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From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a committee of Publishers and Associations.

2023 FEDERAL TAX UPDATE

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# 2023 Federal Tax Update

## Individual Returns

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2023 FEDERAL TAX UPDATE
INDIVIDUAL RETURNS

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• Inflation Reduction Act Expands and Extends Individual Energy Credits
• IRA Transfers to Charity Complicated by SECURE
• SCOTUS Cancels Biden’s Student Loan Forgiveness Program
• Department of Education SAVEs and Expands IDR Relief
• Some Virtual Currency Reporting Changes Start in 2023, Others Delayed
• Divorced Couples Face Tax Problems with Alimony and Exemption in Agreements
• Inflation Reduction Act Extends ARPA Changes to Premium Tax Credits
• Foreign Asset Reporting Remains on IRS Exam Hit List
• Recent Cases and Rulings Highlight IRS Audit Issues on Individual Returns

PROPOSED TAX LEGISLATION

Biden’s Budget Proposal, Economic Blueprint

On March 9, 2023, President Biden released his $6.8 trillion FY2024 budget, which includes over $4 trillion in net tax increases over the next 10 years. 29% of the increases in net tax comes from reforms to international tax rules. Treasury’s accompanying details the administration’s new and recycled tax proposals, many of which have been in prior budgets and legislative attempts.

Like most presidential budgets, this one represents what President Biden dreams would solve the nation’s trouble, not what will likely happen in a Republican controlled House and a barely Democratic controlled Senate.

Generally, some of the new policy proposals include:

• Creation of a digital asset mining energy excise tax;
• Expanding the net investment income tax (NIIT) to applicable pass-through business income;
• Increasing to 5%, up from 3.8, the NIIT on all investment and business income for taxpayers with more than $400,000 in earnings, while also increasing to 5% the Medicare tax on wages and salaries;
• Creation of the Neighborhood Homes Credit (to support building/renovating affordable owner-occupied housing); and
• Modifying rules related to retirement plans to prevent excessive accumulations by high-income taxpayers in tax-favored retirement accounts.
Additionally, some key highlights of other and perhaps more familiar proposals include:

- Increasing the top individual income tax rate to 39.6%;
- Increasing the statutory corporate rate to 28%;
- Making permanent the expansions to the Earned Income Tax Credit for childless workers;
- Making permanent the New Markets Tax Credit (NMTC);
- Extending the expansion of the Child Tax Credit to certain children through 2025 and making the credit fully refundable;
- Repealing the deduction for foreign-derived intangible income (FDII);
- Taxing carried (profits) interest income as ordinary income;
- Repealing deferral of gain from like-kind exchanges completed in tax years beginning after Dec. 31, 2023, when greater than $500,000;
- Repealing certain fossil fuel subsidies;
- Increasing the excise tax rate on repurchase of corporate stock to 4%;
- Imposing a 25% minimum tax on total income, generally inclusive of unrealized capital gains, for all taxpayers with wealth greater than $100 million; and
- Making permanent the excess business loss limitation, treating excess business losses carried forward from the prior year as current-year business losses instead of as NOL deductions beginning in 2024.

**House GOP Released Individual and Business Tax Package**

House Republicans started tax talks this year by releasing a trio of bills for an individual and business tax package. The following three bills, released on June 9, 2023 make up the American Families and Jobs Act: *Tax Cuts for Working Families Act (H.R. 3936)*, *Small Business Jobs Act (H.R. 3937)*, and *Build It in America Act (H.R. 3938)*.

Generally, the package would, among other provisions:

- Increase the information reporting threshold for a service-recipient taxpayer for services performed by an independent contractor or subcontractor from $600 to $5,000;
- Restore the previous reporting threshold for Form 1099-K to $20,000 in annual sales and 200 in annual transactions. The American Rescue Plan Act of 2021 reduced the annual sales threshold to $600 and eliminated the transaction threshold;
- Increase the maximum amount a taxpayer may expense of qualifying property under §179 to $2.5 million, reduced by the amount by which the cost of qualifying property exceeds $4 million;
- Expand the exclusion from gain from qualified small business stock under §1202;
- Create a new bonus standard deduction on top of the existing standard deduction for tax years 2024 and 2025;
- Delay when taxpayers must begin amortizing research and experimental expenditures;
- Extends 100% bonus depreciation for qualified property;
• Reallocate reporting requirements for qualified opportunity zones and establishes special rules for capital gains invested in rural opportunity zones; and

• Repeal several clean energy credits created by the Inflation Reduction Act while modifying the clean vehicle credit.

Going nowhere fast. Since the June 9th release, the GOP-drafted package has sat dormant in committee. What’s in the way of a floor vote? The package doesn’t do anything to address SALT. House Republicans in Northeastern districts told Republican leaders they oppose the bill for that reason. Even passage in the House means little as the Democratic controlled Senate wants their own tax bill. There is bi-partisan support for several changes, but compromise for the good of the country is slow going and, thus, we are likely to see year-end, last-minute legislation – as always.

What Are the Odds That Tax Legislation Is Enacted in 2023?

The Republican majority approved two new rules in the US House of Representatives that will impact (or eliminate) tax legislation in the 118th Congress.

1. A three-fifths majority is required for any increases in income tax rates for individuals, corporations, and estates and trusts. The chair of the House Ways and Means Committee, Jason Smith, has signed a pledge not to raise taxes.

2. The House “cut-as-you-go” rule (CUTGO) requires any increases in mandatory spending to be offset with cuts to other mandatory spending – like Social Security, Medicare, Veterans’ Benefits, and Unemployment Compensation programs. With this rule in place, the House cannot approve any full-funded increases to these programs, unless they also cut some other mandatory spending programs.

Note. The refundable portion of the child tax credit, the childcare credit, and the earned income tax credit are counted as mandatory spending. Any enhancements in these programs (like those in COVID-19 relief legislation that expired after 2021) are pretty much stymied for the next few years.

Proposed Cannabis Excise Tax Bill Goes Up in Smoke

The House passed the Marijuana Opportunity Reinvestment and Expungement (MORE) Act, on April 1, 2022, by a vote of 220 to 204. On July 21, 2022, Finance Committee Chairman Ron Wyden (D-OR) and Sen. Cory Booker (D-NJ) formally filed the Cannabis Administration and Opportunity Act (CAOA). Although neither bill passed, the introduction in 2022 of the two bills at least show some interest in reconciling state and federal differences on the marijuana issue.

ENACTED LEGISLATION

The Consolidated Appropriations Act, 2023 (Dec. 29, 2022) Includes SECURE 2.0

SECURE 2.0 - With some bipartisan support, the long awaited SECURE 2.0 (officially known as Securing a Strong Retirement Act of 2022) was included in the Consolidated Appropriations Act, 2023. While more than 90 changes were made, a few significant changes are mentioned here:
1. Beginning in 2023, required minimum distributions (RMDs) begin at age 73. After 2032, RMDs begin at age 75. Penalties for failure to withdraw the RMD will drop from 50% to 25% in 2023. The penalty drops to 10% if the late RMD is taken by the end of the second year following the year it was due.

2. Beginning in 2023, employer matching contributions can be made to a ROTH (if the employer plan is modified to allow this change.)

3. Beginning in 2023, the credit for small employer pension plan startup costs is enhanced. The 3-year small business startup credit is increased from 50% to 100% of administrative costs, up to an annual cap of $5,000 for employers with up to 50 employees. Employers with 51 to 100 employees are subject to old rules.

4. Beginning in 2023, eligible employers with 50 or fewer employees may be entitled to an additional credit for contributions to a newly established pension plan (other than a defined benefit plan.) Generally, the credit is a percentage of the amount contributed by the employer on behalf of employees, up to a per-employee cap of $1,000. The applicable percentage is 100% in the first and second years, 75% in the third year, 50% in the fourth year, 25% in the fifth year. Further reductions apply for employers with 51 to 100 employees and contributions to employees with compensation in excess of $100,000, as indexed, are not taken into account.

5. Beginning in 2023, a qualified taxpayer may elect as part of their qualified charitable distribution (QCD) a one-time QCD of up to $50,000 (indexed for inflation) to certain charitable remainder annuity trusts, charitable remainder unitrusts, or charitable gift annuities.

6. Continuing into 2023, withdrawals are penalty free if the taxpayer is affected by a federally declared disaster. The withdrawal can be made within 180 days of the disaster if the taxpayer's personal residence is within the disaster area and if he or she has sustained a loss. The Act makes permanent a prior provision.

7. Beginning in 2024, as with ROTH IRAs, Roth 401(k) plans and other employer-sponsored plans will be exempt from RMDs.

8. Beginning in 2024, IRA catch-up contributions (currently $1,000) will be indexed for inflation.

9. Beginning in 2024, employers may match student loan payments with plan contributions.

10. Beginning in 2024, employers are required to auto-enroll eligible workers in elective deferral accounts. Businesses with 10 or fewer employees and businesses less than three years old are exempt. Unless the employee opts out, employees will be enrolled at a minimum contribution rate of 3% of their salary, increasing 1% a year thereafter until reaching a 10% contribution rate.

11. Beginning in 2024, unused 529 account savings may be rolled over into a ROTH IRA without penalty, provided the rollover amounts fall within annual ROTH IRA contribution limits and the 529 is at least 15 years old.

12. Beginning in 2024, the annual qualified charitable distribution (QCD) limit of $100,000 will be indexed for inflation.

13. Beginning in 2024, all catch up contributions at age 50 or older will need to be made to a ROTH account if the taxpayer had wages in the prior year of more than $145,000 to “qualified plans” (401(k), 403(b), and 457(b) plans). The $145,000 number is indexed for inflation beginning in 2025. The pre-tax catch-up contribution for 2023 is $7,500. In 2024, the high-income taxpayer will lose this deduction.
14. Beginning in 2025, individuals ages 60 through 63 may make catch-up contributions to their de-
ferred contribution plan of up to $10,000 (or 150% of the regular catch-up if greater). For 2023, 
the catch-up amount is $7,500.

Resources: For more information on the 90+ provisions included in SECURE 2.0, Alice Orzechowski 
filmed FlexCasts™ on the individual changes and on the business changes to IRAs and pension 
plans included in the legislation. Check here for details.

Tax Extenders - The Consolidated Appropriations Act did not include the extenders that we expected. 
Three major items were left out of the omnibus bill:

1. The business interest limitation (§163(j)) is tougher for taxpayers beginning in 2022. In 2021 the 
   interest deduction was limited to 30% of earnings before interest, taxes, depreciation, and amor-
tization (EBITDA). In 2022, the interest deduction is limited to 30% of earnings before interest and 
taxes (EBIT). The change means less interest is currently deductible.

2. Bonus depreciation (§168(k)) drops from 100% in 2022 to 80% in 2023 of qualifying property.

3. Research and Experimental expense (§174) must be amortized, rather than expensed, for tax years 
   beginning after Dec. 31, 2021. IRS has confirmed that this is “a change in accounting method” and 
   reporting will be required.

Inflation Reduction Act of 2022 (Aug. 16, 2022)

President Biden signed into law on Aug. 16, 2022, the Inflation Reduction Act of 2022 (IRA22), a 730-page 
slimmed down successor to the BBBA addressing climate, health care and taxes. Tax provisions in the Act 
include (1) funds allocated to the IRS to increase enforcement, particularly promised to be aimed at upper 
income individuals and businesses, (2) an expansion of electric vehicles credits, (3) new credits for energy 
efficient home improvements, and (4) an extension of expanded ACA credits through 2025. A 15% corpor-
ate minimum tax that impacts very large corporations and a tax on corporate stock buybacks is included. 
Although earlier versions proposed changes to the carried interest rules, the taxation of carried interest is 
unchanged for 2022 and the foreseeable future.

Consolidated Appropriations Act, 2022 (Mar. 15, 2022)

President Biden signed into law on March 15, 2022, a $1.5 trillion omnibus that provides the IRS with a 
6% fiscal year (FY) 2022 funding boost and statutory direct-hire authority to address the agency’s ongoing 
backlog. The government spending bill, the Consolidated Appropriations Act, 2022, came more than five 
months past the start of the fiscal year after a congressional stalemate led Congress to extend FY 2021 
funding levels several times via continuing resolutions to prevent a government shutdown.

Note. The 2,741-page omnibus bill contained no major tax law changes (or extenders to ARPA 
provisions).

Infrastructure Investment and Jobs Act (Nov. 15, 2021)

The Infrastructure Investment and Jobs Act (IIJA) contained three pages adding new reporting requirements 
for certain virtual currency transactions for statements required to be submitted after Dec. 31, 2023.
American Rescue Plan Act of 2021 (Mar. 11, 2021)

The American Rescue Plan Act of 2021 (ARPA) provided additional relief to address the continued impact of COVID-19 on the economy, public health, state and local governments, individuals, and businesses. The bill included two provisions that impact 2023 tax returns:

- make student loan forgiveness tax-free through 2025, and
- provide premium assistance for certain health insurance coverage through 2025.

EXPIRING PROVISIONS

Below is an updated chart of expiring provisions:

<table>
<thead>
<tr>
<th>IRC §</th>
<th>Provision</th>
<th>Expiration</th>
</tr>
</thead>
<tbody>
<tr>
<td>36B</td>
<td>ACA premium tax credit increases (extended through 2025 by the Inflation Reduction Act)</td>
<td>Dec. 31, 2025</td>
</tr>
<tr>
<td>108(a)(1)(E)</td>
<td>Exclusion from gross income of discharge of qualified principal residence indebtedness, but reduced from $2 million to $750,000 for discharge of indebtedness after Dec. 31, 2020</td>
<td>Dec. 31, 2025</td>
</tr>
<tr>
<td>108(f)</td>
<td>Exclusion from gross income any amount of federal or private education loan that is discharged between and including 2021 and 2025</td>
<td>Dec. 31, 2025</td>
</tr>
<tr>
<td>25C</td>
<td>Energy efficient home improvement credit</td>
<td>Dec. 31, 2032</td>
</tr>
<tr>
<td>30C(g)</td>
<td>Alternative fuel refueling property credit</td>
<td>Dec. 31, 2032</td>
</tr>
<tr>
<td>30D(g)</td>
<td>Clean vehicle credit</td>
<td>Dec. 31, 2032</td>
</tr>
<tr>
<td>30B</td>
<td>Credit for fuel cell vehicles (30% current credit drops to 26% in 2033 and 22% in 2034)</td>
<td>Dec. 31, 2034</td>
</tr>
<tr>
<td>25D</td>
<td>Residential clean energy (solar) property credit (30% current credit drops to 26% in 2033 and 22% in 2034)</td>
<td>Dec. 31, 2034</td>
</tr>
<tr>
<td>213</td>
<td>Medical at 7.5% of AGI</td>
<td>Permanent</td>
</tr>
<tr>
<td>25A</td>
<td>Transition from deduction for qualified tuition and related expenses to increased income limitation on lifetime learning credit. $80,000 ($160,000 MFJ) AGI</td>
<td>Permanent</td>
</tr>
</tbody>
</table>
Individual Tax Rates (§1, §15, §63(c)(2)(A))

The TCJA reduced the individual tax rates for 2018 through 2025. The temporary tax rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37% (Rev. Proc. 2022-38).

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>2024 Taxable Income</th>
<th>2023 Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>not over $23,200</td>
<td>not over $22,000</td>
</tr>
<tr>
<td></td>
<td>not over $16,550</td>
<td>not over $15,700</td>
</tr>
<tr>
<td></td>
<td>not over $11,600</td>
<td>not over $11,000</td>
</tr>
<tr>
<td>12%</td>
<td>over $23,200</td>
<td>over $22,000</td>
</tr>
<tr>
<td></td>
<td>over $16,550</td>
<td>over $15,700</td>
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<tr>
<td></td>
<td>over $11,600</td>
<td>over $11,000</td>
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<tr>
<td>22%</td>
<td>$94,300</td>
<td>over $89,450</td>
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<tr>
<td></td>
<td>over $63,100</td>
<td>over $59,850</td>
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<tr>
<td></td>
<td>over $47,150</td>
<td>over $44,725</td>
</tr>
<tr>
<td>24%</td>
<td>over $201,050</td>
<td>over $190,750</td>
</tr>
<tr>
<td></td>
<td>over $100,500</td>
<td>over $95,350</td>
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<tr>
<td></td>
<td>over $100,525</td>
<td>over $95,375</td>
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<tr>
<td>32%</td>
<td>over $383,900</td>
<td>over $364,200</td>
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<td>over $191,950</td>
<td>over $182,100</td>
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<tr>
<td></td>
<td>over $191,950</td>
<td>over $182,100</td>
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<tr>
<td>35%</td>
<td>over $487,450</td>
<td>over $462,500</td>
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<tr>
<td></td>
<td>over $243,700</td>
<td>over $231,250</td>
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<tr>
<td></td>
<td>over $243,725</td>
<td>over $231,250</td>
</tr>
<tr>
<td>37%</td>
<td>over $731,200</td>
<td>over $693,750</td>
</tr>
<tr>
<td></td>
<td>over $603,350</td>
<td>over $578,100</td>
</tr>
<tr>
<td></td>
<td>over $609,350</td>
<td>over $578,125</td>
</tr>
</tbody>
</table>

President Biden’s Proposals. President Biden has proposed in his 2024 budget an increase to the top tax bracket for single individuals making more than $400,000 and married couples making more than $450,000.

Tax practitioner planning. The marriage penalty is alive and well. Although the House and Senate bills that went into the conference committee to reconcile their differences included top rates taking effect over $1,000,000 MFJ and $500,000 single, the final TCJA reduced the MFJ number to just $100,000 over that applying to the single taxpayer.

Tax practitioner planning. CBO estimates that the top 1/5th of taxpayers receive 44% of the value of major tax expenditures (like capital gains rates and itemized deductions), while only 11% percent goes to the bottom 2/5ths. However, even with substantial tax expenditures, the top 1% of American taxpayers still pay an effective tax rate of 31%, on average, while the bottom 20% of the population pay an average of 4%.
2023 Estimated Tax Penalty (Topic No. 306 Penalty for Underpayment of Estimated Tax)

The percentage threshold to avoid a 2023 estimated tax penalty is 90% of current year tax. The penalty is waived if withholding and estimated tax payments are at least 100% (110% for some) of prior year tax.

4th Quarter 2210 Penalty is Calculated at 8%

The IRS has announced (Rev. Rul. 2023-17) the interest rates for taxpayer underpayments and overpayments for the fourth quarter of 2023. These rates apply quarter by quarter. An 8% underpayment rate applies for computing penalties for underpayment of estimated tax. Other interest rates for underpayments and overpayments are:

- 8% for overpayments;
- 8% for underpayments;
- 5.5% for the portion of a corporate overpayment exceeding $10,000;
- 7% for corporate overpayments; and
- 10% for large corporate underpayments.

Filing Requirements (§6012)

An individual is required to file a tax return if the taxpayer’s gross income for the taxable year exceeds the applicable standard deduction. Married individuals are required to file a return if that individual’s gross income, when combined with the individual’s spouse’s gross income, for the taxable year is more than the standard deduction applicable to a joint return, provided that: (i) such individual and his spouse, at the close of the taxable year, had the same household as their home; (ii) the individual’s spouse does not make a separate return; and (iii) neither the individual nor his spouse is a dependent of another taxpayer who has income (other than earned income) in excess of $500 (indexed for inflation).

**Tax practitioner planning.** Under old law, the filing requirement was based on the exemption amount and the prior law standard deduction. For 2023, the filing requirement is based on standard deduction amounts of the $13,850 single, $20,800 head of household, and $27,700 MFJ.

Filing Status

Head of Household Filing Status (§695(g))

The TCJA required the Treasury to issue due diligence rules for paid preparers in determining the eligibility for a taxpayer to file as head of household (HOH). The IRS responded with a revised Form 8867.

**Tax practitioner planning.** Form 8867, Paid Preparer’s Due Diligence Checklist, includes HOH questions as well as questions regarding EITC, CTC/ACTC, and AOTC.
Tax Court Reminds Taxpayer about Single Filing Status Rules *(Mohamed H. Elbasha v. Comm., TCM 2022-001)*

Mohamed H. Elbasha was married at the close of the 2008 tax year but contended he was entitled to the single filing status because his wife lived abroad. Simply having a spouse living apart or abroad is insufficient for a person to be considered unmarried.

To file under the single filing status, a person must be unmarried, not a surviving spouse, and not a head of household (§1(C)). The determination of whether an individual is married is made at the close of the taxable year unless that individual’s spouse dies during that year (§7703(a)(1)). A person is not considered married at the close of the taxable year if he either (a) is separated from a spouse under a decree of divorce or separate maintenance agreement, or (b) furnishes over half of the costs of maintaining a household that does not include the spouse but does include a certain qualifying child or children (§7703(a) and (b)).

Tax Return Was Jointly Filed Even Though Spouse Did Not Sign the Return *(Om and Anjali Soni v. Comm., CA-2, No. 22-829-ag (Jul. 27, 2023))*

The US Court of Appeals, Second Circuit, affirmed the Tax Court’s Jan. 7, 2022, opinion that Om and Anjali Soni’s 2004 tax return was jointly filed. Four circumstances were identified as probative of the taxpayers’ intent. First, Anjali knew “a return had to be filed” because “[s]he was generally aware of the U.S. tax system but chose not to engage.” Second, Anjali knew of Om’s “expert knowledge” because he was an experienced businessman and she “chose to trust [his] handling of their family’s finances, which included [the] preparation and filing of their returns, including the [Return].”Third, the Sonis filed a joint petition in the Tax Court. And fourth, Anjali only belatedly challenged the IRS’s characterization of the Return as “joint,” not having “disavow[ed]” its “joint status” until trial. The Appeals Court found that the fact that the Sonis filed a joint tax return for every year from 1999 through 2003, and from 2005 through 2014, further supported their finding that the Sonis intended to file jointly.

**Tax practitioner planning.** Why would taxpayers argue that the return was not a valid joint return? Taxpayers are jointly and severally liable for taxes and penalties on a jointly filed return. Perhaps the Sonis hoped to protect Mrs. Soni’s separately held assets.


The Ninth Circuit Court of Appeals found that the Tax Court did not err by concluding that Lindsey Jones tacitly consented to the filing of a joint return. A joint tax return signed by one spouse on behalf of the other is valid so long as the non-signing spouse tacitly consented to filing the joint return. See *Hennen v. Comm., [CCH Dec. 24,658], 35 T.C. 747, 748–49 (1961)*. The key question is whether both spouses intended at the time of filing to file a joint return.

The Court found that Jones tacitly consented to filing the 2010 joint tax return because she had provided her then-husband with her W-2s and other tax information, she failed to file a separate income tax return, and she later allowed her spouse in a subsequent marriage to sign her name to their joint tax returns.
NAME AND ADDRESS CHANGES

How a Marriage Impacts Taxpayers (Tax Tip 2023-91)

Anyone saying “I do” this year should review a few tax-related items after the wedding. Newlyweds who use the new spouse’s last name (or a hyphenated name) must report their name change to the Social Security Administration using Form SSA-5. The name on a person’s tax return must match what is on file at the SSA. If marriage means a change of address, use IRS Form 8822 to notify the IRS. Newly married couples may be under withheld. If both work, they are likely to move into a higher tax bracket or be affected by the additional Medicare tax.

Tax practitioner planning. A name mismatch will delay a tax refund and cause e-file rejects.

How a Divorce Impacts Taxpayers (Tax Tip 2023-97)

Divorced and now back to using a former last name? The name on a taxpayer’s tax return must match Social Security Administration (SSA) records. Use Form SSA-5 to make the change. If the taxpayer’s address changes, use IRS Form 8822 to notify the IRS of the change. Check withholding. A new Form W-4 may be required.

Dependent’s Name Change

Notify the SSA if a dependent has a name change. For example, notify the SSA if a taxpayer adopted a child and the child’s last name changed. If the child does not have a Social Security number, the taxpayer may use an Adoption Taxpayer Identification Number on their tax return. An ATIN is a temporary number. Apply for an ATIN by filing Form W-7A, Application for Taxpayer Identification Number for Pending US Adoptions with the IRS.

Getting a New SS Card

File Form SS-5, Application for a Social Security Card. The Form SS-5 is on SSA.gov, or the client may call 800-772-1213 for the form. The taxpayer’s new card will reflect the name change.

Unreported Address Change Can Cause IRS Problems

It is important for a taxpayer to notify the IRS when they move so that they can receive notices and other communications from the IRS. If a taxpayer notifies the IRS of a change in address and the IRS sends mail to the wrong address a notice may be invalid because the IRS has a statutory requirement to address mail to a taxpayer’s last known address (IRM 4.8.9.12.4).

Use Form 8822 to change addresses. Most tax preparation software supports this form. See, Charles D. Williams v. Comm., CA-5, 18-60536, Nov. 27, 2019 where the IRS properly mailed a notice of deficiency to Mr. William’s last known address because the individual failed to mail a clear and concise notice of change of address to the Service before the notice of deficiency was mailed.
Revised IRS Publication Explains Tax Benefits for Members of the Military (Publication 3, Armed Forces’ Tax Guide)

The IRS provides Tax Information for Members of the Military to help you meet the unique tax obligations of your military clients. This publication includes topics that affect current and former military personnel, along with resources where you can go to find more information.

Also see.  
FS-2023-14 for “helpful” information for military personnel provided by the IRS in a June 8, 2023, fact sheet.

IRS Posts Tax Tip for Military Spouses (Tax Tip 2023-105)

“Lots of military spouses are also entrepreneurs – here’s some tax info they can use” is a new posting on IRS website. Many military spouses run businesses or do gig work, and whether it’s a side hustle or a major operation, the IRS lists tax resources and tools in this information release intended to help the military spouse keep things running smoothly for their tax return.

Note. Military spouses have a 21% unemployment rate.

PERSONAL EXEMPTIONS AND DEPENDENTS

No Personal Exemption Deduction Through 2025 (§151 - §153)

Definition of a Qualifying Child Remains the Same

The definition of a qualifying child remains the same as in prior law, but it is used for a different purpose than the personal exemption deduction. A “qualifying child” is required for the child tax credit, childcare credit, and the education credits.

Five “Qualifying Child” Tests Must Be Satisfied (§152(c))

- Child must be related to taxpayer §152(f)(1).
- Age. The child must not have attained the age of 19 by the end of the calendar year or must be a student who has not attained the age of 24 by the end of the calendar year (§152(c)(3) and (f)(2)) and must be younger than the taxpayer (§152(c)(3)(A)). Exceptions to these requirements exist for any individual who is totally and permanently disabled at any time during the year (§152(c)(3)(B)).
- Child must have the same principal place of abode as the taxpayer for more than half of the year (§152(c)(1)(B)).
- Child must not provide more than half of his or her support for the year (§152(c)(1)(D)).
- Joint return restriction. The child must not have filed a joint return (other than for a claim of refund only) (§152(d)(1)(E)).
Who Can Claim the Tax Benefits of the Qualifying Child? (Tax Tip 2022-98)

In its Summer Tax Tip 2022-98, the IRS explains the specific rules about who may be eligible to claim the child for tax purposes when parents who share custody of a child are divorced, separated, never married or live apart.

Only one person can claim the qualifying child as a dependent. Only one person can claim the tax benefits related to a dependent child who meets the qualifying child rules. It’s important that each parent understands who will claim their child on their tax return. If two people claim the same child on different tax returns, it will slow down processing time (particularly for the second-to-file parent who must paper file) while the IRS determines which parent’s claim takes priority. Remind the client that the duplication of the child tax benefits may result in an audit.

Custodial parents generally claim the qualifying child as a dependent on their return

• The custodial parent is the parent with whom the child lived for the greater number of nights during the year. The other parent is the noncustodial parent.
• In most cases, because of the residency test, the custodial parent claims the child on their tax return.
• If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income.

Noncustodial parents may be eligible to claim a qualifying child. Special rules apply for a child to be treated as a qualifying child of the noncustodial parent.

• The custodial parent can release the dependency exemption and sign a written declaration or Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent for the noncustodial parent to submit with their tax return.
• This also applies to some tax benefits, including the child tax credit, additional child tax credit, and credit for other dependents. It doesn’t apply to other tax benefits, such as the earned income credit, dependent care credit or head of household filing status.

Should My Client Sign a Form 8332?

Divorcing parents will still argue over the Form 8332. Since the child’s exemption is no longer deductible beginning in 2018 (thanks to the TCJA), what’s there to argue about when the parents are divorcing? Just let the custodial parent claim whatever . . . No! That’s not the right answer for the noncustodial parent since the exemption and the child tax credit go together. The new and improved child tax credit may still be worth fighting for, whether you represent the custodial or noncustodial parent.

Advise the client who you represent (custodial or noncustodial) that the divorce decree should specifically address the dependency and why. If a Form 8332 is required, the noncustodial parent (but not necessarily the custodial parent) is better off securing a several year signature when the divorce is finalized, rather than begging the ex-spouse each year. The effective dates that apply for the Form 8332 are found in Part II. The instructions explain how the custodial parent can revoke her/his several year Form 8332 if circumstances change.

Tax practitioner aid. Direct your client to Publication 504, Divorced or Separated Individuals to help clients understand who is eligible to claim their child.
The American Rescue Plan Act expanded the Child Tax Credit with the intention of reducing child poverty by supplementing the earnings of families receiving the tax credit. Specifically, the Child Tax Credit was revised for the tax year 2021 only. Beginning in 2022, the child and dependent care credit rules reverted to those applicable in 2020.

<table>
<thead>
<tr>
<th></th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Child Tax Credit</td>
<td>$2,000 (children under 17)</td>
</tr>
<tr>
<td>Family Tax Credit</td>
<td>$500</td>
</tr>
<tr>
<td>Phase out</td>
<td></td>
</tr>
<tr>
<td>MFJ</td>
<td>$400,000</td>
</tr>
<tr>
<td>Single (and other)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Child Tax Credit</td>
<td>Partially refundable up to $1,600</td>
</tr>
</tbody>
</table>

No Social Security Number Means No Credits (Adam Sowards V. Comm., TCM 2023-99)

Adam Sowards and his spouse jointly filed federal income tax returns for the three years at issue. The 2008 return claimed the additional child tax credit (ACTC) with respect to his four children, along with the earned income tax credit (EITC) and the recovery rebate credit. The 2009 return claimed the ACTC with respect to the four children, along with the EITC. The 2010 return claimed the child tax credit (CTC) with respect to the four children. The returns did not provide SSNs for the children or his spouse, none of whom had SSNs when the returns were filed.

Shortly after Mr. Soward filed his returns, IRS notified him that his claims for the CTC, the ACTC, and the EITC for the years at issue would be disallowed as mathematical or clerical errors pursuant to §§6213(b)(1) & (g) (2). Mr. Soward secured SSNs for his children, but 24(e), as amended and in effect when Mr. Soward filed his amended returns to include the children's SSNs, disallowed any claim for such credits with respect to a child whose taxpayer identification number had not been issued before the due date for filing the relevant return. The EITC and recovery rebate credit were not allowed because no valid taxpayer identification number was provided for his spouse (an undocumented immigrant), as required by §32(m) and §6428, respectively.

The expanded child and dependent care credit provided in ARPA expired Dec. 31, 2021. Beginning in 2022, the child and dependent care credit reverted to prior law.
**Inflation.** The child and dependent care expense amount is not indexed for inflation. The $3,000 and $6,000 amounts were put into the law in 1976! The dollar had an average inflation rate of 3.65% per year between 1976 and today, producing a cumulative price increase of 439.59%. The $3,000 amount would be about $16,000.

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### UNEMPLOYMENT BENEFITS

**2023 Unemployment Benefits Are Taxable**

Unemployment benefits received in 2023 are taxable on the Federal return. The exclusion of unemployment benefits only applied to 2020.

**Tax Practitioner planning.** Unemployment benefits are “unearned income” in computing kiddie tax.

**State tax.** Alabama, California, Montana, New Jersey, Pennsylvania, and Virginia completely exempt unemployment benefits from taxable income. Indiana and Wisconsin partially exempt unemployment benefits. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no state income tax. The remaining states that have an income tax, fully tax unemployment benefits.

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### CAPITAL GAINS AND DIVIDENDS

**Rates for Long-term Capital Gains and Qualified Dividends (§1)**

The TCJA retains the present law maximum rates on net capital gains and qualified dividends. Although the long-term capital gains tax rates remain the same in 2023, the income thresholds have been increased.

**2023 Long-Term Capital Gains Rates and Brackets**

<table>
<thead>
<tr>
<th>MFJ</th>
<th>Single</th>
<th>Head of Household</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>not over $89,250</td>
<td>not over $44,625</td>
<td>not over $59,750</td>
<td>0%</td>
</tr>
<tr>
<td>over $89,250</td>
<td>over $44,625</td>
<td>over $59,750</td>
<td>15%</td>
</tr>
<tr>
<td>over $553,850</td>
<td>over $492,300</td>
<td>over $523,050</td>
<td>20%</td>
</tr>
</tbody>
</table>

**Other capital gains rates.** The maximum rates for certain depreciation recapture and collectibles (e.g., precious metals) are 25% and 28%, respectively. Net capital losses are subject to the $3,000 annual limit.

**IRS Announces Intent to Treat NFTs as §408(m) Collectibles (IR-2023-50)**

On Mar. 21, 2023, the IRS announced that they are soliciting feedback for upcoming guidance regarding the tax treatment of a nonfungible token (NFT) as a collectible under the tax law. The IRS requested comments on any aspect of NFTs that might affect the treatment of an NFT as a collectible.

**Nonfungible token.** A nonfungible token (NFT) is a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. Distributed ledger technology, such as blockchain technology, uses independent digital systems to record, share and synchronize transactions, the details of which are recorded simultaneously on multiple systems.
nodes in a network. A token is an entry of data encoded on a distributed ledger. A distributed ledger can be used to identify ownership of both NFTs and fungible tokens, such as cryptocurrency.

**Collectible.** Section 408(m)(2) of the tax code provides for a specific list of items that constitute collectibles for certain purposes. Acquisition of a collectible by an individual retirement account (IRA) or individually-directed account of a qualified plan is treated as a distribution from the account equal to the cost to the account of the collectible. Generally, collectibles also do not have as advantageous capital-gains tax treatment as other capital assets.

**Additional guidance coming.** Until additional guidance is issued, the IRS intends to determine when an NFT is treated as a collectible by using a “look-through analysis.” Under the look-through analysis, an NFT is treated as a collectible if the NFT’s associated right or asset falls under the definition of collectible in the tax code. For example, a gem is a collectible under §408(m); therefore, an NFT that certifies ownership of a gem is a collectible.

**Why do I care?** The long-term capital gains rate on gains from the sale of collectibles may be as high as 28%.

**Example of an NFT Transaction That Includes Two Taxable Events**

Sharon uses Bitcoin to buy an NFT. She must report a capital gain or loss depending on how the price of the Bitcoin changed since it was acquired. When Sharon sells (or exchanges) the NFT, she will incur a capital gain or loss depending on how the price of her NFT changed since she acquired it.

**Other Capital Gain/Loss Reporting Issues**

**Form 1099-B Includes Basis Reporting**

**Basis reporting for debt instruments and options.** Basis reporting began for debt instruments and options acquired on or after Jan. 1, 2014 (§6045(g)(3)(c)).

**How Is Basis Calculated for Form 1099-B? (§6045(g)(2)(B))**

**Identification of securities.** If a taxpayer has acquired securities on different dates or at different prices and sells less than the entire position in the security, the broker reports the sale according to the taxpayer’s adequate and timely identification of the security to be sold. If no identification is provided, the sale is reported in this order:

- any shares for which the acquisition date is unknown; then
- the shares that were acquired first, whether they are covered or non-covered securities.

**Other Basis Reporting Issues**

**Transfer statement must be provided when securities received via inheritance or gift.** Estate executors must provide to estate beneficiaries a transfer statement that includes the decedent’s date of death and the description, basis, and the executor’s valuation for the security(ies) transferred. Those making a gift of a security must provide a transfer statement to the gift recipient disclosing the donor’s purchase date and basis in the security(ies) transferred.
Tax practitioner planning. If the tax practitioner knows that the stock sold was inherited, the date of death should appear in the date acquired box at 1b on Form 1099-B. If it doesn’t, the basis reported by the broker will need to be corrected to FMV (or alternate valuation date, if applicable) at the date of the decedent’s death. Also, remember that if the stock is inherited, its holding period is automatically long-term (§1223(9)).

Opportunity Zone Investment Reporting (Form 8997)

An investor in a Qualified Opportunity Zone Fund (QOF) uses Form 8997 to inform the IRS of the QOF investments and deferred gains held at the beginning and end of the current tax year, as well as any capital gains deferred by investing in a QOF and QOF investments disposed of during the current tax year. See Opportunity Zones Frequently Asked Questions for more information and guidance.

VIRTUAL CURRENCY

Unreported virtual currency transactions led the IRS to add a question to the tax return starting in 2019. The virtual currency question first appeared on Schedule 1, which is a form required from only some taxpayers. In 2020, the question was moved to the front of Form 1040. Moving the question to the front of the Form 1040 means all filers must answer “yes” or “no”.

IRS Has Been Refining the Question Each Year

At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?
Yes___ No___

Tax practitioner planning. According to the instructions, you can safely check “No” if your client only purchased cryptocurrency in USD or sent coins between their wallets during 2023.

Notably, the 2023 iteration uses the term “virtual currency” rather than “digital asset.” Additionally, the bifurcated question indicates a noteworthy progression because it shows that the IRS is expanding its focus beyond mere ownership to taxable events involving digital assets.

How Is Virtual Currency Taxed? [Digital Assets, FAQs]

Virtual currency transactions are taxable by law just like transactions in any other property. Taxpayers transacting in virtual currency may have to report those transactions on their tax returns.

Notice 2014-21 provided answers to frequently asked questions relating to the taxation of virtual currencies.

Also see.

IR-2018-71, where the IRS reminded taxpayers to report virtual currency transactions.

Sales. Virtual currency is treated as property for U.S. income tax purposes. The general income tax principles that apply to property transactions also apply to virtual currency. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer incurs a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally
realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer.

**Example.** Steve bought 10 Bitcoins for $10,000 in 2010. He sold them in April 2023 for $250,000. He must report the sale on his Schedule D as the sale of property. Steve has a long-term capital gain of $240,000. Lucky Steve.

**Tax practitioner planning.** A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. Thus, a Form 1099-K is required if the taxpayer has transactions totaling more than $600 beginning in 2023. There is bi-partisan support to increase the $600 to perhaps $5,000 or $10,000. Watch for an update.

**Miners.** When a taxpayer successfully “mines” virtual currency, the fair market value of the virtual currency as of the date of receipt is includable in gross income. The fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.


**Airdrops.** A taxpayer does not have gross income under §61 as a result of a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency ([IRS FAQ #22](https://www.irs.gov/individuals/ask-the-expert/airdrop-hardfork-irs-faqs-rev-rul-2019-24)).

**Hard fork.** A hard fork is unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. When a taxpayer receives cryptocurrency from an airdrop following a hard fork, the taxpayer has ordinary income equal to the fair market value of the new cryptocurrency when it is received, which is when the transaction is recorded on the distributed ledger, provided the client has dominion and control over the cryptocurrency so that they can transfer, sell, exchange, or otherwise dispose of the cryptocurrency ([IRS FAQ # 24](https://www.irs.gov/individuals/ask-the-expert/airdrop-hardfork-irs-faqs-rev-rul-2019-24)).

**Example (Situation 2 in Rev. Rul. 2019-24).** Bob holds 50 units of Crypto R, a cryptocurrency. On Date 2, the distributed ledger for Crypto R experiences a hard fork, resulting in the creation of Crypto S. On that date, 25 units of Crypto S are airdropped to Bob’s distributed ledger address, and Bob has the ability to dispose of Crypto S immediately following the airdrop. Bob now holds 50 units of Crypto R and 25 units of Crypto S. The airdrop of Crypto S is recorded on the distributed ledger on Date 2 at Time 1, and, at that date and time, the fair market value of Bob’s 25 units of Crypto S is $50. Bob receives the Crypto S solely because Bob owns Crypto R at the time of the hard fork. After the airdrop, transactions involving Crypto S are recorded on the new distributed ledger and transactions involving Crypto R continue to be recorded on the legacy distributed ledger.

Bob received a new asset, Crypto S, in the airdrop following the hard fork; therefore, Bob has an accession to wealth and has ordinary income in the taxable year in which the Crypto S is received. See §61 and §451. Bob has dominion and control of Crypto S at the time of the airdrop, when it is recorded on the distributed ledger, because Bob immediately has the ability to dispose of Crypto S. The amount included in gross income is $50, the fair market value of Bob’s 25 units of Crypto S when the airdrop is recorded on the distributed ledger. Bob’s basis in Crypto S is $50, the amount of income recognized.
Staking Rewards are Taxable when Received *(Rev. Rul. 2023-14)*

Revenue Ruling 2023-14 provides that if a taxpayer stakes cryptocurrency native to a proof-of-stake blockchain and receives additional units of cryptocurrency as rewards when validation occurs, the fair market value of the rewards received is included in the taxpayer’s gross income in the taxable year in which the taxpayer gains dominion and control over the rewards. The fair market value is determined as of the date and time the taxpayer gains dominion and control over the rewards.

The revenue ruling clarifies that this is also the case if a taxpayer stakes cryptocurrency through a cryptocurrency exchange and the taxpayer receives additional units of cryptocurrency as rewards as a result of the validation.

No Loss Deductible for Substantial Decline in Value of Cryptocurrency *(CCA 202302011)*

The taxpayer claimed a worthless stock deduction under §165, which provides a deduction for losses that are evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. The taxpayer had not abandoned or otherwise disposed of the cryptocurrency, and the cryptocurrency was not worthless because it still had value. Therefore, the taxpayer did not sustain a loss under §165.

Cryptocurrency §165 loss is miscellaneous itemized deduction. The CCA further states that even if the taxpayer sustained a loss under §165, the loss would be disallowed because §67(g) suspends miscellaneous itemized deductions for taxable years 2018 through 2025. Section 165(g) provides that if any “security” which is a capital asset becomes worthless during the taxable year, the loss is treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security as a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form. Since the cryptocurrency is none of the items listed in §165(g)(2), and therefore §165(g) did not apply.

When is cryptocurrency loss a capital loss? Sales, exchanges, and other dispositions of digital assets may result in recognition of gain or loss. The character of a gain or loss resulting from a disposition of a cryptocurrency generally depends on whether the property is a capital asset in the hands of the taxpayer. A taxpayer not in the trade or business of dealing in cryptocurrency will generally realize capital gain or loss on the sale or exchange of a cryptocurrency. The taxpayer in the CCA should have sold (to an unrelated party) the cryptocurrency if he wanted to recognize a loss.

Kraken Must Comply with Summons for Customer Crypto Transactions *(US v Payward Ventures, Inc., 23-mc-80029-JCS (ND Cal. (Jun. 30, 2023)))*

On March 30, 2021, Payward Ventures, Inc., doing business as Kraken.com, was issued a summons for relevant information on cryptocurrency transactions by Kraken’s customers for the years 2016 through 2020. After Kraken failed to comply with the summons, the Government filed a petition to enforce the summons. The Court agreed that parts of the summons were overly broad. The Court ordered Kraken to produce the following documents for Kraken users with any combination of accounts having at least the equivalent of $20,000 in value of transactions (regardless of type) in cryptocurrency in any one year, for the period Jan. 1, 2016, through Dec. 31, 2020:

1. Name (including full name, any pseudonym, or any user ID);
2. Date of Birth;
3. Taxpayer Identification Number; 
4. Physical Address; 
5. Telephone Number; 
6. Email Address; and 
7. All transactional ledgers for the periods at issue.

**Tax practitioner planning.** The order to comply means that the IRS will be looking at unreported Kraken transactions in the next year or two.

**“John Doe” Summons Issued to SFOX and Circle Virtual Currency Exchanges**

On Aug. 15, 2022, a federal court in the Central District of California authorized the IRS to serve a John Doe summons to OX Labs Inc. (DBA SFOX). SFOX is a cryptocurrency prime dealer for professional traders and institutional investors and has over 175,000 registered users.

On Apr. 1, 2021, a federal court in the District of Massachusetts approved an IRS summons to the payments company known as Circle and its affiliates to turn over customer records to the agency.

**Note.** Coinbase received a “John Doe” summons in 2016. Circle received a “John Doe” summons in 2021. OX Labs Inc. (DBA SFOX) received a “John Doe” summons in 2022.

**Tax practitioner note.** The use of “John Doe” summons to request records has resulted in increased compliance activity.

**IRS Summons Nets More than $4 Million of Unreported Cryptocurrency Gains** (*James H. Kim v. Comm., TCM 2023-91*)

In response to a summons, the IRS received information reports from Coinbase, Inc. a virtual currency exchange, reporting the proceeds of James Kim’s transactions in Bitcoin and Litecoin (during 2013 through 2016), and Ethereum (during 2017). For 2013 to 2016, Mr. Kim reported no cryptocurrency gains or losses. For 2017, he received an information return from Coinbase that reported $18,557,230 of proceeds from virtual currency transactions. On the 2017 Schedule D, Mr. Kim reported gross proceeds in that amount but offset against those proceeds a claimed basis of $18,515,161, reporting a short-term capital gain of $42,069.

From Coinbase records, the IRS determined that Mr. Kim failed to report 2013 short term capital gains of $75,400 and failed to report 2017 short term capital gains of $4,066,629 and 2017 long term capital gains of $74,565.

**“Clean hands” doctrine doesn’t apply.** Mr. Kim did not dispute the amount or character of the net capital gains determined in the notice of deficiency for 2013 and 2017. But he contended that the virtual currency assets that gave rise to these gains “were completely wiped out” in 2020, during the early days of the COVID epidemic. He asserts that the actions (or inaction) of the U.S. government in response to the COVID epidemic “directly caused [that] harm” and that, “under the Clean Hands doctrine of U.S. law,” the IRS should be estopped from collecting tax on his 2013 and 2017 gains.

The Court found that when relevant, the “unclean hands” defense applies only to conduct immediately related to the cause in controversy. The government’s actions in response to the COVID epidemic have no relationship whatever to the determination of Mr. Kim’s 2013 and 2017 tax liabilities. A fundamental tenet of the Federal income tax is the “annual accounting principle.” This principle dictates that a taxpayer’s
income for a particular year be calculated on the basis of the events occurring during that year. Any capital losses Mr. Kim realized in 2020 are thus irrelevant in determining his tax liabilities for 2013 and 2017.

Other Virtual Currency News

- **Chief Counsel Advice (CCA) 202035011** – Describes the tax consequences of receiving convertible virtual currency as payment for performing microtasks through a crowdsourcing platform.
- **Chief Counsel Advice (CCA) 202114020** – Addresses the receipt of Bitcoin Cash as a result of the hard fork.
- **Chief Counsel Advice (CCA) 202124008** – Describes the applicability of Internal Revenue Code Section 1031 to exchanges of Bitcoin for Ether, Bitcoin for Litecoin, and Ether for Litecoin.
- **Chief Counsel Advice (CCA) 202302011** – Addresses the applicability of IRC (§)165 to cryptocurrency that has declined in value.
- **Chief Counsel Advice (CCA) 202302012** – Addresses the qualified appraisal requirement for charitable contributions of cryptocurrency.
- **Chief Counsel Advice (CCA) 202316008** – Describes the tax consequences to an individual who holds a cryptocurrency that undergoes a protocol upgrade.

Cryptocurrency Provisions in the Infrastructure Act

The Infrastructure Investment and Jobs Act had three significant cryptocurrency-related tax provisions.

1. First, it classified cryptocurrency exchanges as “brokers” who will be required to comply with 1099-B cost basis reporting. Going forward, cryptocurrency exchanges will be held to the same standards as traditional stockbrokers like TD Ameritrade and JP Morgan.

2. Second, the bill classified cryptocurrency as a “covered security.” As a result, cryptocurrency exchanges will be required to keep records of cost basis and transfer that information between exchanges when users transfer digital assets.

3. The provision requires businesses accepting cryptocurrency in excess of $10,000 in a transaction to file a Form 8300.

   **Note.** Beginning with calendar year 2024, businesses must e-file all Forms 8300 if they’re required to electronically file at least 10 information returns including Form 8300.

**IRS Issues Proposed Regs that Delay Effective Date for Broker Digital Asset Reporting [Reg-122793-19, RIN 1545-BP71]**

For sales or exchanges of digital assets that take place on or after Jan. 1, 2025, the proposed regulations would require brokers, including digital asset trading platforms, digital asset payment processors and certain digital asset hosted wallet providers, to report gross proceeds on a newly developed Form 1099-DA and to provide payee statements to customers.

Brokers, in certain circumstances, would also be required to include gain or loss and basis information for sales that take place on or after Jan. 1, 2026, on these information returns and statements, so that customers have the information they need to prepare their tax returns.
The proposed regulations would also require real estate reporting persons, such as title companies, closing attorneys, mortgage lenders and real estate brokers, who are treated as brokers for dispositions of digital assets, to report the disposition of digital assets paid as consideration by real estate purchasers to acquire real estate in real estate transactions that close on or after Jan. 1, 2025. These real estate reporting persons would also be required to include on Form 1099-S the fair market value of digital assets paid to sellers of real estate in real estate transactions that close on or after Jan. 1, 2025.

Finally, the proposed regulations set forth gain (or loss) computation rules, basis determination rules and backup withholding rules applicable to digital asset sale and exchange transactions and provide many useful definitions.

**Warning.** FinCen is considering FBAR reporting for virtual currency held in foreign exchanges. FATCA reporting would follow quickly.

**Virtual Currency Password Alert**

For clients holding substantial amounts of virtual currency, planning for death or incapacity is critical. Each virtual currency has a unique electronic address that is used for transferring the virtual currency between the user’s wallets. A private key is required to transfer virtual currency. If an individual dies or becomes incapacitated without another person knowing his or her private key, the virtual currency becomes inaccessible and is essentially worthless.

**Tax practitioner planning.** Ask all clients if they have any virtual currency transactions.

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**STOCK OPTIONS**

§83(b) Election

Section 83(a) provides, generally, that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property over the amount (if any) paid for the property is included in the service provider’s gross income for the taxable year. If, however, upon receiving the property, the taxpayer’s rights in the property are not transferable or are subject to a substantial risk of forfeiture, §83(a) provides that the taxable event does not occur until the first time that the transferee’s rights in the property are:

- transferable, or
- not subject to a substantial risk of forfeiture, whichever occurs earlier.

Section 83(b) and §1.83-2(a) permit the taxpayer to elect to include in gross income, as compensation for services, the excess (if any) of the fair market value of the property at the time of transfer over the amount (if any) paid for the property.

Under §83(b)(2), an election made under §83(b) must be made in accordance with the regulations thereunder and must be filed with the IRS no later than 30 days after the date on which the property is transferred to the taxpayer.
IRS Issues Audit Technique Guide on Equity (Stock)-Based Compensation

For more information on equity-based compensation, see the IRS Audit Technique Guide (ATG). Along with defining the term equity-based compensation, the ATG explores both statutory and non-statutory options, the taxation of restricted stock units (RSUs), and provides tips for where to gather appropriate documentation, including researching Securities and Exchange Commission (SEC) filings. The ATG was written before the enactment of §83(i).

Section 83(i) Election

The TCJA allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion (“inclusion deferral election”) with respect to qualified stock must be made no later than 30 days after the first time the employee’s right to the stock is substantially vested or is transferable, whichever occurs earlier.

Tax practitioner planning. An inclusion deferral election is made in a manner similar to the manner in which a §83(b) election is made.

When income becomes taxable. If an employee elects to defer income inclusion under the provision, the income must be included in the employee’s income for the taxable year that includes the earliest of:

- the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;
- the date the employee first becomes an excluded employee (as described below);
- the first date on which any stock of the employer becomes readily tradable on an established securities market;
- the date five years after the first date the employee’s right to the stock becomes substantially vested; or
- the date on which the employee revokes her inclusion deferral election.

Tax planning provision. The election must be made within 30 days of the exercise of the option or the settlement of the RSU.

ESOP and ISO. A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option. In that case, the option is not treated as a statutory option, and the rules relating to statutory options and related stock do not apply.

Qualified employee. Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual:

1. who was a 1% owner of the corporation at any time during the 10 preceding calendar years,
2. who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity,
3. who is a family member of an individual described in (1) or (2), or
4. who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years.

**Qualified stock.** Qualified stock is any stock of a corporation if:

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation.

However, qualified stock does not include any stock if, at the time the employee’s right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or restricted stock units (“RSUs”) and does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

**Eligible corporate stock.** A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80% of all employees who provide services to the corporation in the U.S. (or any U.S. possession) are granted stock options, or RSUs, with the same rights and privileges to receive qualified stock (“80% requirement”). For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present law employee stock purchase plan (ESPP) rules.

However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights, and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU. For purposes of the provision, corporations that are members of the same controlled group are treated as one corporation.

Notice 2018-97 clarifies that the determination of whether an employer satisfies the 80% requirement must be made on a calendar-year basis, without regard to awards granted in prior calendar years.

**Notice to employee.** Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee’s right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election).

- The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee that (a) the employee may (if eligible) elect to defer income inclusion with respect to the stock; and (b) about the income inclusion rules that apply when making an income inclusion deferral election. The notice must state that, when an employee elects to defer income, the amount of income included at the end of the deferral period will be based on the value of the stock at the time the employee’s right to the stock first becomes substantially vested, even if the value of the stock declined during the deferral period (including cases when the value of the stock declined below the employee’s tax liability with respect to such stock), and
- Subject to withholding as provided under the provision.
Finally, the notice to the employee also must include the employee’s responsibilities with respect to the withholding.

Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

**FICA and FUTA.** An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

**Year of inclusion.** For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers. The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

**Effective date.** The provision generally applies with respect to stock attributable to options exercised or RSUs settled after Dec. 31, 2017.

### SOCIAL SECURITY (FICA) PAYMENTS

<table>
<thead>
<tr>
<th>FICA and SE Tax Update Chart</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum FICA (OASDI) Wage Base</td>
<td>$147,000</td>
<td>$160,200</td>
</tr>
<tr>
<td>FICA/Medicare Tax Rate 6.2% + 1.45%</td>
<td>7.65%</td>
<td>7.65%</td>
</tr>
<tr>
<td>SE Tax Rate</td>
<td>15.3%</td>
<td>15.3%</td>
</tr>
<tr>
<td>Maximum Medicare Wage Base</td>
<td>Unlimited</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Medicare Rate</td>
<td>1.45%</td>
<td>1.45%</td>
</tr>
<tr>
<td>Earned Income Ceilings for Social Security Benefits &lt; Full Retirement Age</td>
<td>$21,240</td>
<td>$21,240</td>
</tr>
<tr>
<td>Medicare B and D Premiums</td>
<td>170.10/mo.</td>
<td>164.90/mo.</td>
</tr>
<tr>
<td></td>
<td>$2,041.20 to $7,874.40</td>
<td>$1,780.00 to $7642.80</td>
</tr>
</tbody>
</table>
Medicare B & D Premium Surcharge in 2023

Surcharge on Medicare B and D premiums. In Medicare parlance, the surcharge is known as the Income-Related Monthly Adjustment Amount (IRMAA). Medicare Part B and Part D premiums are determined based on an insured’s AGI. The premium amount for a current year is determined based on the person’s income from two years prior. For 2023 Medicare recipients, modified adjusted gross income for 2021 is calculated using:

- the Medicare recipient’s 2021 adjusted gross income, plus
- any tax-exempt interest, EE bond interest used for educational purposes, and any excluded foreign earned income.

<table>
<thead>
<tr>
<th>2023 Medicare Part B and D Premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>If 2021 AGI is</td>
</tr>
<tr>
<td>Individual</td>
</tr>
<tr>
<td>Under $97,000</td>
</tr>
<tr>
<td>$97,000-$123,000</td>
</tr>
<tr>
<td>$123,000-$153,000</td>
</tr>
<tr>
<td>$153,000-$183,000</td>
</tr>
<tr>
<td>$183,000-$500,000</td>
</tr>
<tr>
<td>$500,000+</td>
</tr>
</tbody>
</table>

Example. Emma and Ed normally have an AGI below $170,000, but in 2021, they sold their rental property at a substantial gain. Because of the extraordinary income, their 2021 AGI is in excess of $750,000. Thus, their combined Medicare B and D premiums for 2023 will be $14,340 instead of $3,958. Their 2021 gain is subject to a “hidden tax” of $10,382 two years after the sale.

Disputing the surcharge. Medicare recipients are allowed the opportunity to dispute the surcharge determination and use income from a later year if their circumstances change due to a major event such as the death of a spouse, divorce, retirement, or a significant cutback in hours worked.

Social Security Trustee Report Projects That Social Security Trust Funds Will Be Exhausted After 2033 [Trustee Reports Mar. 31, 2023]

Over the past 35 years, the SSA trust fund has accumulated $2.9 trillion in reserves. The Social Security trust fund will be exhausted by 2033. When the funds are depleted, Social Security will be able to pay only 76% of promised benefits from ongoing FICA taxes beginning in 2033.

Tax practitioner planning. Social Security benefits are taxable when income exceeds $25,000 for individuals and $34,000 for married couples. The thresholds have never been indexed for inflation. When taxes on Social Security benefits were first imposed in 1983, the tax affected only about 10% of senior households. Today it affects nearly 50% of senior households (65 million recipients).
Medicare. The Medicare trust fund is projected to be depleted in 2031. At that time, dedicated revenues will be sufficient to pay 89% of costs. The Trustees project that the share of cost that can be financed with dedicated revenues will decline slowly to 77% in 2046.

2023 Full Retirement Age for Social Security Benefits is 67

The full retirement age for Social Security benefits hit its final phase-in and is now age 67 beginning in 2022. Unless there is subsequent legislation, full retirement is at age 67 (for the near future.)

Tax practitioner planning. Workers with an older full retirement age will have fewer months between age 67 and age 70 to earn delayed retirement credits toward their retirement benefit. Workers who take their Social Security at age 62 will see a bigger reduction from their full retirement benefit (i.e., 25% reduction if full retirement age is 66 and a 30% reduction if full retirement age is 67). Forty-two percent of men and 48% of women take their Social Security benefits at 62, the earliest they are eligible. Only 2% of men and 4% of women wait until 70 to collect the maximum benefits available.

CANCELLATION OF DEBT

Cancellation of Debt is Taxable Income Unless an Exception Applies

For those who have cancellation of debt income, exclusions apply if the debt is cancelled in bankruptcy or during insolvency, is a qualified farm debt, or is a qualified real property business debt (§108 and Form 982).

