b. $100,000
c. $150,000
d. $250,000

¶ 408 SCHEDULE K

Schedule K of Form 1065 summarizes the ordinary and separately stated items shown on the individual partners' Schedule K-1s. However, decisions must also be made, related to the following:

- Code Sec. 179 expense elections
- Aggregation for Sec. 199A

- Aggregation for Sec. 465 at-risk purposes
- Grouping of activities for purposes of
  - Passive activities and at-risk
  - But the passive activity grouping may affect Code Sec. 1411 net investment income tax (NIIT)

Reporting Passive Loss Activities

Although a partnership is not subject to the PAL rules, it must determine such "activities" because what the partnership aggregates cannot be disaggregated by the partner. The partnership must attach a statement to the return showing the income or loss for each PAL activity or classification.

The partnership grouping may affect the partners in two ways: (1) passive loss application, and (2) the Sec. 1411 Medicare surtax application. Although what the partnership binds together cannot be separated, a partner may add additional activities to the partnership's grouping.

It is generally best to disaggregate to allow the partners the greatest flexibility in grouping at their level. However, partnership groupings must satisfy the appropriate economic unit standard. The partnership must also have the books and records needed to disaggregate.

Partner K-1 Issues

Schedule K-1 shows a great deal of information that affects the partners, but it also includes some questions intended to help the IRS identify significant issues. If the IRS develops a type of AI to identify high audit risk situations, these questions are going to be very important. The K-1 shows the following information:

- The partners' allocable share of profit and loss, partner by partner
- A reconciliation of the capital account (transactional tax basis required)
- Unrecognized Code Sec. 704(c) gain/loss
- Shares of liabilities
  - Recourse
  - Nonrecourse
  - Qualified nonrecourse: Works for at-risk basis. These liabilities must be in connection with the activity of holding real property. The lender must be in the trade or business of lending and not have an interest in the activity.

¶ 409 ALLOCATIONS OF PROFIT AND LOSS

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

The regulations state that if a partnership has the right language in its agreement, the IRS will not challenge its allocation. According to the Sec. 704(b) substantial economic effect safe harbor, the correct language includes:

- Capital accounts are maintained per the regulations.
- Liquidating distributions follow the capital accounts.

- There is either (1) a deficit restoration obligation, which states that if the capital account is negative, the partner has to give the partnership money; or (2) a qualified income offset, which states that a taxpayer cannot make the capital account go negative by an allocation, but if it happens to go negative because of something like a distribution, the taxpayer must bring it back up to zero with an allocation of income.

There is also a substantiality test, which is beyond the scope of this chapter.

Target Allocations

If a partnership was liquidating and filed a partnership return just once in the life of the partnership, it would be easy to do allocations that match the economics of the deal. The problem is that partnerships do not liquidate one time and file one return. They liquidate one time but file lots of returns. Basically, a target allocation means that at the end of each year when the partnership has to file its tax return, it should pretend that it liquidated at that year and determine how much each partner would get if it liquidated. The allocation is then made to "target" a capital account balance that matches the distribution from the hypothetical liquidation.

Target allocations exist because the safe harbor agreement does not prescribe distributions upon liquidation. Safe harbor agreements focus on allocations and then use capital balances to determine rights to distributions. In a target agreement, distributions are typically made by agreement. Income or loss is then allocated to hit a target capital account that reflects the distribution "waterfall." The target capital is generally Sec. 704(b) "book"; allocations would then be of book items rather than tax. Book–tax disparities are still governed by Code Sec. 704(c). There is more burden on the preparer; no safe harbor is satisfied. There are many simple agreements where allocations and distributions are made in the same proportions as invested capital. Those simple agreements do not raise issues.

Special Allocations of Nonrecourse Deductions

Nonrecourse deductions are those financed by nonrecourse borrowing. The problem with nonrecourse deductions is that they cannot meet an economic effect test because the principle of economic effect is that that taxpayer will match the tax allocations to the economics.