COD Income Was Not Taxable Because Of Insolvency (Katrina White v. Comm., TCM 2023-77)

Katrina White owned and operated a body sugaring place. The business struggled and she fell behind on loan payments. Her bank loan was forgiven and the bank issued a Form 1099-C on the forgiven amount of $14,433. Ms. White did not report the cancellation of debt income on her timely filed 2016 return. The IRS examined Ms. White’s return and determined the COD income to be taxable.

At Tax Court, Ms. White argued that the discharge of the debt should be excluded from income because she was insolvent at the time of discharge (§108(a)(1)(B)). She provided a worksheet and documentation to prove her insolvency. The Court agreed the taxpayer that the discharge was excludable.

Tax practitioner planning. If the client is insolvent, complete a worksheet showing the fair market value of assets and the total liabilities at the time of discharge. Gather all of the documents that support the numbers on the worksheet.

Proof of Insolvency Lacking for Exclusion of Cancelation of Debt Income (Ernesto and Marilyn Patacsil v. Comm., TCM 2023-8)

The discharge of indebtedness is income (§61(a)(12)). Section 108(a) provides an exclusion to the extent of the taxpayer’s insolvency (§§108(a)(1)(B) & (3)) and defines an insolvent taxpayer as one who has an “excess of liabilities over the fair market value of assets” (§108(d)(3)). The burden to prove insolvency is on the taxpayer. Because Ernesto and Marilyn Patacsil couldn’t prove the FMV of their assets and the extent of their liabilities, the cancellation of debt due to the foreclosure of their properties was not excludable.
Why do we care? FMV of properties immediately before the cancellation is required. The judge seemed willing to accept a Zillow number on FMV if the taxpayers (or their CPA) had evidence of the date the Zillow valuation was obtained (i.e., the date the loan was cancelled). Since it is likely we’d be doing the tax return months after the cancellation, we should advise the client that an undated Zillow number won’t work and that they need an appraisal or “broker price opinion” to prove insolvency.

Insolvency Must Be Proved to Exclude CODI *(Donald S. Ahaiwe, pro se, v. Comm., TCSO 2023-7)*

Donald Ahaiwe claimed an exclusion from income for canceled debt related to a credit card. Mr. Ahaiwe argued that he was insolvent at the time the debt was canceled and, therefore, met the requirements of §108(a)(1)(B) for the exclusion.

Mr. Ahaiwe has the burden of proving his claim that he was insolvent. In support of his burden, Mr. Ahaiwe relied upon an “insolvency worksheet” he created, but the Court found the “worksheet is little more than numbers on a page.” Mr. Ahaiwe provided neither testimony nor documentation that established how the assets shown on the worksheet were valued, and the balances of the liabilities shown on that document were not confirmed by any independent evidence. Mr. Ahaiwe’s claim that he was insolvent at the time his credit card debt was forgiven was rejected by the Court.

Tax practitioner planning. When claiming the §108 exception for insolvency, collect as much documentation as possible of the value of assets and the balance of liabilities.

Discharge of Student Loan Indebtedness is Not COD Income

The ARPA excluded from gross income in taxable years 2021 through 2025 amounts related to the discharge of certain student loan debt, whether federal or private. The exclusion is applicable to discharges of loans after Dec. 31, 2020, and before Jan. 1, 2026.

SCOTUS Flunks Biden’s Plan to Cancel Some Federal Student Debt *(SCOTUS Blog)*

On June 30, 2023, by a vote of 6-3, the Supreme Court ruled that the Biden administration overstepped its authority last year when it announced that it would cancel up to $400 billion in student loans. The Biden administration had said that as many as 43 million Americans would have benefitted from the loan forgiveness program; almost half of those borrowers would have had all of their student loans forgiven.

The Student Loan Repayment Recess is Over

COVID-19 relief for student loans ended this year. Student loan interest resumed on Sept. 1, 2023, and payments started in October 2023. The Department of Education will communicate with borrowers to resume payments.

Department of Education Promotes Student Loan Forgiveness in New Proposed Regs *(SAVE Plan)*

The Department of Education (DOE) has proposed regulations that would amend the Revised Pay as You Earn (REPAYE) plan, which first became available in 2016. This new version of the REPAYE plan would be the most generous income-driven repayment (IDR) option for the vast majority of student loan borrowers, making it easier for them to access a repayment plan. The proposed changes would substantially reduce monthly debt burdens and lifetime payments, especially for low and middle-income borrowers,
community college students, and borrowers who work in public service because of the combination of their earnings and borrowing amounts.

Cutting undergraduate loan payments in half. Under the new plan, borrowers would only be required to pay 5% of their discretionary income (calculated as income above 225% of the Federal poverty guideline) on loans borrowed for their undergraduate studies. This is half the rate charged on the most generous existing IDR plans, including the current REPAYE plan. Under this proposal, a borrower who has only undergraduate loans would pay 5% of their discretionary income toward those loans. Borrowers who have only graduate school related loans would still pay 10%. In addition, borrowers who have loans for both types of programs would pay between 5% and 10%— based upon a weighted average calculated from the share of their original loan balances borrowed for undergraduate versus graduate study.

Stopping unpaid interest accumulation. The DOE estimates that as many as 70% of borrowers on existing IDR plans have seen their balances grow after entering those plans. In many cases, even borrowers making all required payments see their balances grow because the payment they can afford is lower than the accrued interest. Under the Department’s proposed regulations, borrowers won’t see their balances balloon while they’re making regular payments, including those who have a $0 payment. Under the proposed plan, a borrower would continue to have their monthly payment first applied to interest, but if it is not sufficient to cover that amount, any remaining interest would not be charged. This would extend existing interest benefits under the current REPAYE plan, in which borrowers have at least half of their unpaid interest waived each month.

Lowering the number of monthly payments required to receive forgiveness for borrowers with smaller loan balances. The DOE is concerned that borrowers with small balances are discouraged from using existing IDR plans – even if they would benefit from lower monthly payments – because of the length of time required to receive loan forgiveness. Existing IDR plans provide forgiveness to borrowers with remaining balances after 20 or 25 years of payments, regardless of the amount borrowed. For example, a borrower who attended a community college, even for only a semester, and never experiences high earnings will not receive forgiveness for 20 years, only 5 years sooner than a borrower with debt from a professional degree.

Under these regulations, the Department proposes a shortened timeframe for receiving loan forgiveness for borrowers based upon their original principal balance. Those who borrowed $12,000 or less would receive loan forgiveness after making the equivalent of 10 years of payments. Every additional $1,000 borrowed above that amount would add 1 year of monthly payments to the required time a borrower must pay before receiving forgiveness.

Tax practitioner planning. Information on applying for the SAVE plan is here.

Other paths to tax-free student loan forgiveness. Borrowers working at nonprofit organizations or in the public sector are exempt from tax if they are forgiven under the Public Service Loan Forgiveness (PSLF) program. Borrowers who cannot maintain gainful employment due to a medical condition are exempt from tax if loans are forgiven under the Total and Permanent Disability (TPD) Discharge program. Borrowers who were a current or recently withdrawn student when the school closed (i.e., Corinthian College, Heald College, Wyotech, etc.) may apply for loan forgiveness on the Closed School Application for a tax exempt cancellation of debt.
Compensation for Injury or Sickness and Punitive Damages Taxable (§104)

Generally, compensation for personal injuries and sickness is excluded from gross income, specifically:

1. Amounts received under workers’ compensation (§104(a)(1));

2. The amount of damages received (other than punitive damages) on account of personal physical injuries or physical sickness (§104(a)(2)). The exception generally excludes only physical injuries but not emotional distress (because of age, race, gender, or disability), libel, slander, and other nonphysical wrongs;

3. Amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (§104(a)(3));

4. Amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces, Foreign Service, or Public Health Service (§104(a)(4)); and

5. Amounts received as disability income attributable to injuries incurred as a direct result of a terrorist or military action (as defined by §692(c)(2) and §104(a)(5)).


Other Settlements and Awards Are Taxable

Court awards and damages. To determine if settlement amounts received by compromise or judgment are included in income, the item that the settlement replaces must be considered. Include the following as ordinary income:

1. Interest on any award.

2. Compensation for lost wages or lost profits.

3. Punitive damages if they relate to a physical injury or physical sickness.

4. Damages for:
   a. Patent or copyright infringement,
   b. Breach of contract, or
   c. Interference with business operations.

5. Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.

6. Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.

7. Attorney fees and costs relating to whistleblower awards where the underlying recovery is included in gross income.
Legal Fees for Securing a Taxable Award

Legal fees paid to secure a taxable judgment are a miscellaneous itemized deduction subject to the 2% AGI limit. The TCJA suspended these miscellaneous itemized deductions for 2018 through 2025, thus the victim pays tax on the gross award even if he or she receives only a part after legal fees and costs.

**Tax practitioner planning.** Can the victim avoid tax by having the attorney fees paid directly to the attorney? The Supreme Court held that attorney fees, including those paid directly to the litigant’s attorney on a contingent fee basis, are fully includible in the gross income of the litigant *(Comm. v. Banks, 543 US 426 (2005))*.

**Exception.** §62(a)(20) establishes an above-the-line deduction for attorney fees and court costs paid in connection with discrimination and certain other suits. §62(a)(21) establishes an above-the-line deduction for attorney fees and court costs associated with suits involving whistleblower claims. The suit must involve:

- Unlawful discrimination,
- A private cause of action under Medicare Secondary Payer statute or certain claims against the federal government,
- A whistleblower award for providing information regarding violations of tax laws.

Preparing For an Audit on Taxability Issue

Advise your client to do these three things to prepare for an audit of the taxability of a settlement payment. In the settlement agreement: (1) Specify the amount that is due to personal physical injury; (2) specify that the amount is excludable from taxable income under §104; and (3) specify that the payor will not issue a Form 1099 on the amount paid for physical personal injury.

Disability Payments Taxable if Premiums Paid by Employer *(Cynthia Hailstone and John Linford v. Comm., TCS 2023-17)*

John Linford was provided disability insurance by his employer. Under the terms of the policy, employees were not required to contribute to the policy premiums. Rather, the company was required to pay 100% of the premiums. During 2017, Mr. Linford was approved and he received $105,000 of disability payments and a 2017 Form W-2 reporting the payments. He did not report the payments.

Under §105(a) if the amounts of the disability payments were paid under a policy for which the contributions (premiums) were paid by the company, the exclusion under §105(c) does not apply. Rather, under §61 the disability payments Mr. Linford received in 2017 are includible in his gross income. Accuracy-related penalties applied because Mr. Linford did not have reasonable cause and did not act in good faith in not reporting the disability payments.

Firefighter’s Harassment Settlement Not Excludable Personal Injury Award *(Suzanne Montes v. Comm., USTC, Docket No. 17332-21 (Jun. 29, 2023))*

Suzanne Montes is a San Francisco firefighter. She was assigned to an all-male firehouse. Within days of her assignment, she was subjected to disparaging comments, sabotaged equipment, and “extremely unsanitary things (were done) to her personal property.” She complained to her chiefs of the harassment, “which only served to increase the harassment she was suffering from.” Ms. Montes filed a lawsuit and subsequently received a settlement of $382,000. Her CPA told her the settlement was not taxable and she didn’t report the payment.
Physical injury requirement not met. Settlement proceeds are excludable under §104(a)(2) only if the settlement is paid “on account of personal physical injuries or physical sickness.” The agreement between Ms. Montes and the City does not specify amounts paid for physical injury. It does talk about emotional injury and emotional distress. Ms. Montes’ complaint seeks compensation for “emotional and mental distress, damage to her reputation, and humiliation.” The Court found that since the payment was not for physical injury, it must be included in her taxable income.

Also see.

*William Henry McGhee v. Comm., TCM 2023-97*, where a $571,681 settlement payment for age discrimination was not excludable under §104.

**Malpractice Settlement Regarding a Personal Injury Lawsuit was Taxable** *(Debra Jean Blum v. Comm., CA-9, 21-71113 (Mar. 22, 2022))*

Debra Jean Blum received a payment of $125,000 in 2015 in settlement of a lawsuit she had filed against lawyers who had previously represented her in an unsuccessful personal injury lawsuit against a hospital. She did not report this amount on her 2015 federal income tax return. The only question was whether Ms. Blum was entitled to exclude from her gross income the $125,000 settlement payment as damages received “on account of personal physical injuries or physical sickness” under §104(a)(2).

Legal malpractice not on “account of physical injury.” An agreement between the parties stated that Ms. Blum’s physical injuries were alleged to have resulted from a hospital incident. She lost the resulting lawsuit. The agreement with the law firm, thus, clarified that the payment was in lieu of damages for legal malpractice, which lies outside §104(a)(2). Ms. Blum was not entitled to exclude the settlement payment from her gross income as it was not received “on account of personal injury or physical sickness,” but from a legal malpractice settlement. The Appeals Court affirmed the decision of the Tax Court.

**OTHER INCOME**

Failure to Pay Premiums on Life Insurance Securing Loans Resulted In Taxable Income *(Robert Doggart V. Comm., TCS 2023-25)*

Before 2017, Robert Doggart took out a series of loans against two life insurance policies that he held with Prudential Insurance Co. The cash value of his policies served as collateral for the loans. While incarcerated, Mr. Doggart stopped paying premiums on the two policies. As a result, each policy lapsed and Prudential used the cash values of the policies to repay the loans plus interest due. Prudential subsequently issued Mr. Doggart Form 1099–R for 2017 with respect to each policy and reported taxable distributions from life insurance to the IRS of $13,214 and $5,366, calculated as the outstanding loan amount repaid by the cash value of the policy less the total premiums Mr. Doggart paid with respect to the policy. Mr. Doggart failed to file a 2017 tax return.

Constructive distribution occurred from termination of life insurance policy. A taxpayer can receive a constructive distribution from the termination of his life insurance policy, which must be included in gross income, even if the taxpayer does not physically receive cash or other property from the policy during the tax year (see *Black v. Comm.*, TCM 2014-27; *Brown v. Comm.*, TCM 2011-83.) A constructive distribution is included in gross income insofar as it exceeds the taxpayer’s investment in the life insurance contract (see *Sanders v. Comm.*, TCM 2010-279.)

*Tax practitioner planning.* Fools ignore a *Form 1099.*
Malpractice Award Arising from a Divorce Settlement Was Taxable - Attorney Fees Weren’t Deductible (Carole Holliday v. Comm., TCM 2021-69)

Carole Holliday filed a malpractice lawsuit against her divorce attorney. She claimed that her divorce attorney’s representation constituted negligence and gross negligence and that he breached the duty of fair dealing and his fiduciary duties “by influencing * * * [her] to mediate and enter into a transaction that was not fair to * * * [her] under the circumstances” and by not pursuing an appeal. The malpractice defendants agreed to pay Ms. Holliday $175,000. Ms. Holliday’s malpractice attorney received the settlement check, deducted his fee of $73,500, and transferred the remaining $101,500 to Ms. Holliday.

Taxpayer reported zero income from settlement. On her tax return, Ms. Holliday reported other income of zero. She acknowledged the receipt of $101,500 through an attached Form 1099-MISC Summary and a Line 21 Statement on which she reported “Other Income from Box 3 of 1099-Misc” of $101,500. But the Line 21 Statement then subtracted $101,500 with the description “Misclassification of Lawsuit recovery of marital assets,” resulting in total other income of zero.

Court found the settlement proceeds taxable. Ms. Holliday claimed that the settlement proceeds were a nontaxable return of capital because they compensated her for the portion of her marital estate that she “was rightfully and legally entitled to but did not receive because of the malpractice of her attorney.” The court found that the settlement proceeds were taxable income because they compensated her for the alleged failings of her divorce attorney.

How much is taxable? The settlement consisted of $175,000, of which Ms. Holliday’s malpractice attorney retained $73,500 as a fee for representing her in the lawsuit. The full amount of the settlement proceeds, including the fee the taxpayer paid her malpractice attorney, is includible in gross income. The legal fees are not deductible because they are miscellaneous itemized deductions disallowed by the TCJA.

ADJUSTMENTS TO GROSS INCOME

Health Savings Accounts

How much may be contributed to an HSA? Two types of contributions may be made to HSAs: regular and catch-up. Both have annual limits.

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<thead>
<tr>
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<tbody>
<tr>
<td></td>
<td>Family</td>
<td>Self only</td>
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<td>Max out-of-pocket</td>
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<td>Contribution limit</td>
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<td>$4,150</td>
</tr>
<tr>
<td>Additional catch-up contribution for taxpayer age 55 or older</td>
<td>$1,000 per qualifying spouse</td>
<td>$1,000 per qualifying spouse</td>
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Tax practitioner note. Assets in health savings accounts increased 45% to over $98 billion, according to investment-service provider Devenir’s 2021 Year-End HSA Research Report. Thirty-two million account holders have accumulated $98 billion in HSA accounts, with an average total balance of $19,224.

Note. Health Savings Accounts totaled $12.4 billion ten years ago. A more than eight-fold increase in account balances demonstrates the growing popularity of HSAs.
Catch-up contributions may be made by individuals who are at least 55 years of age but not yet enrolled in Medicare. Qualified individuals with HSA-compatible health plans who are 55 or older may contribute an additional $1,000 to their HSA. These “catch-up” contributions may be made only to a person’s own individual HSA account, not to a family HSA in his or her spouse’s name (Pub. 969). For example, a wife may not contribute a catch-up contribution to a family HSA in the husband’s name. She would have to open her own separate HSA.

**HSA Contribution Limits Vary Based on Circumstances**

Married couples are limited to one maximum HSA family contribution amount regardless of whether each spouse has a self-only or family HSA. For example, if the husband has a self-only HSA and the wife has a family HSA, the maximum 2023 HSA contribution is $7,750 and is split evenly between the spouses unless they agree to split the amount otherwise.

**Penalty on HSA Nonqualified Distributions**

There is an additional tax on distributions from an HSA that are not used for qualified medical expenses of 20% of the disbursed amount. The penalty is waived in cases of disability or death and for individuals age 65 and older. HSAs are not subject to required minimum distributions regardless of the account owner’s age.

**Medicare Premiums Can Be Reimbursed from an HSA (Pub. 969, pg. 9)**

Even though Medicare premiums are withheld from Social Security benefits, individuals who are 65 or older can use HSA money tax-free to pay premiums for Medicare parts B and D and Medicare Advantage plans (but not premiums for Medicare supplement policies), in addition to paying for other out-of-pocket medical expenses.

**CARES. Over-the-Counter Drugs Can Be Reimbursed from HSA or FSA**

CARES allows patients to use funds in HSAs and Flexible Spending Accounts for the purchase of over-the-counter medical products, including those needed in quarantine and social distancing, without a prescription from a physician. The change is effective retroactively to Jan. 1, 2020, and is permanent.

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**QUALIFIED STATE TUITION PROGRAMS §529**

There are more than 16 million §529 accounts as of Dec. 31, 2022 – up 340,000 accounts from the year before. §529 plans may have gained more popularity as a result of TCJA, which allowed distributions for K through 12 private school tuition. The average 529 plan account balance is $25,903, which is less than one year’s tuition, room, and board at most public universities.

**§529 Plans (§529(c); Appropriations Act)**

The SECURE Act Made Two Changes to §529 Plans

1. **Student loans.** SECURE provided that up to $10,000 (reduced by the amount of distributions so treated for all prior taxable years) could be withdrawn from a §529 plan for the purpose of paying principal or interest on any qualified education loan of the beneficiary or his or her siblings. Effective for distributions made after Dec. 31, 2018.
**Tax practitioner note.** The loan interest paid off with the distribution is not deductible.

2. **Apprenticeship programs.** SECURE also provided that a qualified distribution includes tuition, books, supplies, and equipment required for Apprenticeship Programs if the program is properly registered and certified by the Department of Labor. Effective for distributions made after Dec. 31, 2018.

**SECURE 2.0 Allows Rollover to Roth IRA Beginning in 2024 for Some §529 Plans**

1. Beginning in 2024, some §529 funds may be rolled over tax-free to a Roth IRA for the beneficiary in a trustee-to-trustee transfer. This change allows unused college savings to be transferred to the beneficiary’s retirement account without taxes.

2. The life-time rollover limit is $35,000 and the §529 account must have been open for at least 15 years. The annual rollover amount cannot exceed the annual contribution limit for Roth IRAs, but there are no AGI limits. §529 contributions (and earnings on those contributions) in the last five years may not be rolled over.

**Distributions for Elementary and Secondary School Tuition Are Qualified**

TCJA modified §529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious elementary or secondary school. This limitation applies on a per-student basis, rather than a per-account basis. Thus, under the provision, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distributions received by the individual would be treated as a distribution subject to tax under the general rules of §529.

**K-12.** The term “elementary or secondary” means kindergarten through grade 12 as determined under state law, the same as for the Coverdell education savings account (Notice 2018-58).

**Tax practitioner planning.** Most parents need to save for their children’s college. Some parents are able to save so much money that they have plenty to pay for private K-12 tuition costs, as well as college costs. Wealthier parents and grandparents will find this provision particularly attractive.

**Section 529 Can Be a Gift Tax Planning Device** ([529 Plans: Questions and Answers](#))

The estate and gift tax rules applying to educational IRAs also apply to contributions to qualified tuition programs. Contributions to a qualified tuition program will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the present law gift tax exclusion provided by §2503(b) and also are excludable for purposes of the generation-skipping transfer tax, provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift tax exclusion limit of $17,000, or $34,000 in the case of a married couple, in 2023.

**Special rule for 2023 contributions exceeding $17,000/$34,000 limit ($85,000/$170,000 for five-year gift).** If a contribution in excess of $17,000 ($34,000 in the case of a married couple) is made in one year, the contributor may elect to have the contribution treated as if made ratably over five years beginning in the year the contribution is made. This rule allows donors to contribute up to $85,000 every five years ($170,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect
to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor’s gift tax return. If a donor making an over $17,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includible in the donor’s estate.

**Tax practitioner planning.** The 3.8% NII tax can be avoided if the income is used tax-free for college expenses.

**Is the §529 plan part of the donor’s estate?** Contributions to a §529 plan are treated as a completed gift (rather than future or conditional gifts) for Federal tax purposes and are immediately removed from the donor’s estate. If the donor made the five-year election (described above) and died before the five-year period ended, the portion of the contribution allocated to the years after the donor’s death is included in their Federal gross estate.

**State Tax Benefits of §529 Plan Contributions for Your Out-of-state Clients**

For California residents there is no state tax deduction for §529 plan contributions. But, what about clients that are residents of other states? Arizona allows up to a $4,000 deduction by a married couple filing jointly for §529 plan contributions. Montana allows up to a $6,000 deduction for §529 plan contributions on the married filing joint return. Of course, rules vary between states – always check the state’s website for the details and updates. For a summary of state tax provisions related to §529 plan contributions, see Saving For College’s webpage [here](#).

**Changes Are Coming to FAFSA Rules for “Grandparent §529 Plans”**

For the 2024-2025 school year, the Department of Education has made favorable changes to untaxed income rules for student loan applications on the FAFSA (Free Application for Federal Student Aid). Qualified distributions from 529 plans that are owned by a grandparent will no longer affect aid eligibility. Grandparent gifts to help the student with college costs will no longer be counted as untaxed income. In prior years, untaxed income added to financial aid income in the expected family contribution calculation (EFC).

**Tax Practitioner planning.** These changes as well as others (questions on the FAFSA will be reduced from 108 to 36) are included in the FAFSA Simplification Act summarized [here](#) at studentaid.gov.

**What To Recommend for Amounts Leftover in the §529 Plan**

- Rollover leftover funds to another family member (gift taxes may apply if rolled over to a different generation).
- Use up to $10,000 to pay off college loan of the beneficiary or a sibling.
- Rollover leftover funds to the beneficiary’s ABLE account.
- Beginning in 2024, SECURE 2.0 allows rollovers of some §529 plan balances to a Roth IRA. Restrictions apply.

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1. These untaxed income changes also apply to §529 plan distributions and gifts from other (nonparental) individuals.
ABLE PLANS §529A

Achieving a Better Life Experience Act of 2014 (ABLE Act) was enacted on Dec. 19, 2014, as part of the Tax Increase Prevention Act of 2014. States can offer specially designed, tax-favored ABLE accounts to individuals with the onset of a disability before age 26. ABLE accounts are designed to enable individuals with disabilities and their families to save for and pay for disability-related expenses. Any state can offer its residents the option of setting up one of these ABLE accounts, or if it chooses, to contract with another state that offers such accounts. Contributions totaling up to the annual gift tax exclusion amount, $17,000 (2023), can be made to an ABLE account each year, and distributions are tax-free if used to pay qualified disability expenses.

**Tax practitioner planning.** As of Dec. 31, 2022, there were more than 134,000 ABLE accounts opened, representing more than $1.18 million in assets, according to data from ISS Market Intelligence. The National Disability Institute estimates that there are approximately 61 million individuals living with disabilities in the United States.

### Tax Tip Summarizes Basic ABLE Account Rules

People with disabilities can use an ABLE account to help pay qualified disability-related expenses. The ABLE savings account doesn’t affect their eligibility for government assistance programs. Like the 529 plan, contributions to the ABLE aren’t deductible for federal tax purposes, distributions, including earnings, are tax-free to the beneficiary, if they are used to pay qualified disability expenses (QDEs). See Tax TIP 2022-112.

**Annual contribution limit.** The 2023 limit is $17,000. Certain employed ABLE account beneficiaries may make an additional contribution up to the lesser of these amounts:

- The designated beneficiary’s compensation for the tax year.
- The poverty line for a one-person household. For 2023, this amount is $14,580 in the continental US, $18,210 in Alaska, and $16,770 in Hawaii.

**Example.** Carmen is a qualified beneficiary for an ABLE account. She earns $6,000 at her summer job. The maximum contribution to her 2023 ABLE account is $17,000 plus $6,000 or $23,000. And remember, if Carmen is at least 18 years old and not a dependent of another, she may qualify for the non-refundable Saver’s Credit.

**Tax practitioner planning.** Although this change allows for contributions to the ABLE account for a working beneficiary, the potential of Medicaid taking funds in excess of $100,000 or taking funds at the death of the beneficiary may mean that a special needs trust is advisable for those with the means to contribute more for the beneficiaries.

**Rollovers and transfers from §529 plans.** Families may roll over funds from a §529 plan to another family member’s ABLE account. The ABLE account must be for the same beneficiary as the §529 account or for a member of the same family as the §529 account holder. Rollovers from a §529 plan count toward the annual contribution limit.

**Example.** Owen is a qualified beneficiary. Owen’s parents established a §529 account for him several years ago. He is now qualified for an ABLE account. The 2023 $17,000 annual contribution limit would be met by parents contributing $10,000 to their Owen’s ABLE account and rolling over $7,000 from his §529 plan to the same ABLE account.
The IRS Answers a Few Questions about ABLE

Qualified disability expenses (QDEs) are any expenses incurred at a time when the designated beneficiary of an ABLE account is an eligible individual that relate to the blindness or disability of the designated beneficiary and are for the benefit of the designated beneficiary in improving the designated beneficiary's health, independence, or quality of life. Section 1.529A-2(h)(1) provides that QDEs include, but are not limited to, expenses related to the designated beneficiary's education, housing, transportation, employment training and support, assistive technology and related services, personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, and funeral and burial expenses (see Information Letter 2022-0007).

ABLE distributions. Distributions from an ABLE account for the QDEs of the designated beneficiary are not included in the designated beneficiary's gross income or the designated beneficiary's estate's gross income and are not taxable gifts. Under §1.529A-3(d)(1), if any amount of a distribution from an ABLE account is includible in gross income, the income tax imposed would be increased by an amount equal to 10% of the includible amount.

Payments made on mortgage or vehicle purchase. Payments made towards a home mortgage or vehicle purchase, both during the designated beneficiary's life and upon the designated beneficiary's death, are QDEs if the property or vehicle is owned by the designated beneficiary. This includes the payment of the remaining balance of the loans after the designated beneficiary's death.

Repayment of SSI or SSDI. Repayment of an overpayment of Supplemental Security Income (SSI) or Social Security Disability Insurance (SSDI) benefits would be a QDE because they fall under the category of “financial management” under §1.529A-2(h)(1).

ABLE account balance at death of beneficiary. There may be federal tax implications when the remaining balance of an ABLE account goes to a spouse or a named beneficiary upon the death of the designated beneficiary of the account. The regulations provide that a qualified ABLE program may permit a change in the designated beneficiary of an ABLE account during the life of the designated beneficiary, to take effect upon the designated beneficiary's death.

- If the successor designated beneficiary is both a sibling of the designated beneficiary and an eligible individual at the time of the transfer, there are no income tax implications for the designated beneficiary's estate or the successor designated beneficiary. However, the ABLE account would be subject to the payment of any outstanding QDEs of the designated beneficiary as well as any state Medicaid reimbursement claims.
- A transfer to a successor designated beneficiary who is both a sibling of the designated beneficiary and an eligible individual has no gift tax or generation-skipping transfer (GST) tax implications. If the successor designated beneficiary is anyone else, the transfer is a gift for gift tax purposes by the designated beneficiary to the successor designated beneficiary, and the GST tax applies if the successor designated beneficiary also is two or more generations below the designated beneficiary’s generation assignment (e.g., a grandchild). If the successor designated beneficiary is the spouse of the designated beneficiary, the gift tax marital deduction under §2523 may apply.

ABLE states. See T. Rowe Price Saving for College website for the states that are currently working on ABLE bills or that have enacted ABLE legislation.

Means-tested programs. In general, an ABLE account is not to be counted in determining the designated beneficiary’s eligibility for many federal means-tested programs, or in determining the amount of any
benefit or assistance provided under those programs, except to the extent that the balance in the ABLE account exceeds $100,000.

**Death of the beneficiary.** A qualified ABLE program must provide that, upon the designated beneficiary’s death, any state may file a claim for the amount of the total medical assistance paid for the designated beneficiary under the state’s Medicaid plan after the establishment of the ABLE account.

**Tax practitioner planning.** Because a balance in the ABLE account can be seized for medical expenses at the death of the beneficiary, the account trustee should pay out from the account in a timely manner.

**IRS reporting forms.** The IRS developed two new forms that ABLE account programs will use to report relevant account information annually to designated beneficiaries and the IRS: (1) Form 1099-QA for distributions and (2) Form 5498-QA for contributions.

**Tax practitioner planning.** A Special Needs Trust is a better option for high-net-worth individuals with children or grandchildren with disabilities, as it allows for larger contributions. To avoid complicated oversight and potentially strained relationships, a pooled special needs trust may be advisable. A pooled special needs trust is structured as a master trust with individual subaccounts. About $3 billion is in pooled special needs trusts in 2021. Advise your client to consult with an attorney.

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**DIVORCE SETTLEMENTS**

**Property Settlement vs. Alimony (§1041)**

Generally, no gain or loss is recognized on transfers of property between spouses or on transfers of property to a former spouse that are “incident to a divorce” (§1041(a); §1041(d)). This tax-free §1041 transfer is treated as a gift, meaning that neither spouse recognizes any income as a result of the transfer. The carryover basis rules apply. Alimony, on the other hand, creates both income and deductions. Determining if the transfer of property is property settlement or alimony can often be difficult, depending on the intent of the parties. In 1984, to eliminate the questions plaguing the courts concerning the taxpayers’ intent and the nature of payments, Congress amended §71 in favor of following six objective tests (including the child support override rule). If a payment satisfies all of these factors, then the payment is alimony; if it fails to satisfy any one of these factors, then the payment is not alimony.

**Example.** Beverly and Bob are divorcing. Their marital property is valued at $2 million. They have agreed that Beverly will keep the house with a FMV of $1 million and Bob will keep the rental property with a FMV of $1 million. While that is an equal division of the FMV of their properties, it may not be an equal division of after-tax value. Section 1041 requires the transferee to take the transferor’s tax basis in the property received. If we say that Beverly and Bob have a basis of $800,000 in their personal residence and an adjusted basis (after depreciation and §1031 deferred gains) of $200,000 in the rental property, the tax consequences of a subsequent sale are very different for Beverly and for Bob.

**Tax practitioner planning.** Always take into consideration the tax basis of property divided in a divorce.

**Definition of (1) a divorce or separation instrument and (2) the incident to divorce six-year transfer rule.** A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a “divorce or separation instrument” and the transfer occurs not more than six years after the date on which the marriage ceases. A “divorce or separation instrument” means (A) a decree of divorce or separate
maintenance or written instrument incident to such a decree, (B) a written separation agreement, or (C) a decree requiring a spouse to make payments for the support or maintenance of the other spouse (§1.1041-1T(b), FAQ #7).

**Amount Paid to Ex-Spouse to Buy Her out of Dental Practice Did Not Increase Taxpayer’s Basis**
(Steven Matzkin and Sarah Schroeder v. Comm., TCM 2020-117)

In January 2003, Steven Matzkin formed, with a partner, Dental Care Alliance, LLC (DCA). When Dr. Matzkin formed DCA, he was married to Georgeann. In May 2008, after more than 20 years of marriage, Dr. Matzkin filed for divorce. Under Florida law, DCA was a marital asset. An appraisal performed in 2007 valued his interest in DCA at $21 million. The Matzkins’ property settlement and spousal support agreement provided that Steven would pay Georgeann over time $10.5 million for her half of DCA.

**Payments did not increase basis.** In May 2012, Dr. Matzkin sold his interest in DCA for $93,770,600. On their 2012 return, Steven and Sarah Matzkin claimed a basis in DCA of $85,735,315. The IRS audited the return and made an adjustment for the amount of property settlement payments made to Georgeann, arguing that the payments did not increase his basis in the partnership.

Section 705(a)(1) provides that a partner’s initial basis is increased by the sum of the partner’s distributive share of “(A) taxable income of the partnership as determined under §703(a), (B) income of the partnership exempt from tax under this title, and (C) the excess of the deductions for depletion over the basis of the property subject to depletion.” Steven’s payments to Georgeann and his divorce lawyer did not affect his distributive share of DCA’s income or deductions. Accordingly, these payments did not increase or otherwise affect his basis under §705(a)(1). While the court agreed with Dr. Matzkin that his payments to Georgeann were part of a property settlement, it does not follow that his payments generated additional basis in DCA.

**Tax practitioner planning.** Section 1041 clearly prohibits a spouse from increasing basis when he or she buys out the former spouse’s interest in a house, for example. Partnership law does not change the result when making payments to buy out the former spouse’s interest in a partnership. Payments to the former spouse do not create basis in the partnership.

**Also see.**

*Joseph R. Belot v. Comm.*, TCM 2016-113, where $1,580,000 payment from former spouse to buy out his interest in a dancing school business was “incident to a divorce” and not taxable.

*PLR 201901003*, where the payment to the ex-spouse was transfer “incident to the divorce” even though past the usual six-year test because an amended order started the six-year presumption over again.

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**ALIMONY/SPOUSAL SUPPORT**

**Alimony Deduction Repealed After Dec. 31, 2018 (§215)**

The deduction for alimony and separate maintenance payments was repealed starting in 2019. Correspondingly, alimony and separate maintenance payments are not included in income. The provision is effective for any divorce or separation instrument executed after Dec. 31, 2018, or for any divorce or separation instrument executed on or before Dec. 31, 2018, and modified after that date, if the modification
expressly provides that the amendments made by this section apply to such modification. Divorce instruments executed prior to 2019 are grandfathered.

**Tax practitioner note.** This is a permanent repeal, not one that sunsets like other individual provisions.

**Prenuptial.** Many prenuptial agreements include provisions about how much a spouse would pay in alimony in the event of a divorce. The couple had a deal, and now Congress has changed the game retroactively.

**Tax practitioner planning.** Advise clients, especially wealthy ones who you suspect have a prenuptial, to contact their attorney.

**Alimony trusts repealed.** The TCJA repealed §682, which provided, prior to the repeal of §71 for agreements executed after Dec. 31, 2018, that a spouse who is divorced or legally separated under a decree of divorce or of separate maintenance must include in income the income of any trust to which he or she is entitled to receive and which, except for this section, would be includible in the gross income of the grantor spouse.

**Tax practitioner note.** Alimony trusts allowed divorcing spouses to avoid some of the restrictions imposed by §71. Section 71, prior to its repeal by the new law, required that alimony cease on the death of the payee spouse, imposed recapture requirements on excess alimony payments, and imposed restrictions on alimony payments related to contingencies related to a child. Alimony trusts were exempt from these provisions.

**Divorce subsidy.** The disallowance of the alimony deduction (and the corresponding change to alimony income) is expected to raise an estimated $6.9 billion over the next decade.

**Acrimony rather than matrimony.** Imagine the anger at the bargaining table when the payor figures out that child support AND alimony are not deductible. Will marital courts take tax into consideration when awarding child support and alimony? What kind of arguments between the divorcing spouses will arise from this drastic change to the payor spouse’s after-tax income? Was the spread between the payor spouse’s tax bracket and the recipient spouse’s tax bracket so dramatic as to require the closing of this “loophole?”

**Tax practitioner planning.** Instead of alimony, perhaps a different split of marital property will help the payor, especially if the “extra” is a low basis asset or a zero-basis retirement plan.

**Alimony Deduction/Income for Agreements Executed Before Jan. 1, 2019 (§71 & §215)**

**Tax practitioner note.** Taxpayers who claim a deduction for paying alimony must provide the date of their divorce or separation agreement on Line 19c of Schedule 1 of Form 1040 to confirm that the deduction qualifies. 2023 forms are released later in the year.

Alimony and separate maintenance payments are deductible from income by the payor spouse if includible in income of the payee spouse. For payments made to, or on behalf of, spouses (or former spouses) to qualify as deductible alimony, very specific requirements must be met:

1. Payment must be made in cash (transfer of property or services does not qualify).
2. Payments must be received by spouse (or on behalf of spouse, i.e., indirect alimony).
3. Payment is required under divorce or written separation agreement (i.e., no voluntary payments).
4. There is nothing in the agreement designating that the payment is not alimony or that the payment is not taxable to the recipient spouse.

5. Payee and payor spouse cannot live together (no joint return).

6. Alimony must stop after payee spouse’s death (state statutes may require if agreement silent).

7. Payments are not related to a child-related contingency (e.g., child reaches age 18).

8. Recapture may be required if “excess front-loading” (i.e., if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000 and to the extent the payments in the second year exceed the payments in the third year by more than $15,000).

**Alimony Requirement #4: Payment of Sallie Mae Loan of Ex-Spouse Not Alimony *(Jerry Vanderhal v. Comm., TCS 2018-41)*

Jerry Vanderhal divorced in 2011. The divorce agreement included a reference to a Sallie Mae student loan account that related to his former spouse. That reference was found in the “Division of Community Debts” section of the agreement and obligated Mr. Vanderhal to “assume and hold his former spouse harmless” from that debt. The agreement also included a section titled “Tax Free Transfers” that stated the parties believe and agree that the transfers of property between them required by the agreement were tax-free transfers of property between them and were therefore tax-free transfers of property made pursuant to §1041 and were not taxable sales or exchanges of property or payments for alimony, except where the agreement specifically denoted payments as such.

On his 2013 tax return, Mr. Vanderhal claimed an alimony deduction for the payments he made on the Sallie Mae student loan. The alimony was disallowed because the payments did not fit within the definition of alimony. Instead, the payments constituted a division of property. Specifically, the divorce decree designated the payment as not allowable as a deduction under §215(b)(1)(B) (which was repealed in 2017).

**Alimony Requirement #6: Millions in Payments by Hedge Fund Partner to Ex-wife Did Not Meet Alimony’s Survival Criterion *(Andrew Redleaf v. Comm., CA-8, 21-2209, 21-2224, Aug. 5, 2022)*

Andrew Redleaf is the majority partner at Whitebox Advisors, LLC, a hedge fund asset management firm. The Redleaf’s marriage termination agreement (MTA) required Mr. Redleaf to pay his ex-spouse $140 million including $1,500,000 per month for sixty months. Mr. Redleaf deducted $51 million in payments he made to his ex-spouse in 2012 and 2013 as spousal maintenance (alimony). The issue in the case was whether the alimony payments would stop after payee spouse’s death.

The **Court’s tests.** To determine whether a payor has liability to continue payments after the payee’s death, the courts apply the following sequential approach: (1) the Court first looks for an unambiguous termination provision in the applicable divorce instrument; (2) if there is no unambiguous termination provision, then the Court looks to whether payments would terminate at the payee’s death by operation of State law; and (3) if State law is ambiguous as to the termination of payments upon the death of the payee, the Court will look solely to the divorce instrument to determine whether the payments would terminate at the payee’s death.

“Rather surprisingly, given the overall sophistication of the document and the substantial state court litigation between the parties that followed, the MTA contained no provision clarifying (designating) that the payments in question were not includable in Elizabeth’s gross income and allowable as a deduction.
to Andrew, §71(b)(1)(B)4; and no provision unambiguously stating that Andrew had no liability to make payments for a period after Elizabeth’s death, §71(b)(1)(D).”

Therefore, the Court concluded that Minnesota law unambiguously established that the MTA was not a spousal maintenance agreement. Rather, it was a contractual division of marital property. The payments by Mr. Redleaf were not deductible as alimony.

**Alimony Requirement #6: Tax Court Allowed Alimony Paid in Arrears Under Court Order**  
*Jeffrey and Sandra Siegel v. Comm., TCM 2019-11*

Jeffrey Siegel was divorced in 2003. He was required to make spousal maintenance payments of $10,110 per month and child support of $5,000 per month. After the divorce, Siegel’s business went into bankruptcy, his income fell drastically, and he fell behind in making the payments required by the judgment of divorce. On Feb. 12, 2012, after several legal proceedings, the Supreme Court of New York found Siegel to be in contempt and sentenced him to 150 days in jail unless he paid $225,000 for arrearages owed to his former spouse. The sole issue for decision was whether $225,000 that Siegel paid in response to the 2012 order was deductible.

**Was payment required even after former spouse’s death?** To be deductible as alimony, among other requirements that the IRS agreed were satisfied, there must be “no liability to make the payments for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.”

**Was the 2012 court order a “money judgment”?** Alimony arrearages retain their character when paid and are deductible if paid in arrears. A money judgment is not alimony because the requirement to pay the judgment extends beyond the death of the former spouse. The court found that “the 2012 order entered no judgment in favor of Siegel’s ex-spouse and by its terms provided her with no means of enforcing the judge’s order. By its terms, the 2012 order clearly is not a money judgment. The 2012 order is a contempt order to achieve the payment of alimony arrearages.”

**Alimony Requirement #6: Legal Fees Paid on Behalf of Ex-Spouse Are Not Alimony**  
*Terrence E. Aragoni v. Comm., TCS 2023-3*

Terrance Aragoni was ordered to pay $15,000 to his former spouse’s attorney. Mr. Aragoni deducted the payment as alimony. The payment did not constitute deductible alimony within the meaning of §71(b) because the obligation to pay survives the death of the payee spouse.

**Alimony Requirement #6: Payments Did Not End at Death of Recipient Spouse**  
*Mark Hexum v. Comm., CA-7, 2018-1 USTC ¶50,168, Feb. 27, 2018*

Mark Hexum paid his ex-wife, Sherri, half of the net gain from the sale of their marital home because the Illinois family court ruled payment was required under their divorce agreement. Mark had been responsible for the house’s mortgage and expenses after the divorce, and in his view, the equity accrued before the sale was not “marital property” that he should have been made to split with his ex-wife when the house was sold. He characterized the payment as alimony and deducted it on his tax return.

Mark and Sherri settled on the terms of their divorce in a dissolution agreement. As alimony, Mark agreed to pay Sherri a percentage of his salary and of the incentive-based pay that he received. The agreement provided that “maintenance is taxable income to Sherri and deductible by Mark [under] Section[s] 71(a) and 215 of the Internal Revenue Code.” It incorporated Section 510 of the Illinois Marriage and Dissolution
of Marriage Act, which provided that unless the agreement says otherwise, “the obligation to pay future maintenance is terminated upon the death of either party” (750 ILCS 5/510(c) (2012)).

In a separate paragraph regarding the marital home, Mark and Sherri agreed to sell the house and divide equally “the net equity of said property,” and they agreed that Mark would “pay all expenses associated with the ... property until [then].” Accordingly, from when the agreement took effect to when the house was sold, Mark paid the mortgage on the property; he also paid to replace some carpeting. In total, he paid $25,906. Mark believed that before the gain from the sale was divided, he should first be reimbursed that sum as non-marital property. Sherri moved the family court to hold Mark in civil contempt when he withheld the money. The circuit judge rejected Mark’s view of the agreement and directed him to pay Sherri half of the net gain.

On his 2013 tax returns, without consulting a lawyer or accountant, Mark told his tax preparer that he paid alimony in a total amount that included the $12,953 payment to Sherri, and he claimed a deduction. The IRS determined the payment was not alimony under §71 and disallowed the deduction.

The Tax Court ruled for the Commissioner. The Tax Court said that “it is undisputed by [Mark] that he would have continued to have an obligation to make the payments on the gain from the real estate even if his former spouse had passed away before the sale.” Thus, the Tax Court concluded, the payment did not qualify as alimony (§71(b)(1)(D)).

Mark appealed the Tax Court decision. Mark appealed and argued that the equity accrued in the house after the divorce was not marital property under Illinois state law, and thus, he reasoned, his payment of half of its value was necessarily alimony. He also said the payment qualified as alimony under §71(b), as described on the IRS’s website, and so was properly deducted.

Appeals Court agrees payment wouldn’t end at death. The Appeals Court found that Illinois law unambiguously provided that the payment at issue would not terminate at Sherri’s death. Mark was to transfer half of the net gain from the sale. This is a fixed amount and so is categorized either as maintenance in gross or a property settlement. (And because periodic maintenance was ordered, it must be the former.) Regardless, Mark’s obligation would not terminate at Sherri’s death. Because the payment did not meet the requirement of §71(b)(1)(D), it is not alimony.

Alimony Requirement #7: Child-related Contingency Means Alimony Not Deductible

(Alejandro J. and Elena G. Rojas v. Comm., TCM 2022-77)

Alejandro and Cristina divorced in 2012. On July 25, 2012, the Los Angeles Superior Court entered a judgment of dissolution, that stated in part:

“[F]amily support shall be payable by Respondent [Alejandro] to Petitioner [Cristina] in the monthly amount of $4,500.00 payable on the 1st of each month. . . Such support order commences Aug. 1, 2011, and is continuing until both minor children emancipate or Petitioner remarries. If Petitioner remarries, the family support obligation shall be modified to $2,500.00 per month until each minor child emancipate[s].”

Note. This is a grandfathered divorce agreement, and if the Court found the payment to be alimony, the payments would be deductible by the payer in 2023.

Child support not deductible. Section 215(a) generally permits an individual to deduct from gross income “alimony or separate maintenance payments,” as defined in §71(b). However, §215(b) provides that this deduction is allowable only if the alimony or separate maintenance payments are includible in the recipient’s gross income under §71. Alimony or separate maintenance payments are not includible in the payee
spouse’s gross income and consequently no deduction is allowable under §215, for certain such payments that are made or treated as made to support the payor spouse’s children (§71(c)).

**Child-related contingency makes family support not deductible.** The provision of the divorce instrument requiring Alejandro to make family support payments only until both minor children are emancipated is a child-related contingency. The existence of this child-related contingency triggers the application of §71(c)(1) and (2)(A) and makes the payments in question nonincumbible in Cristina’s gross income under §71(a) and hence nondeductible by Alejandro under §215(b).

**Interest Collected on Child Support Arrearages Is Taxable (Susan Rodgers v. Comm., TCM 2023-56)**

Ms. Rodgers received child support payments that the State of Alabama collected from her former spouse. Because the former spouse was in arrears on child support payments, the Circuit Court ordered him to pay arrearages of $5,362 and interest of $10,682. The State of Alabama issued a Form 1099-INT for the amount of interest it collected on Ms. Rodgers’ behalf. While child support payments are not taxable, of course, interest income is.

**$300 EDUCATOR DEDUCTION**

For 2023, teachers and other educators who teach in kindergarten through grade 12 classrooms and purchase books, supplies, COVID-19 related items, and other classroom materials out-of-pocket can deduct up to $300 of those expenses. The maximum deduction climbs to $600 for married filing jointly if both spouses are eligible educators (but not more than $300 each).

**Tax practitioner note.** Deductions related to home schooling, pre-school, or college classes are not allowed.

**STANDARD DEDUCTION**

**Standard Deduction (§1(c)(2)(A), §2(a), §32, §63(c))**

The standard deduction increased across all filing statuses for 2018 through 2025. The amount of the standard deduction is indexed for inflation annually after 2018.

<table>
<thead>
<tr>
<th>Standard Deduction Table</th>
<th>2024</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Filing Joint &amp; Qualifying Widow(er)</td>
<td>$29,200</td>
<td>$27,700</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$21,900</td>
<td>$20,800</td>
</tr>
<tr>
<td>Single</td>
<td>$14,600</td>
<td>$13,850</td>
</tr>
<tr>
<td>Married Filing Separate</td>
<td>$14,600</td>
<td>$13,850</td>
</tr>
<tr>
<td>65/Blind-MFJ</td>
<td>$1,550</td>
<td>$1,500</td>
</tr>
<tr>
<td>65/Blind-Single</td>
<td>$1,950</td>
<td>$1,850</td>
</tr>
</tbody>
</table>
Standard Deduction of a Dependent

In 2023, the standard deduction for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of (1) $1,250 or (2) the sum of $400 and the individuals’ earned income.

Itemized Deductions Not Allowed After IRS Prepared Substitute Return ([Shawn Steven Salter v. Comm., TCM 2022-29])

Shawn Salter failed to file a return for the tax year. Having received no return from Mr. Salter, the IRS prepared a substitute for return based on third-party reporting, allowing the taxpayer the standard deduction. Mr. Salter then prepared a late (by seven years) Form 1040 reporting all items of income as shown on the IRS notice of deficiency, but claiming itemized deductions for medical, state, and local taxes, mortgage interest, charitable deductions, and unreimbursed employee business expenses.

Section 63(e)(1) provides that, “[u]nless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year.” Section §63(e)(2), captioned “Time and Manner of Election,” provides that “[a]ny election under this subsection shall be made on the taxpayer’s return.” In certain circumstances a taxpayer may make “a change of election with respect to itemized deductions,” but only when a return was previously filed (§63(e)(3)). The court found the taxpayer remained only entitled to the standard deduction as calculated on the IRS notice of deficiency.

ITEMIZED DEDUCTIONS

STANDARD MILEAGE RATES

The 2023 Standard Mileage Rate for Medical, Moving, and Charity

The IRS provides optional standard mileage rates for self-employed individuals or other taxpayers to use in computing the deductible costs paid or incurred for operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate. The 2023 medical and moving standard mileage rate is 22 cents per mile. The 2023 rate for charitable miles remains at 14 cents.

<table>
<thead>
<tr>
<th>Standard Mileage Rates</th>
<th>1/1 through 6/30/2022</th>
<th>7/1 through 12/31/22</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical</td>
<td>18¢</td>
<td>22¢</td>
<td>22¢</td>
</tr>
<tr>
<td>Moving</td>
<td>-0- except for Military move</td>
<td>-0- except for Military move</td>
<td>-0- except for Military move</td>
</tr>
<tr>
<td>Charity</td>
<td>14¢</td>
<td>14¢</td>
<td>14¢</td>
</tr>
<tr>
<td>Business</td>
<td>58.5¢</td>
<td>62.5¢</td>
<td>62.5¢</td>
</tr>
</tbody>
</table>
MEDICAL, DENTAL, ETC., EXPENSES

Medical Expense Deduction AGI Limit Is 7.5% for 2023

AGI haircut is 7.5%, not 10%. For 2023, the threshold for deducting medical expenses is 7.5%. This threshold also applies for AMT purposes. CAA 2021 made the 7.5% permanent.

Tax practitioner planning. Higher insurance premiums and higher co-pays may mean that more clients will qualify for medical expenses, especially if we remind clients of the advantage of bunching two years of medical into one year.

IRS Posts FAQs about Medical Expenses Related To Nutrition, Wellness And General Health (IR-2023-47)

The FAQs address issues such as whether the cost of nutritional counseling, weight-loss programs, gym memberships and treatment for substance use disorders are considered medical expenses that may be paid or reimbursed under an HSA, FSA, Archer MSA or HRA. Fourteen FAQs are posted. Here are a few:

• The cost of nutritional counseling a medical expense can be paid or reimbursed by an HSA, FSA, Archer MSA, or HRA if the nutritional counseling treats a specific disease diagnosed by a physician (such as obesity or diabetes).

• The cost of a weight-loss program is a medical expense that can be paid or reimbursed by an HSA, FSA, Archer MSA, or HRA if the program treats a specific disease diagnosed by a physician (such as obesity, diabetes, hypertension, or heart disease). Otherwise, the cost of a weight-loss program is not a medical expense.

The cost of a gym membership is a medical expense that can be paid or reimbursed by an HSA, FSA, Archer MSA, or HRA if the membership was purchased for the sole purpose of affecting a structure or function of the body (such as a prescribed plan for physical therapy to treat an injury) or the sole purpose of treating a specific disease diagnosed by a physician (such as obesity, hypertension, or heart disease). Otherwise, the cost of a gym membership is for the general health of the individual and is not a medical expense.

The cost of food or beverages purchased for weight loss or other health reasons is a medical expense that can be paid or reimbursed by an HSA, FSA, Archer MSA, or HRA if (1) the food or beverage doesn’t satisfy normal nutritional needs, (2) the food or beverage alleviates or treats an illness, and (3) the need for the food or beverage is substantiated by a physician. The medical expense is limited to the amount by which the cost of the food or beverage exceeds the cost of a product that satisfies normal nutritional needs. If any of the three requirements is not met, the cost of food or beverages is not a medical expense.

Also see

LTR 202311001, where cost of nonprescription food for an infant was not a medical expense.
Long-Term Care Premium Limits

Annual long-term care insurance premiums are deductible as a medical expense up to:

<table>
<thead>
<tr>
<th>Age of Individual Before Close of Tax Year</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than 40</td>
<td>$450</td>
<td>$480</td>
<td>$470</td>
</tr>
<tr>
<td>More than 40 but not more than 50</td>
<td>$850</td>
<td>$890</td>
<td>$880</td>
</tr>
<tr>
<td>More than 50 but not more than 60</td>
<td>$1,690</td>
<td>$1,790</td>
<td>$1,760</td>
</tr>
<tr>
<td>More than 60 but not more than 70</td>
<td>$4,510</td>
<td>$4,770</td>
<td>$4,700</td>
</tr>
<tr>
<td>More than 70</td>
<td>$5,640</td>
<td>$5,960</td>
<td>$5,880</td>
</tr>
</tbody>
</table>

Four out of five 65-year-olds will need some long-term care (Center for Retirement Research of Boston College). About one in six will pay $100,000 or more for long-term care services.

**Tax practitioner planning.** Ninety percent of the carriers that were selling long-term care insurance 10 years ago have withdrawn from the business. Those that remain are tightening underwriting standards and are raising premiums on existing policies. Sales of new stand-alone policies are down by 75% from a decade ago.

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STATE AND LOCAL TAXES

**History Lesson.** The deduction for state and local taxes had been a feature of the U.S. Tax Code since the Civil War.

Schedule A State and Local Tax (SALT) Deduction Limited to $10,000

**Limitation doesn’t apply to investment and trade or business property.** For 2018 through 2025, an individual, as a general matter, is allowed to deduct state, local, and foreign property taxes and state and local sales taxes only when paid or accrued in carrying on a trade or business, or an activity described in §212 (relating to expenses for the production of income). Thus, the provision allows only those deductions for state, local, and foreign property taxes and sales taxes that are presently deductible in computing income on an individual’s Schedule C, Schedule E, or Schedule F on such individual’s tax return.

**$10,000 limit exception.** A taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of (i) state and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in §212, and (ii) state and local income, war profits, and excess profits taxes (or sales taxes in lieu of income taxes, etc.) paid or accrued in the taxable year. Foreign real property taxes may not be deducted under this exception.

**Tax practitioner planning.** According to IRS stats, half of SALT deductions come from six states: California, New York, New Jersey, Illinois, Pennsylvania, and Texas. New York and California receive more than one-third of the deduction’s total value nationwide. In 2016, New York residents who itemized their deductions had an average SALT deduction of $22,000. Eighty-eight percent of SALT deductions benefit those with income in excess of $100,000.
Is the SALT Limit Constitutional?

Connecticut, Maryland, New York, and New Jersey claimed that the SALT limit violated their state’s right to control their own taxing authority and policies. Their petition for certiorari was denied by the Supreme Court on Apr. 18, 2022. The SALT limit stands.

Thirty-six States and one locality have enacted SALT workaround – more to come. States pass workaround legislation after Notice 2020-75. Notice 2020-75 announced the Treasury’s intent to issue regulations to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment. This notice gave the green light to states to enact legislation that would mitigate the impact of the SALT limitation on its passthrough business owners.

States enacting legislation, so far . . . Alabama, Arkansas, Arizona, California, Colorado, Connecticut, Hawaii, Georgia, Iowa, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Mississippi, Montana, Nebraska, North Carolina, New Jersey, New Mexico, New York Nebraska (and New York City), Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Virginia, West Virginia, and Wisconsin passed legislation to approve the workaround. There is pending legislation in Maine, Pennsylvania, and Vermont. Watch for updates from your state legislature. And be sure to check effective dates.

Note. It is estimated that the SALT workaround will cost the federal government $50 billion by the end of 2025.

IRS Data Shows SALT Cap Repeal Benefits High-Income Earners [TaxFoundation.org (Sep. 13, 2023)]

A Tax Foundation report analyzed IRS data reported on 2020 returns. The SALT deduction benefits high-income taxpayers in high tax paying states. That is no surprise to tax professionals as low- and moderate-income taxpayers are more likely to use the standard deduction. The chart below is one of many included in the Tax Foundation report. It lists the top 10 counties for SALT deductions claimed per itemizing taxpayer. According to the report “d.”

<table>
<thead>
<tr>
<th>County, State</th>
<th>Reported per Itemizing Filer</th>
<th>SALT Deduction Claimed per Itemizing Filer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nassau County, NY</td>
<td>$32,687</td>
<td>$9,382</td>
</tr>
<tr>
<td>Putnam County, NY</td>
<td>$25,238</td>
<td>$9,320</td>
</tr>
<tr>
<td>Falls Church City, VA</td>
<td>$28,920</td>
<td>$9,315</td>
</tr>
<tr>
<td>Santa Clara County, CA</td>
<td>$60,756</td>
<td>$9,304</td>
</tr>
<tr>
<td>Bergen County, NJ</td>
<td>$33,050</td>
<td>$9,287</td>
</tr>
<tr>
<td>Fairfield County, CT</td>
<td>$52,168</td>
<td>$9,270</td>
</tr>
<tr>
<td>Morris County, NJ</td>
<td>$33,137</td>
<td>$9,255</td>
</tr>
<tr>
<td>Suffolk County, NY</td>
<td>$27,709</td>
<td>$9,246</td>
</tr>
<tr>
<td>Hunterdon County, NJ</td>
<td>$26,222</td>
<td>$9,229</td>
</tr>
<tr>
<td>San Mateo County, CA</td>
<td>$81,508</td>
<td>$9,200</td>
</tr>
</tbody>
</table>
Do High State Tax Rates Drive Individuals And Businesses To Low Or No Tax States? (The Center On
Budget And Policy Priorities)

The Center on Budget and Policy Priorities says “no” in its Aug. 9, 2023, 73-page report. The report
concludes that state taxes play a minimal role in decisions involving interstate moves. The report cites
California out-migration as an example saying: “California has the highest marginal tax rate in the nation
but has had the second lowest out-migration rate among households earning $200,000 or more during
roughly the past decade.” Iowa, Mississippi, Nebraska, and West Virginia have cut income taxes but
“should harbor no illusions that such a move will stem — let alone reverse — their states’ long-standing
net out-migration trends.”