Therefore, the partnership will allocate income to the partner who received a benefit from that income. It will allocate a deduction to the partner who suffered a detriment that gave rise to that deduction. No partner bears a risk for nonrecourse loans because the non-partner lender bears a potential risk of loss. It is then not possible to match deductions financed by nonrecourse debt to the partner who suffers the economic detriment associated with that deduction. The absence of economic effect means the allocation must follow the partners' interests in the partnership.

However, the regulations state that nonrecourse deductions may be allocated by agreement, if the agreement satisfies the "deemed in accordance with the partners' interests test," which requires certain language to be included in the agreement.

Instead of a qualified income offset or a deficit restoration obligation, the partnership agreement must have a "minimum gain chargeback." Partners can be allocated losses in excess of their Sec. 704(b) capital if those allocations are nonrecourse. The chargeback ensures they will not exit the partnership with a negative capital account. It then functions similar to a qualified income offset for recourse allocations.

Target Allocation Agreement

A target allocation agreement does not meet the safe harbor (liquidating distributions are not based on capital) but generally targets Sec. 704(b) capital. It is often characterized by a reference to target capital based on a hypothetical liquidation at book value. The preparer must determine the target allocation.

To identify a target allocation, look to the agreement, which refers to "hypothetical" items, including 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 the taxpayer to reach a hypothetical "target" capital equal to the hypothetical distributions.

EXAMPLE: Partner A contributes $100,000 and Partner B contributes $50,000 to the AB Partnership. There is a distribution waterfall:

- Partner A gets 6% preference on his capital first.
- Partner A gets his $100,000 contribution next.
- Partner B gets his $50,000 capital next.
- Partner A gets 50% and Partner B gets 50% of any upside.

Year 1 income = $30,000.

Assets after Year 1 = $180,000 (capital plus income).

Find the "target" capital balances. With $180,000 to distribute,

- Partner A gets $6,000.
- Partner A gets $100,000.
- Partner B gets $50,000.
- Partner A gets $12,000; Partner B gets $12,000.

So, Target A = $118,000; Target B = $62,000.

The $30,000 profit is allocated so that the capital, based on a hypothetical liquidation, matches the target.

- $100,000 plus $18,000 income = $118,000 target.
- $50,000 plus $12,000 income = $62,000 target.

Other Provisions Governing Allocations

Allocations that relate to precontribution gain or loss must take into account the built-in gain or loss at contribution. These allocations are governed by Sec. 704(c). If partners' interests change during the year, the "varying interest rule" of Sec. 706(d) applies. Allocations may be made using an interim close of the books or by proration. The rules for allocations when interests vary are the following:

- Interim close is the default rule.
- Proration must be elected by the signed partner agreement.
- Proration still requires "extraordinary item" tracking by date.

¶ 410 CODE SEC. 704(C) REPORTING

The basic premise of Code Sec. 704(c) precontribution gains or losses is that partnership allocations relate to items of gain and loss that arise while the owners are in a partnership form. 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. This is now tracked (by amount) on the partners' Schedule K-1 forms.

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

1. Is there a Sec. 704(c) item?
2. What is the amount of the Sec. 704(c) item?
3. To which partner does it belong?

Questions 1 and 3 can be tracked on Schedule K-1. A box is checked when a partner contributes property with a built-in gain or loss. A second question asking for the unrecognized Sec. 704(c) gain or loss at the beginning and the end of the year was required beginning with the 2019 K-1. Book–tax capital comparisons are the easiest way to deal with the new questions.

Capital Accounts

An essential element of substantial economic effect is the proper maintenance of capital accounts. The Code Sec. 704(b) regulations have specific rules that are neither traditional "book" or "tax." Practitioners call it Sec. 704(b) book, and it often is the same as tax. Special adjustments may be needed for admittance of new partners and distributions of property, including exercise of options and option equivalents.