People move for employment opportunities, family, lower housing costs, or a warmer snow-free climate.
Utah, Colorado, Idaho, and Montana are snowy and icy and yet they have experienced lots of migration as
families look for an outdoors-oriented lifestyle.

INTEREST

The number of homeowners who benefitted from the home mortgage deduction is approximately 13.8
million, down from 32.3 million in 2017. After the law change, the deduction saves taxpayers $25 billion,
down from $60 billion in 2017. Most of this decline in benefit is due to the doubling of the standard
deduction.

Mortgage Interest Deduction Modified for 2018 Through 2025

Acquisition Indebtedness (§163(h)(3)(B)(i))

$750,000 acquisition debt. The TCJA provides that, in the case of taxable years beginning after Dec. 31,
2017, and beginning before Jan. 1, 2026, a taxpayer may treat no more than $750,000 as acquisition in-
debtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebt-
ededness incurred before Dec. 15, 2017, this limitation is $1,000,000 ($500,000 in the case of married tax-
payers filing separately). Thus, acquisition indebtedness incurred before Dec. 15, 2017, is grandfathered.

Binding contract exception. A taxpayer who entered into a binding contract before Dec. 15, 2017, to close
before Dec. 31, 2017, and who did close the purchase by April 1, 2018, is treated as having incurred the
acquisition debt before Dec. 15, 2017.

Sunset of provision. For taxable years beginning after Dec. 31, 2025, a taxpayer may treat up to $1,000,000
($500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness,
regardless of when the indebtedness was incurred.

Tax practitioner planning. Acquisition indebtedness includes debt on both first and second homes
incurred in acquiring, constructing, or substantially improving a qualified residence of the tax-
payer and which is secured by the residence. The proposal to repeal the interest deduction on a
second home was dropped in the final bill.

Example. Harry and Bess, a married couple, purchased their home in May 2016. Their acquisition
debt was $1.5 million. Since Harry and Bess incurred their mortgage debt before Dec. 15, 2017,
their mortgage is grandfathered, and they may deduct interest on $1 million of acquisition debt
on their 2023 tax return. If the mortgage interest paid in 2023 is $68,000, they may deduct only
$45,333 of the interest (1.0/1.5 x $68,000).
**Example.** Harry and Bess, a married couple, purchased their home in June 2023. Their acquisition debt was $1.5 million. Since Harry and Bess incurred their mortgage debt after Dec. 15, 2017, their mortgage is not grandfathered, and they may deduct interest on only $750,000 of acquisition debt on their 2023 tax return. If the mortgage interest paid in 2023 is $68,000, they may deduct only $34,000 of the interest (.750/1.5 x $68,000).

**Example — continued.** If Harry and Bess are unmarried, they may each deduct interest on $750,000 of acquisition debt on their 2023 tax return. Married filing separate taxpayers are limited to $375,000 each.

**Home Mortgage Interest Deduction Revised by Tax Court (Frank and Collette McNamara v. Comm., TCS 2023-22)**

In 2019, Frank and Collette McNamara owned two homes, which they acquired after Oct. 1987 and before Dec. 16, 2017. The McNamaras owned the first home in Virginia for the entire year. They owned the second home in Massachusetts until May 10, 2019, when they sold it. On their 2019 Form 1040, the McNamaras claimed a total mortgage interest deduction of $39,226 for their two homes. The IRS disallowed $9,140 of the deduction, asserting that the McNamaras miscalculated the deduction for the Massachusetts home. Despite having sold the home in May 2019, they calculated the deduction using a 12-month period to determine the average mortgage balance, the determination of which was necessary for calculating their mortgage interest deduction on up to the $1 million dollar limit in place for mortgages acquired before Dec. 16, 2017.

**Mortgage balance is calculated only for the months prior to sale.** The McNamaras erred when they calculated the average mortgage balance for their Massachusetts home using the 12-month period instead of the 5-month period during which the home secured the outstanding balance on the mortgage. Calculating the average mortgage balance for the Massachusetts home using a five-month period caused their mortgage indebtedness for 2019 to exceed the $1 million limit such that a portion of the interest they paid is not deductible. Accordingly, the Tax Court agreed with the IRS calculation of the mortgage interest deduction.

**Example.** The average loan balance for the residence owned for the entire year was $700,000. The average loan balance for the residence owned for five months before sale was $400,000 (5 months of $400,000 each month). The combined balance of loan one and two EXCEEDS the $1 million limit. If the loan is treated as a twelve-month balance (5 months of $400,000 and 7 months of zero each month thereafter), the average loan balance is $166,666. The combined balance of loan one and two is BELOW the $1 million limit.

**Refinancing Acquisition Indebtedness**

The $1,000,000 limitation continues to apply to any indebtedness incurred on or after Dec. 15, 2017, to refinance a qualified residence indebtedness incurred before that date to the extent that the indebtedness resulting from the refinancing does not exceed the amount of the refinanced debt.

**Example.** George and Barbara refinanced their home in 2023 when their acquisition debt had a balance of $900,000. They withdrew $200,000 at the refinance to pay off personal bills. They may only deduct interest on $900,000 of the new mortgage (even if they used the proceeds from the refi to make improvements to their house).
Minimizing the Impact on Property Taxes and Mortgage Interest With a Home Office

The Schedule A tax deduction is limited to $10,000. It also limits the home mortgage interest deduction to a loan of $750,000 (the prior law $1,000,000 debt limit is grandfathered for loans originating before Dec. 15, 2017). If part of the house is used for a qualifying home office, a percentage of property tax and mortgage interest is deductible on Form 8829. This allocation may help avoid some of the negative impact of the TCJA.

**Example.** John uses 20% of his home regularly and exclusively as the principal place of business for his consulting firm. He gets no benefit for the property taxes he pays because his state income tax exceeds the $10,000 limit. His home acquisition debt is $900,000 (exceeding the $750,000 limit by $150,000). John avoids some of the impact of the TCJA change to his Schedule A deductions as he is able to claim 20% of his property tax and mortgage interest as home office expense on his Schedule C.

Home Equity Indebtedness ([§163(h)(3)(C)(i)](j))

The deduction for interest on home equity indebtedness suspended from 2018 through 2025. Thus, for taxable years beginning after Dec. 31, 2017, a taxpayer may not claim a deduction for interest on home equity indebtedness whether the indebtedness is new or old. Equity indebtedness was not grandfathered.

**What is equity debt?** Your clients may believe that borrowing from the equity of their home is equity debt, but for tax law, “equity debt” has a specific meaning. It doesn’t matter if “acquisition debt” is in the form of a first mortgage, second mortgage, or home equity line of credit (HELOC). Instead, it is always about where the borrowed money is used. Under the new law, for example, interest on a home equity loan used to build an addition to an existing home is typically deductible, while interest on the same loan used to pay personal living expenses, such as credit card debt, is not. As under prior law, the loan must be secured by the taxpayer’s main home or second home (known as a qualified residence), not exceed the cost of the home, and meet other requirements.

**Tax practitioner planning.** According to a 2007 Census Report, people take out home equity loans to make renovations (45%), pay off their debts (26%), buy a car (9%), or pay for medical or tuition (4%). From these figures you could extrapolate that interest paid on equity borrowing is “acquisition debt” for almost half of borrowers because the funds were used for renovations.

**Equity borrowing for business use.** Taxpayers who borrowed from their home for business purposes (and who made a [§1.163-10T(o)(5)](j) election and are able to trace borrowed funds to business, rental, or investment) may still deduct interest on that borrowing.

Election to Treat Debt As Not Secured By A Qualified Residence

A taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner ([§1.163-10T(o)(5)](j)).

**§1.163-10T(o)(5) election wording.** “Homeowner elects to treat her home mortgage debt secured by her personal residence located at 1400 15th Avenue, Waterloo, IA, as not secured by said residence. This §1.163-10T(o)(5)(i) ‘election out’ allows use of the ‘direct tracing’ rules under §1.163-8T.”
Comment. Under §1.163-8T, the proceeds of the character of the interest take the character of the proceeds, i.e., business or investment.

Tax practitioner note. There is no requirement that the §1.163-10T(o)(5)(i) election be attached to the taxpayer’s tax return.

Example. George and Mary took out a second mortgage on their home in 2017 to secure funds for the down payment on a rental property. In 2017, they properly made a “§1.163-10T(o)(5) election” to trace the interest on the borrowed funds to their rental property and have been deducting the interest as rental property interest for the past years. In 2023, they may continue to deduct on their Schedule E the portion of the interest on their home mortgage that is attributable to the rental purchase.

Example — continued. In 2017, George and Mary did not make an election to trace their mortgage interest to the rental property BECAUSE their Schedule E rental deductions were limited by the passive loss rules. Instead, they claimed the interest expense on the refi proceeds as home equity borrowing on their 2017 Schedule A. For 2023, they may only claim mortgage interest on their original acquisition loan, properly amortized to what its balance would have been in 2023.

Investment Interest Rules Remain the Same, BUT . . .

Investment interest expense is allowed to the extent of net investment income. Use Form 4952 to calculate the amount deductible for 2023 and the amount carried forward to future years.

Tax practitioner planning. A client with a small amount of investment interest expense may not get the benefit of the investment interest deduction if the client is using the standard deduction.

Other Mortgage Interest Rules Unchanged

Form 1098 Mortgage Interest Reporting Requirements

Three reporting requirements have been added to the Form 1098, Mortgage Interest Statement. Form 1098, Mortgage Interest Statement, must include:

- the amount of outstanding principal on the mortgage at the beginning of such calendar year,
- the date of the origination of the mortgage, and
- the address (or other description in the case of property without an address) of the property which secures the mortgage (§6050H(b)(2) as amended).

Tax practitioner planning. Adding the loan balance to Form 1098, Mortgage Interest Statement, will provide the IRS with information allowing it to easily target returns where the mortgage balance exceeds the $1,000,000/$750,000 acquisition debt limit.

Qualified Residence and Correct Collateral

What exactly is a qualified residence? A residence may include a house, condominium, cooperative, mobile home, house trailer, boat, or similar property; a second residence must contain sleeping, cooking, and toilet facilities (§1.163-10T(p)).
The collateral must be correct. Residence mortgage interest is deductible only if the mortgage is properly secured and collateralized. A secured debt is one in which there exists a signed instrument (such as a mortgage, deed of trust, or land contract) that:

- makes the taxpayer’s ownership in a qualified home security for payment of the debt;
- provides, in case of default, that the home could satisfy the debt; and
- is recorded or is otherwise perfected under any state or local law that applies (§1.163-10T(o)(1)).

Mortgage Interest Is Deductible Only for the Legal or Equitable Owner of the Property

Section 163(a) provides the general rule that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. To meet the requirements of §163, the mortgage must be the obligation of the taxpayer claiming the deduction, not the obligation of another. However, §1.163-1(b) provides in relevant part: “Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness.” The courts have disallowed a deduction for mortgage interest when the taxpayer is unable to establish legal, equitable, or beneficial ownership of mortgaged property (Gabriel Daya v. Comm., TCM 2000-360; Song v. Comm., TCM 1995-446).

Tax practitioner planning. Always check the Social Security number reported on Form 1098. Does it belong to your client?

Equitable owner. Mortgage indebtedness generally must be an obligation of the taxpayer and not an obligation of another (Golder v. Commissioner, 604 F.2d 34, 35 (9th Cir. 1979)), aff’g TCM 1976-150). However, taxpayers who are not directly liable on a mortgage may nevertheless deduct mortgage interest paid if he or she is the legal or “equitable” owner of the property subject to the mortgage (§1.163-1(b)).

“Burden and benefit” indicators. Factors established by various tax courts to determine “equitable” ownership include:

<table>
<thead>
<tr>
<th>“Burden and Benefit” Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who has right to possess or use property?</td>
</tr>
<tr>
<td>Who pays insurance?</td>
</tr>
<tr>
<td>Can property be improved without named borrower’s consent?</td>
</tr>
<tr>
<td>May legal title be obtained simply by paying balance of full purchase price?</td>
</tr>
</tbody>
</table>

Tax practitioner planning. It is important that the legal and equitable owners have a written agreement as to ownership — important for tax purposes and in the case of death or irreconcilable differences resulting in separation.
## Action Items for Property Where One Party Is Not on the Title

1. Include the co-owner’s name on the title at purchase. This is a good idea, but it may not be possible if the co-owner has bad credit and would thus jeopardize the loan.

2. Add the co-owner’s name to title after purchase. This is a solution, but it may not work if adding someone to the title calls the loan or results in substantial fees or costs in changing the title.

3. Engage a real estate attorney to write a valid sales contract (recorded or unrecorded) between the two owners.

## Interest Not Deductible Unless Taxpayer Can Prove Legal or Equitable Ownership

*H. Shilgevorkyan v. Comm., TCM 2023-12*

H. Shilgevorkyan needed to satisfy three requirements to be entitled to a home mortgage deduction under §163(a) and (h)(2)(D)

1. The indebtedness must have been his obligation;
2. He must either be the legal or equitable owner of the property secured by the mortgage; and
3. The residence must have been his qualified residence.

Mr. Shilgevorkyan couldn’t show that he was the legal or equitable owner. A quit claim deed from his brother wasn’t proof of ownership. Because his brother did not have an ownership interest in the property in question, the brother could not transfer ownership to the taxpayer. Finally, Mr. Shilgevorkyan couldn’t prove that he lived in the house or that it was his second home. Mr. Shilgevorkyan couldn’t even show that he made mortgage payments.

## Charitable Contributions

### AGI Percentages for 2023

The AGI percentage limit described in §170(b)(1)(A) was increased by the TCJA for certain charitable contributions by an individual taxpayer of cash to public charities and certain other organizations from 50% to 60%, effective for tax years 2018 through 2025.

<table>
<thead>
<tr>
<th>AGI Limits</th>
<th>Ordinary Income Property and Cash</th>
<th>Capital Gain Property to the Recipient</th>
<th>Capital Gain Property for the Use of the Recipient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Charities, Private Operating Foundations, and Private Distributing Foundations</td>
<td>60%</td>
<td>30%</td>
<td>20%</td>
</tr>
<tr>
<td>Non-Operating Private Foundations</td>
<td>30%</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>
**30% qualified conservation contribution percentage increased to 50% or 100%**. In general, the 30% limit of conservation contributions to public charities of capital gain property, generally conservation easements, increased to 100% if the individual making the qualified conservation contribution is a qualified farmer or rancher and 50% if the individual is not a qualified farmer or rancher.

**Contribution of capital gain property.** Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50% limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

**Donor Advised Funds Are a Popular Alternative to Private Foundations**

A donor advised fund (DAF) allows an individual to irrevocably donate assets to a charitable entity today, receive a tax deduction now, but delay the distribution of the assets to the charity to a later time. With tax reform’s doubling of the standard deduction, some clients may lose the tax benefit of their contributions unless they bunch their donations into one year. The DAF allows clients to donate several years’ worth of contributions in one year but make their pledge payments over several years. That’s an advantage that we talk about regularly, but there are other advantages to the DAF.

1. The DAF can be used to hold a long-term base of assets that can be used to fund gifts perpetually into the future.

2. The DAF can simplify the process of gifting appreciated stock to several charities, as a large block of stock can be donated to the DAF. The DAF can sell the stock and then distribute cash according to the donor’s direction.

3. The DAF can function in a manner similar to a private non-operating, grant-making foundation, but with fewer costs, no exposure to excise tax on investment income, and higher limits on deductibility of contributions.

4. The DAF can accept donations of privately held business interest, pre-IPO shares, real estate, and Bitcoin, in addition to the more traditional cash and publicly traded securities.

**Tax practitioner planning.** A private foundation is still appropriate if the donor wishes to make grants to individuals, retain greater control over investments, or compensate family members for foundation work.

**Resources.** Community Foundations offer DAFs as well as Vanguard Charitable, Schwab Charitable, and Fidelity Charitable.

**Charitable Distributions from IRAs Are Still Good**

An IRA owner age 70½ or over may directly transfer from his or her qualified IRA up to $100,000 per year to an eligible charitable organization. This provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

**Direct trustee to charity transfer required.** To qualify, the funds must be contributed directly by the IRA trustee to the eligible charity. Amounts so transferred are not taxable, but no deduction is available for the amount given to the charity.
Transfers can be part of RMD. Transferred amounts are counted in determining whether the owner has met the IRA’s required minimum distribution (RMD) rules. Where individuals have made nondeductible contributions to their traditional IRAs, a special rule treats transferred amounts as coming first from taxable funds, instead of proportionately from taxable and nontaxable funds, as would be the case with regular distributions.

One important warning when using a Qualified Charitable Distribution (QCD) to satisfy an RMD obligation is that an RMD is presumed to be satisfied by the first distribution that comes out of the IRA for the year. Because §408(d)(3)(E) does not permit an RMD to be rolled over back into another IRA, once an RMD occurs, it is irrevocably distributed and taxable.

Example. Leonard’s IRA custodian told him he had to take a $15,000 RMD from his IRA in 2023. On Jan. 2, 2023, Leonard took a $15,000 distribution to satisfy his entire 2023 RMD. In March, Leonard realized that it may have been better for him to do a QCD instead, as he was planning to contribute to charity later in the year anyway. However, he cannot undo his prior RMD, which is irrevocable once distributed. At best, Leonard can simply use the $15,000 distribution he took from his IRA, donate it to a charity, claim a $15,000 charitable deduction as an itemized deduction on Schedule A, and hope that it at least mostly offsets his January taxable distribution. Thus, take the QCD before the RMD or it ends up on Schedule A.

Who Benefits from an IRA Transfer to a Charity?

- Non-itemizers get the full benefit for the contribution and the standard deduction. With the increased standard deduction, this provision is even more important.
- Since the IRA distribution made to a charity is not included in the client’s taxable income, the many AGI-related phase-outs are minimized. For example, the client does not experience a 60% charitable contribution base limitation, or an increase in the amount of Social Security benefits taxable if the individual takes an IRA RMD that is included in AGI and then deducts the amounts paid to charity on his or her Schedule A.
- Since the IRA distribution made to a charity is not included in the client’s AGI, the Medicare B and D premium surcharge may be reduced if an IRA transfer is made directly to the charity.
- Clients may want to rethink the source of large charitable contributions during their lifetime. Perhaps the gift from an IRA will be a better choice than the gift of appreciated stock when considering that an IRA produces income in respect of a decedent at the death of the account owner. Leaving stock may result in less tax to the beneficiary.

SECURE. Coordination with Qualified Charitable Distributions

Because IRA contributions are now deductible for those who qualify for the QCD provision, SECURE reduces the allowable QCD by the IRA deduction allowed for a taxpayer over 70%. “The amount of distributions not includible in gross income by reason of the preceding sentence for a taxable year shall be reduced (but not below zero) by an amount equal to the excess of — (i) the aggregate amount of deductions allowed to the taxpayer under §219 for all taxable years ending on or after the date the taxpayer attains age 70%, (ii) the aggregate amount of reductions under this sentence for all taxable years preceding the current taxable year.”

Example. Joe made traditional IRA contributions at age 71 and 72 for a total of $14,000. A few years later, Joe directs the custodian of his IRA to make a qualified charitable distribution of $25,000 to the Salvation Army. The first $14,000 of the distribution is not treated as a QCD. Thus, $14,000 will be included in Joe’s income as a taxable distribution, and Joe may deduct $14,000 on his Schedule A as a charitable contribution.
An Increased Standard Deduction Makes Charitable Deductions Less Attractive to Some

The doubling of the standard deduction will mean fewer taxpayers will benefit from itemizing their deductions. For a client using the standard deduction, making a $1,000 donation to the Salvation Army won’t reduce their taxes. Charities worry that there will be a drop in donations because of tax reform.

**Example.** In 2023, Hans and Greta have no uninsured medical, will max out their SALT at $10,000 and have paid off their home mortgage. They contribute $10,000 each year to their church. With just $20,000 of itemized deductions, Hans and Greta will claim the $27,700 (2023) standard deduction. They would get more benefit if they “bunched” their contributions and paid their 2023 and 2024 pledge by year-end. Or maybe they should consider a donor advised fund to concentrate their deduction.

**Reminder.** The $600 (MFJ) charitable deduction in arriving at AGI for non-itemizers is not available for 2023.

**Planning for charitable giving.** The doubling of the standard deduction means that many clients lose the tax benefit of their charitable contributions. Planning may help.

1. Bunch deductions by paying two years of pledges in the same year, and none the next year.
2. Consider a donor advised fund to “prepay” several years of donations in one taxable year.

**Tax practitioner aid.** See Tax Tip 2019-142 for a resource in answering clients’ questions.

Determining the Value of Donated Non-Cash Property

Refer your clients to IRS Publication 561 for examples on valuing noncash items donated to charity. The following documentation is required.

- Less than $250. “Separate contributions of less than $250 are not subject to the requirements of §170(f)(8), regardless of whether the sum of the contributions made by a taxpayer to a donee organization during a taxable year equals $250 or more” (§1.170A-13(f)(1)).
- $250 or more. For all contributions of $250 or more, the taxpayer generally must obtain a contemporaneous written acknowledgment from the done (§170(f)(8)).
- $500 or more. Additional substantiation requirements are imposed for contributions of property with a claimed value exceeding $500 (§170(f)(11)(B)).
- More than $5,000. Still more rigorous substantiation requirements, including the need for a “qualified appraisal,” are imposed for contributions of property, or similar items of property, with a claimed value exceeding $5,000 (§170(f)(11)(c)).

**What are “similar items”?** The term “similar items of property” is defined to mean “property of the same generic category or type,” such as clothing, jewelry, furniture, electronic equipment, household appliances, or kitchenware (§1.170A-13(c)(7)(iii)). “Similar items of property” must be aggregated in determining whether gifts exceed the $500 and $5,000 thresholds (§170(f)(11)(F)).

**Tax practitioner planning.** Claiming a $6,000 contribution of “household goods” would require an appraisal. Claiming a $3,000 donation of furniture and a $3,000 donation of clothing would not. Categorize the noncash donations carefully.
Required documentation. For any non-cash contribution exceeding $5,000, the regulations require the donor to:

1. obtain a qualified appraisal for the contributed property,
2. attach a fully completed appraisal summary (Form 8283) to the tax return on which the deduction is claimed and maintain records pertaining to the claimed deduction in accordance with §1.170A-13(b)(2)(ii) and §1.170A-13(c)(2).

Qualified Appraisal

What is a qualified appraisal? The term “qualified appraisal” means an appraisal that is:

- prepared no earlier than 60 days prior to the donation nor later than the extended due date of the tax return for the year of the donation,
- conducted by a qualified appraiser in accordance with generally accepted appraisal standards,
- not prepared for a fee based on a percentage of the appraised value of the donated item (§170(f) (11)(E)(I)), and
- certified as prepared for tax-related IRS purposes (§1.170A-17(a)(1)).

Who is a qualified appraiser? The term “qualified appraiser” means an individual who:

- has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations,
- demonstrates verifiable education and experience in valuing the type of property subject to the appraisal,
- regularly performs appraisals for which the individual receives compensation, and
- has not been prohibited from practicing before the IRS at any time during the three-year period ending on the date of the appraisal (§1.170A-17(b)(1)).

What must be included in the qualified appraisal? The actual appraisal is required to include all of the following information:

- A detailed description of the property,
- If tangible personal property, the property’s physical condition,
- The date of the donation,
- Terms of any agreement between the donor and the donee regarding the use or disposition of the donated property,
- The name, address, and ID number of the appraiser,
- The appraiser’s qualifications, including education, experience, and memberships in appraisal organizations,
- A statement that the appraisal is to be used for income tax purposes,
- The date the property was appraised,
• The fair market value of the donated property on the date of the contribution (§1.170A-17(a)(3)).

In addition, the appraiser must include on his or her appraisal summary a declaration that the appraiser may be subject to a penalty if a substantial or gross valuation misstatement results from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund.

RECENT CASES AND RULINGS ON CHARITABLE CONTRIBUTIONS


In 1998, Braen Commercial Holdings Corp. (a family mining company founded in 1904) purchased a 505-acre plot of land in Ramapo, New York, with an eye to developing it into a granite quarry, adding to an existing stable of four quarries. Years of delays and disputes with both the state and town followed, including litigation over a 2004 zoning change made by Ramapo. As part of a 2010 settlement of this lawsuit, Ramapo purchased 425.5 acres of the property for $5,250,000 and rezoned the remainder to its pre-2004 designation. Holdings’ 2010 tax reporting treated the sale to Ramapo as a bargain sale that had generated a charitable contribution of $5,220,000, and the Braens claimed proportionate shares of this amount on their respective tax returns as deductions under §170. The IRS disallowed these deductions in full and determined accuracy-related penalties.

Holdings asserted a fair market value of $17,472,000 based on a mineral value of $14,554,000 for 175 acres and a land value of $2,918,263 for 212.5 acres on which no mining would be performed (with the remaining 38 acres reserved as a buffer). An explanation attached to the return stated that, although Holdings “would be entitled to a charitable contribution deduction of $12,222,000, it “is only claiming a charitable contribution of $5,222,000” to avoid a dispute with the IRS over the value of the transferred property and a potential substantial or gross valuation misstatement penalty.”

Was settlement of the lawsuit a substantial benefit to Holdings? Contributions of property generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return (Seventeen Seventy, TCM Memo. 2014-124). The courts have found that a transfer of real property in exchange for development approvals is a benefit and precludes a finding of the requisite donative intent (Triumph, TCM 2018-65.) The Court found that Holdings gained the significant benefit of a change to its then-governing zoning designation as part of the coordinated settlement and land purchase agreement. This benefit was required to be taken into account when analyzing any charitable contribution deduction. Having failed to do so, the Braens are not entitled to the claimed charitable contribution deductions.

Contemporaneous acknowledgement flawed. The Court opined that even if were to overlook Holdings’ failure to value the zoning reversion, the deduction nonetheless would have been barred because of a “fatal defect in the contemporaneous written acknowledgment.” The 2011 acknowledgment letter provided by the Ramapo town attorney did not satisfy §170(f)(8). Holdings negotiated for and received the zoning change as part of the settlement and land purchase, and, to satisfy §170(f)(8), the acknowledgment was required to both identify the zoning change as consideration and provide a good-faith valuation of it. The letter plainly did not do so, instead stating that Holdings did not receive “any goods or services, in whole or in part, as consideration” other than the $5,250,000.
Purported Appraisal Was Prepared in Exchange for a Prohibited Appraisal Fee *(Calvin Lim and Helen Chu v. Comm., TCM 2023-11)*

On their joint Federal income tax return for 2016 Calvin Lim and Helen Chu reported a noncash charitable contribution deduction of $1,608,808 passed through to them from Integra - a pass-through entity created by Michael Meyer as part of his “Ultimate Tax Plan” scheme. Because the contribution amount exceeded the maximum allowable deduction for 2016, taxpayers claimed a $1,195,073 deduction for 2016 and carried the balance of $415,711 forward to their 2017 return.

“Prohibited appraisal fee” disqualifies the appraisal. Section 170(f)(11) disallows a deduction for certain noncash charitable contributions unless specified substantiation and documentation requirements are met. In the case of a contribution of property valued in excess of $500,000, the taxpayer must obtain and attach to his return “a qualified appraisal of such property.” The Court found that the appraisal submitted by Mr. Lim and Ms. Chu could not be “qualified” because the appraiser (Michael Meyer) prepared it in exchange for a “prohibited appraisal fee.”

The engagement letter specified that Mr. Meyer’s fee would be the greater of $25,000 or an amount calculated by reference to the assets transferred. In the latter case, his fee was defined as 6% of the “deductible amount” of assets up to $1 million, plus 4% of the “deductible amount” of assets exceeding $1 million. The engagement letter further specified that Mr. Meyer’s fee would be $84,000, which presupposes that the deductible amount of the assets transferred would be $1,600,000. Mr. Meyer’s fee was clearly based, directly or indirectly, on the appraised value of the units allegedly donated to the charity. His agreement with Mr. Lim and Ms. Chu thus constituted a prohibited fee arrangement. For that reason alone, the purported appraisal was not a “qualified appraisal” within the meaning of §170(f)(11)(D).

Tax Shelter Promoter Penalties Applied Because Of Faulty Appraisals *(James Tarpey v. US, CA-9, Doc. No. 22-35208 (Aug. 17, 2023))*

James Tarpey, a lawyer, and businessman, formed Project Philanthropy, Inc. d/b/a/ Donate for a Cause (“DFC”) around 2006. DFC facilitated the donation of timeshares for timeshare owners who no longer wanted to pay timeshare fees or otherwise wanted to dispose of their timeshare properties. Tarpey promised potential customers that they could receive generous tax savings from donating their unwanted timeshares to DFC. Tarpey himself appraised the value of some of the properties donated to DFC, and other properties were appraised by his sister, Suzanne Tarpey, and real property appraisers Ron Broyles and Curt Thor.

**Tax shelter promoter penalty.** 26 U.S.C. §6700 imposes a penalty on promoters and others involved in the organization or sale of tax shelters if they make false statements or exaggerate valuation, in this case, in the form of timeshare appraisals. The Ninth Circuit Court of Appeals upheld the district court’s determination on summary judgment that taxpayer was liable for the appraisals of Broyles and Thor because, as a matter of law, taxpayer knew or had reason to know Broyles and Thor were disqualified as appraisers under the Treasury regulations, and taxpayer forfeited his argument on appeal that he was unaware the appraisals would be imputed to DFC.

**Disqualified appraisers.** Taxpayers must obtain a “qualified appraisal” of property if a donation of that property results in a claimed deduction of more than $5,000. The Treasury regulations disqualify as an appraiser (i) the donee of the property, (ii) persons related to the donee, and (iii) persons used by the donee whose appraisal practice is not sufficiently diversified by performing the majority of their appraisals for persons other than the donee. (§1.170A-13(c)(5)(iv)(C), (E), (F)). The Appeals Court agreed with the district court that “Tarpey constitutes the donee,” Tarpey and DFC are “related,” and Tarpey, his sister, Broyles, and Thor were all disqualified pursuant to the last exclusion because they did not perform a majority of their appraisals for persons other than DFC.
Donation of Appreciated Stock was Assignment of Income (Estate of Scott M. Hoensheid et al. v. Comm., TCM 2023-34)

Scott Hoensheid in anticipation of the sale of Commercial Steel Treating Corp. (CSTC), a closely held corporation, contributed 1380 shares of CSTC to Fidelity Charitable Gift Fund (a donor advised fund).

Contributing appreciated stock. When a taxpayer disposes of appreciated property via charitable contribution, they typically do not recognize any gain. This is because the taxpayer can avoid paying tax on the unrealized appreciation in the property and deduct the fair market value of the property contributed to a qualified charitable organization. Contributions of appreciated property are therefore tax-advantaged compared to cash contributions. Donor-advised funds can further optimize a contribution by allowing a donor to get an immediate tax deduction but defer the actual donation of the funds to individual charities until later.

Anticipatory assignment of income doctrine. The anticipatory assignment of income doctrine is a fundamental principle of income taxation that holds that income must be taxed to the person who earns or creates the right to receive it. This doctrine prevents taxpayers from avoiding tax by arranging anticipatory assignments of income, which transfer the right to receive income from one person to another before the income is received.

For example, if a taxpayer assigns the right to receive wage income or a debt instrument carrying accrued but unpaid interest to another person before receiving the income, the taxpayer cannot avoid tax on that income. Similarly, if a taxpayer gratuitously transfers shares of stock that carry a fixed right to proceed of a pending, pre-negotiated transaction, the taxpayer’s right to income from those shares is deemed fixed and cannot be avoided through an anticipatory assignment of income.

In determining whether an anticipatory assignment of income has occurred with respect to a gift of shares of stock, the focus is on the realities and substance of the underlying transaction, rather than on formalities or hypothetical possibilities. If a transaction involving shares of stock has become “practically certain to occur” by the time of the gift, despite the remote and hypothetical possibility of abandonment, a donor’s right to income from those shares is deemed fixed, and an anticipatory assignment of income has occurred.

Gain must be recognized as if donated stock was sold. Waiting to transfer CSTC shares until two days before closing eliminated any risk and made the sale a virtual certainty. Mr. Hoensheid’s right to income from the sale of CSTC shares was thus fixed as of the gift on July 13, 2015. The Court ruled that gain must be recognized on the sale of the 1,380 appreciated shares of CSTC stock.

Tax practitioner planning. To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor must bear at least some risk at the time of contribution that the sale will not close. Thus, a gift of appreciated stock should not be made so close to the sale as to trigger the assignment of income threat.

Charitable deduction denied for lack of a qualified appraisal. The Court concluded that Mr. Hoensheid made a valid gift, and although the Court determined that gift to be an assignment of income, Mr. Hoensheid may nevertheless be entitled to a charitable contribution deduction under §170.

Section 170(f)(11)(A)(i) provides that “no deduction shall be allowed . . . for any contribution of property for which a deduction of more than $500 is claimed unless such person meets the requirements of subparagraphs (B), (C), and (D), as the case may be.” Subparagraph (D) is the relevant one here, requiring that, for contributions for which a deduction in excess of $500,000 is claimed, the taxpayer attach a qualified appraisal to the return.
The court found that the submitted appraisal was “substantially deficient”: (1) the appraiser did not have appraisal certifications and did not hold himself out as an appraiser; (2) the appraisal did not sufficiently describe the appraiser’s qualifications and valuation experience; (3) the appraisal was based upon an incorrect date of the contribution. For lack of a qualified appraisal, the Court agreed with the IRS’s disallowance of the taxpayer’s $3,282,511 charitable contribution.

**Tax practitioner planning.** Because the contribution exceeded $500,000, the return preparer had the appraisal in hand so it could be attached to Mr. Hoenshied’s tax return. Particularly in this case, reviewing the appraisal may have saved the charitable contribution deduction.

**Non-Cash Donations of More Than $5,000 Require an Appraisal (Duncan Bass v. Comm., TCM 2023-41)**

Duncan Bass made noncash charitable gifts in 2017 to Goodwill, the Salvation Army, and Lend-A-Hand, which were reported on three Forms 8283 attached to his tax return. According to the Form 8283, the gifts to Goodwill had an appraised fair market value of $10,286 and were purchased for $4,360, while the gifts to the Salvation Army had an appraised fair market value of $10,060 and were purchased for $4,175. The gifts to Lend-A-Hand had an appraised fair market value of $10,340 and were purchased for $4,440. For the gifts, in Section B Part I, “Information on Donated Property,” Mr. Bass indicated that he had donated “various” property in “good used” condition.

**Similar items of property are treated as one property.** For any noncash charitable contribution exceeding $5,000, the donor is required to obtain a “qualified appraisal” for the property contributed. Relying on the fact that he made 173 separate trips to Goodwill and the Salvation Army and received a donation acknowledgment receipt for each trip, at trial Mr. Bass testified that because the donated items reflected on each receipt had a fair market value of less than $250, he did not need to have any of the items appraised. Mr. Bass “misapprehends the applicable law.”

For purposes of determining the $5,000 threshold, property, and all “similar items of property” donated to one or more charitable organizations is treated as one property (§ 1.170A-13(c)(1)(i)). The phrase “similar items of property” is defined as “property of the same generic category or type, such as lithographs, paintings, photographs, books, clothing, jewelry, furniture, electronic equipment, household appliances, toys, and everyday kitchenware (§ 1.170A-13(c)(7)(iii)).

**Contribution of Cryptocurrency Requires Appraisal (CCA 20230212)**

The Chief Counsel Advice ruled that a qualified appraisal is required for the donation of cryptocurrency of more than $5,000 (§170(f)(11)(C)). If a taxpayer uses the value reported on a cryptocurrency exchange, the charitable contributions is not allowable nor is the reasonable cause exception for the requirement to obtain a qualified appraisal satisfied.

**Deed Was Not a Proper Contemporary Written Acknowledgement (Kenneth and Anita Brooks v. Comm., TCM 2022-122)**

On Dec. 15, 2006, the Kenneth and Anita Brooks Family LLC purchased 85 acres of real property known as Cotton Row Farm in Liberty County, Georgia, for $1,350,000. On the same day, the LLC subdivided the property into two parcels of 44 and 41 acres. The LLC granted and recorded a conservation easement over the 41-acre parcel on Dec. 27, 2007, to Liberty County.

The LLC claimed a charitable contribution deduction of $5,100,000 on its 2007 Form 1065 for the contribution of the easement to Liberty County. A Form 8283, Noncash Charitable Contributions, with an appraisal
summary was attached to the LLC’s 2007 tax return. The Form 8283 reported that the donated property was a qualified conservation contribution on a 41-acre tract of vacant land; that the donation was valued at $5,100,000; and that the property was purchased on Dec. 15, 2006. The adjusted or cost basis of the donated property was reported as $1,350,000, the cost basis of the entire 85-acre contiguous parcel, instead of the cost basis of only the 41-acre encumbered parcel.

**Deed not the same as donee receipt.** While there was dispute between the taxpayers’ appraiser and the IRS appraiser over the fair market value of the conservation easement, the Court disallowed the entire deduction (and subsequent carryover of contribution deductions) based on the lack of a “contemporaneous written acknowledgement” (CWA) of the constitution by the donee organization as required by §170(f)(8)(A). The Court ruled that the Easement Deed did not meet the requirements of §170(f)(8) and, consequently, cannot serve as the CWA required by the statute.

**Contemporaneous Receipt Did Not Include “No Goods and Services” Statement So No Charitable Deduction Allowed** *(Martha Albrecht v. Comm., TCM 2022-53)*

Martha Albrecht and her late husband acquired a large collection of Native American jewelry and artifacts during their marriage. In December 2014, Ms. Albrecht donated 120 items from this collection to the Wheelwright Museum of the American Indian. In connection with the donation, the Wheelwright Museum and Ms. Albrecht executed a “Deed of Gift” dated Dec. 19, 2014, that consisted of five pages. The first page stated that Ms. Albrecht “hereby donates the material described below to the Wheelwright Museum of the American Indian under the terms stated in the Conditions Governing Gifts to the Wheelwright Museum of the American Indian.”

The second page of the deed was titled “Conditions Governing Gifts to the Wheelwright Museum of the American Indian” and specified conditions governing gifts to the museum. One of these conditions stipulated in relevant part that “the donation is unconditional and irrevocable; that all rights, titles and interests held by the donor in the property are included in the donation, unless otherwise stated in the Gift Agreement.” Despite “the Gift Agreement” reference on the second page of the deed, no such agreement was included with the deed, and the Wheelwright Museum did not provide Ms. Albrecht with any further written documentation concerning the donation.

**Contemporaneous written acknowledgement must include “no goods or service” statement.** For any contribution of $250 or more, §170(f)(8)(A) requires that the taxpayer obtain from the donee organization, and maintain in her files, a “contemporaneous written acknowledgement” (CWA). The CWA must include (i) the amount of cash and a description (but not value) of any property other than cash contributed; (ii) whether the donee organization provided any goods or services in consideration, in whole or in part, for any such property; and (iii) a description and good faith estimate of the value of any such goods or services. §170(f)(8)(B). Furthermore, the taxpayer must receive the CWA from the donee organization on or before the earlier of the date the taxpayer files his return or the due date for filing such return (§170(f)(8)(C)).

**The gift deed was not good enough to save the deduction.** The deed did not state whether the Wheelwright Museum provided any goods or services with respect to the donation. The terms of the deed were subject to a separate agreement, but the Wheelwright Museum did not provide Ms. Albrecht with this document before the return was filed or with any other suitable receipt for the gift.

**When is a gift deed good enough for proper substantiation?** Where a deed does not contain such an explicit statement, courts have previously looked to the deed as a whole to determine whether the donee provided goods or services in return for the donation. Specifically, the courts have considered whether the deed (i) effectively states whether any goods or services were provided in the exchange; (ii) states the
Whose mistake is this? Ms. Albrecht lost the entire charitable deduction because of a technicality as there seems to have been no issue regarding the value of items donated. Should the taxpayer know the substantiation rules? No, she hired people to help her make and make this gift. So, who is to blame?

- The attorney. Since there were legal documents drawn up, it seems Ms. Albrecht would have retained a lawyer to help her. The lawyer should have known the substantiation rules and protected her charitable deduction. Did the lawyer notice that a “gift agreement” was missing?

- The museum. A charity should absolutely know the substantiation requirements. After all, the law and regulations have been publicized and enforced for decades.

- The tax preparer. The tax preparer should have been the last line of defense. The preparer knows the rules and should have asked to see the “no goods and services” receipt from the Museum. We can guess that the preparer thought the deed was good enough, but this case demonstrates that the return preparer (us too) should also have asked for a traditional receipt from the charity to put in his file this, or any, big donation.

**Tax practitioner planning.** In our Federal Tax Update classes, we regularly discuss establishing an office policy on when to ask for a receipt to check for “the goods and services” statement. What dollar amount is big enough to “require” the client to provide a receipt? $1,000, $5,000, $10,000? Your decision.

Charitable Contribution Denied; Substantiation Rules Not Strictly Complied With *(Joe Alfred Izen v. Comm., 38 F.4th 459 (5th Cir. 2022))*

During an IRS audit of Joe Alfred Izen’s 2012 tax return, Mr. Izen remembered he donated his 50% partnership interest in a vintage airplane to the Houston Aeronautical Heritage Society. He filed a Form 1040X claiming a $338,080 deduction for the donation. To the Form 1040X he attached Form 8283, Noncash Charitable Contribution, and a written letter from the Houston Aeronautical Heritage Society that described the donation. The letter did not mention Mr. Izen and did not provide his taxpayer identification number.

**Contemporaneous written acknowledgment.** Section 170(f)(12)(A)(i) disallows the deduction unless the requisite contemporaneous written acknowledgment is included in the tax return claiming the deduction. The Appellate Court agreed that Mr. Izen did not provide a satisfactory contemporaneous written acknowledgment with his Form 1040X. The letter from the Society discussing the donation of the airplane that Mr. Izen included was addressed to Philippe Tanguy, not Mr. Izen. The letter did not substantiate the contribution of the airplane under §170(f)(12)(B)(i). Mr. Izen also included a copy of the donation agreement between him, Tanguy, and the Society, but the agreement failed to satisfy §170(f)(12)(B)(i) as it lacked Mr. Izen’s taxpayer identification number. Finally, Mr. Izen attached Form 8283 to his Form 1040X, but the Form 8283 did not include his social security number.

**Tax practitioner planning.** This taxpayer prepared his own tax return, but there is still a lesson for us. If you’re preparing this return, be sure to ask for the charity receipt and check that the name of the donor matches your client’s name. That is an easy mistake to watch for, but this taxpayer...
also needs a receipt with the “no goods and services” verbiage. In addition, he needs an appraisal and Form 8283 signed by the appraiser and the charity. The devil is in the details, or the deduction is lost.

$3.5 Million Property Charitable Contribution Deductions Denied for Lack of Appraisal ([Duane Pankratz v. Comm., TCM 2021-26 (Mar. 4, 2021)])

In 2008, Duane Pankratz donated his interests in four oil and gas projects, valued at $2 million, to Missionary Church, Inc. and made a large noncash donation of 5.78 acres for road and utility improvements, valued at $1,513,146, to the Church’s Rapid City, South Dakota, campus. In 2009, he donated a conference center to Keystone Project, Inc., another religious organization, leaving the fair market value blank.

The issue before the court. The Form 8283 that Duane Pankratz used stated in plain language on its face that an appraisal is generally required to be attached for donated property worth more than $500,000. Mr. Pankratz didn’t attach appraisals to his returns. The main question presented to the court was whether the failure to attach appraisals can be due to reasonable cause when a taxpayer admits that he did not review his tax returns before filing.

Strangely, Mr. Pankratz conceded that he did not attach a qualified appraisal to his tax returns of either his oil and gas interests, his land, or the conference center. Do we have to go farther? Maybe. Mr. Pankratz argued that he had “reasonable cause” for the position he took on his return because he reasonably relied on a certified public accountant and his oldest employee’s advice. The court found this employee was not a competent tax adviser and his experience was not enough to make him competent to prepare a large and complex tax return. The same was held for the CPA.

To make matters worse, the court found that Mr. Pankratz failed to actively review Form 8283 because the form clearly mentioned that an appraisal was generally required for the donated property. What did Mr. Pankratz do? Mr. Pankratz signed the tax return without the appraisal.

Argument. Section B of Form 8283 has to be completed when a taxpayer donates property worth more than $5,000. The top of section B tells taxpayers that appraisals are generally required for properties that they list. Part I notes again that for deductions of more than $500,000 “you must attach a qualified appraisal of the property.” Question 5(c) asks for the “[a]ppraised fair market value.” Part III is a declaration of an appraiser—and requires the signature of the appraiser used for the listed properties in Part I.

The court sarcastically stated: “We think that four mentions of “appraisal,” “appraiser,” or “appraised” on one page of the form is pretty good notice that substantial noncash donations need to be backed up by an appraisal.” Yet despite all these warning signals, Mr. Pankratz never had a professional appraisal performed or attached one to either his 2008 or 2009 return for any of the large noncash charitable donations that he claimed.

No appraisal, no deduction. Duane Pankratz was denied charitable contribution deductions. In addition, Pankratz substantially understated his tax for both tax years at issue. He argued that he had reasonable cause and acted in good faith in taking the erroneous tax return position. Pankratz lacked reasonable cause for omission of appraisals resulting in penalties being imposed on the disallowed charitable deductions.

“Reasonable Cause” for Omitted Basis on Form 8283 Saves the Deduction ([Wendell H. Murphy, Jr., and Wendy Murphy v. Comm., TCM 2023-72])

Wendell and Wendy Murphy, through Duplin Land Development Inc., an S corporation, owned two tracts of land, which they developed into a 1,500-lot residential community with two 18-hole golf courses, a
clubhouse, a recreation facility, and multiple nature trails. Tract 1 shares a border with Northeast Cape Fear River, and Tract 2 is an interior, land-locked tract to the north. Duplin Land Development, Inc. donated in 2010 perpetual conservation easements - each constituting a “qualified real property interest” under §170(h)(1)(A)) - on Tract 1 and Tract 2 to a “qualified organization” under §170(h)(1)(B). Relying on appraisals, the Murphys claimed charitable contribution deductions of $7,344,095 for the Tract 1 easement and $1,080,814 for the Tract 2 easement as “qualified conservation contributions” on their tax returns. The Murphys’ expert valued the easements on the basis that each tract would be developed as residential housing, assuming in each instance that the other tract would remain a golf course. Attached to the return was an incomplete Form 8283, “Noncash Charitable Contributions”, that did not report the Murphy’s basis in either Tract 1 or Tract 2.

Incomplete Form 8283. Basis of the contributed properties was left blank on the Forms 8283. Therefore, taxpayer did not comply with the substantiation requirements of §170(f) and Reg. §1.170A-13(c). While normally a fatal flaw, the judge points to an exception to the disallowance of the contribution deduction “if it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect” (§170(f)(11)(A)(ii)(II)). Because the IRS substantiation compliance and reasonable cause issues were considered “new matter” at trial, the IRS had the burden of proof and failed to carry that burden.

Tax practitioner planning. Always make sure all items are completed on the Form 8283. The CPA firm that completed the S corporation return should have had the land basis because it had the accounting records to prepare a balance sheet for the Form 1120-S.

War of the Appraisers. The Tax Court analyzed the appraisals submitted by Duplin Land Development and the IRS and found both appraisals to be lacking. The Court ruled the Tract 1 easement to be valued at $2,790,274 and the Tract 2 easement to be valued at $100,000.

Missing Basis Entry on Form 8283 Means Taxpayer Loses Non-Cash Charity Deduction of $7,949,000 (Oakhill Woods, LLC, Effingham Managers, LLC, Tax Matters Partner v. Comm., TCM 2020-24)

Strict substantiation requirements apply. To deduct non-cash contributions in excess of $5,000, the donor must obtain a qualified appraisal of the contributed property, attach a “fully completed” appraisal summary to the return on which the deduction is first claimed, and maintain records containing specified information (§1.170A-13(c)(2)(i)(A), (B), and (C)). The Form 8283, Non-Cash Charitable Contributions, appraisal summary that Oakhill Woods attached to its 2010 return indicated that it acquired the property by purchase on Aug. 1, 2007, but Oakhill Woods did not enter an amount in the space provided for the “Donor’s cost or other adjusted basis.” With respect to “cost or adjusted basis” Oakhill Woods’ attachment stated:

“A declaration of the taxpayer’s basis in the property is not included in * * * the attached Form 8283 because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction. Furthermore, the taxpayer has a holding period in the property in excess of 12 months and the property further qualifies as “capital gain property.”

Omission of basis on Form 8283 fatal to deduction. The required appraisal summary must provide, among other things, the adjusted cost or other basis of the donated property (§1.170A-13(c)(4)(iii)(E)). Congress directed the Secretary of Treasury to adopt stricter substantiation requirements for charitable contributions to alert the Commissioner, in advance, of potential overvaluations of contributed property and thereby deter taxpayers from claiming excessive deductions in the hope that they would not be audited (S.

2. As an exception to the rule, if the donor is “unable” to provide information on its cost basis in the donated property, the donor may substitute an explanatory statement attached to the Form 8283 (§1.170A-13(c)(4)(iv)(C)(1)). Oakhill did attach an explanation, but the attachment did not provide satisfactory excuses for its omission.
Prt. No. 98-169 (Vol. 1), at 444; 1984 Blue Book, at 503-504. Because Oakhill’s omission of its basis in the contributed property from the Form 8283 it attached to its 2010 return prevented the appraisal summary from achieving its intended purpose, Oakhill’s failure to meet the requirement of §1.170A-13(c)(4)(ii)(E) could not be excused by substantial compliance. The charitable deduction was denied in full.

**Tax practitioner planning.** Be sure to complete all required information on Form 8283. While the appraisal is the responsibility of the appraiser, the completion of Form 8283 is the responsibility of the tax preparer.

**Tax practitioner note.** *Form 8283* was revised November 2022. Particularly see Section B, part one, on the second page that includes a check box that describes the type of property donated.

Also see.


**Conservation Easement Deductions Are Target for IRS Exam**

On March 11, 2022, the Joint Committee on Taxation (JCT) released its report, Tax Treatment of Charitable Contributions, JCX-2-22. Although not law, it is a useful resource.

Charitable contribution deductions for the value of conservation easements are under close scrutiny by the IRS. This is evident in numerous recent opinions out of the US Tax Court and notices from the IRS, IRS Notice 2017-10. The JCT report identifies the policy concerns relating to conservation easement deductions, mainly with regard to (i) inflated valuations of easements (which then turns into the amount used for deduction), and (ii) the requirement that the restriction for conservation purposes be “in perpetuity.”

**Special Rule for “Qualified Conservation Easement” Contributions**

Generally, taxpayers are not entitled to deduct gifts of property that consist of less than the taxpayers’ entire interest in that property (§170(f)(3)). An exception to this general rule is that taxpayers are permitted to deduct the value of a contribution of a partial interest in property that constitutes a “qualified conservation contribution” (§170(h)(1); §170(f)(3)(B)(iii)). For a contribution to constitute a qualified conservation contribution, the taxpayer must show that the contribution is of a “qualified real property interest,” to a “qualified organization,” and “exclusively for conservation purposes.” For the donation to be deductible, the conservation purpose must be protected in perpetuity (§170(h)(5); §1.170A-14(a)).

Contributions of property “generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.” A taxpayer who receives goods or services in exchange for a contribution of property may still be entitled to a charitable contribution deduction if the taxpayer makes a contribution that exceeds the fair market value (FMV) of the benefit the taxpayer receives and makes the excess payment with the intention of making a gift.

**Watch out for “quid pro quo” exchanges when conservation easements are granted.** In determining whether a payment is a contribution or a gift, it must be determined if the transaction in which the payment is involved is structured as a quid pro quo exchange. The taxpayer must show that she or he intended to make a charitable contribution in an amount that exceeded the FMV of the consideration received in the exchange and that she or he actually made a charitable contribution in an amount that exceeded the FMV of that consideration (§1.170A-1(h)(1) & (2)).
Strict quid pro quo formula must be followed. A quid pro quo analysis ordinarily requires two parts: (1) the value of the contributed conservation easement, and (2) the value of the consideration received in exchange for the easement (Rolfs v. Comm., 668 F.3d 888 (7th Cir. 2012); 2012-1 USTC ¶150,186).


In 2015, an entity purchased 163 acres for $490,010 and contributed it to Pickens Decorative Stone, LLC (“Pickens”), a partnership, for federal income tax purposes. Pickens granted to Foothills Land Conservancy a conservation easement over most of the property. Pickens claimed a charitable contribution deduction of $24,700,000 for the donation of the conservation easement.

The easement deed recited the conservation purposes and generally prohibited commercial or residential development. But it reserved certain rights to Pickens, including the rights to engage in forestry and recreational activities such as hiking, camping, hunting, fishing, and horseback riding. In connection with these recreational activities, Pickens reserved the right to build fences, bridges, and trails. Pickens also reserved the right to construct barns, sheds, and facilities “for the generation of renewable electrical power.” The IRS disallowed the deduction, stating that the easement’s conservation purpose was not “protected in perpetuity” as required by §170(h)(5)(A), and the IRS sought summary judgment, which was denied.

Tax practitioner note. Taxpayers seeking to deduct noncash charitable contributions in the form of conservation easements should be sure to “cross the t’s and dot the i’s” in the conveyances themselves as well as in the tax returns in which the charitable deduction is requested. Where a grantor reserves certain rights of use to the property deeded as a conservation easement, then the holder of the conservation easement should have, maintain, and adopt policies, procedures, and practices designed to enforce the conservation purposes of the grant. Otherwise, the IRS may suspect a scam and disallow the claimed charitable contribution deduction, the proposed dedication for conservation purposes “in perpetuity.”

Also see.

Nathaniel Carter v. Comm., TCM 2020-21, where a provision in the easement violated the perpetuity requirement by subjecting the land that was supposed to be protected in perpetuity from such development to commercial or residential development.

Railroad Holdings, LLC v. Comm., TCM 2020-22; Rock Creek Property Holdings, LLC v. Comm., Docket No. 5599-17 (Feb. 7, 2020); Oakbrook Land Holdings, LLC, 154TC No. 10, (May 12, 2020); Belair Woods, LLC, TCM 2020-112; and Cottonwood Place, LLC v. Comm., TCM 2020-115, where taxpayers violated the perpetuity requirement in §170(h)(2)(c).

Proposed Regulations Make Syndicated Conservation Easement Transactions Listed Transactions

On Dec. 8, 2022, the IRS released a notice of proposed rulemaking that would identify certain syndicated conservation easement transactions and substantially similar transactions as listed transactions, a type of reportable transaction. Material advisors and certain participants in these listed transactions are required to file disclosures with the IRS and are subject to penalties for failure to disclose. The proposed regulations do not modify or amend Notice 2017-10 that has been under attack in recent court cases because it was issued without following the APA’s notice and comment procedures. (See Green Valley Investors, LLC, et al. v. Comm., 159 T.C. No. 5 (Nov. 9, 2022)).
Legislative Changes Coming for Syndicated Conservation Easements

For contributions made after Dec. 29, 2023, the Consolidated Appropriations Act, 2023 disallows a charitable deduction for a qualified conservation contribution if the deduction claimed exceeds 2 ½ times the sum of each partner’s relevant basis in the contributing partnership, unless:

1. the contribution meets a 3-year holding period test,
2. substantially all of the contributing partnership is owned by members of a family, or
3. the contribution relates to the preservation of a certified historic structure.

Note. In the case of a contribution for the preservation of a certified historic structure, a new reporting requirement applies.

The Act also provides taxpayers the opportunity to correct certain defects in an easement deed (excluding easements involved in abusive transactions) and makes some changes to the statute of limitations and penalty provisions.

Why do we care? The IRS has tried to audit all syndicated conservation easement returns with success and only a few failures. Congress finally stepped up to help the resource-strapped IRS and put limits on the charity deduction, but not until the end of 2023. In the meantime, the K-1 from a syndicated conservation easement deal will show large contributions and a negative capital account.

MISCELLANEOUS ITEMIZED DEDUCTIONS

Miscellaneous Itemized Deductions Subject to 2% Limit Suspended (§62, New §67(g))

The TCJA suspends all miscellaneous itemized deductions that are subject to the 2% floor under present law. Prior law and IRS guidance provided examples of items that were deductible as miscellaneous itemized deductions subject to the 2% AGI limit for 2018 through 2025.

Expenses for the collection and production of income. The non-exhaustive list includes:

- appraisal fees for a casualty loss or charitable contribution
- casualty and theft losses from property used in performing services as an employee
- clerical help and office rent in caring for investments
- depreciation on home computers used for investments
- excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust
- fees to collect interest and dividends
- hobby expenses, but generally not more than hobby income
- indirect miscellaneous deductions from pass-through entities
- investment fees and expenses
- loss on deposits in an insolvent or bankrupt financial institution
• loss on traditional IRAs or Roth IRAs when all amounts have been distributed repayments of income
• safe deposit box rental fees, except for storing jewelry and other personal effects
• service charges on dividend reinvestment plans
• trustee's fees for an IRA, if separately billed and paid

**Tax preparation fees (§212).** The deduction for tax preparation fees for the personal tax return of the taxpayer is suspended.

**Tax practitioner planning.** Of course, we will continue to allocate our tax preparation fees between Schedule A, C, E, and F to protect as much of the deduction as possible.

**Unreimbursed employee business expenses (§67).** IRS Publication 529 included the following as a non-exhaustive list of employee business expenses:

• business bad debt of an employee
• business liability insurance premiums
• damages paid to a former employer for breach of an employment contract
• depreciation on a computer a taxpayer’s employer requires him to use in his work
• dues to a chamber of commerce if membership helps the taxpayer perform his job
• dues to professional societies
• home office or part of a taxpayer’s home used regularly and exclusively in the taxpayer’s work
• job search expenses in the taxpayer’s present occupation
• laboratory breakage fees
• legal fees related to the taxpayer’s job
• licenses and regulatory fees
• malpractice insurance premiums
• medical examinations required by an employer
• occupational taxes
• passport fees for a business trip
• repayment of an income aid payment received under an employer’s plan
• research expenses of a college professor
• rural mail carriers’ vehicle expenses
• subscriptions to professional journals and trade magazines related to the taxpayer’s work
• tools and supplies used in the taxpayer’s work
• purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer’s work
• union dues and expenses
• work clothes and uniforms if required and not suitable for everyday use
• work-related education

Other miscellaneous itemized deductions subject to the 2% floor. Other miscellaneous itemized deductions subject to the 2% floor included:

• repayments of income received under a claim of right (only subject to the 2% floor if less than $3,000),
• repayments of Social Security benefits, and
• the share of deductible investment expenses from pass-through entities.

Tax practitioner planning. Miscellaneous itemized deductions not subject to the 2% AGI floor continue to be deductible.

Examples illustrate the breadth of the change:

Example — legal fees. A San Francisco jury awarded Dewayne Johnson $250 million for punitive damages after his cancer was linked to Monsanto’s Roundup weedkiller. The punitive damages are taxable (§104(a)(2) and (c)), but the legal fees paid by Mr. Johnson are not deductible, thanks to a TCJA change since they are miscellaneous itemized deductions subject to the 2% of AGI limit.

What does Mr. Johnson net from the punitive damage award? If the attorneys’ contingent fees are 50%, Mr. Johnson nets $125 million after their share. Then the IRS takes 37% of the gross award, or $92.5 million, and California (Mr. Johnson’s state of residency) takes $8.75 million — California didn’t conform to the elimination of the miscellaneous itemized deduction provision in the TCJA. What’s left? $23.75 million of the $250 million headline in the newspaper!

Tax practitioner planning. Legal fees can be netted against the award only if the award is paid for federal civil rights discrimination (age, race, religion, sex). See §62(a)(20).

Example — financial planner fees. In 2023, Paul paid $35,000 of financial planner fees for the management of his stock portfolio. The fees are a miscellaneous itemized deduction and not deductible.

Example — education expense. Bruce is a computer science teacher at Homestead High School. Because his field is constantly changing, he spent in 2023 $9,000 to attend several professional conferences on teaching, to take a college class on advanced coding, and to buy books, supplies, and software for use in his classes. None of the expenses is deductible — except for the (puny) $300 educator deduction. Bruce could ask his school district to reimburse him, but good luck with that one, considering every school’s paltry budget.

Example — outside sales. Jane works for a small software company as a commissioned sales representative. She is not reimbursed for her mileage, meals and entertainment, or travel. In 2023, she spent $10,000. Because employee business expenses are no longer deductible, Jane is now spending after-tax dollars. She would like to convince her employer to establish an accountable plan to reimburse her for her properly accounted for expense. But the employer wasn’t paying any of Jane’s expenses before, why now? Because she has lost a big tax deduction! To convince her employer to reimburse her, Jane may have to take a cut in her commission percentage (i.e.,
Jane was getting commission/wages of $100,000 and paying expenses of $10,000 out of her own pocket. Maybe instead, she can take $90,000 of commission/wages and the employer can pay the $10,000 of expenses. This can result in a bonus to the employer — because wages are lower, he will pay less payroll taxes and workers’ compensation insurance).

Can the Taxpayer Capitalize Investment Adviser Fees to the Cost of the Stock?

**No! Investment management fees cannot be capitalized.** The IRS denied investors the option of capitalizing investment management fees paid to a broker as carrying charges under §266. The investors wanted to avoid alternative minimum tax and other limitations on miscellaneous itemized deductions, the law in effect before 2018. With the suspension of miscellaneous itemized deductions, there was a big incentive to capitalize investment adviser fees (CCA 201721015).

*The CCA states:* “Consulting and advisory fees are not carrying charges because they are not incurred independent of a taxpayer’s acquiring property and because they are not a necessary expense of holding property. Stated differently, consulting, and advisory fees are not strictly analogous to common carrying costs, such as insurance, storage, and transportation.”

**Tax practitioner planning.** Instead of an asset management fee, perhaps Paul can pay transaction fees. Transaction fees can be added to basis.

**Limitation of Gambling Losses (§165(d))**

Gambling losses are limited to gambling winnings. The TCJA clarifies that the limitation on losses from gambling transactions applies not only to the actual costs of wagers incurred by an individual, but also to other expenses incurred by the individual in connection with the conduct of that individual’s gambling activity. The provision clarifies, for instance, an individual’s otherwise deductible expenses in traveling to or from a casino are subject to the limitation under §165(d).

**Tax practitioner planning.** This provision is meant to limit expenses of gambling professionals.

**Tax practitioner planning.** The doubling of the standard deduction will mean that some small, casual gamblers will not get a tax benefit from their gambling losses.

**Example.** Nancy has a W-2G from Harrah’s for $5,000 that she won on a poker machine. Nancy’s spouse figures that Nancy spent $8,000 winning that $5,000. Wait until Nancy and her spouse find out that the gambling winning will cost them tax because they are not itemizing deductions for 2023.

**Court Accepts Gambling Winnings As Reported On Tax Return, But Needs Records Of Gambling Losses (Jacob Bright v. Comm., Tax Court Docket No. 10095-22 (May 4, 2023))**

Jacob Bright received 24 Forms W-2 for 2019 that totaled $110,553. He hired a tax preparer who reported his gambling activity on a Schedule C showing $240,895 of gross receipts and an equal amount of expenses. The IRS determined that Mr. Bright was not a professional gambler and that his gambling winnings should be reported as miscellaneous income and that his gambling losses should be a miscellaneous itemized deduction, not subject to the 2% AGI limits (thus, still deductible after TCJA as long as the taxpayer itemized his or her deductions).

**Note.** Use Schedule 1 to report 2023 gambling winnings.
Mr. Bright did not know how his return preparer calculated the winnings reported on his Schedule C but since he was unable to establish that his gambling winnings were less than what he reported on his own return, the Court agreed with the IRS that gambling winnings were $240,895. Mr. Bright failed to establish gambling losses in the amount he reported on his return. Casino records, however, established to the Court’s satisfaction that he had gambling losses of no less than $191,756.

Taxpayers Were Not Professional Gamblers *(Susan and James Mercier v. Comm., USTC Docket No. 7499-228 (Mar. 18, 2023))*

In 2019, Susan Mercier was employed as an accountant at a Nevada charter school and James Mercier operated an appliance repair business. During the year, the Merciers spent time gambling at several Nevada casinos. They gambled on days when they earned extra players card points or received some other advantage. They played only video poker machines using a strategy they developed based on statistical information about video poker. Both Mr. and Mrs. Mercier have extensive knowledge of video poker. Based on the foregoing, they considered themselves professional gamblers — but not until after receiving the IRS Notice of Deficiency for failing to include gambling income.

Ms. Mercier prepared their 2019 tax return. She initially included the gambling winnings of $19,612 from the Forms W-2G in the return, but later decided not to include the winnings when she noticed that doing so increased the amount of tax due. Why were taxes higher? Losses are only deductible as miscellaneous itemized deductions. When she claimed gambling losses on their Schedule A, the result was lower than the standard deduction. Therefore, Ms. Mercier chose not to report the income from Forms W-2G in the 2019 return and took the standard deduction instead of itemizing deductions.

Who is a professional gambler? Generally, deductions are allowed only for activities that are conducted with the motive of making a profit (§183). Gambling activity may be considered a trade or a business if it is conducted with continuity, regularity, and for the primary purpose of earning a profit. As in all “hobby loss” cases, a nine-factor test is used to determine whether gambling activity was for the primary purpose of earning a profit (Reg. §1.183-2(b)). The factors include: (1) whether the activity was carried out in a business-like manner; (2) the taxpayer’s expertise; (3) the time and effort the taxpayer spent gambling; (4) the expectation that assets used in the activity may increase in value; (5) the taxpayer’s success in nongambling activity; (6) the taxpayer’s history of winnings and losses; (7) the amount of the occasional profits from gambling; (8) the taxpayer’s financial status; and (9) the presence of elements of personal pleasure or recreation.

The Court agreed with the IRS that the Merciers were not professional gamblers, noting particularly that they did not keep records (rather they relied on casino records) and that they had reported in previous years gambling losses on Schedule A as would a casual gambler and as they began to do for 2019.

Section 165(d): TCJA Amendment Not Applicable to Certain Expenses Related to Trade or Business of Gambling *(CCA 202111012)*

The TCJA amended §165(d) to provide that neither a casual nor professional gambler could claim wagering losses in excess of wagering income. The question before the Chief Counsel was “does TCJA’s amendment to §165(d) treat a professional gambler’s ordinary and necessary business expenses as losses from wagering transactions?” The CCA conclusion: “No, §165(d) does not apply to the ordinary and necessary expenses of a business in the trade or business of gambling.”
CASUALTY AND OTHER LOSSES §165 & §166

Special Rules for Qualified Personal Casualty Losses for Disaster-Related Relief (§24(d) and §32)

If an individual has a net disaster loss:

- The amount of the deduction is equal to the sum of the net disaster loss and the excess that exceeds 10% of the individual's AGI,
- Using $500 (instead of $100),
- The standard deduction is increased by the net disaster loss, and
- Not applying the AMT treatment of certain recoveries and standard deduction (§56(b)(1)(D) or (E)) to so much of the standard deduction as is increased by third bullet point above.

Automatic Extension of Filing Deadlines in Case of Individual Taxpayers Affected by Federally Declared Disasters (§7508A)

Automatic 60-day extension. In the case of any qualified taxpayer, a mandatory 60-day extension has been added to the one-year waiver of taxes and interest option that may be granted by the Secretary of Treasury. This is effective for federally declared disasters after Dec. 20, 2019 (the date of enactment of HR 1865).

A qualified taxpayer includes:

- An individual whose principal residence is in the disaster area,
- Any taxpayer if the principal place of business (other than the employee) is located in a disaster area,
- A relief worker assisting in a disaster area who is affiliated with a government or philanthropic organization,
- A taxpayer whose records show necessity to meet certain deadlines by reason of a presidentially declared disaster or terrorist or military actions,
- Any individual visiting a disaster area who was killed or injured as a result of the disaster, and
- Solely with respect to filing a joint return, any spouse of the above-mentioned individual.

Application to pension contributions. This automatic extension period also applies to making contributions to a qualified plan, including making distributions, recharacterizing contributions, and making a rollover.

Personal Casualty Losses (§165(h))

For 2018 through 2025, the TCJA provides that a taxpayer may claim a personal casualty loss only if such loss was attributable to a presidentially declared disaster.

Example. Evelyn had a house fire that destroyed a painting left to her by her father. The FMV of the painting at her father’s death was $30,000. The insurance company limited reimbursement for artwork to $1,000. Evelyn’s $29,000 casualty loss is not deductible.
Presidentially Declared Disaster Losses ([Help During Disasters](#))

Wildfires, floods, and hurricanes have dominated the news in recent months. Tax relief is available for victims of presidentially declared disasters. The IRS website is updated regularly for newly designated disaster areas, including recent tax relief for the California, Oregon, and Washington wildfires.

**Postponed filing dates.** The IRS website, at recent tax relief, provides postponed filing dates for taxpayers located in affected areas.

**Reconstructing records.** See IRS website [here](#) for basics on reconstructing records. While the IRS website does not contain technical information for the preparation of the return, it does include helpful information for a client in an area prone to disasters or for a client who has experienced the personal devastation caused by a disaster. And for us, the IRS webpage can provide us with an easy source of “cut and paste” information for a client who has lost their house or business in a fire, hurricane, or other disaster.

**If the client needs money.** If the client needs money to pay for living expenses after a disaster:

- Because banks and ATMs are often closed after a fire, flood, or hurricane, stockpiling a bit of cash in a fireproof safe might be good pre-disaster planning;
- A hardship withdrawal from one’s retirement plan or 401(k) is probably available;
- FEMA makes cash available, and FEMA relief is not taxable; and
- For small businesses, the Small Business Administration has an emergency grant of up to $10,000 (known as an EIDL) and low-interest disaster loans.

**TIGTA Warns That Casualty and Theft Loss Deductions Continue to Be Erroneously Processed Without a Valid FEMA Number ([TIGTA Report Number 2021-40-045](#))**

The TCJA limited the personal casualty and theft loss deduction to only those claims associated with federally declared disasters for Tax Years 2018 through 2025. Casualty and theft loss deductions are reported on Form 4684. Taxpayers are instructed to enter the Federal Emergency Management Agency (FEMA) number that qualifies as a federally declared disaster area on their Form 4684. TIGTA’s review of Tax Year 2019 tax returns processed as of Sep. 3, 2020, identified 34,699 tax returns that claimed a casualty and theft loss deduction. TIGTA found that 12,075 (35% percent) of the 34,699 had a FEMA number that did not match the FEMA number on the taxpayer’s tax account, had an invalid FEMA number or were missing the FEMA number.

**TIGTA says missing FEMA number should delay processing.** IRS management’s analysis of the 7,761 tax returns TIGTA identified in a prior TIGTA review determined that only 2.4% of cases would potentially be examined. This IRS finding supported TIGTA’s prior recommendation that tax returns missing the FEMA number should be identified for review during processing rather than being examined after processing.

**IRS Posts Tax Tip on Disaster Relief Sources ([Tax Tip 2023-67](#))**

Fires, floods, and hurricanes — IRS.gov has information and resources that can help taxpayers and tax practitioners before and after a disaster.
IRS Answers FAQs for Disaster Victims [FAQs]

This IRS webpage contains information to help taxpayers and tax practitioners with common tax-related questions after a disaster. A few highlights from the 38 FAQs follow:

- Disaster relief applies to the clients of tax preparers who are unable to file returns or make payments on behalf of the client because of a federally declared disaster.

- If the taxpayer is outside of the disaster area, he or she may qualify for relief if the preparer is in the federally declared disaster area and the preparer is unable to file or pay on the taxpayer’s behalf.

- If an affected partnership or S corporation cannot provide the taxpayer with the records necessary to file his or her return, then the taxpayer is an affected taxpayer. Filing and payment deadlines are postponed until the end of the postponement period just like the affected partnership or S corporation.

- If a taxpayer properly claimed a casualty loss deduction on an original return and in a later year receives reimbursement for the loss, the taxpayer does not amend the original return. Instead, the taxpayer should report the amount of the reimbursement in gross income in the tax year in which the reimbursements were received, to the extent the casualty loss deduction reduced their income in the tax year that the taxpayer reported the casualty loss deduction.

- The IRS will not abate interest on balances due on liabilities for prior years.

- The IRS will consider waiving late payment penalties when the reason for the late payment is due to reasonable cause related to the disaster.

Qualified disaster mitigation payments are excludable from the recipient’s income. Such payments are amounts paid under the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act (as in effect on Apr. 15, 2005) to or for the benefit of the owner of any property for hazard mitigation. In calculating the casualty loss, if a FEMA payment is for replacement of lost or destroyed property, subtract the amount in figuring the casualty loss.

**Tax practitioner planning.** Preparers and/or staff should consider reviewing these FAQs before filing a disaster loss return.

**SECURE 2.0 Provides for Penalty-Free Disaster Recovery Distributions**

SECURE 2.0 provides that sponsors of 401(k), 403(b), governmental 457(b) and money purchase pension plans can offer penalty-free distributions called “qualified disaster recovery distributions” (QDRDs) to participants affected by federally declared disasters, and this relief is available permanently. To be eligible, participants must have their “principal place of abode” in the disaster area and have suffered an economic loss due to the disaster. The maximum penalty-free distribution per disaster is $22,000, and sponsors are responsible for ensuring participants do not exceed this limit across all plans under their control. Participants have 179 days to take a QDRD after the incident period or disaster declaration, and the relief applies to disasters occurring on or after Jan. 26, 2021.
Storm Damage Loss Flounders and Sinks for Lack of Appraisals or Other Proof of Loss *(Thomas and Maureen Richey v. Comm., TCM 2023-43)*

Thomas and Maureen Cleary Richey owned a home and a boat in March 2017, when Winter Storm Stella hit Stone Harbor and flooded the city’s streets. Richey and Cleary claimed that the storm damaged the waterside portion of their property and their 40-foot boat, *The Celtic Dream*. On their 2017 tax return, they claimed total casualty losses of more than $820,000 and a deduction—after considering the income limitation—of nearly $740,000.

Calculating the deduction. There are three rules for determining a casualty loss deduction. The first rule is that only physical damage can be counted as a casualty loss and decreases in property value due to a prospective buyer’s fear of future casualties do not qualify. The second rule is that the loss must be proximately caused by a sudden, externally caused event, and not by progressive deterioration. The third and final rule is that the deduction is subject to various limitations, including that it can only be taken in the year the loss occurred, it cannot exceed the adjusted basis of the damaged property, and it is only deductible if the taxpayer is uninsured or filed a timely insurance claim. Taxpayers must also provide proof of the difference in fair market value before and after the casualty event, typically through competent appraisal.

Deduction didn’t hold water. The taxpayers did not provide an adequate appraisal of the before and after values of the house. The MLS printouts submitted did not provide an actual valuation of the vacation home, and the fact that the Realtor’s MLS-based appraisal considered market shifts due to the fear of future flooding would by itself render it to be inadequate proof of loss. Appraisals are not always necessary. The cost of repairs may suffice in showing the storm damage, but receipts and estimates submitted included items less related to restoration than to improvement. One estimate, for example, included the cost of building a deck and installing a pool, neither of which had been part of their home before the storm. As regards the deduction for storm damage to the boat, taxpayers failed to submit appraisals of the before and after value, evidence of repairs, or documentation of insurance reimbursements. The entire casualty loss deduction was disallowed.

Tax practitioner planning. TCJA eliminated the personal casualty loss until 2025. If Winter Storm Stella was a designated Federal disaster, properly documented losses would be deductible.

ADDITIONAL TAX ON NET INVESTMENT INCOME (NII) §1411

3.8% Tax on NII Remains After TCJA *(§1411; T.D. 9644; REG-130843-13; REG-130507-11; §1.411-0 through §1.411-10)*

The 3.8% NII tax is imposed on the lesser of:

1. an individual’s NII for the tax year, or
2. MAGI in excess of a floor:
   a. $200,000 for single and head of household;
   b. $250,000 for joint filers and surviving spouses; or
   c. $125,000 for a married taxpayer filing separately (§1411(a)(1) & (b); §1.1411-2(b)(1); §1.1411-2(d)(1)).
No inflation adjustments. These threshold amounts are not adjusted for future inflation. The $200,000, $250,000, and $125,000 thresholds have not changed since the tax took effect in 2013. In the past ten years, the tax returns impacted by the NIIT have grown from 3 million in 2013 to 7 million in 2022.

Proposed changes. The House Republicans have proposed raising the thresholds to $400,000 for married filing joint and to $200,000 for married filing separate. President Biden has proposed raising the rate to 5% on those with MAGIs in excess of $400,000.

NIIT FAQs (Q&A on the Net Investment Income Tax)

Among the issues addressed are the MAGI thresholds for individuals and basic information about what is and isn’t included when calculating NII.

Net Investment Income Tax Cannot Be Reduced by Foreign Tax Credits (Paul Young Kim v. US (5:22-cv-00691 (CA-9, Mar. 28, 2023))

Paul Kim is a U.S. citizen who resided in South Korea until Sep. 2015, when he relocated to California. For the taxable year ending December 31, 2015, Mr. Kim timely filed a Form 1040 reporting in addition to the amount of regular income tax owed $644,382 in net investment income tax (“NIIT”).

Subsequently, Mr. Kim filed a Form 1040X for the 2015 tax year seeking a refund of $638,232 in NIIT. Mr. Kim claimed, under the U.S. – South Korea Income Tax Treaty, that (1) a Korean Resident is exempt from the U.S. Social Security tax and Medicare tax and that NIIT is a Medicare tax, and (2) NIIT can be reduced by the foreign tax credit.

Is NIIT Medicare tax? The IRS argued that NIIT is a tax on investment income, not wages or self-employment income and thus is not affected by the exemption in the United States – South Korea Income Tax Treaty. The Court was unconvinced and left the issue to further appeal.

NIIT cannot be reduced by the FTC? In an alternate attempt at relief, Mr. Kim argued that if the NIIT is not a Medicare tax and is instead an income tax, the foreign tax credit should reduce the NIIT. The Court disagreed. The NIIT is a tax that appears in Chapter 2A of the Code. Consequently, IRS regulations under the NIIT disallow credits that can be taken against Chapter 1 taxes – specifically the foreign tax credit – from reducing the amount of NIIT.

Also see. Catherine Toulouse v. Comm., 157 TC, No. 4, Dec. 61,917 (Aug. 16, 2021), where Catherine Toulouse owed $11,540 of net investment income tax. She offset the NIIT with foreign tax credits claiming that tax treaties with France and Italy allowed her to offset all U.S. income taxes with the $51,456 of taxes she paid to France and Italy in the year at issue. The foreign tax credit is in chapter 1, subtitle A of the IRC, and it expressly applies only against taxes imposed by chapter 1. However, the NIIT is in chapter 2A, subtitle A. Thus, the foreign tax credit does not apply against the NIIT.

ALTERNATIVE MINIMUM TAX AND EXEMPTIONS

Alternative Minimum Tax (§55)

For 2023, AMT exemptions increased from $118,100 to $126,500 for MFJ and from $75,900 to $81,300 for single filers and heads of household. The phase-out thresholds for the exemptions start at higher income levels for the 2023 tax year as well: $1,156,300 for MFJ and $578,150 for single and head of household filers.
Married

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Who pays AMT? The top three preferences impacting AMT are exemptions, state taxes, and miscellaneous itemized deductions. All three of these deductions have been suspended by the TCJA. With the increased exemptions, phase-outs, and the elimination of most exclusion preferences, many clients escaped AMT beginning in 2018. Deferral preferences, like the ISO bargain element and depreciation adjustments, will be the major cause of any AMT occurring after 2017.


Widow Can’t Use Deceased Husband’s AMT Credits (Nadine Vichich v. Comm., 146 TC No. 12)

Before his marriage to Nadine Vichich, William Vichich exercised incentive stock options that resulted in AMT liability, which he reported on a 1998 tax return filed jointly with his first wife, Marla. Payment of the AMT liability in 1998 generated an AMT credit carryforward of $304,442. Ms. Vichich was married to Mr. Vichich from 2002 until his death in 2004. On her 2009 tax return, Ms. Vichich reported an AMT credit of $151,928 derived from her deceased husband’s 1998 AMT credit carryforward that she used to offset her individual income tax liability. The court agreed with the IRS that Ms. Vichich was not entitled to any premarital credit carryforwards.

Tax practitioner planning. Whether there is a death or a divorce, the marriage ceases to exist, and tax attributes reported on a joint return for an earlier year must be properly allocated for subsequent years to the divorced spouses or to the surviving spouse, as applicable.

Also see.

Calvin v. United States, 354 F.2d 202 (10th Cir. 1965), where the taxpayers attempted to use net operating losses that originated with the taxpayer wife before their marriage to offset the taxpayer husband’s income earned in their first year of marriage. Relying on §6013(d) and §1.172-7, the Court of Appeals for the 10th Circuit concluded that, for losses occurring before marriage, “the net operating loss provisions are personal to the taxpayer who incurred such loss and only available in other years to offset income of the same taxpayer.”

Zeeman v. United States, 395 F.2d 861 (2d Cir. 1968), where the Court of Appeals for the 2nd Circuit relied on the reasoning in Calvin to deny a loss carryback to the taxpayer in the “reverse situation” who sustained losses after her husband’s death and then sought to carry them back to joint returns in which all of the reported income belonged to her husband. The court in Zeeman noted succinctly that “[t]he merger of * * * [married couples’] income for tax purposes is linked between different years for only so long as they are married.”
KIDDIE TAX

In general. The 2023 Kiddie Tax applies if either parent is alive at the close of the year, the child does not file a joint return for the taxable year, and the child either (a) has not attained age 18 by the close of the year, or (b) has attained age 18 before the close of the year, but the child’s earned income does not represent more than half of support needs and the child has not attained age 19 by the close of the year, or the child is a full-time student who has not attained age 24 as of the close of the year. For 2023, the first $1,250 of unearned income of a child is tax-free. The next $1,250 is taxed at the child’s tax rate. Any amount over $2,500 is taxed at the parent’s rate.

Taxable Scholarship Income

Scholarship proceeds used for expenses other than qualified tuition and related expenses (i.e., tuition, fees, books, and equipment required for the enrollment or attendance of a student at an educational institution or for a specific course taken at the institution) are generally included in income and considered to be unearned income.

Kiddie Tax and the 3.8% NII Tax

The NII tax does not apply until the child’s AGI exceeds $200,000.

Tax practitioner planning. There is no exemption from kiddie tax for children with disabilities.

ENERGY CREDITS CHANGES IN INFLATION REDUCTION ACT

Energy Efficient Home Improvement Credit (FAQs)

The prior law provided a 10% tax credit for qualified energy-efficient improvements and expenditures on the taxpayer’s primary residence through 2021. Under prior law, the credit was subject to a $500 lifetime limit. IRA22 extended the credit through 2032, effective for property placed in service after Dec. 31, 2021.

New for 2023! For property placed in service after Dec. 31, 2022, the credit is equal to 30% of the costs for all eligible home improvements made during the year. The credit is expanded to cover the cost of certain biomass stoves and boilers, electric panels and related equipment, and home energy audits. Roofing and air circulating fans will no longer qualify for the credit, and some energy-efficiency standards are updated. The $500 lifetime limit is replaced by a $1,200 annual limit on the credit amount, and annual limits for specific types of qualifying improvements are modified.

Beginning in 2023, the annual limits for certain types of improvements are:

- $250 for an exterior door ($500 total for all exterior doors);
- $600 for exterior windows and skylights; central air conditioners; electric panels and certain related equipment; natural gas, propane, or oil water heaters; natural gas, propane, or oil furnaces or hot water boilers; and
- $2,000 for electric or natural gas heat pump water heaters, electric or natural gas heat pumps, and biomass stoves and boilers (this category is not subject to the $1,200 annual limit).
2025. Beginning in 2025, no credit will be allowed unless the manufacturer of any qualifying item creates a product identification number for the item, and the person claiming the credit includes the number on their tax return.

Note. For property placed in service after Dec. 31, 2022, IRA22 provides that the credit is allowed on any dwelling unit used by the taxpayer, not just the primary residence.

IRS Explains Requirements for Home Energy Audit Credit (Notice 2023-59)

The IRA22 created a non-refundable Energy Efficient Home Improvement Credit for the purchase and installation of certain energy efficient improvements in taxpayers’ principal residences.

The credit amount is equal to 30% of the total amount that taxpayers pay during the year for:

- qualified energy efficiency improvements installed during the year,
- residential energy property expenditures, and
- home energy audits.

Maximum credit. The maximum credit for home energy audits is $150. Therefore, taxpayers can claim a 30% percent credit on audits that cost up to $500. The credit is nonrefundable.

Qualified auditor. The home energy auditor must provide a written audit report to the taxpayer. Starting in 2024, taxpayers will need to substantiate that a “qualified auditor” conducted their home audit. To satisfy this requirement, the written audit should state that the auditor is certified by one of the certification programs listed on the Department of Energy certification programs for the Energy Efficient Home Improvement Credit page to conduct the home energy audit.

The Residential Clean Energy Credit (FAQs)

The Residential Energy Efficient Property Credit or “solar credit” has been available since 2005. The prior law provided a tax credit for the purchase of solar electric property, solar water heating property, fuel cells, geothermal heat pump property, small wind energy property and qualified biomass fuel property. The credit rate was 26% through 2022 and was scheduled to be reduced to 22% in 2023 before expiring at the end of 2023.

New for 2023! The IRA22 renames the credit to the Residential Clean Energy Credit and extends the credit through Dec. 31, 2034, restoring the 30% credit rate Jan. 1, 2022, through Dec. 31, 2032, and then reducing the credit rate to 26% in 2033 and 22% in 2034. It will end in 2035 unless Congress renews it.


Eligible Property

The scope of the credit has changed. Battery storage technology is added to the list of eligible property, effective for expenditures after Dec. 31, 2022. The term “qualified battery storage technology expenditure” means battery storage device that is installed in connection with a dwelling unit located in the United States that is used as a residence by the taxpayer and has a capacity of not less than 3 kilowatt hours. However, also beginning in 2023, the credit will no longer apply to biomass furnaces and water heaters.
Criteria to Qualify for the Credit

The Office of Energy Efficiency & Renewable Energy (EERE) states the following criteria determines whether your client can qualify for the Federal solar tax credit:

- Installation. The solar energy system was installed between Jan. 1, 2006, and Dec. 31, 2034.
- Location. The solar system is located at the individual’s primary or secondary residence in the US, or for an off-site community solar project, if the electricity generated is credited against, and does not exceed, the home’s electricity consumption. The IRS has permitted a taxpayer to claim a §25D tax credit for purchase of a portion of a community solar project.
- Ownership. The individual owns the solar system (i.e., they purchased it with cash or through financing but are neither leasing nor are in an arrangement to purchase electricity generated by a system they do not own).
- First user. The solar system is new or being used for the first time. The credit can only be claimed on the “original installation” of the solar equipment.

High-Efficiency Electric Home Rebates

Although not a tax credit, the High-Efficiency Electric Home Rebate Program provides rebates to low- and middle-income families who purchase energy-efficient electric appliances or make non-appliance upgrades in their homes. The maximum rebate amounts for appliances are $840 for a stove, cooktop, range, oven, or heat pump clothes dryer, $1,750 for a heat pump water heater, and $8,000 for a heat pump for space heating or cooling. Rebates for non-appliance upgrades are also available, up to $1,600 for insulation, air sealing, and ventilation, $2,500 for electric wiring, and $4,000 for an electric load service center upgrade. To qualify, a family’s total annual income must be less than 150% of the median income where they live, and each family is limited to no more than $14,000 in total rebates under the program.

Rebates will be distributed to families through state and tribal governments that establish their own qualifying programs. The $4.5 billion rebate fund will be available through Sep. 30, 2031.

CLEAN VEHICLE CREDIT (ELECTRIC VEHICLE CREDIT)

Prior to the IRA22, a taxpayer who placed in service a qualified plug-in electric vehicle was eligible for a nonrefundable tax credit of up to $7,500. This was known as the “Qualified Plug-in Electric Drive Motor Vehicle Credit.” The credit phased out beginning with the second calendar quarter following the calendar quarter in which vehicles manufactured exceeded 200,000.

**Factoid:** More than two million electric vehicles and 100,000 chargers are on the road today.

Credit extended through 2032

The IRA22 extends and modifies the $7,500 tax credit for plug-in electric vehicles, allowing certain clean vehicles to qualify and eliminating the current 200,000 per manufacturer limit after 2022. The credit has been renamed the “clean vehicle credit.”

**Tax practitioner planning.** Tesla, Toyota, Ford, and General Motors hit the 200,000-vehicle limit in prior years and their vehicles were disqualified from the electric vehicle credit (Ford and Toyota were in the phase out stage). If these vehicles were purchased in 2022, they did not qualify for the credit. If they are purchased in 2023 (and otherwise meet the 2023 MSRP and AGI requirements), they may qualify for the credit.
IRS Releases Updated FAQs for Clean Vehicle Credits

Fact Sheet 2023-22 updated FAQs related to new, previously owned, and qualified commercial clean vehicles. The FAQs cover 10 topics:

- Topic A: Eligibility Rules for the New Clean Vehicle Credit
- Topic B: Income and Price Limitations for the New Clean Vehicle Credit
- Topic C: When the New Requirements Apply to the New Clean Vehicle Credit
- Topic D: Eligibility for Previously Owner Clean Vehicle Credit
- Topic E: Income and Price Limitations for Previously Owner Clean Vehicles
- Topic F: Claiming the Previously Owned Clean Vehicles Credit
- Topic G: Qualified Commercial Clean Vehicles Credit
- Topic H: Transfer of New Clean Vehicle Credit and Previously-Owned Clean Vehicles Credit
- Topic I: Registering a Dealer/Seller for Seller Reporting and Clean Vehicle Tax Credit Transfers
- Topic J: Seller Report Information for Buyers of New and Previously-Owned Clean Vehicle Tax Credits Beginning in 2024

Credit Amounts

The amount of the credit depends on when the vehicle was placed in service (took delivery), regardless of purchase date.

For vehicles placed in service January 1 to April 17, 2023:

- $2,500 base amount
- Plus $417 for a vehicle with at least 7 kilowatt hours of battery capacity
- Plus $417 for each kilowatt hour of battery capacity beyond 5 kilowatt hours
- Up to $7,500 total

In general, the minimum credit will be $3,751 ($2,500 + 3 times $417), the credit amount for a vehicle with the minimum 7-kilowatt hours of battery capacity.

For vehicles placed in service April 18, 2023, and after:

Vehicles will have to meet all of the same criteria listed above, plus meet new critical mineral and battery component requirements for a credit up to:

- $3,750 if the vehicle meets the critical minerals requirement only
- $3,750 if the vehicle meets the battery components requirement only
- $7,500 if the vehicle meets both

A vehicle that doesn’t meet either requirement will not be eligible for a credit.
Qualifying Vehicles

Final assembly in North America. The credit is not available unless final assembly of the vehicle occurs in North America. This provision is effective upon enactment, Aug. 16, 2022. Here is a Department of Energy list of cars and trucks assembled in North America.

Tax practitioner planning. The effective date means that Hyundai, Porsche, Toyota, and Kia are disqualified until, and unless, they begin to assemble in North America.

VIN Required

Beginning in 2023, no credit is allowed unless the taxpayer includes the vehicle identification number of such vehicle on the tax return for the taxable year. Sellers are required to provide taxpayer and vehicle information to the IRS for tax credit eligible vehicles.

Critical Minerals and Battery Requirements

Proposed regulations were released April 17, 2023, related to certain requirements that must be met for critical mineral and battery components for the new clean vehicle credit, which is set to apply to vehicles placed in service on or after April 18, 2023, the day after the Notice of Proposed Rulemaking is published in the Federal Register.

Mineral requirement. Beginning for qualifying vehicles placed in service on or after April 18, 2023, critical minerals requirements for a battery are as follows:

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

The applicable percentages for the critical minerals’ requirement are as follows:

- 2023 - 40%
- 2024 - 50%
- 2025 - 60%
- 2026 - 70%
- 2027 and later - 80%

Battery requirement. Beginning for qualifying vehicles placed in service on or after April 18, 2023, the battery component requires that the percentage of the value of the components contained in such battery that were manufactured or assembled in North America must be equal to or greater than the applicable percentage. The applicable percentages for the battery component requirement are as follows:

- 2023 - 50%
- 2024-2025 - 60%
- 2026 - 70%
- 2027 - 80%
- 2028 - 90%
- 2029 and later - 100%
Both the minerals and the battery requirements take effect for vehicles purchased and placed in service after Dec. 31, 2022. Thus, the critical mineral and battery requirements take effect in 2023 if guidance is issued by the Secretary before Jan. 1, 2024. Otherwise, the requirements take effect in 2024.

**Fewer vehicles qualify.** The tougher rules on the origin of vehicle batteries results in fewer electric vehicle models qualifying for clean vehicle credit. The new list of eligible vehicles includes 16 domestically manufactured models from Ford, General Motors, Stellantis (parent of Chrysler, Dodge, and more), and Tesla, with 10 models qualifying for the full $7,500 tax credit and the rest qualifying for half that amount. Taxpayers can check whether a specific make and model of vehicle meets the critical mineral and battery components through [fueleconomy.gov](http://fueleconomy.gov).

### All-electric vehicles that can qualify for the credit.

<table>
<thead>
<tr>
<th>2023 BMW 330e</th>
<th>2023 Lincoln Aviator PHEV</th>
</tr>
</thead>
<tbody>
<tr>
<td>2023 BMW X5 xDrive45e (PHEV)</td>
<td>2023 Lincoln Corsair Grand Touring</td>
</tr>
<tr>
<td>2023 Cadillac Lyriq</td>
<td>2023 Mercedes EQS SUV</td>
</tr>
<tr>
<td>2023 Chevrolet Bolt EV</td>
<td>2023 Nissan Leaf</td>
</tr>
<tr>
<td>2023 Ford E-Transit</td>
<td>2023 Rivian R1S and R1T</td>
</tr>
<tr>
<td>2023 Jeep Grand Cherokee 4xe</td>
<td>2023 Tesla Model 3, S, X, and Y</td>
</tr>
<tr>
<td>2023 Jeep Wrangler 4xe</td>
<td>2023 Volkswagen ID 4</td>
</tr>
</tbody>
</table>

### Purchase Price Limits

Beginning in 2023, IRA22 imposes limits on the purchase price of the vehicle. Cars must have an MSRP that does not exceed $55,000, and SUVs, vans and trucks must have an MSRP that does not exceed $80,000.

### Qualifying Taxpayer

**Income limits.** Beginning in 2023, IRA22 adds AGI limitations (with no phaseout provision) of $150,000 for single, $300,000 for married, and $225,000 for head of household. The AGI for this purpose can be from the tax return for the taxable year the credit is being claimed or the preceding year.

**Example.** Sarena graduated law school in 2022, In 2023 she purchases a qualifying electric vehicle. Her AGI in 2022 was $80,000. Her AGI in 2023 is $155,000. Sarena qualifies for the credit as she can choose to use her 2022 AGI, rather than her 2023 AGI.

### Plug-in Hybrids

Plug-in hybrids can qualify for the credit as long as they have a battery of 7kWh capacity or greater. IRS maintains a [list](http://www.irs.gov) of qualified vehicles. Plug-in hybrids that can qualify for the credit.

| 2023 Audi Q5 TFSI Quattro   | 2023 Jeep Wrangler 4xe   |
| 2023 BMW 330e               | 2023 Lincoln Aviator Grand Touring |
| 2023 BMW X5 xDrive45e       | 2023 Lincoln Corsair Grand Touring |
| 2023 Chrysler Pacifica      | 2023 Volvo S60 Recharge   |
| 2023 Ford Escape            | 2023 Volvo S60 T8 Recharge |
| 2023 Jeep Grand Cherokee 4xe|                             |
How to Claim the Credit

To claim the credit, file Form 8936, Qualified Plug-in Electric Drive Motor Vehicle Credit (Including Qualified Two-Wheeled Plug-in Electric Vehicles) with the tax return. The vehicle’s VIN is required.

Credit at Time of Purchase

Beginning in 2024, instead of waiting to file a tax return, the credit may be obtained at the time the vehicle is purchased. Reconciliation on the buyer’s tax return will be required to make sure that the purchaser meets AGI requirements.

Leased Vehicles May Avoid Income and MSRP Rules

Leased EVs may qualify for a $7,500 (commercial) tax credit, which is not subject to the same requirements as the consumer new-vehicle credit. In the case of a lease, the dealer would receive the credit and potentially pass the savings on to the consumer by lowering the vehicle’s purchase price. High-income consumers and those who lease high-cost EVs can also enjoy the credit if the dealer passes the savings along. Some automakers already factor the full $7,500 tax credit into their lease deals.

Critical Dates in IRA22

<table>
<thead>
<tr>
<th>Date of purchase and delivery</th>
<th>Jan. 1, 2022, to Aug. 15, 2022</th>
<th>Aug. 16, 2022, to Dec. 31, 2022</th>
<th>2023</th>
<th>2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>200,000 of sales limit applies</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Assembled in N. America applies</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>MSRP limit applies</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>AGI limit applies</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Critical minerals and battery requirement apply</td>
<td>No</td>
<td>No</td>
<td>On or after Apr. 18, 2023</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Electric Vehicle Recharging Station

The Alternative Fuel Refueling Property Credit expired at the end of 2021, but the IRA22 extended the credit through 2032. For homeowners, the credit is worth 30% of the costs of “qualified alternative fuel vehicle refueling property” installed in the home, up to a credit of $1,000.

“Bidirectional” charging. Starting in 2023, the IRA22 clarifies that the credit applies to the purchase of “bidirectional” charging equipment, which can charge the battery of an electric vehicle and discharge electricity from the battery back out to the electric grid.

State and Local EV Credits [TaxFoundation.org (Sep. 20, 2023)]

19 states offer an EV tax credit. 24 states charge an additional registration fee for licensing electric vehicles, and six states tax EV charging stations. Both taxes are a way to replace gas tax which is the general revenue source for highway costs.

Note. Energysage.com and Electrek.com have lists of state credits available for electric vehicle purchases. Be sure to check for updates and changes for the client’s resident state.
PREVIOUSLY OWNED “CLEAN VEHICLES”

Beginning in 2023, the IRA22 adds a new credit for used electric or fuel cell vehicles now known as “clean vehicles” in new §25E, which provides a credit of 30% of the purchase price for qualified buyers, capped at $4,000.

Qualified Vehicle

A “previously owned clean vehicle” is defined as:

- A model year at least two years earlier than the calendar year of acquisition (e.g., 2021 or older if acquired in 2023),
- The original use commenced with a person other than the buyer,
- Acquired in a qualified sale (by a dealer for $25,000 or less where this credit has not yet been taken for the vehicle), and
- Meets similar design requirements as those set forth in §30D or §30B.

VIN Required

No credit is allowed unless the taxpayer includes the vehicle identification number of the vehicle on the tax return for the taxable year.

Qualified Buyer

Further, the purchaser must be a “qualified buyer,” which means an individual who purchases the vehicle for use and not for resale, with respect to whom no deduction is allowable with respect to another taxpayer under §151, and who has not been allowed a credit under this section for any purchase during the 3-year period ending on the date of the purchase of such vehicle.

Income Limits

The income limits on who can receive a §25E credit, is tested based on the lesser of current or prior year modified adjusted gross income are: Joint return - $150,000, Head of household - $112,500, and others - $75,000.

Effective date. Generally, this provision is effective for qualified vehicles acquired after Dec. 31, 2022, and before Jan. 1, 2033. The provision allows for the transfer of the credit to the dealer for vehicles acquired after 2023.

ADOPTION CREDIT AND ASSISTANCE PROGRAMS

Adoption Tax Credit [§36C; §137, Topic No. 607 Adoption Credit and Adoption Assistance Programs]

Taxpayers who adopt children may claim a tax credit for qualified adoption expenses. A taxpayer may also exclude from income adoption expenses paid by an employer. The credit is phased out for taxpayers with AGI in excess of certain thresholds.
### Adoption Credit and Phase-out Limits

<table>
<thead>
<tr>
<th></th>
<th>2024</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adoption Credit</td>
<td>$16,810</td>
<td>$15,950</td>
</tr>
<tr>
<td>Phase-out</td>
<td>$252,150 - $292,150</td>
<td>$239,230 - $279,230</td>
</tr>
</tbody>
</table>

#### Tax practitioner planning.

The limit applies separately to the credit and the employer benefit exclusion. In other words, as long as adopting parents pay more than $31,900 in qualified 2023 adoption expenses, they may exclude an employer adoption benefit of $15,950 and also claim an adoption credit of $15,950.

### What are qualified adoption expenses?

Qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging), and other expenses, which are directly related to, and the principal purpose of which is, the legal adoption of an eligible child by the taxpayer. All reasonable and necessary expenses required by a state as a condition of adoption are qualified adoption expenses, including the cost of construction, renovations, alterations, or purchases specifically required by the state to meet the needs of the child. Expenses are not qualified adoption expenses if they are incurred in connection with the adoption by an individual of a child who is the child of such individual’s spouse.

### When adoption credit is allowed.

The adoption credit is allowed in the earlier of (1) the taxable year following the taxable year the expenses (including expenses for an unsuccessful effort to adopt an eligible child) are paid or incurred or (2) the taxable year in which the adoption becomes final (see Notice 97-70 and Form 8839 instructions for more explanation).

### Foreign adoption.

For the adoption of a child who is not a citizen or resident of the United States, no credit is allowed unless the adoption becomes final. Rev. Proc. 2005-31 provides safe harbors for determining the finality of an adoption of a foreign-born child for federal income tax purposes. Foreign adoption expenses are taken into account as if such expenses were paid or incurred during the year that the adoption becomes final (§36C(e)(2)).

### RDPs adopting a child.

If registered domestic partners adopt a child together, one or both of the registered domestic partners qualify for the adoption credit. The partners may not both claim a credit for the same qualified adoption expenses, and the sum of the credit taken by each registered domestic partner may not exceed the total amount paid. The adoption credit is limited to $15,950 per child in 2023. Thus, if both registered domestic partners paid qualified adoption expenses to adopt the same child, and the total of those expenses exceeds $15,950, the maximum credit available for the adoption is $15,950. The registered domestic partners may allocate this maximum between them in any way they agree, and the amount of credit claimed by one registered domestic partner can exceed the adoption expenses paid by that person, as long as the total credit claimed by both registered domestic partners does not exceed the total amount paid by them. The same rules generally apply in the case of a special need’s adoption.

### One RDP adopts the partner’s child.

If a taxpayer adopts the child of his or her registered domestic partner as a second parent or co-parent, the taxpayer (adopting parent) may claim the adoption credit for the qualifying adoption expenses he or she pays to adopt the child.

#### Tax practitioner planning.

A taxpayer may not claim an adoption credit for the expenses of adopting the child of the taxpayer’s spouse (§23). However, this limitation does not apply to adoptions by registered domestic partners, because registered domestic partners are not spouses for federal tax purposes. RDPs considering an adoption should do so before marrying.
Does Your Client Have Questions on the Adoption Credit?

The IRS has a Tax Tip to help you quickly provide your client the details on this tax benefit. “Quickly” is especially important during tax season. See Tax Tip 2022-09.

State issues. California does not conform to the Federal rules. See California requirements here. Be sure to check your client’s resident state for conformity issues.

CARES Act and Adoption Expenses

The CARES Act established a new type of penalty-free withdrawal from an IRA or defined contribution plan for childbirth or adoption expenses up to $5,000 per child. The distribution is taxable, but the 10% §10(t) penalty is waived if the distribution is within 12 months following the adoption or birth.

EDUCATION CREDITS

American Opportunity Tax Credit Made Permanent (American Opportunity Tax Credit)

Created under the American Recovery and Reinvestment Act, the American Opportunity Tax Credit is available for up to $2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100% of the first $2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25% of the next $2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable. This tax credit is subject to a phase-out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 MFJ). The PATH Act of 2015 made the American Opportunity Tax Credit permanent.

Requirements for Claiming the American Opportunity Tax Credit

To reduce fraudulent claims, the PATH Act and the Trade Bills (HR 2146 and HR 1295) added verification requirements and expanded penalties.

Form 1098-T for individuals. Taxpayers are not allowed to claim the American Opportunity Tax Credit or the Lifetime Learning Credit under §25A, or the tuition deduction under §222, unless the taxpayer has received a Form 1098-T from the educational institution.

FEIN required on Form 8863. No American Opportunity Tax Credit will be allowed unless the taxpayer includes the employer identification number of any institution to which qualified tuition and related expenses were paid for education furnished with respect to the individual.

Prevention of retroactive claims for Earned Income Credit, Child Tax Credit, and American Opportunity Tax Credit. No American Opportunity Tax Credit will be allowed if the identifying number of the taxpayer is issued after the due date for filing the return ($32(m); §24(e); §25A(l)).

Procedures to reduce improper claims. The return preparer due diligence requirements for the EITC (and the $560 penalty for 2023) will also apply to claims for the American Opportunity Tax Credit ($32(m); §24(e); §25A(l)).

Future credits denied when taxpayers improperly claim credits in prior years. For taxpayers who improperly claimed American Opportunity Tax Credits in a prior year, no credit will be allowed for any taxable year in the disallowance period. The disallowance period is:
• the period of 10 taxable years after the most recent taxable year for which there was a final determination that the taxpayer’s claim of credit under this section was due to fraud, and

• the period of two taxable years after the most recent taxable year for which there was a final determination that the taxpayer’s claim of credit was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

**Tax practitioner planning.** This is the same restriction for improper claims of the EITC.

**Lifetime Learning Credit and American Opportunity Credit Limits Match**

For tax years beginning Jan. 1, 2021, §25A is modified to match the AGI limits and phase-out range of the Lifetime Learning Credit and the American Opportunity Credit. Both credits will begin to phase out at AGI of $80,000 single ($160,000 for MFJ) and be fully phased out at $90,000 ($180,000 MFJ).

**Comparisons of Major Features of the American Opportunity Tax Credit (25A(i)), the Lifetime Learning Credit (25A(c)), and the Higher Education Tuition Deduction (§222)**

<table>
<thead>
<tr>
<th>Feature</th>
<th>American Opportunity Tax Credit</th>
<th>Lifetime Learning Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of benefit</td>
<td>40% of the credit is refundable except if a child subject to Kiddie Tax claims the credit</td>
<td>Nonrefundable tax credit (cannot exceed tax liability)</td>
</tr>
<tr>
<td>Dates applicable</td>
<td>Indefinite</td>
<td>Indefinite</td>
</tr>
<tr>
<td>Maximum benefit</td>
<td>$2,500 (100% of first $2,000 in qualified expenses, 25% of second $2,000) per student</td>
<td>$2,000 (20% of first $10,000 in qualified expenses) per return</td>
</tr>
<tr>
<td>Income limit</td>
<td>Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for MFJ).</td>
<td>Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for MFJ).</td>
</tr>
<tr>
<td>Postsecondary education expenses qualifying for benefit</td>
<td>Tuition, fees, and course materials required for enrollment.</td>
<td>Tuition and fees required for enrollment.</td>
</tr>
<tr>
<td>Type of postsecondary education</td>
<td>First four years of undergraduate education when enrolled in at least a half-time basis in a program leading to a degree, credential, or certificate</td>
<td>For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program</td>
</tr>
<tr>
<td>Form 1098-T</td>
<td>Form 1098-T and FEIN of college required to claim credit</td>
<td>Form 1098-T and FEIN of college required to claim credit</td>
</tr>
<tr>
<td>Form</td>
<td>Form 8863</td>
<td>Form 8863</td>
</tr>
</tbody>
</table>
EARNED INCOME TAX CREDIT §32

The IRS estimates that 22% to 26% of EITC payments are issued improperly. The IRS is unlikely to achieve an improper payment rate below 10% without expanded authorities to address identified erroneous claims, according to the Treasury Inspector General for Tax Administration (TIGTA).

**EITC changes for 2023.** The minimum age for a childless worker to claim the EITC went back up to 25 for 2023 tax returns (19 in 2021). The maximum age limit (65 years of old), which was eliminated for the 2021 tax year, is also back for 2023. The maximum 2023 credit available for childless workers increases to $600 compared to $560 for 2022. Additionally, expanded eligibility rules for former foster youth and homeless youth that applied for 2021 are not available for 2023.

**Update.** The limit on a worker’s 2023 investment income is increased to $11,000 ($11,600 in 2024).

### 2023 Earned Income Tax Credit Table

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>No children</th>
<th>One child</th>
<th>Two children</th>
<th>Three or more children</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or head of household</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income at max credit</td>
<td>$7,840</td>
<td>$11,750</td>
<td>$16,510</td>
<td>$16,510</td>
</tr>
<tr>
<td>Maximum credit</td>
<td>$600</td>
<td>$3,995</td>
<td>$6,604</td>
<td>$7,430</td>
</tr>
<tr>
<td>Phase-out begins</td>
<td>$9,800</td>
<td>$21,560</td>
<td>$21,560</td>
<td>$21,560</td>
</tr>
<tr>
<td>Phase-out ends</td>
<td>$17,640</td>
<td>$46,560</td>
<td>$52,918</td>
<td>$56,838</td>
</tr>
<tr>
<td>Married filing joint</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income at max credit</td>
<td>$7,840</td>
<td>$11,750</td>
<td>$16,510</td>
<td>$16,510</td>
</tr>
<tr>
<td>Maximum credit</td>
<td>$600</td>
<td>$3,995</td>
<td>$6,604</td>
<td>$7,430</td>
</tr>
<tr>
<td>Phase-out begins</td>
<td>$16,370</td>
<td>$28,120</td>
<td>$28,120</td>
<td>$28,120</td>
</tr>
<tr>
<td>Phase-out ends</td>
<td>$24,210</td>
<td>$53,120</td>
<td>$59,478</td>
<td>$63,698</td>
</tr>
</tbody>
</table>

**Filing Form 8867, Mandatory for All EITC Returns**

Proposed regulations require paid tax return preparers to file a due diligence checklist, Form 8867, with any federal return claiming the EITC.

**Be Diligent When Preparing a Return Claiming EITC** ([EITC Central](https://www.erteen.com/ertc-central))

The IRS continues to remind tax preparers of their responsibilities when claiming EITC. Paid preparers who prepare inaccurate returns claiming the EITC may be assessed a $560 penalty per return (2023) unless they can show they met their EITC due diligence requirements.
FOREIGN TAX CREDITS

Ten-year Statute of Limitations Applies to Foreign Tax Credit *(Donald and Leticia Polk v. US, US Federal Court of Claims, No. 1:22-CV-00896 (Aug. 18, 2023))*

Did you know the SOL for a foreign tax credit refund is 10 years? Apparently, neither did the IRS. Donald and Leticia Polk did not file a 2008 tax return. In 2010, the IRS prepared a 2008 substitute income tax return for the Polks that resulted in an assessment of taxes in the amount of $156,796.00, as well as late filing and payment penalties and interest. The IRS took payments from refunds to the taxpayers on subsequent returns. The Polks filed a claim for a refund. The claim was made more than three years after the due date of the return and more than 2 years after the payment of tax (§6511(a)). Part of the amount due was from a foreign tax credit disallowed by the IRS under the general statute of limitations.

Special period of limitation with respect to foreign taxes paid or accrued. If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any possession of the United States for which credit is allowed against the tax, in lieu of the 3-year period of limitation, the period is 10 years from the due date for filing the return for the year in which such taxes were actually paid or accrued (§6511(d)(3)(A)).

INTERNATIONAL ISSUES

Foreign Income Exclusion *(§911, Pub 54)*

The 2023 foreign earned income exclusion is $120,000 ($126,500 in 2024). A qualified individual may exclude, subject to limitations, foreign earned income, and foreign housing costs from gross income. “Foreign earned income” is defined as the amount received by an individual from sources within a foreign country attributable to income earned for services performed by the individual. The term “qualified individual” means an individual whose tax home is in a foreign country and who is a:

- citizen of the US and who establishes that he or she was a bona fide resident of a foreign country or countries for an uninterrupted period, which includes an entire taxable year, or
- resident of the US and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.

Tax practitioner planning. Many taxpayers think that any income earned outside of the US is eligible for the exclusion. There are many restrictions. Send your client to the IRS website for more information on the Foreign Earned Income Exclusion.

Waiver exceptions allowed in some cases. Individuals who are not bona fide residents of a foreign country and fail to meet the 330-day physical presence test may be treated as a qualified individual if they are eligible for a waiver. Waivers may be issued to individuals who were:

- bona fide residents of, or were present in, a foreign country for any period during which individuals were required to leave such foreign country because of war, civil unrest, or similar adverse conditions, which precluded the normal conduct of business by such individuals, and
- able to establish to the IRS that the time requirements of the foreign earned income exclusion could reasonably have been expected to have been met, but for the conditions of war, civil unrest, or similar adverse conditions.
**Tax planning idea.** The IRS annually publishes a list of foreign countries where war, civil unrest, or similar adverse conditions exist for purposes of §911(d)(4)(B) for years in which such conditions exist.

**Foreign Housing Costs Also Excludable or Deductible**

Qualified individuals may also exclude from gross income foreign housing costs to the extent such costs exceed the base housing amount (16% of the foreign earned income exclusion — $19,200 in 2023). The maximum foreign housing exclusion is generally limited to 30% of the foreign earned income exclusion ($36,000 in 2023) but may be increased in specific locations designated by the IRS to be “high cost” localities. The IRS provides adjustments to the foreign housing cost limitation for high-cost areas (Notice 2023-26).

**Example.** Gene, a U.S. citizen, worked and resided in Iraq for all of 2023, for which he was paid a salary of $120,000. Gene’s employer also provided him with housing with a fair rental value of $40,000 in 2023. Gene elects the foreign earned income exclusion and the foreign housing cost exclusion, computed:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of housing provided by employer</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less non-excludable portion ($120,000 x 16%)</td>
<td>($19,200)</td>
</tr>
<tr>
<td>Calculated housing exclusion</td>
<td>$20,800</td>
</tr>
<tr>
<td>Maximum housing exclusion ($120,000 x 30%)</td>
<td>$36,000</td>
</tr>
<tr>
<td>Lesser of calculated or maximum</td>
<td>$20,800</td>
</tr>
</tbody>
</table>

Gene’s foreign housing cost amount is $20,800. Because he has no income from self-employment, the entire amount is attributable to employer-provided amounts and is excludable. Gene’s combined foreign earned income and foreign housing exclusion for 2023 is $140,800 ($120,000 + $20,800).

**Tax planning idea.** The foreign housing exclusion is only available to employees and only for employer-paid housing expenses. The separate foreign housing deduction applies to those with self-employment earnings.

**Tax practitioner planning.** Combat-zone contract workers may qualify for the foreign earned income exclusion (the Bipartisan Budget Act of 2018). Generally, contractors working for the U.S. government do not qualify for the foreign earned income exclusion (see *Alfred S. Co v. Comm.*, TCM 2016-18).

**Statute Of Limitations Did Not Toll for U.S. Citizen Not a Bona Fide Resident of U.S. Virgin Islands** (*DW Tice v. Comm.*, 160 TC No. 8, Dec. 62,194 (Apr. 10, 2023))

DW Tice, a U.S. citizen, filed tax returns for taxable years 2002 and 2003 with the Virgin Islands Bureau of Internal Revenue (VIBIR), claiming residency in the U.S. Virgin Islands. The IRS determined that Mr. Tice was not a bona fide USVI resident under §932(c) but rather a U.S. citizen other than a bona fide USVI resident under §932(a), and therefore was required to file income tax returns “with both the United States and the Virgin Islands.” See §932(a)(2). The IRS issued a notice of deficiency in 2015.

**The Statute of limitations did not toll.** Taxpayers who filed a return only with the VIBIR for taxable years ending before Dec. 31, 2006, do not trigger the statute of limitations under §6501(a) unless they are bona fide residents of the USVI to whom §932(c) applies. See *Cooper v. Comm.*, TCM 2015-72.
Tax Court Agrees Taxpayer Was a Bona Fide Resident Eligible for Foreign Earned Income Exclusion *(Alfred Christopher Morgan v. Comm., TCS 2022-10)*

Alfred Morgan’s tax problems began when he failed to timely file his 2016 tax return. The IRS prepared a substitute return based on the information that they had. Mr. Morgan filed a return showing, in addition to the IRS income items, a Form 2555 claiming a foreign earned income exclusion as a bona fide resident of Saudi Arabia. When the IRS challenged the exclusion, they found fault with the fact that when asked to substantiate his dates of travel to the United States during the period in question, the taxpayer’s information did not exactly match the dates reported on the Form 2555 filed. The IRS urged the court to hold this discrepancy against the taxpayer. The IRS also felt that the fact that Mr. Morgan had a U.S. bank account, a current U.S. driver’s license, health insurance commonly used by retired U.S. service members, and often referred to the United States as “home,” all indicated Saudi Arabia was not his tax home so he should be denied the $94,412 exclusion.