The 2018 and earlier Schedule K-1 asks how capital accounts are reported:

- GAAP
- Sec. 704(b) book
- Tax
- Other

In 2019, all of these methods were allowed, but a separate statement needed to be attached to identify the method. Starting in 2020, practitioners now need to report tax basis capital for all clients. Nonetheless, many agreements mandate that the partnership also maintain Sec. 704(b) capital. Keeping Sec. 704(b) capital in addition to tax basis can be helpful because:

- Allocations are made using a regulatory safe harbor that requires Sec. 704(b) capital.
- Liquidation distributions often follow book capital, and target allocations are tied to book capital.
- New question on unrecognized Sec. 704(c) gain may be tracked by comparing tax and Sec. 704(b) capital.
- Sec. 199A UBIA is based on book depreciation.

The IRS "threatened" to require one of two fairly complex tax basis capital reporting requirements. But when it asked for comments, practitioners responded that they preferred the "transactional" approach, which the IRS had said would not be allowed. However, the Form 1065 instructions now indicate that the transactional approach is the one to use.

¶ 411 DISTRIBUTIONS

A partnership recognizes no gain or loss as a result of a distribution. The partner may recognize gain or loss, and information reporting is required to assist in determining the tax effect. Gain is recognized when cash is received in excess of the partner's outside basis. Loss may arise if the distribution liquidates the partner's interest, consists solely of money and ordinary-income property, and the basis of the partner's interest cannot be allocated in full to the distributed assets. A partnership Sec. 754 election may also lead to a partnership (Sec. 734) basis adjustment.

The Schedule K-1 capital account reconciliation reports (actual) distributions. It also shows changes in debt shares, which also create deemed distributions if the partner's share is reduced, per Code Sec. 752(b). The K-1 reporting for 2020 and beyond now provides greater information to determine the tax effect. Tax basis capital may approximate the partner's outside basis when adjusted for the share of liabilities. Anti-abuse provisions may also cause a partner to recognize gain; these provisions are not identified by the capital reporting.

¶ 412 PARTNER SHARES OF LIABILITIES

Increases and decreases in partners' "shares" of entity liabilities affect basis. A "share" of a liability is determined using the Reg. § 1.752 rules. Recourse liabilities are shared using economic-risk-of-loss principles, and nonrecourse liabilities are shared in a three-step approach, which is somewhat arbitrary but pro-taxpayer. Schedule K-1 requires that the following be reported:

- Share of recourse debt
- Share of nonrecourse debt
- Share 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. When reporting liability shares, Schedule K-1 requires each of the following, ***except?***

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

5. Which of the following is the default rule with respect to the varying interest rule?

a. Fair value
b. Interim close
c. Allocation
d. Equity

6. Which of the following statements is correct with respect to capital account reporting?

- **a.** All methods were allowed in 2018, but a separate statement is attached to identify the method.
- **b.** All partnerships must report tax basis capital for each member starting in 2020.
- **c.** Starting in 2021, K-1s ask how capital accounts are reported.
- **d.** Notice 2019-66 deferred 2019 tax basis reporting until the 2022 year.

CPE NOTE: When you have completed your study and review of chapters 1-4, 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.

¶ 10,100 Answers to Study Questions

¶ 10,101 MODULE 1—CHAPTER 1

1. a. ***Incorrect.*** The SECURE 2.0 Act was not even passed until 2022 and has no retroactive provisions.

b. ***Incorrect.*** Most SECURE Act provisions were effective for tax years beginning January 1, 2020.

c. ***Correct.*** **Most SECURE 2.0 Act provisions are effective for tax years beginning January 1, 2023.**

d. ***Incorrect.*** Most of the SECURE 2.0 Act provisions are applicable for tax years that begin prior to January 1, 2024.

2. a. ***Incorrect.*** The combined amount is greater than $7,500.

b. ***Incorrect.*** This is the maximum elective deferral amount for individuals under age 50.

c. ***Incorrect.*** This is the combined amount for those between the ages of 50 and 59.

d. ***Correct.*** **Participants who are between the ages of 60 and 63 may contribute a maximum of $32,500 to an employer-sponsored 401(k) plan.**

3. a. ***Incorrect.*** The saver's credit is effective after 2026.

b. ***Correct.*** **Starting in 2027, taxpayers earning between $41,000 and $71,000 for married, filing joint taxpayers (and between $20,500 and $35,500 for single taxpayers) will be eligible for a federal retirement saver's match.**

c. ***Incorrect.*** The saver's match will already be effective in 2030.

d. ***Incorrect.*** The effective date for the saver's match occurs prior to 2033.

4. a. ***Incorrect.*** This is the 401(k)-plan elective deferral limit for 2023.

b. ***Incorrect.*** This is the maximum amount a 60-year-old may contribute to a 401(k) plan in 2023.

c. ***Correct.*** **No more than $35,000 in a 529 plan may be rolled over to a Roth IRA during a beneficiary's lifetime.**

d. ***Incorrect.*** The maximum amount that may be rolled over is less than $40,000.

5. a. ***Incorrect.*** Employers have more time than this to amend their plan documents.

b. ***Incorrect.*** Prior to the adoption of the SECURE 2.0 Act, the deadline was January 1, 2022.

c. ***Incorrect.*** The date by which employers must amend their plans to comply with these laws is not January 1, 2023.

d. ***Correct.*** **Employers have until the end of the first plan year beginning on or after January 1, 2025, to amend their plans to comply with these laws.**

6. a. ***Correct.*** **Taxpayers age 70½ or older may make charitable contributions directly from an IRA without being required to include such amounts in taxable income so long as such amounts do not exceed $100,000 per year.**

b. ***Incorrect.*** The maximum charitable contribution amount that can be made tax-free from an IRA is not $125,000.

c. ***Incorrect.*** $200,000 is not the amount shielded from taxation in this context.

d. ***Incorrect.*** The tax-favored amount is less than $250,000.

¶ 10,102 MODULE 1—CHAPTER 2

1. a. ***Correct.*** **The general rule is that taxpayers can choose which method to use.**

b. ***Incorrect.*** There are two ways to calculate the deduction.

c. ***Incorrect.*** The standard mileage rate method may not be used by those operating five or more vehicles at the same time.

d. ***Incorrect.*** Parking and tolls are separately deductible and are not factored into the standard mileage rate.

2. a. ***Incorrect.*** The amount Regina may deduct is higher than $7,320.

b. ***Correct.*** **Regina may take a deduction in the amount of $12,120 (which is 60 percent of $20,200).**

c. ***Incorrect.*** The capped amount for Regina is not $20,200.

d. ***Incorrect.*** The amount that Regina may deduct in year 1 is less than $72,000.

3. a. ***Incorrect.*** This was the standard mileage rate for 2018.

b. ***Incorrect.*** In 2020, this was the applicable rate.

c. ***Incorrect.*** The applicable rate for the second half of 2022 was 62.5 cents per mile.

d. ***Correct.*** **The standard mileage rate for 2023 is 65.5 cents per mile.**

4. a. ***Incorrect.*** Medical purpose driving includes driving to pharmacies.

b. ***Incorrect.*** The cost of driving for medical purposes may be based on the total of actual expenses incurred, but this is not the only option for calculating deductible expenses for medical driving.

c. ***Incorrect.*** If a taxpayer itemizes deductions, total medical expenses must exceed 7.5 percent of adjusted gross income to be deductible.

d. ***Correct.*** **The standard rate for 2023 is 22 cents per mile.**

5. a. ***Incorrect.*** The maximum amount exceeds $2,500.

b. ***Incorrect.*** $5,000 is not the amount of the credit.

c. ***Correct.*** **The maximum credit amount for 2023 is $7,500.**

d. ***Incorrect.*** The maximum amount of the credit is less than $10,000.

6. a. ***Incorrect.*** The SALT cap is more than $7,500.

b. ***Correct.*** **The SALT cap is $10,000**.

c. ***Incorrect.*** $12,500 is not the amount of the SALT cap.

d. ***Incorrect.*** The cap is less than $15,000.