The Tax Court agreed with the taxpayer. The court gave weight to the fact Mr. Morgan is engaged to a woman in Saudi Arabia, holds a Saudi driver’s license, a Saudi residency card, has health insurance in Saudi Arabia, and his employer gave him very favorable job reviews and his employment seemed permanent. The court also found that even though there were minor discrepancies in the dates on Form 2555 and the proof of travel, both the dates reported on Form 2555 and the actual dates of travel to the United States met the time criteria to be eligible for the exclusion.

Also see.

*Deborah Wood v. Comm., TCM 2021-103,* where the Tax Court agreed that Ms. Wood was a bona fide resident of Afghanistan. Ms. Wood had not worked in the United States since 2011 and had worked in Afghanistan for several years.

*Joseph and Jacqueline Bellwood v. Comm., TCM 2019-135,* where Joseph was found not to be a bona fide resident of Saudi Arabia. See this case for the 11 factors that courts use in determining if the taxpayer is a bona fide resident of a foreign country.

Foreign Earned Exclusion on Delinquent Return Disallowed by Court *(Elena and Frederick Weschenfelder v. Comm., TCM 2019-133)*

Elena Lea Morgan Weschenfelder and Frederick Burkhart Weschenfelder were employed by CACI Premier Technology, Inc. (CACI) and Sycoleman Corp. in Iraq during 2004 and 2005. They lived and worked full-time on a military base, living in Republican Guard barracks. The Weschenfelders were employed as intelligence analysts. Their jobs involved strategic and tactical intelligence, and they worked with the Iraqi interim government to help identify threats and coordinate safe passage and gatherings within the country. In 2006, they moved to Germany, where they continued to work for CACI.

Returns claiming the exclusion were delinquent. The Weschenfelders failed to file their 2004, 2005, and 2006 returns. When they failed to file U.S. tax returns, the IRS prepared “substitute” tax returns for the Weschenfelders for the three years at issue. The Weschenfelders submitted delinquent returns on Jan. 8, 2016. Each return showed a Texas address. The return for 2004 did not include a Form 2555, although reference to such a form was made on the first page of the return. The 2005 return included separate Forms 2555 for each spouse, and the 2006 return included a Form 2555 for Mr. Weschenfelder. On line 9 of each Form 2555, the Weschenfelders reported their tax home as a Texas address established in March 2001. They claimed foreign earned income exclusions of $140,109, $103,202, and $71,929 for 2004, 2005, and 2006, respectively.
IRS disallowed foreign earned income exclusion on delinquent return. The IRS claimed that the Weschenfelders were not entitled to the foreign earned income exclusion because that exclusion is only available if a taxpayer makes an election on a timely filed income tax return, an amendment to a timely filed return, or within one year after the due date of the return (§1.911-7(a)(2)). In this case, the Weschenfelders did not file timely returns.

When is the election to exclude foreign earned income “timely filed”? The opening words of §911(a) “At the election of a qualified individual” make clear that the taxpayer must affirmatively elect to exclude the foreign earned income from his or her gross income. The regulations at §1.911-7(a)(2) provide four alternative timing methods by which a taxpayer may validly make the election. The election must be made with:

- A later return filed within the period prescribed in §6511(a) amending the foregoing timely filed income tax return,
- An original income tax return that is filed within one year after the due date of the return (determined without regard to extension of time to file),
- An income tax return filed after the period described above if the taxpayer owes no federal income tax after taking into account the exclusion and files Form 1040 with Form attached either before or after the IRS discovers that the taxpayer failed to elect the exclusion, or
- An income tax return filed after the period described above if the taxpayer owes federal income tax after taking into account the exclusion and files Form 1040 with Form attached before the IRS discovers that the taxpayer failed to elect the exclusion.

Required statement missing. Because the Weschenfelders owed tax on their delinquent 2004 and 2005 tax returns, their election was not timely filed. Although they did not owe tax on their 2006 return, the Weschenfelders’ failure to type or print the statement specified in §1.911-7(a)(2)(i)(D)(3) on the top of the return for that year (and those for 2004 and 2005) was fatal.

Tax practitioner planning. If filing a late return with the exclusion, print the following statement at the top of the first page of the Form 1040: “Filed Pursuant to §1.911-7(a)(2)(i)(D).”

Also see.  
*Damon Redfield v. Comm., (TCM 2017-71)*, where the exclusion was disallowed on Damon’s late filing because the IRS had already filed a “substitute for return” for the year in question.

Man Pleads Guilty To Failing to Report $4.7 Million Earned in UAE and Qatar (IRS CI Newsroom)

According to court documents and statements made in court, from 2013 to 2018, Peter Joseph Tignini worked in the United Arab Emirates and Qatar, earning approximately $4,783,031 in income that he deposited into foreign bank accounts. From 2013 through 2017, Mr. Tignini filed tax returns falsely reporting that his income was only approximately $100,000 each year, an amount near or below the Foreign Earned Income exclusion. Mr. Tignini faces a maximum statutory penalty of five years in prison, as well as a period of supervised release, restitution, and monetary penalties.
Offshore Tax Havens Cost the U.S. Treasury $184 Billion a Year (Picking up the Tab Report)

A report by the U.S. Public Interest Research Group estimates that tax havens used by corporations and wealthy individuals cost the U.S. Treasury $184 billion each year in lost revenue. The report claims that the average small business pays an additional $3,244 each year to cover $110 billion of federal and state taxes avoided by large corporations.

By law, all U.S. citizens and residents must report their worldwide income. This includes income from foreign trusts and foreign bank and securities accounts. The October 2021 release of the “Pandora Papers” will put more pressure to ramp up compliance efforts to find hidden assets.

New IRS Fact Sheet on Foreign Asset Reporting

IRS Fact Sheet 2022-24 on reporting foreign bank and financial accounts is a useful resource when providing information to your clients who have foreign financial interests. The fact sheet includes sections on who needs to report, how and when to report, accounts that are not reported, how to value foreign financial accounts comparisons of Form 8938 and FBAR requirements, amending FBARs, filing late FBARS, penalties for failure to file FBARs, recordkeeping, and how to get FBAR help. For more information, visit Report Foreign Bank and Financial Accounts on FinCEN’s website.

FBAR

Reporting Foreign Bank and Financial Accounts (FBAR Info; IRS FBAR Reference Guide)

If a U.S. person has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, and the account exceeds $10,000 anytime during the year, the Bank Secrecy Act requires the U.S. person to report the account yearly by filing electronically a Financial Crimes Enforcement Network (FinCEN) Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

A U.S. person, including U.S. citizens, residents, and domestic entities, must file his or her 2023 FinCEN Form 114 by Apr. 15, 2024, if:

- the person has a financial interest in or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign country, and
- the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

Example. Karen, a United States person, owns foreign financial accounts A, B, and C with account balances of $3,000, $1,000, and $8,000, respectively. Karen is required to report accounts A, B, and C because the aggregate value of the accounts is over $10,000. It does not matter that no single account exceeded $10,000.

Tax practitioner planning. Owners of foreign accounts are required to report their accounts, even if the accounts do not generate any taxable income.
Must be filed by April 15, with extension to October 15 (no filing required for extension). FinCEN will grant filers failing to meet the FinCEN 114 annual due date of April 15 an automatic extension to October 15 each year.

**Penalty waiver for first-time filer (2015 Highway Funding Bill).** For any taxpayer required to file the FinCEN 114 for the first time, any penalty for failure to timely request for or file an extension may be waived by the IRS.

**Foreign currency conversion.** Need help computing the U.S. dollars when the client sends you the foreign bank account statement? The Treasury Department issues historical currency conversion rates.

**FBAR Filing Simplified for Individuals (BSA E-Filing System)**

FBARs may only be filed electronically. FinCEN has streamlined the process for an individual’s electronic filing an FBAR, FinCEN 114. Individuals are no longer required to register and create an account on the BSA E-Filing System prior to downloading, completing, and submitting the report to the system.

**FBAR Electronic Filing by Third-Party Preparers Requires Authorization on FinCEN (Form 114a).**

Form 114a, Record of Authorization to Electronically File FBARs, must be signed by the filer to allow third-party preparers to e-file the FBAR form. For accounts held jointly with a spouse, each spouse must sign a Form 114a authorizing the e-file. The form is not submitted with the FBAR filing but must be retained by the third-party preparer for five years. Agents, such as attorneys, CPAs, or enrolled agents filing the FBAR on behalf of a client must register to become a BSA e-filer and file as an institution, rather than an individual.

**Tax practitioner planning.** For questions or assistance, contact the BSA e-filing help desk at 866-346-9478 or via e-mail at BSAE_FilingHelp@fincen.gov.

**Reporting Foreign Account and Trust Information on Form 1040**

For 2023, Form 1040, Sch. B, Part III had to be completed if the taxpayer (1) has over $1,500 of taxable interest or ordinary dividends; (2) has a foreign account; or (3) receives a distribution from, was a grantor of, or a transferor to a foreign trust. Line 7a of Part III asks if the taxpayer has a signature authority over financial accounts in a foreign country of more than $10,000. In other words, the IRS has tied together Schedule B, Part III and the requirement to file FinCEN Form 114.


Currently, the FBAR regulations do not define a foreign account holding virtual currency as a type of reportable account. For that reason, at this time, a foreign account holding virtual currency is not reportable on the FBAR (unless it is reportable because it holds reportable assets besides virtual currency). However, FinCEN intends to propose to amend the regulations implementing the Bank Secrecy Act regarding reports of foreign financial accounts to include virtual currency as a type of reportable account.

**Penalties**

To combat money laundering and promote financial transparency, the Bank Secrecy Act (BSA) requires that a U.S. person with a financial interest in or signature authority over foreign financial accounts must file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR) if the total value of the foreign financial accounts exceeds $10,000 at any time during the calendar year. Only one annual FinCEN Form 114
needs to be filed, and it generally requests detailed information about each foreign account being reported. Failure to timely and properly file a required FBAR may subject a taxpayer and others to substantial penalties, depending on whether the failure was willful.

Penalties for violation of the FBAR filing requirement due to the taxpayer’s failure to timely file the form each year are authorized by Section 5321. Penalties are adjusted for inflation. 2023 penalties are as follows: (FinCEN Final Rule, Jan. 18, 2023).

- In general, for a violation other than a willful violation, a penalty not exceeding $10,000 (inflation adjusted to $15,611 for penalties assessed after Jan. 19, 2023); and
- For a willful violation, a maximum of the greater of $100,000 (inflation adjusted to $156,107 for penalties assessed after Jan. 19, 2023) or 50% of the balance in the account or the amount of the transaction.

Tax practitioner planning. Always see an attorney for advice on unreported foreign income and unfiled FBAR and FATCA forms.

No FBAR Penalty If the Foreign Income Was Timely Reported

The IRS will not impose a penalty for the failure to file the delinquent FBARs if the taxpayer properly reported on his or her U.S. tax returns, and paid all tax on, the income from the foreign financial accounts reported on the delinquent FBARs, and the taxpayer has not previously been contacted regarding an income tax examination or a request for delinquent returns for the years for which the delinquent FBARs are submitted (Delinquent FBAR Submission Procedures).

IRS Can Impose Only One Non-Willful Penalty for Late FBAR Covering Multiple Foreign Accounts (21-1195 Alexandru Bittner v. US (Feb. 28, 2023))

The U.S. Supreme Court in a 5-4 decision has held that non-willful Foreign Bank Account Report (FBAR) penalties apply per report, not account. The decision is being hailed as a surprising and significant win for non-willful FBAR non-filers.

200 Accounts Walk Into an FBAR. The Court released its opinion in Bittner v United States on Feb. 28, 2023. Justice Neil M. Gorsuch, authoring the opinion, agreed with Mr. Bittner’s reading of the law in that the Bank Secrecy Act’s $10,000 maximum penalty for the non-willful failure to file a timely report accrues on a per-report, not per-account, basis. “Best read, the BSA treats the failure to file a legally compliant report as one violation carrying a maximum penalty of $10,000, not a cascade of such penalties calculated on a per-account basis,” Gorsuch wrote.

So, this would mean Bittner’s tab is coming to $50,000 for five years of missing reports instead of the IRS’s original penalty assessment of over $2.7 million based on more than 200 accounts. FBAR non-filers are sure to cheer SCOTUS for this decision.

Taxpayer Ordered to Repatriate Funds to Pay for FBAR Penalties (US v. Schwarzbaum (No. 20-12061 (CA-11, Jan. 25, 2022))

Since 2001, Isac Schwarzbaum accumulated millions of dollars in 17 accounts in Switzerland and 4 accounts in Costa Rica. In 2010, Mr. Schwarzbaum participated in the OVDP program reporting various accounts from 2003 to 2010. However, he later withdrew from the program and his case was referred for
audit. The IRS determined Mr. Schwarzbaum was reckless and therefore willful in his failure to report his foreign bank accounts. The District Court held the taxpayer owed almost $18 million in penalties. Further the Court ordered Mr. Schwarzbaum to repatriate foreign assets to support a writ of garnishment under the Federal Debt Collection Procedures Act (FDCPA) in order to satisfy the FBAR penalty assessment.

Note. Isac Schwarzbaum has appealed to the Court for a second time arguing statute of limitation issues, among others. In a June 8, 2023, order, U.S. District Judge Beth Bloom refused to stay the order for repatriation of funds because of Schwarzbaum’s pending appeal.


Arthur Bedrosian held two bank accounts with Union Bank of Switzerland (UBS). The first he opened while a young pharmaceutical sales executive so he could have easy access to cash when traveling overseas. The second he acquired decades later after accepting a loan and investment proposal from the bank. He disclosed neither to the Federal government until 2008, despite his accountant telling him years earlier that he was breaking the law by failing to note a foreign account on his personal tax returns.

When Mr. Bedrosian finally disclosed his foreign holdings in the required FBAR, he left out a key piece of information. The filed form listed just one Swiss bank account with a balance of less than $1 million, even though he later admitted knowing his holdings at UBS were “over a million dollars.” The FBAR also failed to reflect Bedrosian’s ownership of a second Swiss bank account.

Willful penalty is 50% of the account balance. These omissions eventually surfaced, and the IRS assessed the maximum penalty against Mr. Bedrosian for willfully filing an inaccurate FBAR: 50% of the balance of the undisclosed account at the time of the violation, which it calculated to be a $975,789.17 penalty, half the balance of Mr. Bedrosian’s undisclosed account.

Mr. Bedrosian acted willfully by failing to disclose his second Swiss bank account. In upholding the lower court’s opinion, the Appeal Court held that willfulness includes not only knowing, but reckless, conduct. Bedrosian acted willfully because he (1) “clearly ought to have known” (2) “there was a grave risk” that the FBAR filing requirement “was not being met,” and that (3) he “was in a position to find out for certain very easily.”

FBAR Violation Recklessness and, Thus, Willful (Alice Kimble v. US, (CA-FC), 2021-1 USTC 50,110; (Mar. 25, 2021))

Because the penalty for willfully failing to file FBAR is a maximum penalty of the greater of $100,000 (inflation adjusted to $136,399 for 2021) or 50% of the balance in the account or the amount of the transaction, the determination of willful versus non-willful is meaningful.

What’s willfulness? The U.S. Supreme Court in Safeco Ins. Co. of Am. v. Burr, 551 US 47, 57 (2007), defined “recklessness” as “violating an objective standard: action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known.” On Nov. 6, 2015, the IRS issued IRM §4.26.16.6.5.1 and IRM §4.26.16.6.5.2. The IRM defines “willfulness” as “knowledge of the reporting requirements and [a] conscious choice not to comply.” A May 23, 2018, memorandum the IRS Office of Chief Counsel distributed to IRS program managers stated that “[t]he standard for willfulness under §5321(a)(5)(C) is the civil willfulness standard and includes not only knowing violations of the FBAR requirements, but willful blindness to the FBAR requirements as well as reckless violations of the FBAR requirements.”
Applied to OVDP. Alice Kimball had Swiss bank accounts since the 1980s. She did not report the investment income from the accounts or file required FBAR returns. With the advice of counsel, she applied and was accepted into the IRS OVDP program. She filed amended returns to report investment income from her foreign accounts and she filed the missing FBARs. The Oct. 5, 2012, OVDP Closing Agreement required Ms. Kimble to pay a miscellaneous penalty of $377,309. She refused and withdrew from the program. Ms. Kimble testified that she decided to “take her chances” with the IRS. “The penalty was so high that I was advised to appeal the penalty.” Thereafter, the IRS sent Ms. Kimble a letter informing her that any opt out from the OVDP would be irrevocable and might cause her to incur a higher penalty — i.e., the willful penalty versus the reduced OVDP penalty.

“Willful” penalty applied at appeal. Because Ms. Kimble (1) did not disclose the existence of the UBS account to her accountant until 2010, (2) never asked her accountant how to properly report foreign investment income, (3) did not review her individual income tax returns for accuracy for tax years 2003 through 2008, and (4) answered “No” to Question 7(a) on her 2007 income tax return, falsely representing under penalty of perjury, that she had no foreign bank accounts, the court determined that there was no genuine issue of material fact that Ms. Kimble violated §5314 and that her conduct was “willful.” She was assessed a “willful” penalty of $697,229.

Former Donald Trump Campaign Manager Agrees to $3.15 million in FBAR Penalties

(US v. Paul Manafort Jr. (No. 9:22-cv-80660, CA-11 (Feb. 22, 2023))

The District Court entered a consent judgment against Paul J. Manafort Jr. and awarded the government $3,152,190.12 for willful FBAR penalties for tax years 2013 and 2014. According to the complaint, Mr. Manafort had more than 20 accounts in various places including Cyprus, the United Kingdom, St. Vincent, and the Grenadines.

Mr. Manafort was convicted in 2018 of financial crimes including tax and bank fraud. President Trump pardoned Mr. Manafort in Dec. 2020. Despite President Trump’s pardon, the Justice Department’s lawsuit argues that Mr. Manafort still owes FBAR penalties.

Also see.

US v. Isaac Schwarzbaum, CA-11, 2022-1 USTC ¶50,107 (Jan. 25, 2022), where the 11th Circuit Court of Appeals found that the District Court had properly applied the legal standard in analyzing whether Schwarzbaum willfully violated the FBAR reporting requirements. “Willful conduct in the FBAR context includes knowing and reckless conduct. Reckless conduct is action that objectively entails a high risk of harm, which is the standard the district court applied.

George Harrington v. Comm., TCM 2021-195, where the taxpayer’s failure to report $791,661 of investment income from foreign accounts was fraud. The taxpayer filed FBARs reporting accounts in New Zealand but failed to report accounts in the Cayman Islands, Switzerland, or Liechtenstein.

US v. Dennis Ott, US District Court, ED Michigan, 2020-1 USTC ¶50,125 (2/1/2020), where taxpayer’s failure to file FBARs was determined to be willful.

FATCA

Foreign Financial Assets Disclosure Required - [Foreign Account Tax Compliance Act (FATCA)]; TD 9567; Proposed Regs. 26 CFR 1-301, 121647-10]

Form 8938 “Statement of Specified Foreign Financial Assets” must be attached to the tax return for those with assets exceeding $50,000. The Hiring Incentives to Restore Employment (HIRE) Act contained a provision
that both complements and contrasts with the FBAR filing requirement. Specifically, the HIRE Act added §6038D, requiring individual taxpayers with an aggregate balance of more than $50,000 to $150,000 for citizens not living abroad\(^3\) in foreign financial assets to file a statement with his or her income tax return. Unlike the FBAR information, which originates under Title 31 of the USC and normally is not permitted to be verified against a tax return or tax return information due to privacy and disclosure concerns, the provision under §6038D has none of these restrictions. This change allows the IRS to use its full complement of tools to verify the information or lack of information filed.

**Tax practitioner planning.** The IRS added a page to its website for recent developments concerning the Form 8938.

**Specified domestic entity reporting.** Certain domestic corporations, partnerships, and trusts that are considered formed or availed of for the purpose of holding, directly or indirectly, specified foreign financial assets (specified domestic entities) must file Form 8938 if the total value of those assets exceeds $50,000 on the last day of the tax year or $75,000 at any time during the tax year. For more information on domestic corporations, partnerships, and trusts that are specified domestic entities and must file Form 8938, and the types of specified foreign financial assets that must be reported, see the Form 8938 instructions.

**What’s required in the disclosure?** Form 8938 disclosure statement requires the reporting of the maximum value of the foreign assets during the taxable year. The disclosure statement should also provide the following information:

- Financial account - the name and address of the foreign financial institution in which such account is maintained and the number of such account.
- Stock or security - the name and address of the foreign issuer and such information as is necessary to identify the class or issue of which such stock or security is part.
- Contract, interest, or other instrument - such information as is necessary to identify such contract, interest, or other instrument and the names and addresses of all foreign issuers and counterparties with respect to such contract, interest, or other instrument.

**Foreign real estate is not a reportable asset** (Basic Questions and Answers on Form 8938). Foreign real estate is not a specified foreign financial asset required to be reported on Form 8938. For example, a personal residence or a rental property does not have to be reported. If the real estate is held through a foreign entity, such as a corporation, partnership, trust, or estate, then the interest in the entity is a specified foreign financial asset that is reported on Form 8938, if the total value of all specified foreign financial assets is greater than the reporting threshold that applies. The value of the real estate held by the entity is taken into account in determining the value of the interest in the entity to be reported on Form 8938, but the real estate itself is not separately reported on Form 8938.

**Directly Held Tangible Assets Are Not Reportable (Basic Questions and Answers on Form 8938)**

Directly held tangible assets, such as art, antiques, jewelry, cars, and other collectibles, are not specified foreign financial assets. Directly held precious metals, such as gold, are not specified foreign financial assets. However, gold certificates issued by a foreign person are a specified foreign financial asset. The contract with a foreign person to sell assets held for investment is a specified foreign financial asset investment asset.

\(^3\) $200,000 to $600,000 for taxpayers living abroad.
A Foreign Defined Benefit Plan Is a Reportable Asset (Basic Questions and Answers on Form 8938)

A foreign pension plan or deferred compensation plan is a reportable asset. In general, the value of the taxpayer’s interest in the foreign pension plan or deferred compensation plan is the fair market value of his or her beneficial interest in the plan on the last day of the year. However, if the taxpayer does not know or have reason to know based on readily accessible information the fair market value of the beneficial interest in the pension or deferred compensation plan on the last day of the year, the maximum value is the value of the cash and/or other property distributed to the taxpayer during the year. This same value is used in determining whether the taxpayer has met the FATCA reporting threshold.

If the taxpayer does not know or have reason to know based on readily accessible information the fair market value of the beneficial interest in the pension plan or deferred compensation plan on the last day of the year and he or she did not receive any distributions from the plan, the value of the interest in the plan is zero. In this circumstance, the taxpayer should also use a value of zero for the plan in determining whether he or she has met the FATCA reporting threshold. If the taxpayer has met the reporting threshold and is required to file Form 8938, report the plan, and indicate that its maximum value is zero.

Foreign Financial Assets Must Exceed a Filing Threshold Before Form 8938 Is Required (Form 8938 Instructions)

As can be seen by the following chart, the IRS requires individual taxpayers with foreign financial assets in excess of a filing threshold to file a statement with his or her income tax return. For example, a single taxpayer not living abroad must file Form 8938 if the total value of his or her foreign financial assets exceeds $50,000 on the last day of the year or $75,000 at any time during the year. These amounts double for those who are married filing jointly.

<table>
<thead>
<tr>
<th>If Total Value of Foreign Financial Assets Exceed</th>
<th>Not Living Abroad</th>
<th>Single and MFS</th>
<th>Married Filing Joint</th>
<th>Single and MFS</th>
<th>Married Filing Joint</th>
</tr>
</thead>
<tbody>
<tr>
<td>On Last Day of the Year</td>
<td>$50,000</td>
<td>$100,000</td>
<td>$200,000</td>
<td>$400,000</td>
<td></td>
</tr>
<tr>
<td>At Any Time During the Year</td>
<td>OR $75,000</td>
<td>OR $150,000</td>
<td>OR $300,000</td>
<td>OR $600,000</td>
<td></td>
</tr>
</tbody>
</table>

Foreign currency conversion. If the foreign financial asset is reported in a foreign currency, the maximum value of the asset must be determined in the foreign currency and then converted to U.S. dollars. In most cases, the U.S. Treasury Department’s Financial Management Service foreign currency exchange rate for purchasing U.S. dollars must be used. This rate can be found here.

Call or E-mail for Answers to Your FBAR and FATCA Questions

Help with FBAR and FFA reporting is available by phone at 866-270-0733 for callers within the United States and 313-234-6146 for callers outside the United States. Answers can also be found by sending an inquiry to FBARquestions@irs.gov. Call the FinCEN Resource Center at 800-949-2732 or 703-905-3975 or by e-mailing your inquiry to FRC@fincen.gov.
FBAR and FATCA Reporting May Be Required for Same Foreign Asset

The reporting requirement for Form 8938 is separate from the reporting requirement for the FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). An individual may have to file both forms, and separate penalties may apply for failure to file each form. Information on filing a delinquent Form 114 can be found at Delinquent FBAR Submission Procedures. See the IRS Comparison of Filing Requirements for further information.

Other Foreign Reporting Not Duplicated on Form 8938

Other foreign reporting. Taxpayers do not have to report a specified foreign financial asset on Form 8938 if it is reported on one or more of the following forms that have been timely filed for the same tax year:

- Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.
- Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.
- Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company, or Qualified Electing Fund.
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.
- Form 8891, US Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.

Delinquent Foreign Asset Reporting

Streamlined Filing Still Available (Streamlined Procedures, FAQs on Streamlined Procedures, Streamlined Domestic Offshore Procedures, and US Taxpayers Residing Outside of the US)

The streamlined filing compliance procedures, updated Sep. 22, 2023, on the IRS website are available to taxpayers certifying that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from willful conduct on their part. The streamlined procedures are designed to provide to taxpayers in such situations with:

- a streamlined procedure for filing amended or delinquent returns,
- terms for resolving their tax and penalty procedure for filing amended or delinquent returns, and
- terms for resolving their tax and penalty obligations.

ACA'S INDIVIDUAL MANDATE

Individual Mandate Penalty (§5000A)

The TCJA reduced the amount of the individual responsibility payment, enacted as part of the Affordable Care Act (ACA), to zero. The provision is effective with respect to health coverage status for months beginning after Dec. 31, 2018.

Tax practitioner planning. The only change to the ACA individual mandate included in the TCJA was the reduction of the individual mandate penalty to zero. The 3.8% tax on net investment income was retained. The ARPA increased subsidies and eliminated the “cliff.”
A Record Number of People Will Be Claiming the Premium Tax Credit in 2023

A record 16.3 million people signed up for 2023 ACA health plans through HealthCare.gov and the state exchanges. COVID and the Great Resignation are all part of the increase.

Tax practitioner note. Remind clients that excess advances must be repaid. If clients have a significant change in their 2023 projected income after they’ve signed up, they should have updated their marketplace account to avoid receiving excess subsidies.

Form 1095-C Furnishment Date Extended to March 2 Permanently

The IRS extended permanently the deadline for furnishing the Form 1095-C to the employees of an Applicable Large Employer to 30 days after January 31 (REG-109128-21). The due date for furnishment of the 2023 Form to the employee is Mar. 2, 2024.

WHO’S REQUIRED TO HAVE HEALTH INSURANCE

ACA’s Individual Mandate Requires All to Have Health Insurance (ACA Tax Provisions for Individuals and Families)

The ACA requires individuals to have minimum essential coverage for at least one day in a month. However, the TCJA made the penalty for failure to have health insurance -0- for 2019 to 2025.

Tax practitioner planning. For more information, see Affordable Care Act (ACA) Tax Provisions.

Shared Responsibility Payment Is a Priority Status Tax in Bankruptcy (US v. Fazio Alicea, CA-4 (Jan. 19, 2023))

For clients who declared bankruptcy while owing an individual mandate penalty, the Fourth Circuit reversed a district court decision and held that the shared responsibility payment under the Affordable Care Act is a tax rather than a penalty, and it is entitled to priority status under the Bankruptcy Code.

Also see. US v. Russell Brown, CA-9 (Feb. 27, 2023), where the Court ruled that the shared responsibility payment was a tax (not a penalty) and therefore entitled to priority status in the Bankruptcy Code.

Don’t Forget State Requirements. California, DC, New Jersey, Rhode Island, and Vermont have enacted their own individual mandate. These jurisdictions use Form 1095-C to administer their individual mandate requirements. Massachusetts enacted its own individual mandate and uses Form 1099-HC for reporting. The California, Massachusetts, and Rhode Island furnishment requirement for 2023 forms has not been extended and remains Jan. 31, 2024.

ACA CHANGES

The Inflation Reduction Act Extended ARPA’s Increased Premium Subsidies Extended Through 2025

For 2021 and 2022, ARPA increased the amount of financial assistance for people at lower incomes who were already eligible under the ACA. ARPA provided health insurance subsidies to people buying health coverage on the Marketplace who have incomes over 400% of the FPL. This change eliminated the “cliff” originally in ACA. The Inflation Reduction Act extended ARPA changes through 2025.
Premium Subsidies

**Applicants with income up to 150% of FPL are fully subsidized.** Previously, marketplace premium subsidies were partial. Even the lowest income applicant had to pay some portion of their premium.

**Applicants with income between 150% and 400% of FPL received increased subsidies from ARPA change.** People with income of 200% of the FPL had been required to contribute $1,664 in 2021 toward the cost of the benchmark marketplace plan. The ARPA reduced their 2021 contribution to $510. At income of 400% of the FPL, people had been required to contribute up to $5,017 toward the 2021 benchmark plan premium. The ARPA reduced the 2021 contribution to $4,338. Similar reductions apply in 2023.

**Applicants with income above 400% FPL are eligible for subsidies.** Under the ACA, people with income above 400% of the FPL were not eligible for subsidies. The ARPA limits the applicant’s contribution toward the benchmark plan to no more than 8.5% of 2023 household income (8.39% in 2024). This new lower cap on the percentage of a family’s household income that goes toward premiums addresses the “subsidy cliff” for those with household incomes above 400% of the FPL. Instead of no premium tax credits, ARPA made premium tax credits available to these families and caps how much of a family’s household income the family needs to pay towards their premiums.

**Tax practitioner planning.** This change offered relief for older individuals purchasing their insurance on the marketplace. According to the Kaiser Family Foundation, unsubsidized premiums averaged nearly 25% of household income for someone who is 64 years old.

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**WHEN AND HOW THE MARKETPLACE IS USED FOR HEALTH INSURANCE COVERAGE**

State and Federal Marketplaces

The ACA requires health insurance exchanges to be established in every state. Exchanges are marketplaces where individuals and small businesses can shop for and purchase private health insurance coverage. Exchanges may be established either by the state itself as a state-based exchange or by the HHS as a federally facilitated exchange ([IRS - The Health Insurance Marketplace - updated Jun. 8, 2023](#)). For a qualified applicant, the marketplace is the conduit for premium tax credits and a lower net health insurance premium for the individual and his or her family.

Purchasing Coverage at the Marketplace

In the case of an individual who is ineligible for coverage under an eligible employer-sponsored plan or a government plan, the required contribution is the premium for the *applicable plan*, reduced by the maximum amount of any §36B credit for the taxable year (determined as if the individual was covered for the entire taxable year by a qualified health plan offered through the marketplace serving the rating area where the individual resides). Applicable plan means the *single lowest cost bronze plan* available in the individual market through the marketplace that would cover all individuals in the individual’s *nonexempt family*. An individual’s nonexempt family means the family that includes the individual, excluding any exempt family members or family members treated as eligible for coverage under an eligible employer-sponsored plan. The premium for the applicable plan takes into account rating factors (for example, an individual’s age) that the marketplace would use to determine the cost of coverage. Accordingly, the

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4. Individuals for whom the taxpayer properly claims a family tax credit for the year (§1.5000A-1(d)(6)).
premium for the lowest cost bronze plan is the same for all individuals in a nonexempt family (§5000A(e)(1)(B)(ii); §1.5000A-3(e)(4)(ii)(A); §1.5000A-3(e)(4)(ii)(c); Preamble,3, e,ii).

2024 Plan Enrollment at HealthCare.gov

Open enrollment for 2024 at Healthcare.gov begins Nov. 1, 2023, and ends Dec. 15, 2023 for coverage that begins in 2024, in all states that use HealthCare.gov. These are the same open enrollment dates as Medicare markets for those over 65. The last day to enroll for 2024 coverage in Jan. 1, 2024, unless a special enrollment period applies.

Some states have adopted different open enrollment periods. State-run exchanges are encouraged to follow the same schedule, but 17 states and D.C. have different enrollment periods. Check healthinsurance.org for an update for each state.

Example. California legislators have created a permanent extended open enrollment period to Nov. 1 through January 31. The last day to apply for coverage with an effective date of Jan. 1, 2024, is Dec. 15, 2023. New York open enrollment for 2024 plans begins on Nov. 1, 2023, and ends Jan. 31, 2024.

Purchasing insurance after the open enrollment ends. A 2024 marketplace health plan can be purchased after open enrollment only if the individual qualifies for a special enrollment period. Marketplaces have created exceptions for “qualifying life events” (i.e., moving, loss of coverage, hospitalization, marriage, divorce, etc.). Exceptions are also available for “complex situations” like disaster and website problems. An individual can apply for Medicaid or CHIP at any time of the year.

Failure to File 2022 Tax Returns Prevents Advance Premium Assistance Payments in 2024

If an individual receives an advanced premium assistance payment from the marketplace, the individual must file a tax return reconciling the credit. The reconciliation is done on Form 8962 using the information reported on Form 1095-A.

Tax practitioner planning. The individual receiving an advance premium tax credit must file a return with Form 8962 even if he or she is not otherwise required to file.

Individuals who do not file 2022 returns risk the loss of their 2024 advanced premium tax credit. In addition, the IRS may contact the taxpayer to pay back some or all of the advance payments of the premium tax credit.

WHO QUALIFIES FOR THE PREMIUM TAX CREDIT?

16.3 million (up from 14.8 for 2022) people signed up for 2023 ACA health insurance coverage. The top three states for enrollment are Florida (3.2M), Texas (2.4M), and California (1.7M).

Proposed Regs Fix Family Glitch (NPRM Reg-114339-21)

President Biden on Apr. 5, 2022, announced the Treasury Department and IRS’s proposal to eliminate the ACA’s “family glitch” by allowing a spouse or dependents of employees who are offered affordable self-only coverage but unaffordable family coverage to qualify for premium tax credits under §36B. Accordingly, on Apr. 7, 2022, the IRS released proposed regulations that if finalized would extend the minimum value criteria for subsidy eligibility to include dependents for the purchase of ACA coverage. Thus, premium
subsidies would be available for a spouse or dependent of an employee if the employer’s offer of coverage is unaffordable.

**Tax practitioner planning.** The proposed regulation does not add any new requirements for employers.

**Premium Tax Credit is refundable (§36B; §1.36B-0 et seq.; Questions and Answers on the Premium Tax Credit; IRS’s “Facts About the Premium Tax Credit”)**

The premium tax credit is refundable, so taxpayers who have little or no income tax liability can still benefit. The credit also can be paid in advance to a taxpayer’s insurance company to help cover the cost of premiums.

**Premium tax credit helps subsidize the purchase of health insurance.** The *premium tax credit* is an advanceable, refundable tax credit available for an “*applicable taxpayer*” for any month that one or more members of the applicable taxpayer’s family are:

- enrolled in qualified health insurance through the marketplace; and
- not eligible for minimum essential health coverage from another source, such as employer coverage or government coverage, other than the individual market in the state (§1.36B2(a), Q&A #1).

**Eligibility based on income two years back.** Initial eligibility for the premium tax credit is based on the individual’s income for the tax year ending two years prior to the enrollment period. Participants must provide the marketplace with her or his prior year’s tax return. This information is used to determine the amount of any credit that will be paid to insurers in the current year. Providing incorrect information to the marketplace may subject the individual to civil penalties, ranging from $25,000 up to $250,000 for supplying fraudulent information.

**Marketplace estimates current premium credit.** This financial information is used to estimate the individual’s required share of the premiums. The required share of premiums is then subtracted from the premiums for the second lowest-cost *silver plan* (SLCSP) adjusted for age (called the *applicable benchmark plan*) to determine the amount of the premium tax credit. This credit is adjusted for a sliding percentage of household income.

**Tax practitioner planning.** The Henry J. Kaiser Family Foundation has a simple subsidy calculator to estimate the premium assistance for coverage from the marketplaces.

**The premium tax credit is a refundable tax credit; timing is discretionary.** Although the credit is generally payable in advance directly to the insurer, individuals may elect to pay for health insurance out-of-pocket and receive the credit with their tax return. The individual can decide to have all, some, or none of the estimated credit paid in advance directly to the health insurance company (Q&A #3).

**Tax practitioner planning.** Even if the insured owes no tax and receives no advanced premium tax credit, he or she will receive the full amount of their allowable credit as a refund as long as the insured’s health coverage was purchased through the marketplace.

**Too much advance payment of credit may end up as a tax due for the insured.** The final credit amount for 2023 is based on that year’s actual income. Any advance payments of the credit received will be reconciled with the actual premium tax credit on the individual’s 2023 tax return using Form 8962. If the actual allowable credit is more than the advance credit payments, the difference will be added to the individual’s refund or subtracted from the balance due (Q&A #26).
Who’s Eligible for the Credit — Seven Criteria (§36B; §1.36B-2(b)):

- Household income must fall within the FPL guidelines for the taxpayer’s family size (revised by the ARPA).
- If married at the end of the year, a joint tax return must be filed. A qualifying individual may not file a Married Filing Separately tax return (unless the individual meets the criteria in Notice 2014-23, which allows certain victims of domestic abuse or spousal abandonment to claim the premium tax credit using the Married Filing Separately filing status) (§1.36B-2T(b)(2)(i); TDNR JL-2584; Q&A #11).
- Affordable coverage through an eligible employer plan that provides minimum value must not be available to the taxpayer (see Q&A #8 & 9).
- The taxpayer must not be eligible for coverage through a government program, like Medicaid, Medicare, CHIP, or TRICARE.
- The taxpayer must not be claimed as a dependent on another taxpayer’s tax return.
- At the time of enrollment, the taxpayer must be a U.S. citizen or national or an alien lawfully in the United States and not be incarcerated.
- The taxpayer must purchase coverage through the marketplace (Q&A #5).

Household income must be between 100% and 400% of the federal poverty level. In general, individuals and families whose “household income” for the year is between 100% and 400% of the FPL for their family size may be eligible for the premium tax credits assuming all other eligibility criteria are met (Q&A #7). For purposes of premium credit eligibility, household income is measured according to the definition for MAGI. An individual whose MAGI is at or above 100% of the FPL, up to and including 400% of the FPL, may be eligible to receive premium credits. If income is above 400% of the FPL, ARPA provided that individuals and families are eligible for a reduced credit in 2023. ARPA removed the “cliff” through 2022. IRA22 extended the relief through 2025.

Income Levels at 400% FPL Applicable in 2023 Premium Credit Calculation (HHS.gov/povertyguidelines)

<table>
<thead>
<tr>
<th>Number of Persons in Family</th>
<th>48 Contiguous States &amp; DC</th>
<th>Alaska</th>
<th>Hawaii</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$58,320</td>
<td>$72,840</td>
<td>$67,080</td>
</tr>
<tr>
<td>2</td>
<td>$78,880</td>
<td>$98,560</td>
<td>$90,720</td>
</tr>
<tr>
<td>3</td>
<td>$99,440</td>
<td>$124,280</td>
<td>$114,360</td>
</tr>
<tr>
<td>4</td>
<td>$120,000</td>
<td>$150,000</td>
<td>$138,000</td>
</tr>
<tr>
<td>5</td>
<td>$140,560</td>
<td>$175,720</td>
<td>$161,640</td>
</tr>
<tr>
<td>6</td>
<td>$161,120</td>
<td>$201,440</td>
<td>$185,280</td>
</tr>
</tbody>
</table>

Tax practitioner planning. There is no asset test included in the requirements to receive a premium tax credit, only an income test. Clients with significant wealth in assets, but incomes that are subject to some discretion, may be able to manage their income so that they qualify for subsidized health insurance. IRAs or HSAs, §179 expensing, pension, and profit-sharing plans, etc., could all be used to reduce AGI in order to qualify a particular taxpayer for premium credits.
HOW THE PREMIUM TAX CREDIT IS CALCULATED

Applicable individuals report their household income to the marketplace and then enroll in a health plan offered through the marketplace. Financial information provided to the marketplace is used to calculate the applicable individual’s required share of premiums for the health plan. The required share of premiums is then subtracted from the cost of premiums for the second lowest-cost silver plan (SLCSP) adjusted for age (called the applicable benchmark plan) to determine the amount of the premium tax credit.

Definition of Household Income When Calculating the Premium Tax Credit

For purposes of the premium tax credit, household income is defined as the sum of (§36B(d)(2)):

- the taxpayer’s MAGI, plus
- the aggregate modified adjusted gross incomes of all other individuals taken into account in determining that taxpayer’s family size (but only if such individuals are required to file a tax return for the taxable year).

Modified adjusted gross income is defined as adjusted gross income increased by:

- amounts excluded from gross income for citizens or residents living abroad (§911), plus
- any tax-exempt interest received or accrued during the tax year, plus
- Social Security benefits excluded from gross income under §86; Q&A #7.

Extended family member’s income not part of household income if not claimed as a dependent. An eligible related individual not claimed as a dependent is not treated as a related individual and the unclaimed dependent’s household income is independently determined (Preamble,3,e,i,C).

The “applicable percentage” table (§1.36B-3T(g)). The premium tax credit operates on a sliding scale in a linear manner; the result being that as household income increases, the taxpayer’s required share of contribution increases. Beginning in 2015, the percentages of income were indexed in order to hold steady the share of premiums that enrollees at a given poverty level pay over time. Examples below are calculated using the Kaiser Family Foundation calculator at kff.org.

The Final Reconciliation Is Done on Form 8962

Estimated annual premium tax credit is reconciled on Form 8962. If an individual receives advance credit payments in any amount or plans to claim the premium tax credit when filing her or his tax return, a federal income tax return must be filed to reconcile the difference between the advance credit payments made on the individual’s behalf and the actual amount of the credit that should have been claimed, or to initially claim the credit. This is completed by filing Form 8962 with the individual’s tax return. The filing requirement applies regardless if the individual would otherwise be required to file a return (§36B(f); Q&A #3, 4 & 11).

Form 8962, Part 3: Repayment of excess advance payment of the premium tax credit. If the taxpayer’s advance credit payments exceed the allowed premium tax credit, the taxpayer owes the excess as a tax liability, subject to a repayment limitation. This filing requirement applies whether or not the individual would otherwise be required to file a return (§36B(f); Q&A #3, 4 & 11).

Tax practitioner planning. The additional 2023 tax credit payback may be limited to $350 - $1,500 (single, MFS) $700 - $3,000 (MFJ, HOH) if the taxpayer is low-income.
Changes in Circumstances That Can Affect the Amount of the Actual Premium Tax Credit Include:

- differences in household income between the projected and actual income,
- change in marital status,
- birth or adoption of a child,
- other changes to household composition, or
- gaining or losing eligibility for government-sponsored or employer-sponsored healthcare coverage (Q&A #4).

Advance Premium Tax Credits Require Taxpayer Attach Form 8962 to Tax Return *(Chalaulandra Sneed v. Comm., TCS 2023-11)*

Chalaulandra Sneed enrolled in health insurance for herself and her two dependents through the Oklahoma insurance Marketplace. She received Advance Premium Tax Credits (APTC) on the basis of the information she provided in her application. Ms. Sneed did not attach a copy of Form 8962, Premium Tax Credit (PTC), to her income tax return, but later mailed it separately. The notice of deficiency determined that Ms. Sneed was ineligible for the PTC because her MAGI for year at issue exceeded 400% of the federal poverty line amount for her family size. The Affordable Care Act allows a refundable tax credit (the PTC) for eligible taxpayers with household income that is at least 100%, but not greater than 400%, of the federal poverty line amount for the taxpayer’s family size for the taxable year at issue. The APTC may cover some or all of the taxpayer’s monthly premiums for a health insurance plan. When preparing her income tax return, a taxpayer who has received the APTC is required to reconcile the APTC payments made during the year with the amount of the PTC for which she is actually eligible.

Tax practitioner note. A change to the PTC in the American Rescue Plan removed the “cliff” from the credit computation through 2025. A taxpayer can have household income above the 400% mark and still receive a partial PTC.

Failed to Reconcile Advance Premium Tax Credit on Form 8962 *(Denine and Bryan Kerns, pro se v. Comm., TCM 2019-14)*

Denine and Bryan Kerns purchased their health insurance through Covered California. They received an advanced premium tax credit (APTC) of $8,420 in 2014. They timely filed their 2014 return, reporting AGI of $97,061. They claimed personal exemptions for themselves and no exemptions for dependents. The IRS determined that the Kerns were not eligible for any credit because their household income exceeded the maximum allowable under §36B(b) and (c)(1)(A). For 2014, 400% of the FPL was $62,040. The Kerns’ household income far exceeded that amount, and the court found that the taxpayers were ineligible for any APTC.

Also see.

Marie Henry v. Comm., TCM 2023-2, where her household income exceeded 400% of the federal poverty line and she was required to repay the advance premium tax credit payments she received.
Client Year End Planning Letter

Dear [Client’s Name],

As the year draws to a close, it is essential to assess your financial situation and consider strategies to optimize your tax position for the upcoming tax season. This year-end tax planning letter serves as a guide to help you make informed decisions that can positively impact your tax liability. Please keep in mind that tax laws are subject to change at the whim of Congress. Therefore, I strongly advise you to consult with us or your attorney to discuss the latest tax law changes and their implications for your unique situation.

Year-End Tax Planning Steps:

Individual Planning –

Review your income and expenses: Take a close look at your income and expenses for the year to determine if there are any opportunities to reduce your tax liability. Consider deferring income to next year or accelerating expenses into this year, whichever is more beneficial to your tax situation.

Review your withholding and estimated tax payments: Make sure you are withholding enough taxes from your paycheck or making sufficient estimated tax payments throughout the year. Adjust your withholding or estimated tax payments as needed to avoid underpayment penalties.

Review Capital Gains and Losses: If you have investments that have declined in value, consider selling them before the end of the year to offset capital gains from other investments. If you have investments that have increased in value, consider selling them before the end of the year to offset capital losses from earlier sales. Careful and precise planning will maximize your tax savings by sheltering capital gains sooner.

Max out Retirement Contributions: Contribute the maximum allowable amount to retirement accounts such as 401(k)s, IRAs, or SEP IRAs. These contributions can reduce your taxable income and enhance your retirement savings.

Consider Charitable Giving: If you plan to make charitable contributions, consider donating appreciated assets, such as stocks or real estate, to maximize your tax benefits. Be sure to keep proper records of your donations for tax purposes.

Take Required Minimum Distributions. Required Minimum Distributions (RMDs) are minimum amounts that IRA and retirement plan account owners generally must withdraw annually starting with the year they reach age 72 (73 if you reached age 72 after Dec. 31, 2022). RMDs are taxable income and must be withdrawn by year end or a penalty applies. If you have a favorite charity, consider a qualified charitable distribution (QCD) from your IRA. The distribution is not taxable as it is, in practice, offset by the charitable donation.
Business Planning –

Review your business expenses. If you are a cash basis business owner, postponing billings and accelerating deductible expenses may provide substantial tax savings.

Consider Equipment Purchases: Take advantage of the Section 179 deduction and bonus depreciation for eligible business equipment purchased and placed in service by the end of the year. These deductions can reduce your taxable income.

Estate Planning –

Review your estate plan: Review your estate plan to ensure it is up-to-date and reflects your current financial situation. Consider consulting with an estate planning attorney to ensure your plan is comprehensive and effective.

Utilize the annual Gift Tax Exclusion: Consider gifting assets to heirs to take advantage of the annual gift tax exclusion. The 2023 and the 2024 annual gift tax exclusions are $17,000. Making annual gifts can help reduce the size of your taxable estate.

Timing of Deductions –

Bunching Deductions: Consider itemizing deductions in one year if you usually take the standard deduction. This strategy, known as “bunching,” can help you exceed the standard deduction threshold and maximize your deductions. For example, pay your 2023 and 2024 contributions in 2023 to get enough deductions to itemize. Use the standard deduction if 2024.

State and Local Taxes (SALT): Be aware of the SALT deduction limits, and plan accordingly. Some taxpayers may not benefit from paying property taxes or state income taxes in advance.

These are general guidelines to get you started on your year-end tax planning. However, your financial situation is unique, and I recommend scheduling a meeting with me to discuss your specific circumstances in detail. Together, we can develop a customized tax strategy to minimize your tax liability while aligning with your financial goals. Please don’t hesitate to reach out to schedule an appointment. It’s important to act promptly to make the most of your year-end tax planning opportunities.

Thank you for entrusting us with your financial needs. We look forward to assisting you in optimizing your tax position and achieving your financial goals in the coming year.

Warm regards,
Letter for Divorcing Client

Dear [Client’s Name],

I am sorry that your marriage is ending. Our office, as always, is here to help you with this change. There are many considerations in divorce, here are some general tax and financial planning ideas:

For Divorcing Couples:

Filing Status: Determine the most beneficial filing status for each spouse, whether it’s married filing jointly, married filing separately, or head of household. This choice can impact your overall tax liability.

Alimony and Spousal Support: For divorces finalized after December 31, 2018, alimony or spousal support is no longer deductible for the payer and no longer taxable to the recipient.

Child Support: Child support payments are generally not tax-deductible for the payer or taxable for the recipient.

Dependents and Child Tax Credits: Determine who will claim the children as dependents for tax purposes and discuss how child tax credits will be allocated. See more information from the IRS for divorced and separated parents here.

Property Division: Consider the tax consequences of dividing marital assets. The division of certain assets, such as the personal residence, business interests, retirement accounts, and investment properties, have different tax implications upon distribution to one spouse or the other. Our office can be of particular help in understanding the tax problems and solutions in asset divisions.

Retirement Accounts: Assess the potential tax impact of dividing retirement accounts such as 401(k)s, IRAs, or pensions. When dividing retirement accounts, use a Qualified Domestic Relations Order (QDRO) to ensure tax-efficient transfers and to avoid penalties. Seek guidance from your matrimonial attorney to navigate this process. See more on QDROs from the IRS here.

Health Insurance: Understand the impact of divorce on health insurance coverage, especially if one spouse was covered under the other’s employer-sponsored plan. Explore options for continued coverage, such as COBRA or individual plans.

Beneficiary Designations: After a divorce is finalized, review and update your beneficiary designations to reflect your current wishes and circumstances. This may involve changing beneficiaries on life insurance policies, retirement accounts, bank accounts, stock accounts, and any other assets or relevant documents (like your medical power of attorney).

Estate Planning: Update your estate plan, including wills, trusts, and beneficiary designations, to reflect the changes brought about by the divorce. Consult with an estate planning attorney to ensure your wishes are appropriately addressed.

Reading material from the IRS: Information on filing status, as well as other items mentioned above, is discussed in IRS Publication 504.

Additional Considerations for Older Divorcing Individuals

Social Security Benefits: Review the eligibility criteria for claiming Social Security benefits based on your ex-spouse’s work record. You may be eligible for spousal benefits if you were married for at least ten years and meet other requirements.

Long-Term Care Considerations: Assess the impact of divorce on long-term care planning, such as the potential need for long-term care insurance.
Additional Considerations for a Client Changing Her Name After a Divorce

If you decide to change your name after a divorce, there are several entities you may need to contact to update your information. A copy of your divorce decree is often required when changing your name. Here are some common contacts you will need to reach out to:

- **Social Security Administration (SSA):** Notify the SSA about your name change by completing the necessary forms. This will ensure that your Social Security records reflect your new name. Here is a link to the Social Security Administration (SSA) website on how to change your name. The name you use on your tax return must match SSA records. No separate change of name application is required by the IRS.

- **Department of Motor Vehicles (DMV):** Update your driver’s license or state ID card with your new name. Contact your local DMV office for specific instructions and requirements.

- **State Department:** If you have a US passport, you will need to update it with your new name. Visit the State Department FAQ #21 here. For non-US passports, visit the website of your country’s passport agency for instructions on how to update your passport.

- **Financial Institutions:** Inform banks, credit unions, and other financial institutions where you hold accounts about your name change. This includes checking accounts, savings accounts, credit cards, loans, and any other accounts you may have.

- **Insurance Companies:** Contact your insurance providers, including health, auto, home, or any other relevant policies, to update your name on their records.

- **Employer:** Notify your employer about your name change so that they can update their records, payroll, and any other necessary documentation.

- **Utility Companies:** Inform utility companies, such as gas, electricity, water, and internet providers, about your name change to ensure that billing and service accounts are updated.

- **Professional Licensing Boards:** If you hold professional licenses or certifications, such as a medical or legal license, contact the respective licensing boards to update your name on their records.

- **Credit Bureaus:** Notify the major credit bureaus (Equifax, Experian, and TransUnion) about your name change to ensure that your credit reports accurately reflect your new name.

- **Other Contacts:** Consider updating your name with other organizations or entities you have a relationship with, such as memberships, subscriptions, LinkedIn, Instagram, and frequent flyer (and rental car and hotel) accounts.

**We Can Help**

I hope this summary helps you with the decisions coming in the next few months as you consult with your matrimonial attorney and financial planner. Please let me know if our office can assist with questions and tax estimates.

Warm regards,
# 2023 FEDERAL TAX UPDATE
## RETIREMENT PLANS
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CHAPTER TWO HIGHLIGHTS

- SECURE 2.0 Makes Sweeping Changes to Retirement Plans
- Automatic Enrollment will be Required for New Plans
- New Plans for Small Businesses with NO Employer Contribution Begin
- 2022 Proposed Regulations Change RMDs Starting in 2023
- Plan Loan Rollover Dates Changed
- Hardship Withdrawal Rules Revised
- Inflation Adjustments are Minimal for 2023
- 10% Early Withdrawal Penalty Exceptions Added

SECURE 2.0

The SECURE 2.0 Act of 2022 was part of the Consolidated Appropriation Act of 2023 which was signed into law on Dec. 29, 2022. This law made sweeping changes to retirement plans, particularly those sponsored by small businesses. It contains provisions intended to expand coverage and increase retirement savings, provisions to preserve retirement income and finally provisions to simplify and clarify retirement plan rules.

Increasing Retirement Savings Through Automatic Enrollment, New Incentives, and Expanded Coverage

- Promotes saving for earlier retirement by expanding automatic enrollment in 401(k) and 403(b) retirement plans.
- Creates new financial incentives for small businesses to offer retirement plans.
- Creates new retirement plans for small businesses that do not require employer contributions.
- Encourages employee participation by allowing businesses to provide small immediate financial incentives (such as low-dollar gift cards) to increase employee participation. These incentives cannot be paid for with plan assets.
- Allows employers the option to offer Pension-Linked Emergency Savings Accounts. Almost 60% of participants who lack emergency savings dipped into their retirement savings. Separating emergency savings from retirement will hopefully provide participants with a better understanding that one account is for short-term emergency needs and the other is for long-term retirement savings. Employers may automatically opt employees into these accounts at no more than 3% of their salary limited to $2,500. Contributions are made on a Roth-like basis and are treated as elective deferrals for purposes of retirement matching contributions. The first four withdrawals from the account each plan year may not be subject to any fees or charges solely based on such
withdrawals. At separation from service, employees may take their emergency savings accounts as cash or roll into a Roth.

- Increases and modernizes the existing Federal tax credit for contributions to a retirement plan or IRA (the Saver’s Credit).

- For plan years beginning after Dec. 31, 2023, allows Americans to save for retirement longer by increasing the required minimum distribution age to 75.

- Makes it easier for military spouses to save for retirement by offering small employers a financial incentive to boost retirement plan participation. Maximum credit is $500 per military spouse for three years ($200 per spouse plus 100% of employer contributions for that spouse limited to $300). Employers qualify for the credits when military spouses are eligible for plan participation within 2 months of hire, immediately eligible for matching or nonelective contributions as if they had 2 years of service, and immediately 100% vested in all employer contributions.

- Improves coverage for part-time workers in 401(k) plans.

**Encouraging More Flexibility for Americans’ Retirement Options:**

- Expands retirement savings options for nonprofit employees by allowing groups of nonprofits to join together to offer retirement plans to their employees.

- Allows employers of domestic workers (nannies, housecleaners, etc.) to provide retirement benefits under a SEP.

- Offers individuals 60 and older the ability to set aside even greater savings as they approach retirement.

- Permits individuals the choice to pay down a student loan instead of contributing to a 401(k) plan, while still promoting increased retirement savings through an employer match in their retirement plan. Effective for plan years beginning after Dec. 31, 2023.

- Creates new exceptions for the penalty tax on premature distributions.

**Protecting Americans’ Retirement Savings:**

- Safeguards innocent retirees who unknowingly receive retirement plan overpayments.

- Allows plan participants to purchase a QLAC (qualifying longevity annuity contracts) of up to $200,000 (indexed for inflation). This is an inexpensive way for retirees to hedge the risk of outliving their retirement savings.

- If a retirement account holds an annuity, the account is bifurcated between the annuity and the rest of the account to compute RMD. This can cause a higher RMD. Plan participants can now elect to aggregate the account to compute the RMD.

- Requires Treasury to share information regarding registered owners of matured and unredeemed savings bonds with the State where the owner last resided. The States can then use their abandoned property rules to locate the owner.

- Creates a national online searchable Retirement Savings Lost & Found Database at the Department of Labor for workers and retirees to find their lost retirement accounts.
Simplifying and Clarifying Retirement Plan Rules:

- Employers can now amend an existing plan if it increases participants' benefits up to the due date of their tax return, including extensions.
- Employers joining existing MEPs or PEPs are eligible for the small employer pension plan start-up cost credit for three years regardless of how long the MEP or PEP has been in existence.
- Updates family attribution rules for spouses with separate businesses in community property states and for parents with minor children.
- Reduces the notices needed to be provided to employees who have chosen not to participate in the plan.
- As long as the retirement plan operates as if a retroactive plan amendment was in effect, the plan amendments do not need to be made until the first plan year beginning after Dec. 1, 2025.