¶ 10,103 MODULE 1—CHAPTER 3

1. a. ***Incorrect.*** The business factor is one of the five domicile factors. For this factor, it's important to assess what you do, not just where you do it.

b. *Correct.* Forwarding address is not one of the five domicile factors presented. Instead, the five domicile factors include home, business, time, near and dear, and family.

c. ***Incorrect.*** "Near and dear items" is one of the five domicile factors. Another one of the five domicile factors is the family factor.

d. ***Incorrect.*** The time factor is one of the five domicile factors. It's important to note that this does not relate to the 183-day test.

2. a. ***Incorrect.*** California is not sourced to the employer's home state. Instead, California is sourced to the employee's home state. A state that is sourced to the employer's home state is New York.

b. *Correct.* Mississippi is sourced to the employer's home state. Another state that is sourced to the employer's home state is Georgia.

c. ***Incorrect.*** Oregon is not sourced to the employer's home state. Instead, a state that is sourced to the employer's home state is Rhode Island.

d. ***Incorrect.*** Minnesota is not sourced to the employer's home state. Instead, Minnesota is sourced to the employee's home state.

3. a. *Correct.* Wisconsin is sourced to the employee's home state. Another state that is sourced to the employee's home state is North Carolina.

b. ***Incorrect.*** New York is not sourced to the employee's home state. Instead, New York is a state that is sourced to the employer's home state.

c. ***Incorrect.*** Rhode Island is not sourced to the employee's home state. Another state that was sourced to the employer's home state is Nebraska (until July 30, 2021).

d. ***Incorrect.*** Mississippi is not sourced to the employee's home state. Instead, Mississippi is a state that is sourced to the employer's home state.

4. a. *Correct.* Pennsylvania is among the states that have this rule. In general, if the employee works from home for their own convenience, broadly defined, the workdays at home will be treated as days worked at the assigned work location if that is one of the six states for nonresident income allocation and withholding purposes.

b. ***Incorrect.*** Florida is not one of the six states with a "convenience rule." Instead, one of the six states to have this rule is New York.

c. ***Incorrect.*** Hawaii is not one of the six states with a "convenience rule." Employers need to be careful about nexus and convenience rule issues when employees are no longer required to work from home.

d. ***Incorrect.*** Missouri is not one of the six states with a "convenience rule." Instead, one of the six states to have this rule is Connecticut.

5. a. ***Incorrect.*** Income/loss from real property qualifies as income from in-state sources. It's important to note that double taxation is possible for dual residents.

b. *Correct.* Income from in-state sources includes wages for services performed in-state, income/loss from real property, and income/loss from in-state business.

c. ***Incorrect.*** Wages for services performed in-state qualify as income from in-state sources. Note that not all income has a source.

d. ***Incorrect.*** Income/loss from in-state business qualifies as income from in-state sources. Also, it's important to note that states generally allow their residents a credit for taxes paid to other states.

6. a. ***Incorrect.*** This is not the term used for this type of agreement. Note that this type of agreement is not applicable to income earned in a third state that is not party to the agreement.

b. ***Correct.*** **However, reciprocal tax agreements typically exist only between neighboring states, and not all neighboring states have them.**

c. ***Incorrect.*** This is not the term used for this type of agreement. Note that this is applicable to local taxing jurisdictions.

d. ***Incorrect.*** This is not the term used for this type of agreement. Note that there are several considerations for employers with telecommuters. One of these is unemployment insurance.

¶ 10,104 MODULE 1—CHAPTER 4

1. a. ***Incorrect.*** Guaranteed payments can be for capital or for services. Said another way, it is not always clear what is a guaranteed payment.

b. ***Correct.*** **Guaranteed payments are determined without regard to income. In other words, they are not entrepreneurial risk–type payments.**

c. ***Incorrect.*** This is an incorrect statement. Instead, they are deductible to a partnership. Additionally, they are separately reported as ordinary income to the partner.

d. ***Incorrect.*** This is an incorrect statement. Instead, they are treated as if made to a non-partner, not a partner.