A more detailed summary of SECURE 2.0’s provisions can be found [here](#).

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**CONSOLIDATED APPROPRIATIONS ACT OF 2021**

**Distributions During a Working Retirement (CAA 2021)**

Generally, no penalty applies for distributions from a retirement plan once the beneficiary has reached age 59½, even if the plan participant is not separated from employment at the time of the distribution.

Section 401(a)(36) was amended by the Consolidated Appropriations Act of 2021 to allow certain employees in the building and construction industry to make a withdrawal at age 55, rather than 59½. Building and construction industry employees are qualified to avoid the early withdrawal penalty at age 55 if:

1. The individual was a participant in the plan on or before April 30, 2013;
2. The plan was in existence prior to Jan. 1, 1970; and
3. Before Dec. 31, 2011, at a time when the plan provided that distributions may be made to an employee who has attained age 55 and who is not separated from employment at the time of such distribution, the plan received at least one written determination from the Internal Revenue Service that the plan constituted a qualified retirement plan.

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**THE CARES ACT**

**Coronavirus-Related Distribution** ([IRS Coronavirus-Related Relief FAQs](#))

**Qualifying individuals.** In general, CARES waived the §72(t) 10% early withdrawal penalty for distributions up to $100,000 from qualified retirement accounts for Coronavirus-related purposes made on or after Jan. 1, 2020, and before Dec. 31, 2020. Income attributable to such distributions was subject to tax over three years. However, the taxpayer had the option of including the entire distribution of income for the year of the distribution.
Reported in 2020 or over three years. Taxpayers could report the full distribution on their TY 2020 tax return as additional income, or they could report it in equal amounts over the next three years. For example, if a taxpayer took a $15,000 Coronavirus-related early distribution, they could report the full $15,000 as income on their TY 2020 tax return and pay any associated taxes, or they could elect to report $5,000 a year as income and pay the taxes owed on their TYs 2020, 2021, and 2022 tax returns. In either scenario, the additional 10% early distribution tax did not apply.

Repaying distribution. Taxpayers had the option to repay their retirement accounts for the early distribution. If they elected to repay it, they must repay the distribution amount within the three years. If they repaid their early distribution, they are eligible to file an amended return(s) to request a refund for any income taxes they paid on the early distribution. The repayments do not count towards that year’s retirement plan contribution limits, but taxpayers may not deduct repayments from their income.

TIGTA Recommends IRS Action to Identify Noncompliance on COVID-19 Retirement Plan Distributions (Report Number: 2021-16044)

A TIGTA report, released July 20, 2021, found the IRS took several steps to oversee the retirement-related provisions of the CARES Act, which Congress passed in March 2020. That included educating taxpayers and developing high-level compliance plans to enforce taxpayer compliance with the provisions. While taxpayers were allowed to take the distributions, there were various qualifications in both the CARES Act and IRS rules, including that the person or their spouse was diagnosed with COVID-19; that they were laid off, furloughed, had their work hours or pay reduced as a result of COVID-19; or that they were unable to work due to childcare issues. TIGTA recommended that the IRS consider a research project or compliance initiative project to evaluate the accuracy of taxpayer reporting of the COVID-19 related distribution.

THE SECURE ACT

The bipartisan Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed by the House in May 2019 with a 417-3 vote, subsequently passed by the Senate and signed into law in Dec. 2019.

IRA Changes

RMDs. SECURE changed the start date for required minimum distributions (RMDs) to age 72. The age change applied to distributions required to be made after Dec. 31, 2019, with respect to individuals who attain age 70½ after such date. For those who turned 70½ in 2019, their first RMD had to be taken by April 1, 2020 (except CARES waived RMDs for 2020). Anyone who turned 70½ in 2020 did not have to take their RMD until they turned 72.

Tax practitioners note. Pushing the RMD age out to age 72 (and later to 73) did not change the qualified charitable distribution (QCD) rule. Thus, a taxpayer who is 70½ may make a QCD and reduce his or her RMD. But see “coordination with QCD” discussed below.

IRA contributions allowed after age 70½. Beginning in 2020, the age limit for contributions to an IRA has been eliminated. In prior years, contributions to an IRA were not allowed beginning for the year the taxpayer turned 70½.

Coordination with QCD. Because IRA contributions are now deductible for those who qualify for the qualified charitable distribution (QCD) provision, SECURE reduces the allowable QCD by the IRA deduction allowed for a taxpayer over 70½. “The amount of distributions not includible in gross income by reason of the preceding sentence for a taxable year shall be reduced (but not below zero) by an amount equal to the
excess of — ‘(i) the aggregate amount of deductions allowed to the taxpayer under §219 for all taxable
years ending on or after the date the taxpayer attains age 70½,’ (ii) the aggregate amount of reductions
under this sentence for all taxable years preceding the current taxable year.”

Example. Joe made traditional IRA contributions at age 71 and 72 for a total of $14,000. A few
years later, Joe directs the custodian of his IRA to make a qualified charitable distribution of
$25,000 to the Salvation Army. The first $14,000 of the distribution is not treated as a QCD. Thus,$14,000 will be included in Joe’s income as a taxable distribution, and Joe may deduct $14,000 on
his Schedule A as a charitable contribution.

Non-spouse beneficiary. The “stretch” distribution period for non-spouse inherited IRAs is reduced to a
10-year maximum, from a lifetime distribution. The 10-year distribution limit does not apply to “eligible
designated beneficiaries.” These include:

• a surviving spouse;
• a minor child (the exception for a minor child no longer applies once the child reaches the age
of 21 and the remainder of the distributions to that individual must be completed within 10 years
after that date);
• a disabled individual (§72(m)(7));
• a chronically ill individual (§7702B(c)(2)); and
• an individual who is not more than 10 years younger than the deceased participant or IRA owner.
• The change applies to distributions to a non-spouse beneficiary from retirement plans and IRAs
made if the plan participant or IRA owner’s death occurs after Dec. 31, 2019.

Tax practitioner planning. For those who have named a trust as the beneficiary of their IRA or
pension accounts, a review of the trust document is essential. Some “look-through trusts” have
distribution provisions that may result in distributions being held up until the 10th year.

Proposed Regs Change Ten-Year Distribution Rule for Some Non-Eligible Designated Beneficiaries

Proposed regulations, REG-105954-20, were released on Feb. 23, 2022. The proposed regs aim to expand
and clarify the SECURE provisions regarding required minimum distributions to beneficiaries of IRAs or
retirement plans. IRS released Notice 2022-53 stating that these regs will apply no earlier than the 2023
distribution year.

The proposed regulations:

1. Provide that the non-eligible designated beneficiary of a decedent’s account if the decedent died
after his or her required beginning date must take annual distributions for years one through nine,
using the age of the beneficiary for the calculation of the RMD amount. The entire account balance
must be distributed by the end of the tenth year. If the decedent dies before age 72 or 73 (the des-
ignated beginning date), the beneficiary is not required to take distributions before the tenth year.

1. The spousal beneficiary may still roll over the spouse’s IRA or pension account into his or her own IRA.

2. The minor child must still take RMDs based on his or her life expectancy until the child reaches majority (and then
the 10-year rule applies).
**Example.** Mary, age 65, died June 1, 2023. Mary owned a traditional IRA and named her daughter Norma, age 40, as her non-eligible designated beneficiary. Norma does not have to take RMDs during years one through nine because Mary died before her required beginning date. But Norma must withdraw the entire inherited traditional IRA no later than Dec. 31, 2033.

**Example.** If, however, Mary was age 75 at her death, she would have passed her required beginning date for RMDs. Thus, Norma would be required to take RMDs for year one through nine based upon Norma’s life expectancy, and she must withdraw the balance in the IRA by the end of year ten.

**Note.** The ten-year deadline ends on Dec. 31 of the 10th year after the calendar year of the account owner’s death, not the 10-year anniversary of the date of death.

2. Clarify the application of the ten-year rule for the decedent’s minor children. The children are considered minors until they reach their 21st birthday regardless of the age of majority defined in state laws. The “stretch” RMD rules apply until the child’s 21st birthday. On the child’s 21st birthday, the ten-year rule applies.

**Example.** During 2023, Peggy, age 10, inherited an IRA account from her mother. Peggy is a designated beneficiary and can receive distributions based on her single life expectancy until she reaches age 21 in 2033. At age 21, Peggy must withdraw funds based on the ten-year rule. Since her mother had not reached her required beginning date (age 72) at the time of her death, Peggy is not required to take RMDs in years one through nine. She must, however, withdraw the full account balance by Dec. 31, 2043.

**Example.** If instead Peggy inherited her 75-year-old father’s IRA account, Peggy is required to continue taking RMDs based on her single life expectancy even after she reaches age 21. In years one through nine, she will take RMDs. In year 10, she must withdraw the remaining account balance.

**Note.** If a non-designated beneficiary does not take RMDs in year one through nine or does not withdraw the balance in the inherited account by the end of the tenth year, a 50% excess accumulation penalty applies. But see Notice 2022-53 re penalty waiver for 2021 and 2022.

3. Clarify the criteria for what constitutes a disabled beneficiary, and thus, a beneficiary’s eligibility to stretch distributions from IRAs over the disabled beneficiary’s life expectancy. An individual determined by the Social Security Administration to be disabled is deemed to be disabled under a safe harbor in the regs.

4. For both the disabled and the chronically ill eligible designated beneficiary, documentation must be provided to the custodian of the IRA or retirement account by Oct. 31 of the year following the year of the decedent’s date of death.

5. Provide rules for determining if a trust is a designated beneficiary and eligible for the 10-year distribution rule, rather than five years.

6. Clarify how required minimum distribution rules are applied where there are multiple beneficiaries of an IRA. The proposed regulation uses the life expectancy of the oldest designated beneficiary.

**Birth and adoption distributions (QBAD).** Distributions for the birth or adoption of a child of up to $5,000 per individual are penalty-free withdrawals from an IRA and a qualified pension plan. To meet the requirements of the qualified birth or adoption distribution, the individual must take a distribution during the
one-year period beginning on either the date of birth of the child, or the date of the final adoption of the child (under age 18). An individual taking a distribution for the birth or adoption of a child may make an additional contribution back to the plan from which the distribution was made or to an IRA within three years of the date of the distribution.

Note. Spouses may each take a $5,000 distribution if each has a retirement account.

A distribution is not treated as a qualified birth or adoption distribution with respect to any child or eligible adoptee unless the taxpayer includes the name, age, and TIN of such child or eligible adoptee on the taxpayer’s tax return for the taxable year. This change is effective for distributions made after Dec. 31, 2019.

401(k) Changes

Part-time employees. 401(k) plans are required to offer participation to long-term, part-time employees. Employers with 401(k) plans must offer employees who work between 500 and 1,000 hours a year an additional means to participate in the plan. The rule change only affects 401(k) cash or deferral arrangements, and no other qualified plans. A part-time employee is eligible to participate in the employer’s 401(k) plan if the employee has at least 500 hours of service in three consecutive 12-month periods.

The change applies to plan years beginning after Dec. 31, 2020, except that the 12-month periods beginning before Jan. 1, 2021, are not taken into account. Thus, the earliest that a part-time employee will be able to participate in the 401(k) plan is 2024.

Automatic enrollment credit. To encourage participation, a new tax credit of $500 for a three-year credit period is allowed for small employers adding an auto-enrollment provision to their plans. The new credit applies for taxable years beginning after Dec. 31, 2019.

Automatic enrollment percentage increased. Beginning in 2020, the SECURE Act allows the plan to set the automatic enrollment percentage to as high as 15% (was 10%).

SECURE 2.0 requires that new 401(k) and 403(b) plans MUST automatically enroll employees for plan years beginning after Dec. 31, 2024. Initial enrollment is between 3% and 10%, which increases by 1% a year until between 10% and 15%. Employees can still opt-out or elect a different percentage. There are exceptions for:

• Small businesses with ten or fewer employees
• New businesses that have been in existence for less than three years
• Church and governmental plans

Annuity offerings in 401(k) plans. SECURE updates the safe harbor provision for plan sponsors to offer annuities in their 401(k) plans to ease liability concerns. New ERISA §404(e) provides a Fiduciary Safe Harbor for fiduciaries selecting a “lifetime income provider.” When selecting an annuity provider, the fiduciary must engage in “an objective, thorough and analytical search” of providers and obtain several written representations from the annuity provider selected.

New rule makes 401(k) balances easier to interpret. As mandated in the Secure Act, plan sponsors must provide illustrations showing an estimate of how much guaranteed lifetime income, via an annuity, a participant could potentially receive. Two illustrations would be provided at least once a year, with one showing estimated monthly income from a single life annuity and the other as a joint annuity with benefits for a surviving spouse. Hopefully, participants will get a better sense of how much income their retirement savings really will deliver later in life.
Retirement Plans for Small Employers

Several changes are made to encourage more small employers3 to offer retirement benefits to their employees, such as:

Pension plan start-up cost credit. The credit for a small employer starting a pension plan, such as a 401(k), 403(b), SEP IRA, or SIMPLE IRA, has been increased for taxable years beginning after Dec. 31, 2019. For the first credit year and each of the two taxable years immediately following the first credit year, the credit is 50% of plan start-up costs limited to the greater of:

1. $500; or
2. the lesser of:
   a. $250 for each employee of the eligible employer who is not a highly compensated employee and who is eligible to participate in the eligible employer plan maintained by the eligible employer; or
   b. $5,000

Example. Vern starts a 401(k) plan for him and his 20 employees. Vern is entitled to a start-up credit of $5,000 (21 times $250 limited to $5,000) for 2022, 2023, and 2024. (Provided his plan start-up costs are $10,000 or more)

Pension plan start-up costs must be reduced by the amount of the credit allowed.

An additional $500 credit is allowed if the plan has an automatic enrollment feature.

SECURE 2.0 increases the above credit for very small employers (50 or fewer employees) to be 100% of plan start-up costs.

SECURE 2.0 also establishes an additional credit for all or a portion of employer contributions for the first five years from the establishment of the plan. This additional credit does not apply to defined benefit plans. The credit is a percentage of employer contributions limited to $1,000 per employee. The percentage is 100% for the first two years, 75% in the third year, 50% in the fourth year, and 25% in the fifth year. No credit is available in subsequent years. The credit is reduced for employers with 51 to 100 employees by 2% for each employee over 50, and no credit is allowed for employers with over 100 employees. Additionally, no credit is allowed for any employee who earns more than $100,000 a year.

Example. Vern’s matching contributions were $30,000 (between $1,000 and $1,500 per employee). His additional credit is $21,000 (21 employees times $1,000) at 100%.

Multiple employer plans. Small employers of two or more employees may come together to participate in a new class of pooled multiple employer plans (MEPs). An MEP essentially allows small employers to join together to offer pension plans with (presumably) lower administrative costs. A critical factor that made employers skeptical of the MEP was the IRS’s “bad apple” rule. The IRS said that if one employer in the plan defaulted, the whole plan was disqualified. The SECURE Act now provides that if a single employer defaults, the remaining plan maintains its qualified status. SECURE requires the MEP to be administered by a “pooled plan provider.” Generally, changes apply to plan years beginning after Dec. 31, 2020.

3. Generally, a small employer, as defined in §408(p)(2)(C)(i), is one that has no more than 100 employees.
Miscellaneous Changes

Establishing a retirement plan. Beginning in 2020, employers may adopt retirement plans that are entirely employer-funded up to the due date of the tax return, including extensions. Previous law required the employer to establish their plan by Dec. 31 (or the last day of their fiscal year).

In the July 14, 2022, edition of IRS’s Employee Plans newsletter, IRS announced that if the employer adopts a plan after the last day of their fiscal year and elects to treat the plan as having been adopted as of the last day of the preceding fiscal year, that the first Form 5500 required to be filed will be for the current fiscal year. The plan sponsor must check the appropriate box indicating that the employer elects to treat the plan as retroactively adopted as of the last day of the preceding fiscal year.

Pension Provisions in Disaster Tax Relief

Pension plan loans for qualified disasters. The limit on loans from retirement plans for a qualified disaster increased to $100,000 (was $50,000). Disaster loan repayments may be delayed for up to one year.

Qualified disaster retirement plan distributions and repayments. SECURE 2.0 included a provision for a penalty-free distribution from a qualified retirement plan of up to $22,000 for 2021 and later qualified disasters. See instructions for revised Form 8915-F.

Postponement of some retirement plan and IRA deadlines. The IRS may postpone all or only certain deadlines listed in Revenue Procedure 2018-58 based on when the disaster occurred and its severity as well as other factors. Unless the news release for a particular disaster limits the relief, all the deadlines listed in Revenue Procedure 2018-58 will be postponed.

For example, the IRS may:

- extend the 60-day period for plan participants to deposit eligible rollover distributions to another qualified plan or IRA, or
- extend the time for a qualified plan to make a required minimum distribution.

Tax practitioner planning. See Tax Relief in Disaster Situations for the latest disaster-related news releases and related guidance.

IRS Summarizes RMD Changes in the SECURE Acts

A retirement plan account owner must normally begin taking a required minimum distribution (RMD) annually starting the year he or she reaches age 72 (73 if the account owner reaches age 72 after Dec. 31, 2022).

Roth IRAs do not require withdrawals until after the death of the owner; however, beneficiaries of a Roth IRA are subject to the RMD rules. Designated Roth accounts in a 401(k) or 403(b) plan are subject to the RMD rules for 2022 and 2023. However, for 2024 and later years, RMDs are no longer required from designated Roth accounts. 2023 RMDs due by April 1, 2024, are still required.

Revised Life Expectancy Table Issued Beginning in 2022

In November 2020, the IRS issued final regulations containing new life expectancy tables to be used for determining RMDs. The new tables are effective for RMDs beginning on Jan. 1, 2022. The old tables still apply for 2021.
Beneficiaries who were taking RMDs prior to 2022 based on their life expectancy in the year following the owner’s death using the life expectancy tables in effect before 2022 and reducing that number by 1, can reset their life expectancy for 2022 based on the new tables. In order to do this, find the beneficiary’s life expectancy in the new tables based on their age in the year following the owner’s death and reduce that number by 1 for each year since the year of the owner’s death.

**Example.** IRA account owner died in 2018 at the age of 80. The beneficiary, age 55, started taking RMDs in 2019 using a life expectancy of 29.6 and reducing that number by 1 each year so that in 2022 (3 years later) the RMD would be determined by dividing the account balance by 26.6 (29.6 – 3). However, under the new life expectancy tables, the life expectancy for a 55-year-old is 31.6. Therefore, the required minimum distribution for 2022 is calculated by dividing the account balance by 28.6 (31.6 – 3). The required minimum distribution for 2023 is calculated by dividing the account balance by 27.6 (31.6 – 4).

### Three Tables Are Used to Determine RMDs

*The Uniform Lifetime Table* is the table most used by plan owners. It is used to determine lifetime RMDs for most plan participants over the age of 73, including when a spousal beneficiary is a sole designated beneficiary but who is not over 10 years younger than the account owner or when the spouse is not the sole designated beneficiary. The Uniform Lifetime Table is also used to calculate distributions required for an individual who has inherited a tax-deferred retirement account from their spouse and has selected to transfer the account into their own name.

*The Joint and Last Survivor Table* is only used to determine RMDs to plan participants over the age of 73 when a spouse is a sole designated beneficiary and who is over 10 years younger than the account owner.

*The Single Life Table after the SECURE Act* is used by a newly defined class of beneficiaries, called eligible designated beneficiaries. Eligible designated beneficiaries are defined as spouses, disabled or chronically ill individuals, minor children of the account owner/participant, or someone who is no more than 10 years younger than the account owner/participant.

**Tax practitioner planning.** Accounts inherited before the SECURE Act went into effect on Jan. 1, 2020, will continue to utilize the Single Life Table for distribution calculations.

**Example.** A 72-year-old IRA owner applying the Uniform Lifetime Table under the “old” tables would use a life expectancy of 25.6 years to calculate an RMD for 2021. A 72-year-old calculating his RMD in 2023 with the revised tables would use 27.4. If the account balance is $1 million, the 2021 RMD was $39,063 and the 2023 RMD is $36,496, a reduction of $2,567.

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**TAX CUTS AND JOBS ACT**

### Recharacterization of IRA Contributions (§408A(d)(6)(B))

The TCJA repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Thus, for example, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion).
However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual’s income tax return for that year, recharacterize it as a contribution to a traditional IRA.

**With recharacterization gone, is it still advisable to convert?** Converting a traditional IRA to a Roth IRA costs immediate tax. Under the new law, there’s no look-back opportunity to change one’s mind after the conversion if value falls. So, is it still advisable to convert? There are three major advantages to converting: (1) withdrawals are tax-free, as long as certain requirements are met; (2) minimum distributions at 73 are not required, so money grows tax-free longer; and (3) beneficiaries inherit the Roth IRA account tax-free, as long as the account has been open for at least five years.

**Planning Reminders When Converting in 2023**

**Any dollar amount may be converted.** It is not an all-or-nothing deal. Maybe a client should just get started on a small (manageable) IRA conversion with $10,000 or $20,000.

**Rollover prior nondeductible IRAs.** For high-income clients who are not qualified to contribute to a traditional or Roth IRA, another strategy is to recommend that clients contribute to a nondeductible IRA. Now the client can convert that nondeductible IRA into a Roth regardless of the client’s high AGI, and there is little tax at the conversion since the client has a basis in the IRA. Only the earnings on the nondeductible IRA are taxable.

Traditional IRA basis is spread across all traditional IRAs owned by the taxpayer, not just the account where the basis was originally established. Taxpayers with existing traditional deductible IRAs who create a new nondeductible IRA and convert only the new nondeductible IRA to a Roth IRA should note the basis from the nondeductible IRA contribution must be spread to all IRA accounts, leaving a portion of the conversion taxable.

**Separate five-year holding periods apply for conversion contributions.** Taxpayers who convert a traditional IRA to a Roth IRA are required to meet a five-year holding period distinct from an existing Roth IRA five-year holding period.

**Example.** If a calendar-year taxpayer who had no Roth IRAs converted a traditional IRA to a Roth IRA on Feb. 25, 2023, and also made a regular Roth IRA contribution for 2022 on the same date, the five-taxable-year period for the conversion begins on Jan. 1, 2023, while the five-taxable-year period for the Roth contribution began on Jan. 1, 2022.

**Rollover Period for Plan Loan Offset Amounts (§402(c)(3))**

The TCJA extended the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan offset occurs — that is, the taxable year in which the amount is treated as distributed from the plan. A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a §403(b) plan, or a governmental §457(b) plan by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee’s severance from employment.

**Miscellaneous Itemized Deductions**

The TCJA suspended the deduction for miscellaneous itemized deductions subject to the 2% AGI limit. Prior law allowed two IRA-based deductions that are no longer allowable for taxable years 2018 through
2025: (1) trustee’s fees for an IRA, if separately billed and paid, and (2) loss on traditional IRAs or Roth IRAs (when all amounts were distributed).

**TCJA Impacts on Retirement Planning**

The TCJA made only minor changes to the taxation of retirement. But other changes in the TCJA may impact two old tried-and-true planning ideas:

- **Are Roth IRAs more tax advantageous?** The TCJA’s lower individual tax rates may make it more attractive to convert a traditional IRA to a Roth IRA, even with the recharacterization feature gone. It’s hard to imagine that tax rates will be lower than they are right now.

- **The reduction of the state tax deduction, and the doubling of the standard deduction, may make it more attractive to move to a low-tax state in retirement.** Is it time to retire to another state? Discuss with high-income clients the advantage of retiring into a lower tax state. COVID-19 costs have stressed the budgets of most states, if not all. There are California proposals that raise the top individual tax rate and add a “wealth tax.” Higher California taxes may encourage some wealthy taxpayers to leave the state for tax relief. But don’t think California is the only state needing tax revenue to sustain its budget. Others will follow suit, making the choice of a low-tax jurisdiction problematic. Currently, these are *Kiplinger*’s top five tax-friendly states for retirees: Texas, Alaska, Pennsylvania, Iowa, and South Dakota.

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**2023 COST OF LIVING ADJUSTMENTS**

**IRA Traditional Contribution Limits for 2023**

<table>
<thead>
<tr>
<th>Traditional IRA Contribution Limits</th>
<th>2019-2022</th>
<th>2023</th>
<th>2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Max IRA Contribution</td>
<td>$6,000</td>
<td>$6,500</td>
<td>$7,000</td>
</tr>
<tr>
<td>IRA Catch-up Contribution (for those age 50 and over)</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Earned income required.** Generally, a taxpayer is entitled to deduct an amount contributed to an IRA (§219(a)). The deduction, however, cannot exceed the lesser of the deductible amount or an amount equal to the taxpayer’s compensation includible in gross income (§219(b)(1), (5)). Compensation includes net earnings from self-employment (as defined in §1402(a), §401(c)(2), §219(f)(1)).

**TRADITIONAL IRAS**

**2023 contribution amount is $6,500.** An individual can make deductible contributions to an IRA up to the lesser of $6,500 or the individual’s compensation if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $6,500 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount.

**$1,000 additional catch-up IRA contributions are permitted for those 50 and over.** SECURE 2.0 indexes the $1,000 for inflation beginning after Dec. 31, 2024.
$7,500 annual contribution available for those age 50 or over. Both traditional and Roth IRAs allow individuals who have attained age 50 to make additional catch-up IRA contributions.

Active Participation

Active participant rules. Taxpayers with no active participation in a retirement plan are allowed to deduct the full amount of their IRA contributions, assuming the taxpayer has adequate income. If an individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with AGI over certain levels for the taxable year (see next table). Such taxpayers may make, but cannot deduct, IRA contributions.

Tax practitioner planning. There is no AGI limit for those wishing to make non-tax-deductible IRA contributions.

<table>
<thead>
<tr>
<th>Active Participant AGI Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
</tr>
<tr>
<td>Single taxpayers</td>
</tr>
<tr>
<td>Married taxpayers</td>
</tr>
<tr>
<td>Married filing separate</td>
</tr>
</tbody>
</table>

What does active participation in an employer plan mean? An individual is an active participant in a defined benefit plan simply by not being excluded from the plan (§1.219-2(h), Ex. 1), even if there is no knowledge of the plan’s existence (Baumann v. Comm., TCM 1995-313).

Special Rules for Certain Married Individuals

Spousal IRAs. A non-working spouse may make IRA contributions based upon the earned income of his or her spouse.

The one-spouse active participant limitation. For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple’s income is between:

<table>
<thead>
<tr>
<th>Year</th>
<th>2024</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGI Phase-out</td>
<td>$230,000 - $240,000</td>
<td>$218,000 - $228,000</td>
</tr>
</tbody>
</table>

ROTH IRAS

2023 Roth IRA Contribution Amount Is $6,500

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $6,500 or the individual’s compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs in general, a contribution of up to $6,500 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount.
### Roth IRA AGI Thresholds

<table>
<thead>
<tr>
<th>Year</th>
<th>2024</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single and HOH</td>
<td>$146,000 - $161,000</td>
<td>$138,000 - $153,000</td>
</tr>
<tr>
<td>Married Filing Joint</td>
<td>$230,000 - $240,000</td>
<td>$218,000 - $228,000</td>
</tr>
<tr>
<td>Married Filing Separate</td>
<td>$0 - $10,000</td>
<td>$0 - $10,000</td>
</tr>
</tbody>
</table>

**Back Door Roth IRA.** The TCJA Committee Report in footnote 269 on page 114 apparently allows a “back door” contribution to a Roth IRA. “Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.”

**Example.** Mark files an MFJ return showing $300,000 of AGI. Therefore, he is unable to contribute to a ROTH IRA. Instead, he may contribute to a nondeductible IRA and then immediately convert the nondeductible IRA to a Roth IRA.

**Distributions ([§408A(d)]).** “Qualified distributions” of designated Roth contributions are excludable from gross income. A qualified distribution is one that occurs at least five years after the year of the participant’s first designated Roth contribution (counting such first year as part of the five) and is:

- made on or after attainment of age 59½,
- made on account of the participant’s disability,
- made to a beneficiary or estate on or after the participant’s death, or
- made for qualified first-time homebuyer expenses up to $10,000.

**CPA’s Error in Advising a Client on AGI Limits for Roth IRA Contribution is Reason for Recharacterization ([PLR 201930027]).**

The IRS granted a taxpayer an extension of time to recharacterize her Roth IRA contributions as traditional IRA contributions. The taxpayer’s modified AGI exceeded the applicable limits in the years of contribution. The IRS ruled that recharacterization was appropriate since the taxpayer reasonably relied on a qualified tax professional who failed to inform her that her gross income exceeded the income limit to make Roth IRA contributions and also failed to inform her of the time for making the election to recharacterize her Roth IRA contributions until after the deadline expired.

**Tax practitioner planning.** If 2023 AGI exceeds $153,000 ($228,000 MFJ), the taxpayer may not make a Roth IRA contribution.

### 2023 Retirement Plans

**2023 COLAs for Retirement Plans**

Taxpayers with profit sharing and/or money purchase plans may contribute as much as $66,000 for 2023. For taxpayers with a 25% formula, $264,000 of wages will allow the maximum $66,000 contribution.
### Other 2023 Limitations Include:

- The dollar amount under §409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan (ESOP) subject to a five-year distribution period is $1,330,000 in 2023.
- The §414(q)(1)(B) limitation used in the definition of a highly compensated employee (HCE) is $150,000 in 2023.
- The §408(k)(2)(c) SEP minimum compensation is $750 in 2023. The 2023 SEP maximum compensation is $330,000.
- The compensation amount under §1.61-21(f)(5)(i) concerning the definition of “control employee” for fringe benefit valuation purposes is $130,000 in 2023. Compensation amount under §1.61-21(f)(5)(iii) is $265,000 in 2023.
- The dollar limitation under §416(i)(1)(A)(I) concerning the definition of a key employee in a top-heavy plan is $215,000 in 2023.

### 2023 Employee Elective Deferral Limited to $22,500 and $15,500 for SIMPLEs

The dollar limit on annual elective deferrals under §401(k) plans, §403(b) annuities, §457 plans, salary reduction SEPs, and SIMPLE plans are increased by annual inflation-adjusted increments.

### Retirement Plan Age 50 Catch-up Contributions

**SECURE 2.0 provides higher catch-up contributions.** Additional catch-up contributions may be made by an individual who has attained age 60, 61, 62, or 63 before the end of the plan year for taxable years beginning after Dec. 31, 2024.
For 401(k) and 403(b) plans, the higher catch-up contribution is $10,000 or 50% more than the regular catch-up amount in 2024.

**Tax practitioner planning.** The higher catch-up amount will be computed as 50% more than the regular catch-up amount in 2024.

For SIMPLEs, the higher catch-up contribution is $5,000 or 50% more than the regular catch-up amount in 2025.

**IRS delays SECURE 2.0 requirement for Roth treatment for some catch-up contributions.** For tax years beginning after Dec. 31, 2023, SECURE 2.0 required all catch-up contributions to be subject to Roth treatment unless the employee’s compensation is $145,000 or less.

However, the IRS extended the new requirement that catch-up contributions made by higher-income participants must be designated as Roth contributions until 2026. IRS announced in Notice 2023-62 and IR-2023-155 an administrative transition period to help taxpayers transition to the new Roth catch-up requirement.

This notice also clarifies that SECURE 2.0 does not prohibit plans from allowing catch-up contributions, so plan participants who are age 50 and over can still make catch-up contributions after 2023.

**IRA PROVISIONS §408**

**IRA Rules**

**Contribution due date.** Individuals may make contributions to their IRAs until the due date of their tax returns (contributions made by April 15 may be treated as having been made on Dec. 31 of the prior tax year). Filing an extension does not extend the contribution date (§219(f)(3)).

**Nondeductible IRAs always available.** To the extent an individual does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA. Even taxpayers who are eligible to make tax-deductible IRA contributions may elect to make nondeductible contributions instead ( §408(o)(2)(B)). Elective nondeductible contributions must be reported on the individual's tax return.

**Tax on Excess Contributions (§4973)**

In the case of an individual retirement account, there is imposed (for each taxable year) a tax in an amount equal to 6% of the amount of the excess contributions to such individual's accounts or annuities (determined as of the close of the taxable year). The amount of tax for any taxable year will not exceed 6% of the value of the account or annuity (determined as of the close of the taxable year).

**Statute of Limitations**

The statute of limitations on the excise tax for excess contributions starts when Form 5329 is filed. This can lead to an indefinite period of limitations if Form 5329 is not filed. SECURE 2.0 changed the statute to six years from when Form 1040 was filed. If the taxpayer is not required to file Form 1040 the statute of limitations is six years from when Form 1040 would have been filed.
Contributions returned before the due date of return. The penalty does not apply to the distribution of any contribution paid during a taxable year to an individual retirement account or for an individual retirement annuity if:

- such distribution is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year,
- no deduction is allowed under §219 with respect to such contribution, and
- such distribution is accompanied by the amount of net income attributable to such contribution.

In the case of such a distribution, for purposes of §61, any net income described in subparagraph (c) shall be deemed to have been earned and receivable in the taxable year in which such contribution is made. SECURE 2.0 clarifies that this distribution is not subject to the 10% premature distribution tax.

Also see.

 Ronald Fish v. Comm., TCM 2015-176, where the loss showing on K-1 from IRA investment was not deductible; perhaps the return preparer didn’t notice the partner was an IRA.

 Tax practitioner planning. Make sure your client is the owner of the K-1 interest, not his or her IRA or pension plan.

**SELF-DIRECTED IRAS**

While any IRA where the account owner determines where account assets are invested is, by definition, self-directed, the term “self-directed” IRA refers to a specific type of IRA that allows investments in alternative investments such as real estate, private company stock, partnership or LLC interests, bullion, etc. Most mainstream IRA custodians do not allow such investments due to the additional reporting complications, higher risks, and increased fiduciary responsibility.

**Self-directed IRAs present challenges.** The IRS has noted that self-directed IRAs are subject to all the traditional IRA rules, including conforming to the prohibited transaction rules, annual valuation of underlying investments, UBTI, and no loans issued to the IRA. This can present problems for account owners. For example, if real estate is the only asset owned by an IRA, and the account owner is subject to RMDs, where does the cash come from to pay the RMDs? What about paying any real estate related expenses like property taxes? For that matter, how is the account value determined for purposes of calculating the RMDs? This is just one of many scenarios that taxpayers need to consider before choosing to convert their IRA to a self-directed IRA.

**Disqualifying the IRA.** If during any part of the tax year the individual or his beneficiary uses the IRA in a prohibited transaction under §4975, the IRA account is disqualified as of the first day of that tax year and the individual is taxed as having received a taxable distribution equal to the fair market value of all of the assets in the account as of the first day of the year (§408(e)(2)(B)).

 Tax practitioner planning. Currently, the self-directed IRA arena is like the wild, wild West. Taxpayers are well-advised to use extreme caution when selecting a custodian for their self-directed IRA. One slip-up could cause the entire account to become immediately taxable.
Self-Directed IRAs Require Additional Reporting for Hard-to-Value Assets

Reporting requirements apply to IRA investments with no readily available FMV (Form 5498, Box 15a and b). Responding to the increase in self-directed IRAs, the IRS amended the instructions for Forms 5498 and 1099-R to include new reporting requirements that allow the IRS to more efficiently scrutinize the hard-to-value IRA investments typically found in self-directed IRAs. Reportable investments include non-publicly traded stock, non-publicly traded notes, partnership or LLC interests, real estate options, and other hard-to-value investments.

Distribution from Self-Directed IRA Not Taxable Because Taxpayer Did Everything Right *(Raymond McGaugh v. Comm., CA-7, 2017-2 USTC 50,272)*

Raymond McGaugh had a self-directed IRA. Because the IRA custodian was unwilling to purchase a particular stock, the taxpayer arranged the purchase by having the custodian wire funds directly to the issuing company, which in turn issued a stock certificate in the name of the taxpayer’s IRA and sent the stock certificate to the custodian. The Court of Appeals upheld the Tax Court’s decision that the taxpayer was not a “payee or distributee” and that, to the extent he had control over the wired funds, he at most acted as a conduit. The taxpayer did not receive a distribution because no funds ever passed through his hands. Moreover, the taxpayer was not in constructive receipt of the funds because the funds went straight to the issuing company, and the issuing company sent the stock shares to the custodian. At no time did the taxpayer have control over the funds, nor could he negotiate the stock certificate, which was issued in the name of the IRA.

Also see.

*Mark and Julie Vandenbosch v. Comm., TCM 2016-29*, where $125,000 distribution from self-directed SEP-IRA was taxable because of unfettered control when money was deposited into a personal bank account.

*Terry Ellis v. Comm., CA, 8th Cir., 2015-1 USTC ¶ 50,328*, where Ellis directed his IRA to purchase ownership in an LLC, and the LLC paid wages to Ellis in a prohibited transaction, causing the IRA to be disqualified.

**Tax practitioner planning.** When a client starts talking about using their IRA as a funding mechanism for a business, remember the prohibited transaction rules and Ellis. It is virtually impossible to use an IRA to fund a business where the owner of the business is also the owner of the IRA. The best method to get money from one’s retirement plan for a new business is to follow the strict procedures of the Rollover Business Startup plan. It takes time and money to comply (as always), but it’s a better alternative than the $195,900 it cost Ellis.

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**IRAS AND CREDITOR CLAIMS**

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, included exemptions for IRAs and retirement plans from creditors’. For IRAs and Roth IRAs, the exemption limit was originally set at $1 million and is inflation-adjusted every three years. The amount of the exemption is $1,512,350 ($1,362,800 before Apr. 1, 2022).

**Tax practitioner planning.** An employee who owns an IRA (Traditional or Roth) in excess of $1,512,350 million should consider rolling the IRA into their employer plan to get unlimited creditor protection. The $1,512,350 exemption does not apply to SIMPLE and SEP IRAs, as **employer plan** assets are fully protected in bankruptcy. This includes assets in other employer retirement
plans, such as a §401(k). In addition, the $1,512,350 limit will not apply to assets rolled over from an employer plan into an IRA as long as those rollover amounts are kept separate from other assets in traditional or Roth IRAs.

IRA and 401(k) Funds Received in Divorce Not Protected in Bankruptcy (Brian A. Lerbakken v. Sieloff and Associates, PA No. 18-3415 (8th Cir. 2020))

Sieloff represented Lerbakken in his marital dissolution in Minnesota. The court’s decree awarded Brian Lerbakken all of his ex-wife’s IRA and half of her 401(k). Two months after the decree, the court ordered an attorney’s lien against Lerbakken for Sieloff’s legal services. The court expressly permitted Sieloff to recover the unpaid fees from Lerbakken’s interests in his ex-wife’s IRA and 401(k). The unpaid fees exceed the total of Lerbakken’s interests.

Six months after the decree, Lerbakken filed for bankruptcy under Chapter 7, claiming that his interests in the IRA and 401(k) are exempt from the bankruptcy estate as “retirement funds” under 11 USC §522(b)(3)(c). Sieloff, a scheduled creditor, objected to the exemptions. The bankruptcy court disallowed the exceptions. It ruled that Lerbakken’s interests in his ex-wife’s IRA and 401(k) are not “retirement funds.” The Bankruptcy Appellate Panel affirmed. It ruled, relying on Clark v. Rameker, 573 US 122, 130 (2014), that §522(b)(3)(c) applied only to the person who created and contributed to the retirement account.

IRA Not Protected in Bankruptcy Because of Prohibited Transactions (Keith A. Yerian v. Webber, Trustee, No. 18-10944 (11th Cir. June 26, 2019))

Keith Yerian titled IRA-owned cars in his own name and his wife’s name, as well as purchased a condo in Puerto Rico with IRA funds and then used the condo for his personal travel needs. Yerian conceded that he incurred more than $100,000 in tax penalties for abusing his IRA. Ordinarily, that abuse would disqualify him from claiming the wide range of favorable treatment and exemptions typically offered to IRAs. But Yerian — now in bankruptcy proceedings — nonetheless sought to shield the IRA from distribution to his creditors. He argued that Florida has exempted IRAs from bankruptcy administration so long as they were originally established with proper documentation. The court ruled that Yerian forfeited his exemption, upholding the bankruptcy court’s decision, when he engaged in self-dealing transactions prohibited by the IRA’s governing instruments.

10% Early Withdrawal Penalty Automatically Withheld by Plan Administrator Deemed to be IRA Funds for Bankruptcy (In re Kevin Majeski, 22-20947-dob, US Bankruptcy Court, ED, Northern Division (May 11, 2023))

Kevin Majeski was determined to be permanently disabled and withdrew funds from his IRA. Since he was under the age of 59 1/2, the plan administrator automatically deducted the 10% early withdrawal penalty of $3,113 sending it to the United States of America.

When Majeski filed his 2021 income tax return he was able to claim the exception to the 10% early withdrawal penalty and received a refund. The Court ruled the $3,113 was exempt IRA funds for bankruptcy based on tracing the $3,113 withheld by the plan administrator, sent to the United States of America and then back to Majeski in the form of an income tax refund.

Also see.

Barry K. Kellerman, BC DC Ark., 2015-1 USTC ¶50,331; Aff’d by the US District CT, Arkansas (Sep. 14, 2015), where an IRA was not protected by bankruptcy because of prohibited transactions.
Brandon C. Clark et ux. v. William J. Rameker, Trustee et al., SCt; No. 13-299, June 12, 2014, where an inherited IRA was not “retirement funds” for the purpose of bankruptcy exemption.

**Tax practitioner planning.** In light of the Supreme Court’s decision on inherited IRAs, surviving spouses should consider rolling the deceased spouse's IRA into his or her own IRA and not keeping the IRA as an inherited IRA.

**Inherited 401(k) Protected From Creditors** ([In re Corbell-Dockins, Bankruptcy Court, Western District, North Carolina, Docket no. 20-10119](June 4, 2021)).

Bankruptcy creditors cannot take a debtor’s inherited 401(k) account. The 401(k) is not property of the estate as it is an ERISA-qualified plan.

**Tax practitioner planning.** The inherited 401(k) is not treated the same as an inherited IRA. See [Clark](above).

**One-Half of Husband’s IRA Is Subject to Garnishment for Wife’s Crimes** ([US v. Gwendolyn Berry and Michael Berry, 5th Circuit, No. 19-20050 (Feb. 28, 2020)]).

Gwendolyn Berry pled guilty and was convicted of wire fraud, mail fraud, and falsifying a tax return, all in connection with the ongoing theft of funds from her employers. As part of her sentence, she was ordered to pay restitution of more than $2 million. To enforce the judgment, the government applied for a writ of garnishment directed to the Vanguard Group. The government sought to garnish five IRAs held under Gwendolyn’s or her husband’s name. After Gwendolyn agreed to release the funds in the accounts in her name, the government reapplied to garnish Vanguard for 50% of the funds in two accounts in Michael’s name. The district court granted the writ.

Michael and Gwendolyn Berry appealed a final order of garnishment under the Mandatory Victims Restitution Act (MVRA), contending that investment retirement accounts in Michael’s name are not subject to restitution for Gwendolyn’s crime victims. The Appellate Court disagreed.

**Solely managed IRA is community property.** In general, the law of the debtor’s domicile state defines the property interests to which a judgment lien may attach. Thus, the relevant law is that of Gwendolyn’s domicile state, Texas. The Texas Family Code §3.003 states that “[p]roperty possessed by either spouse during . . . marriage is presumed to be community property.” The court found that Gwendolyn’s one-half interest in Michael’s *solely managed IRA* is part of “all property and rights to property of the [spouse] fined” under §3613.4 and is subject to garnishment.

**Tax practitioner planning.** ERISA retirement accounts are also subject to MVRA restitution awards ([US v. DeCay, 620 F.3d 534, 541 (5th Cir. 2010)]).

**ROTH IRA PROVISIONS §408A**

**Distributions (§408A(d)).** “Qualified distributions” of designated Roth contributions are excludable from gross income. A qualified distribution is one that occurs at least five years after the year of the participant’s first designated Roth contribution (counting such first year as part of the five) and is:

- made on or after attainment of age 59½,
- made on account of the participant’s disability,
• made to a beneficiary or estate on or after the participant’s death, or
• made for qualified first-time homebuyer expenses up to $10,000.

**Aggregation and ordering rules (§408A[d](4)).** All Roth IRA accounts owned by an individual are aggregated and treated as one account. Distributions from any Roth IRA are first treated as distributions from (1) contributions, (2) conversions (in order of conversion if multiple conversions have been made), and (3) any earnings. Distributions from Roth IRAs that are not qualified distributions are includible in income to the extent attributable to earnings and are subject to the 10% early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawals that apply to IRAs apply to Roth IRAs.

**Example.** Mark, age 39, established a Roth IRA at Edward Jones in 2021 that is currently worth $12,000 (his contributions were $10,000). Mark opened a second Roth IRA in 2022 with Chase Bank that is currently worth $10,000 (all contributions). In 2023, Mark withdrew $12,000 and closed his Edward Jones account. He did not roll the $12,000 over to another Roth IRA. Because the accounts are aggregated, the entire distribution is treated as a return of basis, not earnings. Mark’s Roth IRA at Chase now consists of $8,000 of contributions and $2,000 of earnings.

**IRS Explains Distribution Rule When Decedent’s Roth IRA Named Marital Trust as Beneficiary (PLR 201923016)**

Decedent established Trust, a living revocable trust, on Date 1. On Date 2, Decedent died after his RMD age. Decedent was survived by Spouse and Daughter. Upon Decedent’s death, Trust became irrevocable and was divided into a marital deduction subtrust, a subtrust for the benefit of Daughter, and a third subtrust. The Marital Trust qualified as a qualified terminable interest property under §2056(b)(7).

At the time of his death, Decedent was the owner of a Roth IRA. Pursuant to the beneficiary designation form for the Roth IRA, Marital Trust was the named beneficiary.

The PLR concluded as follows:

• Spouse is treated as the designated beneficiary (rather than the marital trust) of Roth IRA for purposes of determining the distribution period under §401(a)(9) pursuant to §1.401(a)(9)-4, Q&A-5; and
• RMDs from Roth IRA are calculated based on the life expectancy of Spouse. Because Spouse is treated as the sole designated beneficiary, RMDs under §401(a)(9) are determined pursuant to the rule of §1.401(a)(9)-5, Q&A-5(c)(2). Nevertheless, distributions from Roth IRA that satisfy the rule of §1.401(a)(9)-5, Q&A-5(c)(1), with the first-year distribution determined based on Spouse’s corresponding life expectancy factor in the year of the first distribution under the Single Life Table and, for succeeding years, the initial factor reduced by one each year, would meet the minimum distribution requirements because this method produces distributions that are greater than or equal to the applicable RMDs under §401(a)(9).

**CONVERSION RULES FROM TRADITIONAL IRAS TO ROTH IRAS (§408A)**

All eligible taxpayers are allowed to convert traditional IRAs (including SEPs and SIMPLEs) into Roth IRAs. The amount converted is includible in income as if a withdrawal had been made, but early withdrawal penalties are not assessed.

**Warning.** Recharacterizations are no longer allowed.
**SIMPLE IRA exception.** Amounts distributed from a SIMPLE IRA during the two-year period which begins on the date that the individual first participated in any employer maintained SIMPLE IRA cannot be converted to a Roth or any other IRA other than another SIMPLE IRA (§1.408A-4, Q-4).

**IRS Explains After-Tax Rollovers From §401(k) to Roth IRAs** ([Rollovers of After-Tax Contributions](#))

When a §401(k) distribution is made to multiple accounts, the IRS requires that the pretax and after-tax amounts be allocated between accounts. This results in a sometimes-surprising taxable income even if a distribution equal to the after-tax amount was deposited into a Roth IRA account.

**After-tax amounts can be directed to a Roth IRA.** The IRS has changed its position and now allows the recipient to select how the pretax amount in his or her §401(k) is allocated in a direct rollover to two or more accounts. To make this selection, the recipient must inform the plan administrator of the allocation of specific pretax and after-tax amounts prior to the time of the direct rollovers. “Separate recipients” does not mean separate distributions. It means a distribution sent to multiple accounts ([Notice 2014-54](#)).

**Example.** The §401(k) distribution is $100,000 with 70% from pretax contributions and 30% from after-tax contributions. The employee directs the plan administrator to transfer the pretax amount of $70,000 to a traditional IRA and the after-tax amount of $30,000 to a Roth IRA. No taxable income results from the transfer to the Roth IRA.

**Tax practitioner planning.** The change applies to pretax amounts in elective deferral accounts including §401(k), §403(b), and §457(b).

**A partial distribution must include some of the pretax amounts.** An account holder cannot distribute only the after-tax amounts and leave the rest in the plan. Any partial distribution from the plan must include some of the pretax amounts. This does not change the requirement that each plan distribution must include a proportional share of the pretax and after-tax amounts in the account. To roll over the after-tax contributions to a Roth IRA, the account holder could take a full distribution (all pretax and after-tax amounts) and directly roll over:

- pretax amounts to a traditional IRA or another eligible retirement plan, and
- after-tax amounts to a Roth IRA.

**§401(k) Planning Strategies**

- Always contribute enough to the §401(k) to secure maximum employer-matching contributions.
- Contribute additional dollars to max out the statutory §401(k) pretax amount ($20,500 in 2023 plus $7,500 for those 50 or older).
- If the plan permits, make after-tax contributions to the §401(k) plan, up to the annual defined contribution plan limits ($66,000 in 2023). After-tax contributions can later be distributed tax-free to a Roth IRA.
## Traditional IRA Compared to Roth IRA (IRA FAQs)

<table>
<thead>
<tr>
<th>Features</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who can contribute?</td>
<td>Contributions can be made at any age if the account holder has taxable compensation.</td>
<td>Contributions can be made at any age if the account holder has taxable compensation. AGI must be under threshold.</td>
</tr>
<tr>
<td>Are contributions deductible?</td>
<td>Yes, unless covered by a retirement plan at work and income exceeds threshold.</td>
<td>No.</td>
</tr>
<tr>
<td>How much can be contributed?</td>
<td>Maximum contribution for all traditional IRAs and Roth accounts is $6,500 ($6,000 in 2022) plus $1,000 for those over 50 or earned income if less.</td>
<td></td>
</tr>
<tr>
<td>What’s the deadline to make contributions?</td>
<td>Due date of the return (not including extensions) — Apr. 15, 2024, for 2023 IRA.</td>
<td></td>
</tr>
<tr>
<td>Are minimum distributions required?</td>
<td>Distributions must begin by April 1 following the year in which the account owner turns age 73 and by Dec. 31 of later years.</td>
<td>Not required.</td>
</tr>
<tr>
<td>Are distributions taxable?</td>
<td>Any deductible contributions and earnings that are distributed from the traditional IRA are taxable. The 10% early withdrawal penalty may apply if the account owner is under 59½.</td>
<td>None if it’s a qualified distribution. Otherwise, part of the distribution or withdrawal may be taxable.</td>
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## DESIGNATED ROTH ACCOUNTS

### FAQs on Designated Roth Accounts

What is a qualified Roth contribution program? Employers may offer employees the option to designate some or all of their elective contributions to §401(k), §403(b), or §457 qualified plans to a designated Roth account. If the employer chooses, eligible participants may also roll over existing plan balances to the designated Roth portion of their accounts. Any amounts contributed to a designated Roth account are included in gross income in the year of the contribution, but eligible distributions from the account (including earnings) are generally tax-free. Employers wishing to establish designated Roth accounts as part of their qualified retirement plan must:

- establish a separate designated Roth account for the Roth contributions and the related earnings of each participant,
- maintain separate records for each account,
- refrain from allocating to the designated Roth account amounts from nondesignated Roth accounts unless such amounts are properly rolled over, and
- report designated Roth account contributions separately on employees’ W-2s.
Separate account required. Designated Roth accounts are separate accounts inside §401(k), §403(b), or §457(b) qualified plans that hold designated Roth contributions. Designated Roth accounts:

1. have no AGI limits for contributors, and

2. are subject to required minimum distributions when the owner reaches age 73. Note that SECURE 2.0 no longer requires RMDs for taxable years beginning after Dec. 31, 2023.

Tax practitioner planning. Because there is no AGI limit, designated Roth accounts are particularly attractive to high-income taxpayers. The taxpayer may roll designated Roth accounts to a Roth IRA to eliminate required minimum distributions.

Rollovers from Qualified Plans to Designated Roth Account Rules

Employers who elect to add designated Roth accounts to a §401(k), §403(b), or §457(b) plan may allow in service rollovers by its employees (or surviving spouses) from tax-deferred plan balances to designated Roth accounts. This includes plan amounts that originated from employee elective deferrals and from employer matching and nonelective contributions. Employers may limit the type of contributions eligible for in-plan Roth rollovers and the frequency of such rollovers. Employers are also allowed to stop allowing Roth rollover contributions by amending the plan at allowable amendment periods.

Rollover contributions subject to restrictions. Amounts rolled over from qualified plans to designated Roth accounts are subject to the distribution restrictions inherent in qualified plans. For example, if a qualified plan participant who has not ceased employment makes an in-plan Roth rollover from the participant’s pretax elective deferral account prior to age 59½, that rollover amount and any applicable earnings may not be distributed from the plan prior to participant attaining age 59½ or the occurrence of another event described in §401(k)(2)(B).

Rollover is taxable in the same manner as other Roth conversions. In the case of a permitted rollover contribution to a designated Roth account, the individual must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA. The 10% additional tax applies if the amount rolled over is subsequently distributed from the Roth account within the five-year tax period beginning with the tax year in which the rollover contribution was made and ending on the last day of the participant’s fifth taxable year in the period.

Example. In 2021, Evan, who is 45 years old, rolls $10,000 from his tax-deferred §401(k) plan to a designated Roth account. No other contributions were ever made to Evan’s designated Roth account. Evan takes a distribution of $10,000 from his designated Roth account in 2023. While Evan will not owe any income taxes on the distribution, he will owe a penalty of $1,000 (10%) because the amount rolled over did not stay in a Roth account for at least five years before being distributed.

SIMPLE PLANS

SECURE 2.0 Made Numerous Changes to SIMPLE Plans

SIMPLE Plans can now accept Roth contributions.

Employers can now make additional non-elective contributions for taxable years beginning after Dec. 31, 2023. Contributions must be made in a uniform manner and cannot exceed 10% or $5,000 as indexed for inflation.
The contribution limit to a SIMPLE Plan for employees aged 50 or over has been increased for taxable years beginning after Dec. 31, 2023. If no more than 25 employees, elective and catch-up deferrals increase by 10%. If 26 to 100 employees, deferrals increase by 10% only if the employer contributes either 3% of compensation for all eligible employees or 4% of employee elective deferral contributions.

Employers are now allowed to replace a SIMPLE IRA Plan with a SIMPLE 401(k) plan or other 401(k) plan as long as the new plan requires mandatory employer contributions. Effective for plan years beginning after Dec. 31, 2023.

### ONE-PERSON (SOLO) 401(K) PLANS

**Is a One-Person 401(k) Plan Better Than a Profit-Sharing Plan?**

**Solo 401(k) comparisons — self-employed.** In order to contribute $66,000 to a profit-sharing plan in 2023, a sole proprietor must have $330,000 of net self-employment income. However, a self-employed person only needs $227,500 of net self-employment income in order to contribute $66,000 to a solo 401(k).

| 2023 Profit Sharing Plan vs. Solo 401(k) Comparison — Self-Employed |
|--------------------------|-----------------|-----------------|-----------------|-----------------|
| S/E earnings             | $50,000         | $100,000        | $227,500        | $330,000        |
| Profit-sharing plan      | $10,000         | $20,000         | $45,500         | $66,000         |
| Single-participant 401(k) plan | $30,500       | $40,500         | $66,000         | $66,000         |
| Additional contribution  | $20,500         | $20,500         | $20,500         | $0              |

**Note.** Self-employment tax adjustment not included in the above computations.

**Difference even more dramatic for one-employee corporations.** Assume that the sole proprietor in the above example converts the proprietorship to an S corp. and then asks you how much she can contribute at various earnings levels. With a pure profit-sharing plan such as an SEP, she would need wages of $264,000 to contribute the $66,000 maximum. However, she needs only $182,000 of wages to contribute $66,000 to a single-participant 401(k) plan.

| 2023 Profit Sharing Plan vs. Solo 401(k) Comparison — S Corp. Shareholder |
|--------------------------|-----------------|-----------------|-----------------|-----------------|
| S Corp. wages            | $50,000         | $100,000        | $182,000        | $264,000        |
| Profit-sharing plan      | $12,500         | $25,000         | $45,500         | $66,000         |
| Single-participant 401(k) plan | $33,000       | $45,500         | $66,000         | $66,000         |
| Additional contribution  | $20,500         | $20,500         | $20,500         | $0              |

**Tax practitioner planning.** Taxpayers are limited to only one deferral amount, regardless of the number of plans in which they participate.
Other Solo 401(k) Pointers

- Solo 401(k) plans are available to businesses with no common law employees. Thus, a business that employs only the owner qualifies (or only the owner and the owner’s spouse).
- Form 5500 is required for any 401(k) plan with assets exceeding $250,000; however, many mutual fund companies and brokerage houses offer discount preparation for solo 401(k) plans.
- A plan participant can borrow from a 401(k) plan as long as the strict rules are followed.

SECURE 2.0 Clarifies Due Date for Contributions

- Employee elective deferrals are due on the 15th day of the month after the end of the year, which is January 15 for calendar year taxpayers.
- Employer contributions are due the due date of the tax return including extensions.
- For the first year only after a sole proprietor establishes a solo 401(k) plan, employee elective deferrals are due by the due date of the return including extensions.

NEW SMALL BUSINESS RETIREMENT PLANS

SECURE 2.0 Created Two New Retirement Plans for Small Businesses

Starter 401(k) Plans can be established by employers who currently do not have a plan. This is a deferral only arrangement, no employer match. All employees are enrolled in the plan and defer between 3% and 15%, with the maximum deferral amount the same as IRA limits. This plan is automatically treated as satisfying the ADP nondiscrimination test. For plan years beginning after Dec. 31, 2023.

Safe-Harbor 403(b) Plans can be established by employers who currently do not have a plan. This is a deferral only arrangement, no employer match. All employees are enrolled in the plan and defer between 3% and 15%, with the maximum deferral amount the same as IRA limits. This plan is automatically treated as satisfying the nondiscrimination test. For plan years beginning after Dec. 31, 2023.

MULTIPLE EMPLOYER PENSION PLANS

DOL Changes Who Can Participate in a Multiple Employer Pension Plan

Thirty-eight million US employees do not have pension plans. Former President Donald Trump hoped to reduce those numbers with an Aug. 31, 2018, executive order that directed the Department of Labor to “expand the circumstances under which United States employers, especially small and mid-sized businesses, may sponsor or adopt a multiple employer plan as a workplace retirement option for their employees.”

A multiple employer plan (MEP) is a plan maintained by two or more unrelated employers who are not members of a controlled group. The MEP requires some form of commonality among the firms, such as being in a similar industry. A Department of Labor (DOL) rule, issued July 29 and effective Sep. 30, 2019, expands the parameters for participating in an MEP to include membership in the same association. The DOL
expansion also provides that a professional employer organization (PEO) may sponsor an MEP. SECURE 2.0 allows MEPs to maintain 403(b) plans.

Example. The San Jose Chamber of Commerce may sponsor an MEP for its members.

Advantages. The MEP is maintained by multiple employers for the purpose of pooling plan assets to reduce administrative costs and for advantageous investing. Plans with $10 million in assets are charged almost four times as much in investment fees as those charged to plans with $1 billion in assets.

Employers joining existing MEPs or PEPs are eligible for the small employer pension plan start-up cost credit for three years regardless of how long the MEP or PEP has been in existence.

POOLED EMPLOYER PLANS

SECURE established Pooled Employer Plans - PEP

Pooled Employer Plans are an expanded version of Multiple Employer Plans. With PEPs participating employers do NOT need common nexus.

PEPs may designate a named fiduciary (other than an employer in the plan) to collect contributions to the plan. Such fiduciary is required to implement written contribution collection procedures that are reasonable, diligent, and systematic.

OTHER RETIREMENT PLAN DEVELOPMENTS

Uncashed Distribution Check Does Not Change Year of Taxability or Form 1099-R Requirement (Rev. Rul. 2019-19)

Employer M is the plan administrator of Plan X, a qualified retirement plan under §401(a). A distribution of $900 is required to be made from Plan X to Individual A in 2020. Individual A does not cash the distribution check until 2021. The Revenue Ruling addresses when the distribution is taxable to the individual and what the employer’s withholding and reporting requirements are for 2020.

- Individual A’s failure to cash the distribution check she received in 2020 does not permit her to exclude the amount of the designated distribution from her gross income in that year under §402(a).
- Individual A’s failure to cash the distribution check she received does not alter Employer M’s obligations with respect to withholding under §3405.
- Individual A’s failure to cash the distribution check she received does not alter Employer M’s obligations with respect to Form 1099-R reporting under §6047(d).

Tax practitioner planning. The ruling does not address a few other problems for the individual and the employer. What happens if the check is mailed on Dec. 31, 2020, but isn’t received by the individual until Jan. 2, 2021? What happens if the check is returned to the employer? What happens if the individual can’t be found?
Although IRA Beneficiary Was the Estate, IRA Could Be Transferred to Two Children as Inherited IRAs [PLR 201927009]

Decedent was predeceased by his spouse and was survived by their two children. Prior to their deaths, decedent and his spouse executed a Will and Trust. Pursuant to the Will, the Estate is payable to the Trust. Decedent was the owner of an IRA. Decedent named his Estate as the beneficiary of the IRA. The IRA is currently titled IRA of Decedent FBO Estate. The Estate requested a ruling to allow the estate to divide the IRA, by means of trustee-to-trustee transfer, into two separate inherited IRAs for the benefit of Child 1 and Child 2, respectively.

The PLR concluded that:

- The Estate can transfer, via trustee-to-trustee transfer, the IRA in-kind to inherited IRAs FBO Estate FBO Child 1 and Child 2, respectively (using Child 1 and Child 2’s Social Security numbers), and such in-kind transfers do not constitute taxable distributions within the meaning of §408(d)(1) or constitute a rollover as that term is used in §408(d)(3).
- The inherited IRAs created by means of trustee-to-trustee transfers which will be maintained in the name of Decedent FBO Estate FBO Child 1 and Child 2, respectively, will constitute inherited IRAs as such term is defined in §408(d)(3)(c).

Although IRA Beneficiary Was the Estate, IRA Could Be Rolled Over by Surviving Spouse (PLR 202210016)

Surviving spouse and sole residuary estate beneficiary was treated as payee or distributee of proceeds from decedent’s IRA and was eligible to rollover the IRA proceeds to an IRA set up and maintained in the spouse’s own name, as long as the rollover occurred within 60 days after proceeds were paid to the estate as beneficiary of decedent’s IRA.

The PLR concluded that:

- The surviving spouse will be treated for purposes of §408(d)(1) and §408(d)(3) as the payee or distributor of the IRA proceeds.
- The IRA will not be treated as an inherited IRA as such term is defined in §408(d)(3)(c).
- The surviving spouse will be eligible to rollover the IRA proceeds into an IRA set up and maintained in the surviving spouse’s name, as long as the rollover occurs no later than the 60th day after the date the IRA proceeds are paid to the Estate.
- Except in the case of a rollover to a Roth IRA, the surviving spouse will not be required to include in gross income any portion of the IRA proceeds timely rolled over to an IRA set up and maintained in the surviving spouse’s name.

Elderly Fraud Victims Required to Pay Taxes on Stolen IRA Funds [Dennis and Suzanne Gomas v. US, MD Fla., 8-22-cv-1271-TPB-TGW (Jul. 17, 2023)]

Dennis and Suzanne Gomas, elderly individuals, were the undisputed victims of a complicated theft resulting in the loss of nearly $2 million dollars which was withdrawn from their IRA. The thief, Suzanne’s daughter, was rightly convicted and is serving a lengthy prison sentence. The fact that these elderly taxpayers are now required to pay income tax on monies that were stolen from them seems unjust.
The Court stated that in view of the egregious and undisputed facts presented, it is unfortunate the IRS is unwilling (or believes it lacks the authority) to exercise its discretion and excuse payment of taxes on the stolen funds. The Court felt it was highly unlikely that Congress, when it eliminated the theft loss deduction in 2018, envisioned injustices like this case. The Court determined that the law is clear here and it favors the IRS. Seeking to avoid an unjust outcome, the taxpayers attempted to recharacterize the facts from what they really are – a theft loss – to something else. Established law does not support this effort. The Court is bound to follow the law, even where, as here, the outcome seems unjust. The taxpayers were required to pay income tax on the IRA withdrawals that were stolen from them.

**IRS Penalty Relief for Small Retirement Plans Made Permanent**

The IRS made permanent a pilot program providing administrative relief to certain retirement plan administrators and sponsors from the penalties applicable under §6652(e) and §6692 for failing to timely comply with the annual retirement plan reporting requirements (Rev. Proc. 2015-24).

**Failure to file penalty can be $15,000.** Small businesses that fail to file required annual retirement plan returns, usually Form 5500-EZ, can face stiff penalties, up to $15,000 per return. However, by filing late returns under this program, eligible filers can avoid these penalties by paying only $500 for each return submitted, up to a maximum of $1,500 per plan. For that reason, program applicants are encouraged to include multiple late returns in a single submission. Find the details on how to participate in Rev. Proc. 2015-32.

**Relief is limited.** The relief under this Revenue Procedure is only available to the plan administrator or plan sponsor of (1) certain small business (owner-spouse) plans and plans of business partnerships (together, one-participant plans) and (2) certain foreign plans.

**What is a one-participant plan?** For purposes of this Revenue Procedure, a one-participant plan is a retirement plan with one or more participants that:

- Covers only the owner of the entire business (or the owner and the owner’s spouse); or
- Covers only one or more partners (or partners and their spouses) in a business partnership; and
- Does not provide benefits for anyone except the owner (or the owner and the owner’s spouse) or one or more partners (or partners and their spouses).

**Filing Requirements**

A complete Form 5500-EZ return. The submission must include a complete Form 5500-EZ return, including all required schedules and attachments, for each plan year for which the applicant is seeking penalty relief. All returns submitted must be sent to the IRS in Ogden, Utah, and cannot be filed through the DOL’s EFAST2 filing system.

**Tax practitioner planning.** A delinquent Form 5500-SF return cannot be used. The applicant must file a Form 5500-EZ.

**Delinquent returns must be marked.** For each delinquent Form 5500 series return submitted to the IRS, the applicant must mark in red letters in the top margin of the first page of the return (above the title of the form), “Delinquent Return Submitted Under Rev. Proc. 2015–32, Eligible for Penalty Relief.”

**Required Form 14704.** Each submission must include a completed paper copy of Form 14704. A completed Form 14704 must be attached to the front of the oldest delinquent return in the submission.
Reasonable cause may still apply. Even if the new relief procedure does not apply, no penalty is imposed if it is shown that the failure to timely file is due to reasonable cause. A request for relief due to reasonable cause may be attached to the delinquent return when the return is filed or may be filed separately. The request should state the reason why the return was late and be signed by a person in authority (§301.6652-3(b) and §301.6692-1(c)).

Tax practitioner planning. The Department of Labor offers a similar relief program for businesses with retirement plans that include employees known as the Delinquent Filer Voluntary Compliance Program.

IRS Reverses Itself and Says Retirees in Pay Status Can Cash Out (Notice 2019-18)

In Notice 2015-49, the IRS said it intended to amend its minimum required distribution regulation to state that cashing out annuities in pay status would be a prohibited acceleration. The IRS also said the new regulation would be effective July 9, 2015 (the regulations were never revised). In Notice 2019-18, the IRS announced that it no longer intends to amend the minimum required distribution regulation to address the practice of offering retirees and beneficiaries who are currently receiving annuity payments under a defined benefit plan a temporary option to elect a lump-sum payment in lieu of future annuity payments. Until further notice, the IRS will not assert that a window to cash out annuities in pay status violates the minimum required distribution rules.

Tax practitioner planning. Is it the right decision to cash out the retirement annuity? That’s a good question for the client’s financial planner.

Director Fees Were Really Wages; Pension Deduction Disallowed (David Burbach v. Comm., TCM 2019-17)

David Burbach funded a pension plan by taking “director fees” out of his solely owned corporation, Burbach Aquatics, Inc. (BAI), depositing them into his personal checking account and making personal payments into a pension account. He reported the “director fees” on a Schedule C and then took offsetting deductions for contributions to a one participant defined benefit pension plan.

Wages or director fees? Section 3121(d)(1) provides that “any officer of a corporation” is an employee except one who “does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration.” Director fees are an exception (§31.3121(d)-1(b)). “[A] director of a corporation in his capacity as such is not an employee of the corporation.” Directorial services typically include things like attending board meetings and sitting on committees, while services performed by officers generally include the fundamental everyday decisions about corporate operations.

Burbach failed to present any evidence of specific directorial services he performed for BAI, and he was involved in the everyday decisions about engineering, project management, and marketing. The court also noted that the “director fees” BAI paid Burbach in the years at issue were approximately 10 times the “wages” it paid him (in one of the years at issue, director fees were $275,000 and wages to Burbach were $21,500). The court found that the director fees should properly be recharacterized as wages from BAI.

Pension plan should have been BAI’s. Section 404(a)(1) allows only an “employer” to claim a pension deduction unless the employer is self-employed (§404(a)(8)). Burbach can’t successfully claim to be an employer, and §404(a) limits deductions under §404(a)(1) to contributions made to pension trusts by “an employer.” The plan sponsor and “employer” in this case was BAI, not Burbach. The pension deduction on Burbach’s individual return was disallowed.

Tax practitioner planning. BAI had employees. A pension plan in BAI would have required that the employees be covered, not just the owner.
DOL Releases Final Rule on Changes for the 2023 Form 5500 (Fact Sheet: Changes for 2023 Form 5500)

The Department of Labor’s Employee Benefits Security Administration, the IRS and the Pension Benefit Guaranty Corp. announced changes to the Form 5500 Annual Return/Report of Employee Benefit Plan and Form 5500-SF Short Form Annual Return/Report of Employee Benefit Plan, and related instructions, which apply beginning with 2023 plan year reports.

The key revisions, which include changes related to provisions in the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), include:

- A consolidated Form 5500 reporting option for certain groups of defined contribution retirement plans – defined contribution group (DCG) reporting arrangements.
- Improved reporting by multiple-employer plans (MEPs), including pooled employer plans (PEPs).
- A change in the participant-counting methodology for determining eligibility for simplified reporting alternatives available to small plans.
- A breakout of reporting of administrative expenses paid by the plan on a plan’s financial statements.
- Further improvements in financial and funding reporting by PBGC-covered defined benefit plans.
- The addition of selected Internal Revenue Code compliance questions to improve tax oversight and compliance of tax-qualified retirement plans.
- Technical and conforming changes as part of the annual rollover of forms and instructions.

IRS Employee Manual Revised for Form 5500 Examinations (Examining Process)

The IRS revised IRM 4.71.1, Employee Plans Examination of Returns, Overview of Form 5500 Examination Procedures. Review this guide when preparing for a pension plan audit.

ROLLOVER RULE §408(D)(3)

IRA Distributions Are Subject to the “One-Rollover-Per-Year” Limitation (IRA One-Rollover-Per-Year Rule)

Section 408(d)(3)(A)(I) provides generally that any amount distributed from an IRA will not be included in the gross income of the distributee to the extent the amount is paid into an IRA for the benefit of the distributee no later than 60 days after the distributee receives the distribution. Section 408(d)(3)(B) provides that an individual is permitted to make only one nontaxable 60-day rollover between IRAs in any one-year period.

Tax practitioner planning. Under SECURE 2.0, IRS must simplify and standardize the rollover process by creating sample form for direct rollovers that can be used by both incoming and outgoing plans. This simplified process must be completed by January 1, 2025.

One-year rule applies to the aggregate of IRAs. The Tax Court in Bobrow v. Comm., TCM 2014-21 held that the limitation applies on an aggregate basis, meaning that an individual cannot make more than one nontaxable 60-day rollover within each one-year period even if the rollovers involved different IRAs. In Announcement 2014-15, the IRS indicated that it would follow the interpretation of §408(d)(3)(B) in Bobrow.
One-rollover-per-year rule. An individual can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs he or she may own (Announcement 2014-107 and Announcement 2014-32). The limit will apply by aggregating all of an individual’s IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit.

Example. George requests that his broker distribute $50,000 from his IRA on Sep. 1, 2022. George’s broker mails the distribution check on September 3, and George receives it on September 10. George repays the $50,000 to his IRA on Nov. 5, 2022. George has properly executed a rollover contribution under §408(d)(3), and he does not owe any tax or penalties on the $50,000 distribution.

Tax practitioner planning. It is the date that George actually receives the distribution that starts the 60-day repayment period, regardless of when the distribution is requested or the date the broker mails the check.

Variation. On Mar. 10, 2023, George withdraws another $25,000 from his IRA. George repays $25,000 to his IRA on Apr. 20, 2023, well within the 60-day rollover period. Unfortunately for George, he may not make more than one nontaxable rollover contribution in the 12-month period, which doesn’t end until Sep. 9, 2023. George must pay tax on the $25,000 and, if applicable, the 10% early withdrawal penalty.

Exception to One-Rollover-Per-Year Rule

Rollover contributions distinguished from direct transfers (Rev. Rul. 78-406). The one-rollover-per-year limitation only applies to indirect rollovers (i.e., the taxpayer actually receives the cash and then redeposits it at a later date). Direct transfers from one IRA custodian to another are not considered “rollover contributions” since such funds are not within the direct control and use of the participant. Multiple direct transfers are allowed during a single calendar year. In the event that multiple direct transfers have occurred, participants are still allowed one rollover contribution per year.

Exceptions to the one rollover rule. The one-per-year limit does not apply to:

- rollovers from traditional IRAs to Roth IRAs (conversions),
- trustee-to-trustee transfers to another IRA,
- IRA-to-plan rollovers, plan-to-IRA rollovers, and
- plan-to-plan rollovers.

Self-Certification Procedure for Certain Failed 60-Day Rollovers

The IRS has provided a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day rollover time limit for properly rolling these amounts into another retirement plan or IRA. Following this guidance, eligible taxpayers who missed the time limit will ordinarily qualify for a waiver if one or more of 11 circumstances apply to them (Rev. Proc. 2020-46).

They include:

- an error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;
- the distribution, having been made in the form of a check, was misplaced and never cashed;
the distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;
• the taxpayer’s principal residence was severely damaged;
• a member of the taxpayer’s family died;
• the taxpayer or a member of the taxpayer’s family was seriously ill;
• the taxpayer was incarcerated;
• restrictions were imposed by a foreign country;
• a postal error occurred;
• the distribution was made on account of a levy and the proceeds of the levy have been returned to the taxpayer;
• the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer’s reasonable efforts to obtain the information; or
• distribution was made to a state unclaimed property fund.


Contribution as soon as practical — 30-day safe harbor. The contribution must be made to the plan or IRA as soon as practical after the reason or reasons listed in the self-certification no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

Reporting on Form 5498. The IRS modified the instructions to Form 5498 to require that an IRA trustee that accepts a rollover contribution after the 60-day deadline report that the contribution was accepted after the 60-day deadline. The Form 5498 will then alert the IRS to the late rollover.

Sample letter for self-certification. Ordinarily, the IRS, plan administrators, and trustees will honor a taxpayer’s truthful self-certification that the taxpayer qualifies for a waiver to the 60-day rule under the new revenue procedure. If the IRA custodian requires a written statement, taxpayers may make the certification by using the model letter provided in the revenue procedure on a word-for-word basis or by using a letter that is substantially similar in all material respects. A copy of the certification should be kept in the taxpayer’s files and be available if requested at an audit.

Tax planning point. Even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a later examination.

Surviving Spouse Received One-Half Interest in Community Property IRA (PLR 202034002)

The private letter ruling provides that:
• Taxpayer, as Decedent’s spouse, is treated as having acquired her one-half community property interest in decedent’s IRA;
• Taxpayer is eligible to roll over her one-half community property interest in decedent’s IRA to one or more IRAs established and maintained in her name pursuant to §408(d)(3)(A)(i), provided that the rollover occurs no later than 60 days after the proceeds of the IRA are distributed;
## Comparison Chart of Allowable Rollovers (Rollover Chart)

<table>
<thead>
<tr>
<th>ROLL TO</th>
<th>IRA</th>
<th>SEP IRA</th>
<th>SIMPLE IRA</th>
<th>ROTH IRA</th>
<th>457(b)</th>
<th>403(b)</th>
<th>Qualified Plan</th>
<th>Designated Roth Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRA</td>
<td>YES</td>
<td>YES</td>
<td>YES, after Dec. 18, 2015, and after two-year period.</td>
<td>YES, must include in income.</td>
<td>YES, must have separate accounts.</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>SEP-IRA</td>
<td>YES</td>
<td>YES</td>
<td>YES, after Dec. 18, 2015, and after two-year period.</td>
<td>YES, must include in income.</td>
<td>YES, must have separate accounts.</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>SIMPLE IRA&lt;sup&gt;4&lt;/sup&gt;</td>
<td>YES, after two years.</td>
<td>YES, after two years.</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES, after two years.</td>
<td>NO</td>
</tr>
<tr>
<td>ROTH IRA</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>457(b)</td>
<td>YES</td>
<td>YES</td>
<td>YES, after Dec. 18, 2015, and after two-year period.</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
<td></td>
</tr>
<tr>
<td>403(b)</td>
<td>YES</td>
<td>YES</td>
<td>YES, after Dec. 18, 2015, and after two-year period.</td>
<td>YES, after Dec. 31, 1997. Must include in income.</td>
<td>YES, must have separate accounts.</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>QUALIFIED PLAN</td>
<td>YES</td>
<td>YES</td>
<td>YES, after Dec. 18, 2015, and after two-year period.</td>
<td>YES, after Dec. 31, 1997. Must include in income.</td>
<td>YES, must have separate accounts.</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>DESIGNATED ROTH ACCOUNT</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
</tr>
</tbody>
</table>

4. A distribution and rollover is only allowed after the individual has participated in the SIMPLE IRA for the two-year period during which the additional income tax on distributions from a SIMPLE IRA is 25% instead of 10%.

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Retirement Plans
• Taxpayer will not be required to include in gross income for federal tax purposes, for the year in which the distribution of the decedent’s IRA is made, any portion of the proceeds distributed from the IRA that are timely rolled over to one or more IRAs, set up and maintained in Taxpayer’s name; and

• Surviving spouse’s receipt of the one-half community property interest in decedent’s IRA and the rollover of the one-half community property interest in decedent’s IRA to one or more IRAs set up and maintained in Taxpayer’s name are not transfers within the meaning of §691(a)(2).

**Warning.** The comparison chart shows general information that may not be applicable to all plans. Not all accounts allow rollover contributions (§1.402(a)(31)-1, Q and A 13).

**Tax Planning Question — Should the Client Rollover Their 401(k) Plan Monies to an IRA?**

<table>
<thead>
<tr>
<th>Keep assets in the 401(k)</th>
<th>Rollover assets to an IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributions allowed at any age (rather than 59%) with no 10% penalty if taken in series of equal payments.</td>
<td>Distributions allowed without penalty for first-time home buyers, qualified education expenses, health insurance for long-term unemployed.</td>
</tr>
<tr>
<td>No RMDs at 73 if still working. Distributions allowed at age 55 (rather than 59%) with no 10% penalty if separated from service</td>
<td></td>
</tr>
<tr>
<td>Borrowing allowed from plan</td>
<td>Borrowing from IRA not allowed.</td>
</tr>
<tr>
<td>Capital gain treatment available for net unrealized appreciation on lump sum distribution</td>
<td>Distributions can be taken at any time with tax and penalty. Many restrictions apply to taking 401(k) distribution before separation or age 59%.</td>
</tr>
</tbody>
</table>

**Note.** Consider whether the client’s state taxes 401(k) distributions and IRA distributions differently.

**MINIMUM DISTRIBUTION AMOUNTS**

**Required Minimum Distributions — In General**

**Definition of required minimum distributions.** Required minimum distributions (RMDs) generally are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he or she reaches 73 years of age or, if later, the year in which he or she retires. However, if the retirement plan account is an IRA or the account owner is a 5% owner of the business sponsoring the retirement plan, the RMDs must begin once the account holder is age 73, regardless of whether he or she is retired. Age 73 is scheduled to increase to age 75 in 2033.

**RMD calculation.** The basic RMD calculation is made by dividing the account balance at the end of the prior year by the distribution period (obtained from one of the life expectancy tables). If the employee’s sole beneficiary is the employee’s spouse and the spouse is more than 10 years younger than the employee,
a longer distribution period measured by the joint life and last survivor life expectancy of the employee and spouse is permitted to be used. A beneficiary can be determined as of September 30 of the calendar year following the calendar year of the employee’s death. Retirement account owners are responsible for correctly calculating and withdrawing RMDs, and the amount not withdrawn is subject to a penalty if they fail to do so, unless the shortfall in distributions was due to reasonable error and reasonable steps were taken to remedy the shortfall. In order to qualify for this relief, Form 5329 must be filed with a letter of explanation.

**Life Expectancy Tables (Pub. 590-B)**

In November 2020, the IRS issued final regulations containing new life expectancy tables to be used for determining RMDs. The new tables are effective for RMDs beginning on Jan. 1, 2022. The old tables still applied for 2021.

**Surviving Spouse RMD Election under SECURE 2.0.** For taxable years beginning after Dec. 31, 2023, the surviving spouse can make an irrevocable election to be treated as an employee for RMD rules if the employee died before their required beginning date.

**IRS Issues Proposed Regs on RMDs**

In February 2022, the IRS issued proposed regulations to reflect changes made by the SECURE Act. (See additional discussion of proposed regs above on p. 5.) Subsequently IRS issued Notice 2022-53 indicating that the final regulations would apply no earlier than the 2023 distribution calendar year. Once again the IRS postponed application of the proposed regulations. In July 2023, IRS released Notice 2023-54 which provides relief for Non-Eligible Designated Beneficiaries who inherited retirement accounts from an owner who died on or after their “required beginning date” by eliminating any penalties for failing to take RMDs for 2023. Now the RMD regulations, when issued, will not apply before 2024.

The proposed regs provide for defined contributions plans where the employee has an eligible designated beneficiary. The plan may provide that either the 10-year rule applies, or the life expectancy payments rule applies. The plan may provide an election between the two rules. If the plan does not include either of these optional provisions and the employee has an eligible designated beneficiary, the life expectancy rule applies.

**Required Minimum Distributions (RMD) From Multiple Retirement Accounts**

If an account owner has more than one defined contribution plan, the RMD must be calculated and withdrawn separately for each plan. If the account owner has more than one IRA, the RMD must be calculated for each IRA separately each year (§401(a)(9)). However, the account owner may aggregate the RMD amounts for all IRAs and withdraw the total from one IRA or a portion from each IRA.

**RMDs for IRAs and Defined Contribution Plans Differ in Two Ways (RMD Comparison Chart, Updated Dec. 22, 2022)**

The starting date of an RMD from a defined contribution plan can be delayed past age 73 if the account owner is still working. IRA owners and the 5% owner of the company sponsoring the defined contribution plan must begin RMDs by April 1 of the year following the year in which the account owner turned 73. (Note SECURE 2.0 gradually increases age 72 to age 73 and then to age 75 in 2033.)

Tax practitioner planning. Waiting until April 1 to take one’s first RMD allows the account owner an extra 3½ months to earn tax-deferred amounts on the distribution and the same extra time to pay taxes on the distribution. However, he may lose overall if his tax bracket increases because delaying year one distribution to year two will result in two distributions being taxed in the same year.

RMDs must be taken from each defined contribution account. However, for IRAs, the account owner can total the account balances at year-end, calculate the RMD amount, and then choose to take the RMD from any one of the IRAs. This allows the account owner to make long-term investments in one IRA account without worrying about an RMD, as long as he has other IRAs with balances large enough to support the total distribution.

<table>
<thead>
<tr>
<th>IRA</th>
<th>Defined Contribution Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the required beginning date for an RMD?</td>
<td>The RMD must start by April 1 of the year following the year in which the account owner turns 73, regardless of whether he or she is still employed.</td>
</tr>
<tr>
<td>How are RMDs taken if there are multiple accounts?</td>
<td>If the account holder has more than one IRA, he or she must calculate the RMD for each IRA separately each year. However, he or she may aggregate the RMD amounts for all of his or her IRAs and withdraw the total from one IRA or a portion from each of the IRAs. The account owner does not have to take a separate RMD from each IRA.</td>
</tr>
</tbody>
</table>

Tax practitioner planning. There are no RMD requirements for a Roth IRA while the owner is alive. However, designated Roth accounts are subject to the RMD rules prior to Dec. 31, 2023.

Tax practitioner planning. Employers must continue to make plan contributions for employees who are receiving RMDs, and such employees must also be given the option to continue making salary deferrals if permitted by the plan.

IRS Required Minimum Distribution Worksheets

The IRS has posted worksheets to calculate the amount of RMD from IRAs:

- For IRA owners whose spouse is the sole beneficiary of their IRA and is more than 10 years younger
- For all other IRA owners

Tax practitioner planning. These worksheets are simple. Most tax software and tax planning packages use similar methods of calculation.
Excess Accumulation Penalty Imposed If RMD Rules Ignored, Even If Unintentional

Fifty percent of RMD penalty tax. An additional tax of 50% of the amount of RMD that was not taken is imposed if an account owner fails to:

1. withdraw an RMD, or withdraw the full amount of the RMD, or
2. withdraw an RMD by the applicable deadline.

Example. George turned 73 years old in 2022. At the end of 2021, George had $512,000 in his IRA account. George’s RMD for 2022 was $20,729 ($512,000 IRA balance at the end of 2021 divided by 24.7, the distribution period from the Uniform Lifetime table). George forgot to take his distribution in 2022 and now owes a $10,364 (50% of $20,729) penalty for 2022.

Waiver of the penalty for not taking the full RMD (Retirement Plans FAQs regarding RMDs). The penalty may be waived if the account owner establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall. In order to qualify for this relief, the taxpayer must file Form 5329 and attach a letter of explanation. See the Instructions to Form 5329.

Excess accumulation penalty can be (and usually is) waived (Form 5329 instructions). Taxpayers may request that the IRS waive part or all of the excess accumulation tax. The request is made by attaching a statement to the tax return which explains:

- Any shortfall in the RMD was due to reasonable error; and
- The taxpayer has taken reasonable steps to remedy the shortfall (i.e., the RMD was taken out of the account as soon as the error was discovered).

In addition to attaching the request to the return, taxpayers are required to complete lines 50-54 of Part VIII of Form 5329. The taxpayer writes “RC” and the amount of tax waiver in parenthesis on the dotted line next to line 52. The requested waiver is then subtracted from the total RMD shortfall to arrive at the remaining balance subject to the tax.

SECURE 2.0 reduced the excess accumulation penalty tax. For taxable years beginning after Dec. 29, 2022, the penalty was reduced to 25% of the missed RMD and further reduced to 10% of the missed RMD if the error is corrected timely. Timely correction starts when the penalty is incurred and ends the earliest of:

- The date the IRS notice of deficiency mailed.
- The date the penalty is assessed by IRS.
- The last day of the second tax year beginning after the end of the tax year the penalty was incurred.

Statute of limitations on excess accumulation penalty. The statute of limitations on the excise tax for excess accumulations starts when Form 5329 is filed. This can lead to an indefinite period of limitations if Form 5329 is not filed. SECURE 2.0 changed the statute to three years from when Form 1040 was filed or when the taxpayer is not required to file Form 1040 to three years from when Form 1040 would have been filed.
Distributions and Final Medical Expenses

For many clients, the last year or two of their lives are filled with tens of thousands, if not hundreds of thousands, of unreimbursed medical expenses. Home care, assisted living, memory care, and skilled nursing facility costs are enormous. If the client, or family, can choose which accounts to pay the medical bills from, perhaps withdrawing from the retirement plan or IRA is a good choice.

Example. In Darlene’s last year of life, her daughter spent $200,000 on Darlene’s medical expenses. Her daughter paid for the medical with funds from Darlene’s CD and tax-exempt accounts. Darlene’s AGI for the final year was $75,000. The medical deductions were wasted. Good tax advice might have included taking a distribution from Darlene’s IRA, rather than from the cash accounts, thereby reducing income in respect of decedent (IRD) to the beneficiaries.

10% EARLY WITHDRAWAL PENALTY - §72(T)

A 10% additional tax on distributions from qualified retirement plans is imposed (§72(t)(1)). However, there are specific exceptions to the imposition of the 10% additional tax (§72(t)(2)).

Coronavirus-Related Distributions

CARES waived the 10% penalty on 2020 Coronavirus-related distributions. See the discussion at the beginning of this chapter.

Exceptions for Qualified Plans and IRAs

1. On or after the account owner reaches age 59½.
2. On or after the death of the account owner.
3. After the permanent disability of the account owner.
4. At age 55 if from an employer plan and separated from service (does not apply to IRAs).
5. A series of substantially equal periodic payments (not less frequently than annually) made for the life of the employee or the joint lives of the employee and his beneficiary. SECURE 2.0 states this provision continues to apply if there is a rollover of the account, or an exchange of the annuity providing the payments or an annuity satisfying RMD rules.
6. Distribution made incident to a divorce or made to an alternate payee under a Qualified Domestic Relations Order (QDRO). SECURE 2.0 states that Tribal Courts are now authorized to issue QDROs.
7. For IRS levies.
8. For extraordinary medical expense. (This exception does not require the taxpayer to itemize deductions; however, because the exception is only for deductible medical expenses, it applies to the amount of medical expenses that exceed 7.5% of AGI.)
9. Qualified disaster-relief distribution not in excess of $22,000.
10. Public safety employees, including federal law enforcement officers, custom and border protection officers, firefighters, and air traffic controllers, taking plan distributions if separating from service and over 50. SECURE 2.0 expanded the list of eligible public safety employees to include Private Sector Firefighters, and corrections officers who are employees of state and local governments. Additionally, public safety employees do not need to be aged 50 if they have 25 years of service.

11. Reservists called to active duty for at least 179 days.

12. Birth and adoption distributions up to $5,000 made within one year of birth or adoption.

13. Emergency expenses up to $1,000 per year with no further distributions for three years unless repaid. Emergency expenses are expenses relating to personal or family emergency expenses that were unforeseeable or caused immediate financial need. For distributions after Dec. 31, 2023..*

14. Distributions for a Physician certified terminal illness. *

15. Distributions to domestic abuse survivors (can self-certify) up to $10,000 (or 50% of account balance if less). For distributions after Dec. 31, 2023. *

16. Distributions to purchase a long-term care contract up to $2,500 a year. Policy must provide high quality coverage. For distributions after Dec. 29, 2025. *

17. For 2020 only, waiver of 10% penalty for COVID-19-related distributions up to $100,000. See IRS FAQs.

For IRAs Only

1. For health insurance premiums during long-term unemployment (12 consecutive weeks).

2. For qualified higher education expense.

3. For a qualified first-time home buyer (a $10,000 lifetime limit).

CASES AND RULINGS — EXCEPTIONS FOR QUALIFIED PLANS AND IRAS

Exception #1. IRA Distribution Subject to 10% Penalty If Under 59½ (Wilfred Omoloh v. Comm., TCS 2017-64)

Wilfred Omoloh withdrew $35,000 from his IRA. He claimed he was 59½ at the time of the distribution using a recently acquired birth certificate from his home country of Kenya. The IRS assessed the 10% early withdrawal penalty relying on older records, including Mr. Omoloh’s immigration and naturalization papers, his University of Georgia educational records, and his Texas driver’s license. The court expressed its “concern” over the accuracy of the birth certificate and found for the IRS.

Exception #3. Diabetes is Not a Disability for Early Withdrawal Penalty Exception (Robert Lucas v. Comm., TCM 2023-9)

Robert Lucas began to experience financial problems when he lost his job. To make ends meet, he obtained a distribution of $19,365 from his 401(k) plan. He had not reached 59 ½ years old at the time. Mr.
Lucas treated the distribution as non-taxable based on his understanding that the distribution did not constitute income because of his medical condition - diabetes. The Court determined that the distribution was taxable income and also subject to the 10% premature distribution penalty. Mr. Lucas was diagnosed with diabetes several years prior to the distribution and was effectively treated with insulin shots and other medications. The Court concluded that his diabetes did not render him “unable to engage in any substantial gainful activity” within the meaning of section 72(m)(7); therefore, his condition did “not constitute a disability within the meaning of section 72(m)(7).

Exception #3. Compulsive Gambling Not a Disability for Early Withdrawal Penalty Exception
(Kathryn Gillette v. CIR. No. 19-1343 (7th Cir. 2020))

Kathryn Gillette’s tax troubles stem from her compulsive gambling, which Ms. Gillette says was linked to a prescription medication for restless leg syndrome. Gillette first began taking Mirapex, or its generic version, in the early 2000s. Over the years, her doctor periodically increased her dosage as the medication became less effective. After a large dosage increase in 2010, Gillette began to exhibit compulsive behavior, especially gambling. By 2012, her gambling was out of control: she often stayed at casinos for days, stopped associating with family and friends, and neglected her hygiene. To fuel her gambling, Gillette eventually made an early withdrawal of $104,001 from her IRA, less than two years before she could do so without penalty. Ms. Gillette claimed that she should not be assessed the early withdrawal penalty because of her disability (§72(t)(2)(A)(3)).

Compulsive gambling was “remediable.” Under §72(m)(7), a person is “disabled” if she is “unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.” Even if Ms. Gillette suffered from a condition that would otherwise satisfy that definition of disability, the court concluded that she did not qualify for the exception because her impairment was “remediable” (see §1.72-17A(f)(4)). An impairment is remediable if, “with reasonable effort and safety” it can be “diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.” The record suggests that Gillette’s condition did not prevent her from engaging in her “customary or any comparable substantial gainful activity” in 2012. She continued to operate her rental property business and still reported $126,465 in profit from the business on her tax return. She received treatment for compulsive gambling in a reasonable and safe manner with the help of her family and doctors without interrupting her rental property business. Thus, Ms. Gillette was not disabled by compulsive gambling in 2012 and the early withdrawal penalty applied.

Exception #3. IRA Distribution Taxable and Subject to 10% Penalty
(Christopher Totten, pro se v. Comm., TSCS 2019-1)

On his 2010 return, Christopher Totten reported an IRA distribution of $43,503. However, Totten reported the IRA distribution as a nontaxable rollover on his 2010 return. Section 408(d)(1) provides that any amount paid or distributed out of an IRA is included in the gross income of the payee or distributee as provided under §72. An amount will not be treated as a taxable distribution from an IRA if it is a qualified rollover (§408(d)(1), (3)). A distribution is considered a qualified rollover distribution if the entire amount an individual receives is paid into a qualifying IRA or other eligible retirement plan within 60 days of the distribution (§408(d)(3)).

Totten testified that he used the funds to pay medical expenses. The IRA distribution did not, therefore, meet the requirements for a qualified rollover distribution.

10% penalty applies. Totten had not attained the age of 59½ when he received the distribution at issue. The IRA distribution was therefore an early distribution subject to the additional 10% tax. The additional
10% tax, however, does not apply for certain enumerated exceptions (§72(t)(2)). Totten asserted that the exceptions for a distribution attributable to the individual’s being disabled within the meaning of §72(m)(7) and a distribution made to an individual for medical care expenses apply to his distribution (§72(t)(2)(A) (iii), (B)). Section 72(m)(7) provides that a person shall be considered “disabled” if “he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.” Although Totten submitted evidence that sufficiently proved that, during 2010, he had a serious medical illness, he was employed full-time throughout the year as a medical sales representative. Totten was therefore not “disabled” within the meaning of §72(t)(2)(A)(iii). The 10% penalty applies.

Exception #5. Determination of Substantially Equal Periodic Payments (IRS Notice 2022-6)

Payments in a series are considered substantially equal periodic payments ((§72(t)(2)(A)(iv)) if they are determined in accordance with one of the three methods described below:

Required minimum distribution method. The annual distribution is determined by dividing the account balance by the number of years from the chosen life expectancy table. Under this method, the annual amount must be recalculated annually.

Fixed amortization method. The annual distribution is determined as the amount that will result in level amortization of the account balance using the chosen life expectancy table and a chosen interest rate. Under this method, the annual amount does not change.

Fixed annuitization method. The annual distribution is determined as the present value of an annuity of $1 per year beginning at the employee’s age and continuing for the life of the employee using an annuity factor derived from IRS mortality tables. Under this method the annual amount does not change.

A one-time change from the fixed amortization method or the fixed annuitization method to the required minimum distribution method is permitted to determine the payment for the distribution year of the switch and all subsequent distribution years.

Exception #6. No Exception to 10% Early Withdrawal Penalty Even If the IRA Withdrawal Is Taken to Satisfy a Divorce Court Order (IRA FAQs - Distributions)

The 10% additional tax for taking an early division of a traditional IRA applies even if the withdrawal is taken to satisfy a divorce court order (§72(t)). Unlike distributions made to a former spouse from a qualified retirement plan under a QDRO, there is no “divorce” exception to the 10% additional tax on early distributions from IRAs.

Use trustee-to-trustee transfer for court-ordered amounts. The only divorce-related exception for IRAs is if the account owner transfers his or her interest in the IRA to a spouse or former spouse, and the transfer is under a divorce or separation instrument (§408(d)(6)). However, the transfer must be done by:

1. changing the name on the IRA from the account owner’s name to that of his or her former spouse (if transferring the entire interest in that IRA), or

2. a trustee-to-trustee transfer from the account holder’s IRA to one established by the former spouse.

Sixty-day rollover rules didn’t apply. An indirect rollover didn’t qualify as a transfer to the former spouse even if the distributed amount was deposited into the former spouse’s IRA within 60 days.
Exception #6. IRA Distribution Not Made Pursuant to a QDRO ([Jeremy Summers v. Comm., TCM 2017-125])

On Mar. 18, 2013, Jeremy Summers filed a petition for dissolution of marriage. At that time, he had an IRA that he believed should be split 50-50 with his wife, Karie. His petition for divorce accordingly requested that “[t]he proceeds of IRA should be divided 50% to Petitioner and 50% to Respondent.” To accomplish the division of the IRA, Jeremy withdrew the total proceeds of the IRA, $17,378. He deposited a check in that amount in a Bank of America checking account that he and Karie jointly held. The next day he wrote a check for $8,618 to pay off Karie’s obligation on a car loan. He later transferred another $71 to her to ensure that she received her full 50% interest in the IRA.

1099-R triggered a document matching notice. On his 2013 tax return, Jeremy reported the IRA distribution as taxable but did not report any “additional tax” attributable to the fact that it was an early distribution. The IRS received from Edward D. Jones & Co. a Form 1099-R reporting the $17,378 distribution as an “early distribution, no known exception.” This triggered a document-matching audit. The IRS issued a deficiency notice determining that Jeremy was liable for the 10% additional tax under §72(t)(1).

Without a QDRO, penalty applies. Jeremy argued that the penalty did not apply because the distribution was made “to an alternate payee pursuant to a qualified domestic relations order” and thus was excepted from penalty under §72(t)(2)(c). Jeremy did not qualify for this exception to the penalty:

1. The IRA distribution was made directly to Jeremy and not to “a former spouse * * * who is recognized by a domestic relations order as having a right to receive” a share of the proceeds (§414(p)(8)); and

2. The distribution was not made “pursuant to a qualified domestic relations order.” The requirements of the QDRO provisions must be “rigidly observed” because they “relate to the substance or essence of the statute.”

Exception #7. IRA Early Distribution for Economic Hardship Subject to Penalty ([Candace Elaine v. Comm., TCM 2017-3])

In June 2009, Candace Elaine was laid off from her job of 23 years as a call center manager with a mutual fund company. At that time and during the year in issue, Ms. Elaine was a single mother, raising two daughters on her own without support from anyone else. On account of the then economic downturn, she was unable to find another job, and she remained unemployed until approximately 2014. Consequently, in order to provide for her own subsistence and that of her daughters, Ms. Elaine made a series of withdrawals from her IRA totaling $119,000. At the close of that year, she was under 59½ years of age.

Penalty applies even if economic hardship. Economic hardship is not an exception to the early withdrawal penalty imposed under §72(t). Although Ms. Elaine said that she used some of the distributions for medical expenses and to pay off student loans, she did not provide any substantiation of her claims.

Exception #7. No Hardship Exemption for Attorney’s Distribution Even If She Was Laid Off ([Molly and Jonathon Woll v. Comm., Docket No. 7024-20 (USTC Apr. 29, 2021)])

Molly Woll is an attorney licensed in Minnesota. In 2017, Ms. Woll was laid off by her employer, Thompson-Reuters. This resulted in a termination of her 401(k) savings plan, which at the time had more than $86,000 in it. Of the $86,000 that Ms. Woll pulled out of the 401(k) plan, the Wolls spent $39,000 on living expenses. The Wolls reported the early distribution as income but claimed a hardship exemption for the §72(t) penalty. There is no hardship exception to the early withdrawal penalty. The distribution was subject to the 10% penalty.
Also see.

*Richard and Beverly Fann v. Comm.*, TCS 2017-43, where the IRA distribution was subject to the early withdrawal penalty even though Mrs. Fann’s unemployment created a financial hardship. The medical expense exception to the 10% penalty provided under §72(t)(2)(B) did not apply since the Fanns’ medical expenses did not exceed 7.5% of their AGI.

*David Pritchard v. Comm.*, TCM 2017-136, where the taxpayer argued that the court should grant an exception to the early distribution penalty when the taxpayers used a retirement distribution to pay outstanding federal and/or state income tax liabilities; the court declined since there was not an IRS levy with respect to Mr. Pritchard’s retirement plan.

### CASES AND RULINGS — EXCEPTIONS FOR IRAS ONLY

#### Exception #3. Distribution From 401(k) Subject to 10% Penalty *(Lily Hilda Soltani-Amadi and Bahman Justin Amadi v. Comm.*, TCS 2019-19)*

During 2015, Lily Hilda Soltani-Amadi worked for the state of New York and participated in a §401(k) retirement plan. In 2015, the Amadis entered into a contract to purchase their first home. In order to help finance the down-payment for its purchase, Ms. Soltani-Amadi requested a distribution of $6,686 from her §401(k). On their 2015 return, they did not include in income the distribution from §401(k), nor did they treat the distribution as an early distribution from a retirement plan or report additional tax pursuant to §72(t). The IRS examined the Amadis’ 2015 return and ultimately issued a notice of deficiency attributable to (1) the $6,686 distribution from Ms. Soltani-Amadi’s §401(k) plan and (2) a 10% additional tax on the distribution pursuant to §72(t).

Of course, a distribution from a §401(k) retirement plan is fully taxable pursuant to §72 because the participant’s contributions to the plan are made with “pre-tax dollars.” But what about the penalty for early withdrawal? Isn’t there something about a house down-payment? Yes, but only distributions from IRAs (§72(t)(2)(F)). An early distribution from a §401(k) plan is subject to a 10% penalty even though the funds were used for a first-time home purchase.

### OTHER DISTRIBUTION RULES

#### Hardship Distribution Rules Changed Again (SECURE 2.0)

A retirement plan may, but is not required to, provide for hardship distributions. Many plans that provide for elective deferrals provide for hardship distributions. Thus, 401(k) plans, 403(b) plans, and 457(b) plans may permit hardship distributions.

Rules changed beginning in 2019. Some plans allow a hardship distribution only after the maximum available 401(k) loan has been taken and may prohibit new contributions to the plan for up to six months after the hardship distribution. For plan years beginning in 2019, *The Bipartisan Budget Act of 2018* repealed the six-month prohibition on contributions after a hardship withdrawal. It also repealed the requirement that the account owner must take available loans before a hardship distribution.

**Tax practitioner planning.** It’s up to the employer to adopt and amend the plan. The employer is not required to change its plan.
Guidance on Safe-Harbor Hardship Distributions From 401(k) (FAQs, updated Apr. 18, 2023; TE/GE-04-0217-0008)

Generally, §401(k) plans may provide that an employee can receive a distribution of elective contributions from the plan on account of hardship. A distribution is made on account of hardship only if the distribution is made on account of an “immediate and heavy financial need” of the employee and is necessary to satisfy the financial need (§1.401(k)-1(d)(3)(i); §1.401(k)-1(d)(3)(iii)(B)).

A distribution is deemed to be on account of an “immediate and heavy financial need” if it is for one or more of the following:

- Expenses for medical care deductible under §213(d) for the employee or the employee’s spouse, children or dependents (as defined in §152), or primary beneficiary under the plan;
- Costs directly related to the purchase of a principal residence;
- Payment of tuition, related educational fees, room and board expenses for up to the next 12 months of post-secondary education for the employee or the employee’s spouse, children or dependents, or primary beneficiary under the plan;
- Payments necessary to prevent the eviction of the employee from the employee’s principal residence or foreclosure of the mortgage on that residence;
- Payments for burial or funeral expenses for the employee’s deceased parents, spouse, children or dependents, or primary beneficiary under the plan; and/or
- Expenses for the repair of damages to the employee’s principal residence that would qualify for the casualty deduction under §165. For this purpose, the new limitations suspending deductions for personal casualties (§165(h)(5)) do not apply.

Employer’s reliance on employee representations. A distribution qualifies if the employee represents that the need cannot be met by insurance, reasonable liquidation of assets, cessation of deferrals, or by borrowing from commercial sources at reasonable commercial terms. Under SECURE 2.0 employees can self-certify they had an event qualifying for a hardship distribution. We suggest an employee sign a statement stating that he/she meets all of the hardship distribution requirements.

Tax practitioner planning. Hardship distribution does not mean penalty-free. If all of the above are met, the employee pays ordinary income tax and a 10% penalty on the amount of the hardship. The employee will receive a Form 1099-R, which is used to report the distribution on her or his personal tax return and on Form 5329. The only exception to the 10% penalty is for deductible medical expenses.

RULES ON LOANS TO PARTICIPANTS §4975

Qualified Plan Loans Fast Facts

Twenty percent of active participants in 401(k)-type plans have outstanding loans in any given month. Over a five-year period, 40% of participants borrow from their plans. The average loan balance is $7,860. 401(k)

loans normally must be repaid in full within 60 days of an employee terminating employment. Loan defaults are taxed as a deemed distribution under §72(p) and are subject to the §72(t) early withdrawal penalty, if applicable. Statistics show that almost 86% of employees who leave their jobs default on their 401(k) loans, and then come the unintended tax consequences.

**Loans from Qualified Retirement Plans Subject to Amount and Time Limitations (§72(p). Retirement Plans FAQs Regarding Loans, Updated Apr. 18, 2023)**

Generally, loans from qualified employer plans are treated as distributions from the plan (§72(p)(1)(A)). Distributions from a qualified employer plan are taxable to the distributee in the distributee's taxable year in which the distribution occurs, pursuant to §72 (§402(a); *Prince v. Comm.*, TCM 1997-324). However, a loan will not give rise to a deemed distribution to the extent that the loan (when added to the outstanding balance of all other loans from the plan) does not exceed the lesser of:

1. $50,000 (reduced by the excess, if any, of the highest outstanding balance of loans from the plan during the one-year period ending on the day before the date on which the loan was made, over the outstanding balance of loans from the plan on the date on which the loan was made); or

2. The greater of one-half of the present value of the participant’s “nonforfeitable accrued benefit” under the plan or $10,000 (§72(p)(2)(A)).

But the above exception does not apply unless:

1. The loan, by its terms, is required to be repaid within five years (§72(p)(2)(B)); and

2. “Substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan” (§72(p)(2)(c)). One exception to the five-year repayment requirement is when the loan proceeds are used to “acquire any dwelling unit . . . as the principal residence of the participant” (§72(p)(2)(B)(ii)).

Therefore, loans must be repaid on a periodic basis, at least quarterly or each month. These payments must be in equal amounts and generally must be made through payroll deductions. Plans can provide a grace period for late payments before the loan defaults.

**Exceptions.** In addition to the exception for the purchase of a principal residence (any reasonable period allowed), participants engaged in military service and participants taking a leave of absence without pay may be exempt. For example, plans can suspend the repayment requirement while a person is serving in the military and can then extend the five-year term by tacking on the time allowed without repayment. For persons on a leave of absence, the plan can suspend payments for up to one year but cannot extend the overall five-year term. Participants must make up the missed payments either by increasing their periodic payments or by making a lump-sum payment at the end of the term.

**Loans in default are deemed distributions.** A loan that is in default is generally treated as a taxable distribution from the plan of the entire outstanding balance of the loan (a deemed distribution). The plan’s terms will generally specify how the plan handles a default. A plan may provide that a loan does not become a deemed distribution until the end of the calendar quarter following the quarter in which the repayment was missed (§1.72(p)-1, Q&A-10(a)). A deemed distribution is treated as an actual distribution for purposes of determining the tax on the distribution including any penalty. A deemed distribution is not treated as an actual distribution, so it is not eligible to be rolled over into an eligible retirement plan.
Plans often require full loan repayment if the participant leaves the company. If there is a default, or if the participant does not repay the loan in full on termination of employment, the unpaid balance of the loan is treated as a deemed distribution to the participant that is taxable income. A plan may provide that if a loan is not repaid, the participant’s account balance is reduced by the unpaid portion of the loan. This is referred to as a qualified plan loan offset (QPLO) amount. The QPLO is treated as an actual distribution for rollover purposes. A QPLO amount is defined as a plan loan offset amount that is treated as distributed from a qualified retirement plan, a §403(b) plan, or a governmental §457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee’s severance from employment.

The TCJA extended the period during which a QPLO amount may be contributed to an eligible retirement plan as a rollover contribution from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan offset occurs — that is, the taxable year in which the amount is treated as distributed from the plan.

The plan must specifically authorize participant loans. However, plans that make loans but do not authorize loans can be amended retroactively. Plans must also state the minimum and maximum loan amounts, the number of loans permitted for one participant, repayment terms, interest rate, security required for the loan, and the need for spousal consent. A plan violates the prohibited transaction rules if the plan makes a loan without security.

Refinancing of qualified plan loans may be trouble, trouble, trouble. In the event a loan that satisfies §72(p)(2) is replaced by a loan that has a later repayment date, both loans are treated as outstanding on the date of the transaction (§1.72(p)-1, Q-20, A-20(a)(2)). If the sum of both loans, as well as all other outstanding loans, exceeds the limit of §72(p)(2)(A), then the replacement loan results in a deemed distribution in the amount above that limit.

IRA-based retirement plans cannot make loans to plan participants. Most, but not all, types of retirement plans can make loans to plan participants. Qualified §401(a) plans (including §401(k) plans, profit-sharing plans, and defined benefit plans), certain §403(a) and §403(b) annuity plans, and eligible §457(b) governmental deferred compensation plans can make participant loans. But plans prohibited from making participant loans include individual retirement accounts (both traditional and Roth) and IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRAs.

What happens if a loan is taken from an IRA-based plan? If the owner of an IRA-based plan borrows from the IRA, the IRA is no longer an IRA, and the value of the entire IRA is included in the owner’s income (§408(e)(2) and (3)). If the owner of an IRA pledges part of the IRA as collateral, the part of the IRA that is pledged is treated as distributed (§408(e)(4)).

Plan Loans Require Documentation

Retirement plans (e.g., profit-sharing, money purchase, §401(k), §403(b), and §457(b) plans) may offer loans to their qualified participants.

Tax practitioner planning. IRAs and IRA-based plans (SEP, SIMPLE IRA, and SARSEP plans) cannot offer participant loans. A loan from an IRA or IRA-based plan is a prohibited transaction.

A plan sponsor, in paper or electronic format, for each plan loan granted to a participant must:

- Maintain evidence of the loan application, review, and approval process,
- Retain an executed plan loan,
• If a participant requests a loan to buy or contract a primary residence with a repayment period longer than five, the plan sponsor must obtain documentation of the home purchase before the loan is approved,

• Keep evidence of loan repayments, and

• Maintain evidence of collection activities associated with loans in default and the related Forms 1099-R, if applicable.

Tax practitioner planning. A few missed payments on a 401(k) loan can result in a deemed distribution. This is “borrower beware” tax law.

Failure to Make Timely Payment on Plan Loan Results in Taxable Deemed Distribution (Gerard and Regina McEnroe v. Comm., TCS 2019-21)

In July 2014, Gerard McEnroe borrowed $26,045 from his New York City Employees Retirement System (NYCERS) retirement account to help pay college tuition expenses for one of his children. He immediately began to repay the loan through biweekly payroll withholding. On May 15, 2015, Mr. McEnroe left his job for a job in the private sector. He quickly grew disillusioned with his new position, however, and returned to the city job in September 2015. Mr. McEnroe did not make loan payments to NYCERS after he left in May. When he returned in September, Mr. McEnroe learned that NYCERS determined that his outstanding loan balance would be treated as a distribution. He began payments again in December.

Failed to make payment over six-month period and didn’t catch up late missed payments. Mr. McEnroe failed to make loan payments that were due over a roughly six-month period stretching from June to December 2015. Because he first defaulted in June 2015, which falls in the second calendar quarter, a grace period, if any, would have been required to expire no later than Sep. 30, 2015, the last day of the third calendar quarter (§1.72(p)-1, Q&A-10(a)). Mr. McEnroe did not resume making loan payments, however, until December 2015. Moreover, when he did resume making loan payments, he did not cure the earlier default by remitting the amount of the missed payments plus accrued.

Default was taxable. The court decided that NYCERS properly conclude Mr. McEnroe defaulted on the loan during the year in issue and correctly reported his entire loan balance at the time of the default ($22,284) as a deemed distribution.

Also see.

Louelia Salomon Frias and Mervyn Gil Salomon v. Comm., TCM 2017-139, where missed payments on a 401(k)-loan resulted in deemed distribution.

Gregory Gowen v. Comm., TCS 2017-57, where a CPA’s default on his 401(k) loan resulted in deemed distribution.

PROHIBITED TRANSACTIONS (§4975)

Tax on Prohibited Transactions, Updated Apr. 12, 2023

Certain transactions between a disqualified person and a qualified plan may be subject to a two-tiered excise tax on prohibited transactions. First, a tax equal to 15% of the amount of the prohibited transaction is
due for each year (or part thereof) in the taxable period. Second, if the transaction is not corrected within the taxable period, a tax equal to 100% of the amount involved is assessed.

These excise taxes are collected from the disqualified person(s) who participated in the prohibited transaction.

**Prohibited transactions defined.** Prohibited transactions between a disqualified person and a plan include, but are not limited to, any direct or indirect:

1. Sale, exchange, or lease of property,
2. Loan or extension of credit,
3. Furnishing of goods, services, or facilities,
4. Transfer to or use by or for the benefit of the disqualified person of the income or assets of the plan,
5. Use of plan income or assets by a fiduciary for his or her own benefit or account, or
6. The receipt by a plan fiduciary of consideration for his or her own account from a party who is dealing with the plan in connection with plan income or assets (§4975(c)).

**Tax practitioner planning.** Prohibited transactions are not mutually exclusive; a transaction may fall within the parameters of more than one prohibited transaction type. These transactions show *per se* examples of the kind of self-dealing and participation that is prohibited. The fact that a transaction would qualify as a prudent investment when judged under the highest fiduciary standards is of no consequence.

**Disqualified person.** A disqualified person is a person with a close relationship to the plan, such as:

1. A fiduciary, including a person designated as a fiduciary by §405(c)(1)(B) of the Employment Retirement Income Security Act of 1974 (ERISA),
2. A person providing services to the plan,
3. An employer or employee organization, including a direct or indirect 50% (or more) owner of the employer or organization, whose employees or members are covered by the plan,
4. A member of the family of any individual disqualified person, including spouses, ancestors, lineal descendants, and spouses of lineal descendants,
5. A corporation, partnership, trust, or estate, of which 50% or more is owned by persons described in 1 through 3 above,
6. An officer, director, 10% (or more) shareholder, or highly compensated employee (earning 10% or more of the annual compensation of an employer) of any person described in 3 or 5 above, or
7. 10% (or more) partner or joint venturer of a person described in 3 or 5 above (§4975(e)(2)).

**Special rules for IRAs (§4975(c)(3); §408(e)(2)).** IRA account beneficiaries are generally exempt from the two-tiered excise tax on prohibited transactions. Instead, if an IRA beneficiary engages in a prohibited transaction with the IRA, the account ceases to be an IRA as of the first day of the taxable year in which the
prohibited transaction occurred. This makes the entire balance in the IRA immediately taxable and, if the owner does not meet an exception, subject to the 10% early withdrawal penalty.

SECURE 2.0 clarified that if a taxpayer has multiple IRAs, that only the IRA participating in the prohibited transaction is subject to the disqualification penalty.

IRS Reminds Taxpayers That “Collectibles” Cannot Be Held in a Retirement Plan (Investments in Collectibles in Individually Directed Qualified Plan Accounts (Updated Jan 6, 2023))

The acquisition by a self-directed account under a qualified plan of a “collectible” is treated as an immediate distribution in an amount equal to the cost to the plan of such collectible (§408(m)).

What is a collectible? Collectibles under §408(m)(2) include:

- Any work of art,
- Any rug or antique,
- Any metal or gem (with limited exceptions, below),
- Any stamp or coin (with limited exceptions, below),
- Any alcoholic beverage, or
- Any other tangible personal property that the IRS determines is a “collectible” (§408(m)).