2. a. ***Incorrect.*** Sec. 754 is not an account-level election. Also note that Sec. 743 adjustments are designed to equate the "inside" and "outside" basis.

b. ***Incorrect.*** Sec. 754 is not a partner-level election. However, note that it affects two different transactions.

c. ***Correct.*** **Sec. 754 is an entity-level election. It affects two transactions: sale or exchange of an interest and distributions of money or property from the partnership.**

d. ***Incorrect.*** Sec. 754 is not a transaction-level election. One of the transactions that is affected by Sec. 754 is a distribution of money or property from the partnership.

3. a. ***Incorrect.*** While one of the requirements for a mandatory adjustment is that it is negative, it is not mandatory if it exceeds $50,000. The amount that it must exceed in order to be mandatory is higher.

b. ***Incorrect.*** In this situation, the adjustment would not be mandatory. For example, one of the requirements is that it must be negative, not positive.

c. ***Incorrect.*** Generally, Code Sec. 734 and 743 adjustments are not made unless a Sec. 754 election is in effect.

d. ***Correct.*** **A mandatory adjustment applies to both Code Sec. 734 and Code Sec. 743. It is required if it is negative and exceeds $250,000.**

4. a. ***Incorrect.*** The share of recourse debt is a component that is required by Schedule K-1. Also note that increases and decreases in partners' "shares" of entity liabilities affect basis.

b. ***Incorrect.*** The share of nonrecourse debt is a component that is required by Schedule K-1. It's important to note that nonrecourse liabilities are shared in a three-step approach, which is somewhat arbitrary.

c. ***Correct.*** **Instead, Schedule K-1 requires the share of recourse debt, share of nonrecourse debt, and share of qualified nonrecourse debt.**

d. ***Incorrect.*** The share of qualified nonrecourse debt is a component that is required by Schedule K-1. Note that qualified nonrecourse debt allows at-risk basis.

5. a. ***Incorrect.*** This is not one of the two methods offered by the Treasury. Instead, the two methods are the interim closing method and the proration method.

b. ***Correct.*** **Code Sec. 706(d) says if partners' interests change, distributive shares are to be determined using any method prescribed by the Secretary that takes into account the varying interests.**

c. ***Incorrect.*** This is one of the methods used with respect to varying interest. The proration method is less accurate but administratively simple and must be elected by agreement.

d. ***Incorrect.*** This is not one of the two methods offered by the Treasury. One of the methods is the proration method, but it is not the preferred method.

6. a. ***Incorrect.*** This is an incorrect statement. Instead, in 2019 (not 2018) all methods are allowed, but a separate statement is attached to identify the method.

b. ***Correct.*** **This is a correct statement. Additionally, note that Notice 2019-20 deferred 2018 negative basis reporting until March 15, 2020.**

c. ***Incorrect.*** This is an incorrect statement. Instead, the 2018 and earlier K-1 asks how capital accounts are reported.

d. ***Incorrect.*** While Notice 2019-66 deferred 2019 tax basis reporting, it did not defer it until the 2022 year. Instead, it deferred it until the 2020 year.

¶ 10,105 MODULE 2—CHAPTER 5

1. a. ***Incorrect.*** While ChatGPT can be helpful, it can also be harmful.

b. ***Correct.*** **Also note that ChatGPT sometimes fabricates answers. In fact, some experts estimate that ChatGPT makes stuff up roughly 15 percent to 20 percent of the time.**

c. ***Incorrect.*** Instead, for experienced tax practitioners, it's another tool that can help. For new practitioners, it can be dangerous.

d. ***Incorrect.*** Instead, the database is old. In fact, it usually does not address 2022 or 2023 tax developments.

2. 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.*** 20 percent is not the bonus depreciation rate for the year 2027. Instead, 20 percent is the bonus depreciation rate for the year 2026.

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.