Some exceptions apply. The following coins and metals are not included in the definition of “collectible” under §408(m):

- Certain gold, silver, or platinum coins described in 31 USC §5112 (§408(m)(3)(A)) for the full definition.
- Any coin issued under the laws of any state.
- Any gold, silver, platinum, or palladium bullion of a certain fineness if a bank or approved non-bank trustee keeps physical possession of it (§408(m)(3)).

Tax practitioner planning. Acquiring a collectible may also be a prohibited transaction under §4975(c). For example, the acquisition of artwork or rugs by a self-directed account for use in the participant’s own home is a prohibited transaction.

Owners of IRAs With Assets Invested in Gold and Silver Coins Can’t Store Them in A Safe at Their Home (Andrew and Donna McNulty v. Comm., US Tax Court, CCH Dec. 61,950,157 TC No. 10 (Nov. 18, 2021))

Andrew and Donna McNulty each established a self-directed IRA. Ms. McNulty directed the IRA to purchase American Eagle (AE) coins and took physical possession of the coins. The IRS determined, and the Tax Court agreed, that Ms. McNulty received taxable distributions equal to the cost of the AE coins the year she received physical custody of them. The court also found the McNultys liable for §6662(a) penalties for substantial understatements of income tax attributable to their failure to report taxable distributions from their IRAs.
**Self-directed IRA requirements.** A qualified custodian or trustee is required to be responsible for the management and disposition of property held in a self-directed IRA (§1.4082(e)). A custodian is required to maintain custody of the IRA assets, maintain the required records, and process transactions that involve IRA assets (§408(h) and (i); §1.408-2(e)(4), (5)(i)(2), (iii), (vii)). Independent oversight by a third-party fiduciary to track and monitor investment activities is one of the key aspects of the statutory scheme. When coins or bullion are in the physical possession of the IRA owner (in whatever capacity the owner may be acting), there is no independent oversight.

**Note.** This is a “Check Book IRA, LLC” scheme.

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**RETIREMENT PLAN RESOURCES**

**Extensive Retirement Plan Resources on IRS Website** ([Small Business Retirement Plan Resources](https://www.irs.gov/businesses/small-businesses-self-employed/small-business-retirement-plan-resources))

**Helping Taxpayers Choose, Maintain, and Operate a Plan**

- **Help With Choosing a Retirement Plan** - Provides resources to help compare retirement plan options.
- **Benefits to Starting a Retirement Plan** - Helps find the right retirement plan for retirement security.
- **File a Return or Report** - Learn about Form 5500 annual reports, participant notices, and more.
- **Penalty Relief Program for Form 5500-EZ Late Filers** - Available via a program that waives IRS late filer penalties for small employers.
- **A Plan Sponsor’s Responsibilities** - Learn how to keep retirement plans running smoothly.
- **Types of Plans** - See what the rules are for SIMPLE IRA, SEP, 401(k), and other plans.

**Checklists**

A series of IRS plan checklists may provide help to you in advising your small business clients on how to keep their plans in compliance.

- **401(k) Plan Checklist PDF**
- **SEP Plan Checklist PDF**
- **SIMPLE IRA Plan Checklist PDF**
- **SARSEP IRA Plan Checklist PDF**

**Correcting Plan Errors**

**Website guides on how to find, fix, and avoid making common mistakes in retirement plans.** Employers may choose from a variety of retirement plans for employees, including 401(k)s, SIMPLE IRAs, and SEP IRAs. The IRS recently added to its website guides intended to assist employers with plan administration issues. Each guide provides:

- an overview of the rules for each plan type,
- an overview of the IRS Employee Plans Compliance Resolution System,
• the most frequent errors found in each plan type,
• tips on how to find, fix, and avoid these errors,
• [Correcting Retirement Plan Errors](#) - IRS programs to help fix mistakes in a retirement plan, and
• Fix-It Guides - find and fix errors for SEP, SIMPLE IRA, SARSEP, and 401(k) plans.

Some exceptions. The 10-year distribution limit does not apply to “eligible designated beneficiaries.”

### APPENDIX. 2023 SIMPLE IRA VS. SEP IRA COMPARISON CHART

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<th>PROVISIONS</th>
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<th>SEP IRA</th>
</tr>
</thead>
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<tr>
<td>Eligible employers</td>
<td>Generally, 100 or fewer employees earning at least $5,000 in the prior year and no other retirement plan.</td>
<td>Any size employer.</td>
</tr>
<tr>
<td>Eligible employees</td>
<td>To be eligible, employee must have earned at least $5,000 of wages in any two prior years.</td>
<td>To be eligible, employee must have worked for three of the prior five years and have earned at least $750 (for 2023) of compensation in the current year.</td>
</tr>
<tr>
<td>Employee deferral limit</td>
<td>$15,500 ($19,000 if 50 or older) in 2023.</td>
<td>No employee deferral.</td>
</tr>
<tr>
<td>Employer contributions</td>
<td>3% of compensation if matching program. $15,500 employer contribution limit. 2% compensation if all eligible employees are covered. $6,600 ($330,000 x 2%) employer contribution limit. Catch-up contributions must be matched.</td>
<td>Up to 25% of compensation. Limited to $66,000 in 2023.</td>
</tr>
<tr>
<td>Catch-up contributions</td>
<td>$3,500</td>
<td>N/A</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>Elective deferral not subject to income tax but subject to FICA.</td>
<td>Contributions are from the employer and not subject to income or payroll taxes.</td>
</tr>
<tr>
<td>Deadline for establishing plan</td>
<td>October 1 of the plan year.</td>
<td>Due date of employer’s return including extensions for the plan year.</td>
</tr>
<tr>
<td>Plan year</td>
<td>Calendar year.</td>
<td>Employer’s tax year (includes fiscal year if non-model plan year adopted).</td>
</tr>
<tr>
<td>Early withdrawal penalties</td>
<td>10% early withdrawal penalty applies but increases to 25% penalty for withdrawals in the first two years after participation starts.</td>
<td>10% early withdrawal penalty applies.</td>
</tr>
<tr>
<td>Vesting</td>
<td>100%</td>
<td>100%</td>
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### APPENDIX. 2023 KEY RETIREMENT PLAN RULES

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<th>Maximum Contribution</th>
<th>Maximum Deduction</th>
<th>When to Set Up Plan</th>
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</thead>
<tbody>
<tr>
<td>SEP</td>
<td>Due date of employer’s return (including extensions).</td>
<td>Smaller of $66,000 or 25%&lt;sup&gt;6&lt;/sup&gt; of participant’s compensation, limited to $330,000 for 2023.</td>
<td>25% of all participants’ compensation ($330,000 for 2023).</td>
<td>Any time up to the due date of employer’s return (including extensions).</td>
</tr>
<tr>
<td>SIMPLE IRA and SIMPLE 401(k)</td>
<td>Salary reduction contributions: 30 days after the end of the month for which the contributions are to be made.</td>
<td>Employee contribution: Salary reduction contribution up to $15,500. $19,000 if age 50 or over. Employer contribution: Either dollar-for-dollar matching contributions, up to 3% of employee’s compensation,&lt;sup&gt;7&lt;/sup&gt; or fixed nonelective contributions of 2% of compensation ($330,000 for 2023).</td>
<td>Same as maximum contribution.</td>
<td>Any time between January 1 and October 1 of the calendar year. For a new employer coming into existence after October 1, as soon as administratively feasible.</td>
</tr>
<tr>
<td>Qualified Plan: Defined Contribution Plan</td>
<td>Elective deferral: Due date of employer’s return (including extensions).&lt;sup&gt;3&lt;/sup&gt; Employer contribution: Money Purchase or Profit-Sharing: Due date of employer’s return (including extensions).&lt;sup&gt;8&lt;/sup&gt;</td>
<td>Employee contribution: Elective deferral up to $22,500; $30,000 if age 50 or over. Employer Contribution: Money Purchase: Smaller of $66,000 or 100% of participant’s compensation. Profit-Sharing: Smaller of $66,000, or 100% of participant’s compensation.</td>
<td>25% of all participants’ compensation ($330,000 for 2023), plus amount of elective deferrals made.</td>
<td>By the end of the tax year unless only employer contributions, then any time up to the due date of employer’s return (including extensions).</td>
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<td>Qualified Plan: Defined Benefit Plan</td>
<td>Contributions must be paid in quarterly installments depending on the plan year, due 15 days after the end of each quarter.</td>
<td>Amount needed to provide an annual benefit no larger than the smaller of $265,000 or 100% of the participant’s average compensation for his or her highest three consecutive calendar years.</td>
<td>Based on actuarial assumptions and computations.</td>
<td>Any time up to the due date of employer’s return (including extensions).</td>
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<sup>6</sup> Net earnings from self-employment must take the contribution into account.

<sup>7</sup> Under a SIMPLE 401(k) plan, compensation is generally limited to $330,000 in 2023.

<sup>8</sup> Certain plans subject to Department of Labor rules may have an earlier due date for salary reduction contributions and elective deferrals.
Client Letter with Retirement Planning Ideas and Suggestions

Dear Client and Friend,

As work, bosses, co-workers, and commutes overwhelm us, retirement looks especially good. Here are some general retirement planning ideas to help minimize taxes and maximize retirement income:

1. Contribute to tax-advantaged retirement accounts: Maximize contributions to employer-sponsored plans like 401(k)s or 403(b)s. Consider contributing to Individual Retirement Accounts (IRAs) such as Traditional IRAs or Roth IRAs, depending on your eligibility and tax situation. Take advantage of catch-up contributions if you’re age 50 or older. 2023 contribution amounts are [here](#).

2. Understand tax brackets and income sources: Plan your withdrawals strategically to manage your income within favorable tax brackets. Diversify your retirement income sources (e.g., Social Security, pensions, investments) to have flexibility in managing taxable income. See 2023 federal tax brackets [here](#).

3. Roth conversions and distributions: Consider converting a portion of Traditional IRA funds to a Roth IRA to potentially reduce future tax liabilities. A conversion from a traditional IRA to a Roth IRA is a taxable event. Consult us for the tax cost of this idea. Because Roth IRA distributions are generally tax free, strategize Roth IRA distributions to minimize taxes on investment gains and other taxable income. See IRS information on Roth IRAs [here](#).

4. Manage Required Minimum Distributions (RMDs): Understand RMD rules and deadlines to avoid penalties. Consider using qualified charitable distributions (QCDs) to fulfill RMDs while reducing taxable income. See IRS information on RMDs [here](#) and see Fidelity Investments information on QCDs [here](#).

5. Utilize tax-efficient investment strategies: Optimize your investment portfolio for tax efficiency by considering tax-efficient funds and minimizing taxable events. Understand the tax implications of different investment types (e.g., stocks, bonds, mutual funds) and asset location (e.g., tax-advantaged accounts versus taxable accounts).

6. Health savings accounts (HSAs): Contribute to an HSA if eligible, as it offers triple tax advantages (tax-deductible contributions, tax-free growth, and tax-free withdrawals for qualified medical expenses). Maximize HSA contributions and consider letting the funds grow for retirement healthcare expenses.

7. Long-term care planning: Evaluate long-term care insurance options to mitigate potential healthcare costs in retirement. Explore hybrid insurance products that combine long-term care coverage with other benefits or investment features.

8. Stay updated on tax law changes: Keep informed about any changes in tax laws and retirement regulations that may impact your planning. Consult with our office and with your financial advisor to understand the latest strategies and opportunities. See Kiplinger’s Summary of new retirement rules enacted in December 2022 [here](#).

Remember, these are general ideas, and the effectiveness of specific strategies may vary depending on your individual circumstances. It’s always advisable to consult with our office so that we can provide personalized guidance based on your unique financial situation and the latest tax laws.

Regards,
# 2023 Federal Tax Update
## Real Estate Taxation & Investments

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CHAPTER THREE HIGHLIGHTS

- Tax Issues for Online Rentals
- Depreciation and Cost Segregation
- IRS Keeps Intense Audit Pressure on Passive Activities, Especially on Real Estate Professionals
- Tax Deferred Exchanges for Real Property Only
- Determining If Property Is Dealer or Investor Property
- Foreclosures and COD Income and Exclusions
- §121 Exclusion on Principal Residence Continues to Hold Up
- Monetized Installment Sale Transactions

ONLINE RENTALS (AIRBNB, ONE FINE STAY, HOME AWAY, VRBO)

Online rental sites allow “hosts” to list their properties securely and reach a broad audience while providing “guests” a choice of various accommodations all over the world, from a single room in a residence to an entire house or villa. Offering a wide range of lodging at a variety of price points, the popularity of online rentals has grown significantly since Airbnb was founded in 2008.

Other online services following this same model include Onefinestay and VRBO.

Taxable Income - Maybe Not!

The 14-day-or-fewer rule. According to §280A(g), if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for fewer than 15 days during the taxable year, then the income derived from such use for the taxable year shall not be included in the gross income of such taxpayer under §61.

Tax practitioner planning. Often known as “the Masters’ Rule,” homeowners in locations where major sporting events occur have used this technique for years. In addition, taxpayers receiving remuneration from a film or television crew often have the contract drawn as a “rental agreement” to avoid tax on the income.

Is It Your Personal Residence?

If the dwelling isn’t a personal residence, then the rules under §469 for rental real estate activities apply. Report the activity on Schedule E, applying the passive activity loss rules in §469.

I’m renting out my personal residence - now what? Now, §280A applies for rental of a personal use asset. If the taxpayer rents out the entire dwelling unit, treat the property the same as a vacation rental under §280A, allocating expenses to personal and rental use, then limiting deductions to total rent received. If the taxpayer is renting only a part of the dwelling unit (i.e., a room in the house), divide expenses between the part of the property used for rental purposes and the part used for personal purposes as though it were two separate pieces of property. Report the rental income and rental portion of the expenses (including depreciation) on Schedule E.
Tax practitioner planning. If §280A applies to an activity, report it on Schedule E. Even if the average stay was seven or fewer days, this is not a trade or business activity, nor is it a rental activity. It is the rental of a dwelling unit that you used as a home, and that is always reported on Schedule E.

Tax practitioner planning. If the taxpayer is renting only a room or portion of the personal residence, further limitations apply under §280A if the room is not kept exclusively for rental use.

But I Don’t Own the Home, I’m A Tenant

The rules for reporting rental income, whether short-term or long-term, and the application of §280A for business use of a home apply to both property owners and to tenants “subletting” their homes. Moreover, taxpayers who do not own the property should be cautioned to review the terms of their leases. Arrangements with Airbnb may violate the terms of their rental contracts and subject them to eviction.

What About Occupancy Taxes?

With most services, including Airbnb, the “host” (property owner) is responsible for determining if occupancy taxes are applicable. Some Airbnb hosts may have one of the following ways to handle occupancy tax.

In some locations, like Portland and San Francisco, Airbnb collects occupancy tax from guests and sends it to the tax authority on the hosts’ behalf, with no action needed from the host.

You can confirm if this option is available in your area: In what areas is occupancy tax collection and remittance by Airbnb available?

In other locations, like Washoe County, Nevada, hosts have the option to turn on a feature called Opt-in for Host Remittance of Taxes. Hosts who opt-in instruct Airbnb to turn on collection of occupancy taxes for their listing. The occupancy tax amounts paid by guests will be included in payouts to the host’s default payout method. Hosts are solely responsible for sending the occupancy tax amounts directly to the tax authority.

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<td>Not Personal Residence¹</td>
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<tr>
<td>Rented fewer than 15 days in entire year</td>
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<tr>
<td>Deductions limited?</td>
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<tr>
<td>Passive rules apply?</td>
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<tr>
<td>Average stay seven or fewer days</td>
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<td>Average stay more than seven days</td>
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1. Property used personally less than the greater of (1) 14 days or (2) 10% of total number of days rented at fair market rent.

2. Property used personally more than the greater of (1) 14 days or (2) 10% of total number of days rented at fair market rent.

3. The IRS is clear that these should report on Schedule E. However, §469(I) allowance for $25,000 losses from actively managed rental real estate does not apply.
IRS Clarifies Some Items For “Short-Term Stay” Properties (CCA 20215105)

On Dec. 23, 2021, the IRS released a CCA to address two issues regarding rental property where the average stay is seven days or fewer. The two items covered were passive losses under IRC §469 and self-employment taxes under IRC §1402.

**Passive or Not Passive?** Under §469(c), a passive activity is generally any trade or business activity in which the taxpayer does not materially participate or any rental activity. Treas. Reg. §1.469-1T(e)(3)(iii)(A) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if for the taxable year the average period of customer use for the property is seven days or less. Under §469(h), a taxpayer materially participates in a trade or business activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. In the case of individuals, Treas. Reg. §1.469-5T provides seven tests for material participation. In particular, Treas. Reg. §1.469-5T(a)(1) provides that an individual will generally be treated as materially participating in an activity for a taxable year if the individual participates in the activity for more than 500 hours during such year.

Therefore, while a short-term-stay property does not meet the per se definition of passive because it is not a rental activity, it may still be passive if the taxpayer does not materially participate.

**Self-employment tax?** Treas. Reg. §1.469-1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income or passive activity deductions does not affect the treatment of items of income or deduction under provisions of the Code other than §469. Therefore, whether amounts are passive activity gross income under Treas. Reg. §1.469-2T(c) or passive activity losses under Treas. Reg. §1.469-2T(b) is not determinative of whether those amounts are rentals from real estate under §1402(a)(1) and Treas. Reg. §1.1402(a)-4.

Section 1402(a) provides that the term “net earnings from self-employment” (NESE) means the gross income derived by individuals from any trade or business they carry on, less the deductions that are attributable to such trade or business. However, under §1402(a)(1), rentals from real estate, together with deductions properly deductible and attributable to the rentals from real estate (collectively, “net rental income”), are excluded from NESE, unless these amounts are received in the course of a trade or business as a real estate dealer.

Treas. Reg. § 11402(a)-4(c)(1) provides that rentals from living quarters, where no services are rendered for the occupants, are generally considered rentals from real estate under §1402(a)(1), except in the case of real estate dealers. However, Treas. Reg. §1.1402(a)-4(c)(2) provides,

“Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant . . . are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.”

**Example 1.** Sharon is an individual who directly and solely owns and rents, in the course of a trade or business, a fully furnished vacation property via an online rental marketplace. Sharon is not a real estate dealer within the meaning of Treas. Reg. § 1.1402(a)-4(a). She provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. In addition, Sharon provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest business district. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not
considered a rental activity for purposes of §469 pursuant to Treas. Reg. §1.469-1T(e)(3)(ii)(A). In addition, Sharon materially participates in the activity within the meaning of §469(h)(1) and Treas. Reg. §1.469-5T and, therefore, the activity is not a passive activity within the meaning of §469(c).

The net rental income is not excluded from NESE under §1402(a)(1) because Sharon provides substantial services beyond those required to maintain the space in a condition suitable for occupancy.

Example 2. Karen is an individual who directly and solely owns and rents, in the course of a trade or business, a fully furnished room and bathroom in a dwelling via an online rental marketplace. Karen is not a real estate dealer. Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. Karen cleans the room and bathroom in between each occupant’s stay. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of §469 pursuant to Treas. Reg. §1.469-1T(e)(3)(ii)(A). In addition, Karen materially participates in the activity within the meaning of §469(h)(1) and Treas. Reg. §1.469-5T, and, therefore, the activity is not a passive activity within the meaning of §469(c).

The net rental income is excluded from NESE under §1402(a)(1) because Karen does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy.

**IRS Revises Tax Topic for Renting Residential and Vacation Property**

IRS has updated its online Tax Topic No. 415 (Reviewed or Updated 04-Apr-2023) regarding renting residential and vacation properties. The topic clarifies the personal use rules, minimal rental use exception, and how to divide expenses between rental and personal use.

**Taxpayers Fail to Properly Allocate Expenses (Charles and Amy Lin, pro se, v. Comm. TCM 2023-37)**

In 2019, Charles and Amy Lin rented a room in their home to a close friend who needed a place to stay for ten months before returning to Taiwan. They charged the tenant a modest rent of $300 per month, yielding total rental income of $3,000.

The tenant occupied a bedroom on the basement level of the Lins’ home with an adjoining bathroom and also had use of a kitchen. Other rooms in the basement included a utility room, a recreation room, a storage room that housed air conditioning equipment serving the entire house, and a second storage room. The Lins used the second storage room, and the tenant temporarily stored some luggage there.

On their originally filed return, the Lins offset expenses of $11,034 (100% of insurance and property taxes) against the $3,000 of rental income. Under examination by IRS, they later amended the return to include additional expenses of $22,729, of which $17,051 was depreciation. Because the Lins failed to provide the Court with square footage information, the Tax Court disallowed all of the additional expenses on the amended returns. However, the original loss of $8,034 was left undisturbed by the Court because it was not disallowed by IRS in its audit.
Vacation Homes

Vacation Losses

Section 280A provides that where a dwelling unit is used by a taxpayer as a residence, the taxpayer cannot claim a net rental loss. In this case, deductions attributed to rental use are limited to the excess of gross rental income over the portion of the expenses otherwise allowable (such as mortgage interest and taxes which are allowable without regard to their connection to a business or investment) that are attributable to the rental activity. If the property is not used as a personal residence, all of the rental-related expenses, subject to the passive activity and at-risk rules, are deductible.

Number of days rented impacts deductibility of rental expenses. Whether or not taxpayers may deduct rental-related expenses depends on whether or not the property is used as a residence by the taxpayer during the year. A property is used as a residence if the taxpayer personally used the property more than the greater of 14 days or 10% of the total days it was rented to others at fair rental value (§280A(d)(1)).

Rent income may be tax-free. If the property was used as a personal residence and was rented for 14 days or less during the year, no rental income or expense reporting is required. Any rent income received is nontaxable, regardless of amount. Any related expenses are only allowed as itemized deductions (e.g., mortgage interest, property taxes, and casualty losses).

What are personal use days? A personal use day includes any day, or part of a day, that the property was used by:

- the owner for personal purposes,
- any other person for personal purposes if that person owns part of the property,
- any family member of the owner(s) unless rented for use as the family member’s main home at fair rental value,
- anyone who pays less than fair rental value, and
- anyone under an agreement that allows the owner to use other property.

At the urging of the US Treasury Inspector General for Tax Administration, the IRS now requires taxpayers to report the number of days per year that each rental property is rented at fair rental value and the number of days of personal use.

Tax practitioner planning. Personal use does not include days where the owner worked substantially full-time repairing or maintaining the property, even if family members simultaneously used the property for recreation purposes. Personal use also does not include days where the owner used the property as a primary residence before or after renting it or offering it for rent as long as the property was rented, or tried to be rented, for at least 12 consecutive months, or a period of less than 12 consecutive months if the property was sold or exchanged at the end.

Limiting Deductions Under §280A

Deductions for vacation homes cannot exceed gross rent for the year. Gross rent includes both fair market rent and below-market rent received. Expenses must first be divided into personal use and rental use. Rental use deductions are calculated based on the ratio of the number of days rented at fair market rent over the total number of days the dwelling was used for any purpose.
In determining the number of rental days, include any day the dwelling was rented at fair market rent, even if the taxpayer used it that day. Do not include any day the dwelling was available for rent but not actually rented.

**Caution!** This definition of the total rental days is different for calculating deductions than the definition for determining personal use for the vacation home limitation.

That ratio is applied to all expenses of the dwelling unit, except those directly attributed to renting the property (i.e., rental commissions and advertising) (Prop. Reg. §1.280A-3).

**Ordering Deductions**

Deductions (after applying the rental ratio) are allowable in the following order:

1. Deductions otherwise allowed under the Code even if not for trade or business use (i.e., mortgage interest and property taxes).
2. Deductions allowed for rental use of a dwelling unit.
3. Depreciation and amortization.

**Carryforward disallowed losses from a vacation rental into the next year.** The carryforward expenses are deductible only against the same property’s income in the subsequent year, regardless of whether the taxpayer had any personal use in the following year.

**Example.** Karen owns a lakeside home, which she rents at a fair rental for 90 days during the taxable year. Karen uses the home for personal purposes on 20 other days during the taxable year and also rents it to a friend at a discount for 10 days. Thus, the home is used for some purpose (other than repair or maintenance) for 120 days during the taxable year, and the rental allocation fraction may not exceed 90/120. On the basis of the following figures, Karen determines that the sum of the rental expenses for the home for the taxable year that are deductible is $2,200. The advertising expense and the realtor’s fee are also deductible.

<table>
<thead>
<tr>
<th>Computation of Gross Rental Income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts from rental</td>
<td>$2,400</td>
</tr>
<tr>
<td>Less: Advertising and Realtor’s fee</td>
<td>$200</td>
</tr>
<tr>
<td>Gross rental income</td>
<td>$2,200</td>
</tr>
<tr>
<td>Deductions allowable under #1 above:</td>
<td></td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>$1,000</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>$800</td>
</tr>
<tr>
<td>Amount allowable</td>
<td>$1,350</td>
</tr>
<tr>
<td>Limit on further deductions</td>
<td>$850</td>
</tr>
<tr>
<td>Deductions allowable under #2 above:</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>$400</td>
</tr>
<tr>
<td>Utilities</td>
<td>$600</td>
</tr>
</tbody>
</table>
**Computation of Gross Rental Income**

<table>
<thead>
<tr>
<th>Description</th>
<th>IRS Method</th>
<th>Bolton Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount allowable</td>
<td></td>
<td>$750</td>
</tr>
<tr>
<td>Limit on further deductions</td>
<td></td>
<td>$100</td>
</tr>
<tr>
<td>Deductions allowable under #3 above:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>$1,500</td>
<td>$1,125</td>
</tr>
<tr>
<td>Amount allowable</td>
<td></td>
<td>$100</td>
</tr>
<tr>
<td>Net Rental Income (Loss)</td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td>Expenses carried forward:</td>
<td></td>
<td>$1,025</td>
</tr>
</tbody>
</table>

**Tax Court Takes a More Favorable View** *(Bolton v. Comm., CA-9, 82-2 USTC 9699, aff’d TC 77 TC 104, Dec. 1982)*

The Tax Court overrode the IRS’s proposed regulation method of allocating interest and taxes in a case that was upheld in appeals. The Service’s method uses the same ratio for interest and taxes as for all other expenses. However, because interest and taxes are then deducted first under the ordering provisions, this method may unfairly limit the deduction for other expenses while allowing a deduction for those expenses that could be deducted elsewhere on the return (i.e., Schedule A).

In the Bolton case, the court used the ratio of the number of rental days over the total number of days in the year for the allowable interest and property tax deduction. It then applied the ratio of days at fair market rent over total days used for any purpose to the remaining expenses. The result was a smaller percentage of mortgage interest and property taxes taken against rental income, the remainder of which were deductible on Schedule A. A larger amount of the other expenses attributed to the rental were then allowed before the limitation for gross rents received was met.

<table>
<thead>
<tr>
<th>Description</th>
<th>IRS Method</th>
<th>Bolton Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross rent</td>
<td>$2,200</td>
<td>$2,200</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>(90 ÷ 120) x $1,000 - 750</td>
<td>(90 ÷ 365) x $1,000 - 247</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>(90 ÷ 120) x $800 - 600</td>
<td>(90 ÷ 365) x $800 - 197</td>
</tr>
<tr>
<td>Limit for further deductions</td>
<td>$850</td>
<td>$1,756</td>
</tr>
<tr>
<td>Insurance &amp; utilities</td>
<td>(90 ÷ 120) x $1,000 - 750</td>
<td>(90 ÷ 120) x $1,000 - 750</td>
</tr>
<tr>
<td>Limit for further deductions</td>
<td>$100</td>
<td>$1,006</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(90 ÷ 120) x $1,500 - 100*</td>
<td>(90 ÷ 120) x $1,500 - 1,006*</td>
</tr>
<tr>
<td>Net Rental Income (Loss)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>* Expenses carried forward:</td>
<td>$1,025</td>
<td>$19</td>
</tr>
</tbody>
</table>

**TCJA Makes Choice of Method More Complicated**

It used to be pretty simple. If the taxpayer itemized deductions, the Bolton method would generally produce a better tax result. But studies say that only 8% of US taxpayers itemize deductions under the TCJA. And for those taxpayers who will continue to itemize, the SALT limitation and limits on deductible mortgage interest may reduce or eliminate a vacation home’s deduction on Schedule A.
**Tax practitioner planning.** If your client will now be a standard deduction, consider using the IRS Method. This strategy creates a larger expense carryforward, but at least it preserves the deduction if rental income is higher in a future year.

If property tax deductions for your itemizing client are already limited by the SALT limitation, use the IRS Method for the same reason noted above.

**Note.** Whichever method you choose, if the rental portion of mortgage interest and property taxes exceeds gross rent, those amounts are deductible anyway. This is particularly useful if mortgages between main home and vacation home exceed acquisition debt limits.

**Expenses for Rental of Home to S-Corporation Allowed, But Limited by Personal Use (Thomas D. & Margaret Joan Conrad v. Comm. pro sese, TCM 2023-100)**

Dr. Thomas and Margaret Conrad were 51.25% owners of Financial Management Corporation (FMC), an S-corporation. In 2008 and 2009 Dr. Conrad was paid by FMC for management services and in 2009 Mrs. Conrad was paid for accounting services. They were paid as independent contractors, and the IRS never disputed the worker classification nor made any attempt to recategorize them as employees. Each of them claimed a deduction for business use of their 7500 sq. ft. home on their respective Schedule Cs.

However, in the case of Dr. Conrad, the IRS found that his home office was not used exclusively as his principal place of business. Moreover, FMC paid rent to the Conrads for the office space used by them. Deductions for mortgage interest, property taxes and other expenses were more properly reported on Schedule E against the rent received.

**Note.** The Court acknowledged that although §280A would prevent an employee from deducting expenses for rental of home to his/her employer corporation, because the IRS never contested the Conrad’s worker status, it allowed the deductions.

**The office space was never exclusively used by FMC.** The Conrads’ extended family would occasionally visit the Conrads at the condominium during the years at issue. While at the condominium, the extended family members made personal use of the rooms located in portions set aside for FMC’s office use. As a result, under §289A the deductible expenses each year were limited to the rental income.

**How much interest??!!!** The court’s decision leaves an unaddressed issue about the amount of interest deductible on Schedule A. For 2008 the Conrads paid $328,010 of mortgage interest. The Tax Court accepted the Conrads’ method allocating the mortgage interest related to the condominium equally between their personal and rental activities:

“Half of the Conrads’ mortgage interest, $164,005, is attributable to rental use. This half is deductible as an above-the-line rental expense only to the extent of the $144,000 of rental income FMC paid to the Conrads because of the limit imposed by Proposed Treasury Regulation §1.280A-3(d) (3)(i). The excess, $20,005, is allowable as a Schedule A deduction. In addition, the other half of the $328,010 of mortgage interest, which is attributable to the Conrads’ personal use of the condominium, is allowable as a Schedule A deduction.” *Don’t you think this is way over the $1 million mortgage limitation?*
Overcharged Rent of Residence for Shareholder Meetings Still Excluded Under §280A(g)  (Gary J. Sinopoli, Jr. & Melissa M. Sinopoli, et al v. Comm., TCM 2023-105)

Because of their busy schedules, the three shareholders of Planet LA, LLC, Gary J. Sinopoli, Robert J. Siragusa, and Angela M. Hurring arrived at a plan to have Planet pay them rent for the use of their homes for business meetings in their personal residences. When meetings were actually held, they were generally the only attendees but occasionally one of the spouses attended. Other family members were home during some meetings.

Planet paid rent to each of the shareholders for the use of their residences. They did not obtain an appraisal of the rental value of their residences as meeting space. Dr. Sinopoli researched rental rates for meeting spaces where they each lived and determined that meeting spaces rented at a rate of $1.83 per square foot, which they then used to calculate rent for the residences’ common areas. Initially, the monthly rent to each shareholder (based on the size of the common space) was different. Sometime in 2016 through September 2017 Planet began paying $3,000 in monthly rent to each shareholder. The corporation deducted rent paid of $30,000 in 2015, $40,000 in 2016 and $27,000 in 2017.

For each year at issue the shareholders reported the rent as income on Schedule E of their personal returns and excluded it from their gross income pursuant to section 280A(g), which provides that rental income from the rental of a taxpayer’s residence is not included in gross income if the residence is rented for no more than 14 days in a taxable year.

The IRS researched the local rental rate for meeting space and determined that locally available meeting space accommodating 500 to 1,200 people rented for approximately $500 for a full or half day. The Court agreed with this figure and sustained a $500 rent expense for each meeting that the individuals substantiated with notes of an actual meeting. They did not provide any meeting notes for 2015 but substantiated 12 meetings at Dr. Sinopoli’s residence during 2016 and 9 meetings at Mr. Hurring’s residence during 2017. Accordingly, while the IRS disallowed the rent deduction for 2015 in its entirety, the Court allowed rent expense deductions of $6,000 per year for 2015 and 2016 and $4,500 for 2017.

Also see.

_Dellward R. Jackson v. Comm., TCM 2014-160, aff’d 9th Cir., No. 14-73680; Jan. 9, 2017_, where a motorhome was subject to both §274(d) and §280A, and while the taxpayers met the requirements of §274(d) for one of the two years in question, the court found that since the motorhome was used for personal functions, and no portion of the motorhome was used exclusively for business, §280A prohibited any deduction.

_Susan and Peter Szanto, pro sese v. Comm., TCM 2016-145_, where taxpayers were unable to establish where else they lived for six months while the personal residence wasn’t rented, reducing deductible expenses by half and limiting deduction to amount of rental income.

_Robert and Pamela Redisch v. Comm., TCM 2015-95_, where a minimal effort to rent didn’t convert a personal asset (vacation home) to rental property.
THE PASSIVE LOSS RULES

Do the Passive Loss Rules Apply to Me?

The passive activity loss rules are applied at the individual level and extend beyond tax shelters to virtually every business or rental activity whether reported on Schedule C, Schedule F, or Schedule E, as well as to flow-through income and losses from partnerships, S corporations, and trusts.

Tax practitioner planning. The passive loss limitations also apply in full to personal service corporations. The $469 rules also apply to closely held C corporations but have a limited application.

The §469 Passive Loss Rules: Overview

As a giant first step toward implementing a loss deduction limitation philosophy, Congress simply states that losses (and credits) from passive trade or business activities to the extent they exceed income from all such passive activities, generally, may not be deducted against other income such as salaries and wages or interest and dividends. The two major exceptions are (1) the exemption granted to real estate professionals ($469(c)(7)) and (2) the ability of middle-income taxpayers to deduct up to $25,000 of rental losses from “actively managed” real estate ($469(a)).

Passive losses (and credits) disallowed in the prior year are deductible against current passive income. Any passive activity loss not currently deductible (disallowed) is suspended and becomes deductible in a subsequent year in which the taxpayer either has net passive activity income or completely disposes of the passive activity property to an unrelated party in a fully taxable transaction. In addition, with exceptions, the passive loss rules continue to allow losses and credits from one passive activity to be applied against income for the taxable year from another passive activity ($469(b)).

Basic Passive Loss Rules

Only Two Activities Are Considered Passive:

1. A rental activity without regard to whether or to what extent the taxpayer participates in such activity (therefore, a rental activity is treated as a passive activity, regardless of the level of the taxpayer’s participation); and

2. A trade or business activity in which the taxpayer does not materially participate for the taxable year ($469(c)(1)).

Establishing Material Participation

An individual is treated as participating “materially” in an activity for the taxable year if the individual’s participation meets one of seven participation tests: four time tests, two long-standing (or “look-back”) tests, or a seventh residual facts and circumstances test ($1.469-5T(a)(1)-(7)).

How to “materially participate” (MP) using any of the seven tests. An individual materially participates in an activity if they and/or their spouse:
1. Works 500 or more hours in the activity.

2. Does substantially all the work (i.e., more than 70% of the total business hours for the year are performed by the owner). “Substantially all” includes services of nonowner employees.

3. Works 100 hours, and no one else does more.

4. Works 500 hours in all businesses owned. The individual is deemed to materially participate when the activity is a “significant participation activity” (SPA) for the taxable year and the individual’s aggregate participation in all SPAs during such year exceeds 500 hours.

5. Materially participates in the activity for five of the last 10 years (whether or not consecutive) during the 10 taxable years that immediately precede the taxable year.

6. Participates in a personal service activity with three years of participation. Individual materially participates in a personal service activity (e.g., accountants, lawyers, doctors, etc.) for any three taxable years (whether or not consecutive) preceding the taxable year.

7. Proves facts and circumstances. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year.

Activity Does Not Qualify as Significant Participation Activity (TAM 202229036)

Reg. §1.469-5T(c)(1)(ii) provides that an activity is a significant participation activity (SPA) only if such activity would be an activity in which the individual does not materially participate for the taxable year if material participation is determined without regard to the SPA test in §1.469-5T(a)(4). Under this rule, where an activity satisfies one of the other six tests for material participation under §1.469-5T(a) (excluding §1.469-5T(a)(4)), the activity does not satisfy the requirements to qualify as a SPA under §1.469-5T(c)(1), even though the remaining requirements (trade or business and hours) are met.

In the case under audit, the taxpayer classified certain activities as SPAs. However, the IRS determined that several of these activities met the 5/10 test for material participation by virtue of these activities having satisfied Reg. §1.469-5T(a)(4) (SPA test) in five of the preceding 10 years.

Because they were SPAs for five out of the last ten years, they can’t be SPAs this year! These activities were reclassified because the activities no longer satisfied the SPA requirements under Reg. §1.469-5T(c). This reclassification reduced the number of SPAs in the audit year, such that the taxpayer’s aggregate hours for the remaining SPA activities failed to meet the 500-hour requirement of Reg. §1.469-5T(a)(4). Thus, the taxpayer was no longer treated as materially participating in those activities and they were passive activities under §469.

Also see:

Stephen and Angela Hardy v. Comm., TCM 2017-16, where a non-managing member of an LLC owning a surgical center was considered to have passive income because he had no operational or management control.

Larry Kline v. Comm., TCM 2015-144, where a Southwest Airlines pilot operating a charter fishing boat wins material participation on 100 hours and no one participated more.
Definition of a Rental Activity for Passive Loss Purposes

A rental activity is any transfer of property for compensation. With some major exceptions, an activity is a rental activity for a taxable year if:

- during the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers, and
- the gross income attributable to the conduct of the activity during the tax year represents amounts paid principally for the use of the tangible property (§1.469-1T(e)(3)).

Rentals. A rental activity is treated as a per se passive activity regardless of whether the taxpayer materially participates (§469(c)(2), (4)). However, the rental activities of a taxpayer in the real property business (real estate professional) are not per se passive activities but are treated as a trade or business and subject to the material participation requirements (§469(c)(2); §469(c)(1); §469(c)(7)(B)).

No Rental Income and No Substantiation of Expenses Wipes Out Deductions (Richard J. Cardulla v. Comm. pro se, TCM 2023-89)

Richard Cardulla, a California attorney hand prepared his 2014 and 2015 tax returns. On these he reported expenses resulting in a net loss for six properties he owned. Of these, four were vacant land, one was a house uninhabitable because of earthquake damage, and one actually rented and had income. One of the vacant lots also received a small amount of easement rental income. In addition to noting a lack of substantiation for the deducted expenses, the Court considered the uninhabitable property and vacant land to be investment property — not deductible on Schedule E. And the Court instructed Richard that land is not a depreciable asset.

Rental Loss Denied As Property Was Not Available for Rent (William B. Costello and Maritza Legarcie v. Comm., TCM. 2021-9)

William Costello and Maritza Legarcie attached Schedule E to each of their 2012 and 2013 Forms 1040 reporting income and losses from rental real estate. On those Schedules E, the taxpayers reported that they were real estate professionals who materially participated in a rental real estate activity. On the 2012 Schedule E, they listed an $8,825 loss for Silvertip Drive, Bear Lake, CA. On the 2013 Schedule E, they listed a $9,042 loss for the Silvertip Drive property.

The Silvertip Drive property was flooded sometime in the 2000s and was not thereafter in condition to rent. The taxpayers did not advertise it for rental and reported no rental income for it after 2005. The court concluded that the taxpayers were not entitled to their claimed loss deductions with respect to the property for 2012 and 2013, respectively, since the property was not available for rent.

Activities That Are Not Rental Activities (§1.469-1T(e)(3))

When is a rental activity really a business? The real complexity of the passive loss rules is in making the determination whether a particular activity is a “rental activity,” a “trade or business,” or an “investment.” The regulations exclude from the definition of a rental activity those activities in which the importance of providing services to customers outweighs the importance of providing tangible property to customers (e.g., a hotel is normally a business, not a rental activity). It is important to note that substance controls over form, and the use of legal documents stating that a relationship is a lease is irrelevant.
The regulations have identified certain rental activities as not being passive rental activities. These include activities where the:

- Average period of customer use is seven days or less. Those renting vacation homes may fall under this exception.
- Average period of customer use is 30 days or less and significant personal services are provided by or on behalf of the owner of the property. For example, significant personal services include maid or linen services. Certain services are specifically excluded, such as cleaning public entrances, stairways, or lobbies, and collecting and removing trash.
- Extraordinary personal services are provided by or on behalf of the owner of the property. For example, a hospital room.
- Rental of such property is treated as incidental to a non-rental activity of the taxpayer. This exception applies to property rented to employees at the employer’s convenience and investment property that is held primarily for appreciation when the gross rental income from the property is less than 2% of the lesser of the unadjusted basis or the fair market value of such property.
- Taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers. An example of this would be a golf course.
- Provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

The “average period of customer use” is determined by dividing (1) the aggregate number of days in all periods of customer use for the property (taking into account only periods that end during the taxable year or include the last day of the taxable year) by (2) the number of periods of customer use (§1.469-1(e)(3)(iii)(c)). The regulations define “period of customer use” as follows:

Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals thereof) is treated for this purpose . . . as a separate period of customer use (§1.469-1(e)(3)(iii)(D)).

Also see.

Amy L. Harloff v. Comm., TCS 2014-20, where the average length of a customer stay at the Whistler condo was four days, making the property a business, not a rental activity.

Caution! Although a property may be a business, not a rental activity, it still may be a passive activity! Trade or business activities in which the taxpayer does not materially participate are passive.

Schedule C And Self-Employment Tax?

Well, no. A trade or business activity is subject to self-employment tax if it is profitable. Section 1.1402(a)-4(c)(2) stipulates that because very short-term rentals as defined above are not rentals from real estate, profits are included in determining net earnings from self-employment. However, see the conditions under CCA 202151006 above if substantial services are provided.
Tax practitioner planning. Regardless of whether it’s reported as a short-term activity, it isn’t rental real estate. Therefore, any losses associated with the activity are not allowed to be deducted under the special $25,000 allowance for actively managed rental real estate at §469(a).

Also see.

Stephen and Angela Hardy v. Comm., TCM 2017-16, where a surgeon’s income from a surgery center he did not manage was not subject to SE tax because he received the income in his capacity as an investor (§1402(a)(13)).

Grouping Of Passive Activities

What is an activity for passive loss purposes? Is it each business separately? Or when the client owns two or more businesses, can he “group” them into one activity so that he is able to meet the material participation test?

Combining or separating multiple businesses properly is a tax disaster if the taxpayer does this wrong! When applying the passive loss rules, the first and most important determination made by a taxpayer is defining how many different businesses (i.e., activities) the taxpayer must report to the IRS on the Passive Activity Form 8582. The taxpayer may aggregate, for passive loss purposes, two or more activities reported separately elsewhere on his or her tax return (§1.469-4(c)). But defining separate activities too narrowly, or too broadly, can either lead to evasion of the passive loss rules or, more tragically, make it impossible for the investor to take advantage of the relief provisions afforded him or her under the passive loss regulations.

Reasons for identifying each activity. It is also necessary to identify every separate activity of a taxpayer for the following purposes:

- determining whether the activity is a rental activity,
- determining whether the taxpayer materially participates in the activity (may make it easier to meet the 500-hour test if the activity is a trade or business),
- determining whether the taxpayer has completely disposed of his or her entire interest in the activity (to ascertain if the triggering of loss occurs), and
- applying the transitional rules for pre-enactment interests in passive activities.

Five factors for establishing groupings. The factors given the greatest weight when determining whether activities should be grouped together or kept separate are as follows (§1.469-4(c)(2)):

- The similarities and differences in the respective types of businesses,
- The extent of common control between the businesses,
- The respective geographical locations of each business,
- The extent of common ownership between the businesses, and
- The interdependencies between the businesses.

Any reasonable method for grouping allowed! In spite of the importance of this definition, §469 does not define the term activity (e.g., determining how many different businesses the taxpayer owns). As a general rule, the legislative history suggests a definition of activity that entails dividing economic “endeavors” into
fairly small units, but Congress, in its infinite wisdom, left to the Department of the Treasury the definition of the term in regulations.

**Grouping of Passive Activities Requires Annual Statement on Tax Return**

Taxpayers are required to annually report to the IRS their groupings and regroupings of activities (Rev. Proc. 2010-13). Any additions of specific activities within their existing groupings for purposes of §469 and §1.469-4 are also required (Rev. Proc. 2010-13, Sec. 4.01).

**Statement required for new groupings.** A taxpayer must file a written statement with his or her original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469 (Rev. Proc. 2010-13, Sec. 4.02).

**Statement required for addition of new activities to existing groupings.** If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year, the taxpayer must file a written statement with the taxpayer’s original income tax return for that taxable year. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469 (Rev. Proc. 2010-13, Sec. 4.03).

**Statement required for regroupings.** If it is determined that the taxpayer’s original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and a written statement must be filed with the taxpayer’s original income tax return for the taxable year in which the trade or business activities or rental activities are regrouped (§1.469-4(e)(2)). This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped. If two or more activities are regrouped into a single activity, the regrouping statement must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469. Furthermore, an explanation of why the taxpayer’s original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate must be included (Rev. Proc. 2010-13, Sec. 4.04).

**If a taxpayer fails to report groupings, each activity is treated separately.** Unless the special grouping rules by partnerships and S corporations apply, if a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity, then each trade or business activity or rental activity will be treated as a separate activity under §469 (Rev. Proc. 2010-13, Sec. 4.07). The Commissioner, however, may regroup a taxpayer’s activities to prevent tax avoidance (§1.469-4(f); Rev. Proc. 2010-13, Sec. 4.07).
Relief provision also available if taxpayer reported but failed to make election to group. An exception to the default rules that unreported activities will be treated as separate activities is when a timely disclosure is made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the Service, however, the taxpayer must also have reasonable cause for not making the required disclosures (Rev. Proc. 2010-13, Sec. 4.07).

Disposition Of Passive Activity

Suspended Losses

Current and carryforward passive losses are fully deductible on the disposition of a passive activity. However, §469(g) sets forth three criteria to be met before losses are deductible against nonpassive income. It requires that the taxpayer disposes of an entire interest in a fully taxable transaction to an unrelated party. All gain realized must be recognized. If these three criteria are met, the overall net loss is fully deductible (presuming, of course, that the taxpayer has basis) [§469(g)(1)].

The overall net loss is any loss on disposition and any current or suspended losses from the activity in excess of any gain on disposition or net income from the activity, or net income from all other passive activities. If there is an overall net loss, the entire disposition is not reflected on Form 8582, and the entire loss is reflected on the appropriate schedules. If there are two dispositions, one with an overall net loss and one with an overall net gain, they should be netted.

Nonqualifying Dispositions

A taxpayer is required to dispose of an entire activity in a fully taxable transaction to an unrelated party to fully deduct the current and prior year losses. Note that §469(g) requires a fully taxable event. Transactions not meeting this requirement include like-kind exchanges, conversion to personal use, gifts, transfer due to divorce, installment sales (passive activity loss triggered in ratio to gain reported), transfer due to death, and dispositions to related parties.

- If the taxpayer disposes of an activity by gift, the accumulated current and prior year unallowed losses cannot be deducted in any year. Instead, the basis of the transferred interest must be increased by the unallowed losses.
- A mere change in status, whether it be to a partnership, corporation, or limited liability company, does not constitute a qualifying disposition which would trigger deductibility of suspended losses. Similarly, conversion of a business or rental activity from passive to nonpassive does not trigger losses.
- The transfer of passive activities incident to a divorce is not considered a fully taxable transaction, and any suspended losses would not be freed-up under §469(g). Any transfer of property incident to a divorce will be treated as a gift (§1041(b)). The transfer of passive activities incident to a divorce is treated as a gift, and the losses of the “donor” spouse are added to basis.
- In a bankruptcy, nothing is triggered until the bankruptcy is complete — in other words, when gain or loss is recognized. Furthermore, suspended passive losses must first be applied against any relief of indebtedness (debt cancellation). In many instances, the debt forgiven under §108
fully absorbs the current and suspended passive losses, and therefore nothing is deductible on the return.

- On any disposition, be sure to verify that it is an entire disposition of “substantially all” of the property. On the sale of rental real estate, if the taxpayer made an election to group his or her rentals as one activity under §469(c)(7), the sale of one property would not constitute an entire disposition.

- Only a disposition to an unrelated party is considered a complete disposition. The following are related parties: spouse, brother(s), sister(s), son(s), daughter(s), grandchildren; an individual and a corporation owned more than 50% by the same person; and a partnership and a partner who own more than 50%. See §267 and §707(b) for other related parties.

- If the taxpayer sold a piece of rental real estate and is a real estate professional who meets the relief provisions of §469(c)(7), they may have made an election to treat all of the rental real estate activities as a single activity. If the real estate professional did make the election, they cannot trigger suspended losses as there was not a disposition of the entire activity as required by §469(g).

**REAL ESTATE PROFESSIONALS AND PASSIVE LOSSES**

The Passive Loss Rules and Real Estate Professionals — Deducting Real Estate Losses Against Ordinary Income (§469(c)(7))

Passive loss rules don’t apply to real estate professionals. A taxpayer’s rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. This means that real estate investors who qualify are permitted to deduct their rental real estate losses against other income sources (e.g., commissions, wages, etc.) (§469(c)(7)).

An Individual Satisfies the Real Estate Professional Eligibility Requirements When Three Requirements Are Met

1. **Rental real estate is owned.** The individual must own at least one interest in rental real estate (§1.469–9(b)(6)).

2. **The 50% test.** More than 50% of the individual's personal services during the tax year must be performed in real property trades or businesses (defined below) in which the individual materially participates (defined below).

3. **The 750-hour test.** The individual must perform more than 750 hours of service in those same trades or businesses (§469(c)(7)(B)).

   **Tax practitioner planning.** When considering the real estate professional time tests, each spouse must be considered independently. Spouses’ time cannot be combined to determine if the RE professional tests are met.
The Real Estate Businesses That Can Be Combined

Real property trade or business means real property involved in four general activities:

1. development, redevelopment, construction, reconstruction, acquisition, conversion;
2. rental;
3. operation, management, leasing; or
4. brokerage trade or business (§469(c)(7)(C)).

**Tax practitioner planning.** Any hourly combination in these four “blessed” businesses is permitted. For example, a taxpayer who spends 100 hours managing rentals and 651 hours selling real estate exceeds the 750-hour minimum.

Mortgage Broker Not in Qualified Real Estate Business *(Kurt and Michelle Hickam, pro se v. Comm., TCS 2017-66)*

During 2011 and 2012, Kurt Hickam brokered real estate mortgages and other loans as an independent contractor for a mortgage brokerage company where he was a branch manager. During 2012, Mr. Hickam was also paid wages by an employer for originating loans. In both positions, Mr. Hickam’s brokered or originated loans were secured by real estate.

In addition to brokering mortgages and originating loans, Mr. Hickam managed and maintained three rental real estate properties in San Jose and Capitola, California, two single-family residences and a nine-unit apartment complex. He owned the apartment complex jointly with his brother and parents, but none of his relatives participated in the management or maintenance of the property. Mr. Hickam claimed rental real estate loss deductions of $47,730 and $48,945 for 2011 and 2012, respectively, for the three properties.

**Not real property trade or business.** The court held that neither Mr. Hickam’s mortgage brokerage services nor his loan origination services were performed in a real property trade or business within the meaning of §469(c)(7)(c), that the hours he spent performing his mortgage brokerage services and his loan origination services are not included for purposes of the real estate professional test, and that he did not meet the definition of a real estate professional under §469(c)(7)(B) for 2011 or 2012.

Also see. *(Rodney and Lauraine Guarino v. Comm., TCS 2016-12)*, where the court accepted that Rodney’s mortgage brokerage activity constitutes a “brokerage” trade or business, but it does not constitute a “real property brokerage” trade or business.

The Time Tests Cause the Most Problems for Real Estate Professionals

**It’s a time test that requires proof.** The total time spent in any combination of real estate-related activities is used to determine if the 50% and the 750-hour tests are met.

**Only one spouse needs to be the real estate professional.** In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse *separately* satisfies the requirements (§469(c)(7)(B)) *(Tony R. and Denelda Sims Goolsby v. Comm., TCM 2010-64)*. Thus,
if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not passive per se under §469(c)(2). Instead, the real estate professional’s rental activities would be governed by the trade or business passive activity criteria (whether or not the taxpayer materially participated in the trade or business) under §469(c)(1).

Required work for the 50%/750-hour test is different from the required work for material participation. With two restrictions, participation is any work done by an individual in any capacity, management, or operations, in connection with an activity in which the individual owns an interest (§469(c)(7)(B) & (D)).

Restriction for employees. When this eligibility test is applied, the personal services of an employee are not counted unless the employee is also at least a 5% owner (i.e., owns more than 5% of the outstanding stock or more than 5% of the total combined voting power) (§469(c)(7)(D)(ii)). For example, in Gregory and Linda Bahas, pro sese v. Comm., TCS 2010-115, the time Linda spent as an employee/manager didn’t count toward the 750-hour test, as she was not an owner of the real estate agency where she worked. Her time would have counted had she been at least a 5% owner. One more issue: the Tax Court erroneously held that the 750-hour test applied to each rental. It does not. It is only important that the taxpayer spends 750 hours cumulatively in all real estate businesses. Also, in James F. and Lynn M. Moss v. Comm., 135 TC No. 18, Sep. 20, 2010, the time spent “on-call” is not counted as hours worked in a real estate profession for purposes of satisfying the 750-hour test.

Substantiation of time requirement. With respect to the evidence that may be used to establish hours of participation, the extent of an individual’s participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries (§1.469-5T(f)(4)).

Working Full Time Job Flunks the 50% Test (George F. & Rachel S. Teague v. Comm., TC Summ. 2023-16)

George and Rachel Teague own a duplex in New Hampshire that they live in half and rent out the other half, and two “dilapidated” cabins in Maine. Rachel is a stay-at-home mother who works 2 four-hour shifts per week at a pregnancy center. George is a full-time sales representative for Comcast. While the Court accepted that George had taken six weeks’ vacation during 2017, that still left 1,840 hours (40 hours per week for 46 weeks) to overcome in order to meet the “more than 50%” of all personal services test.

The court simply did not believe George’s testimony that in addition to 769 hours traveling and obtaining materials and supplies, he worked on fixing and furnishing the Maine cabins for 102 days at 12 hours per day during the year. The court emphasized that the cabins were located on a resort lake, that the entire Teague family was there enjoying a boat and other water equipment when George said he was working his long hours, and that he must have had meals and other activities with his family.

Court Shortcuts Decision for Full-Time Employees (Robert L and Pamela M. Drocella, pro sese, v. Comm., TCSO 2023-12)

For 2018, Robert and Pamela Drocella were full-time employees. Robert was employed by Northrup Grumman Systems Corp and Pamela by the US Department of Defense. For their six rental properties in Maryland, they claimed losses totaling $62,983. They claimed the losses as real estate professionals.
Although the Drocellas submitted hand-written logs of their work on the rental activities, neither provided the number of hours he or she performed as an employee. The Court allowed that the Drocellas also performed personal services with respect to their rental real estate activities, but determined they could not prove that more than one-half of either of their total personal services performed in trades and businesses were performed on their rental real estate activities during that year. Consequently, they failed to sustain their burden to prove either met the description of a real estate professional under §469(c)(7)(B).

Thus, failing the first prong of the §469(c)(7)(B) test, the Court stopped there and declared the Drocellas were not entitled to deduct the rental real estate loss for 2018. The Court noted it need not address the reasonableness of the logs or whether either performed more than 750 hours of services during the taxable year in real property trades or businesses in which he or she materially participated.

767 Hours Spent On Rental Activities Was Not Good Enough To Claim Real Estate Professional Exception To Passive Loss Rules (Heather and Edison Dunn v. Comm., TCM 2022-112)

Heather and Edison Dunn, a married couple, owned three rental properties including a 21-unit apartment building in Hephzibah, GA. The Dunns claimed more than $140,000 in rental losses in the two years under audit, claiming they were real estate professionals.

The Dunns’ logbooks showed 767 hours of work on their rental properties. However, the logs did not specify which spouse worked these hours. If a taxpayer is married, activity by the taxpayer’s spouse counts in determining “material participation” by the taxpayer (§469(h) and TR §1.469-5T(f)(3)). Spousal attribution may not be used to satisfy the 750-hour annual service requirement specified in §469(c)(B).

More problems. A taxpayer qualifies as a real estate professional if more than one-half of the personal services performed in trades and businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates.

- The Dunns both worked full time and could not show that they spent more time on rental activities than they did on their employment.
- Material participation is measured on each rental activity. Since the Dunns did not elect to aggregate their properties into one activity, they did not materially participate in the 21-unit building as it located 150 miles from their home and was cared for by a property manager.

Real Estate Professional Gets No Losses on Properties Not Considered “Rental Activities” (Greg A. Eger, et al. v. United States, CA9, Case No. 19-17022, Aug. 13, 2020)

Greg and Julie Eger owned 36 rental properties in the years 2007-2009. The Egers grouped all the properties together into a single “rental activity,” including three properties in Mexico, Colorado, and Hawaii. The vacation destination properties produced losses for the years in question that were deducted by the Egers who claimed real estate professional status on their returns.

Reg. §1.469-1T(e)(3)(ii)(A) excludes from the definition of “rental activity” the use of tangible property when the “average period of customer use of such property is seven days or less.” As a result, the IRS excluded the three properties from the Egers’ aggregation election. Upon appeal to the Ninth Circuit, the taxpayers did not attempt to dispute the average stay by tenants. Instead, the Egers argued that the management companies hired to market and rent the properties were the customers for purposes of calculating the average period of use.
In rendering its decision in favor of the IRS, the appellate court commented: “When deciding who is a customer between individuals paying to stay in a property and the company responsible for marketing the property and managing payments, few people who are not creative tax lawyers would argue it is the latter.”

**Tax practitioner planning.** A vacation rental is more like a hotel than a rental activity. A business and a rental cannot be aggregated.

**Tax practitioner planning.** Real estate professional audits are all about records. Warn your clients.

Also see.

Christian and Francine M. Sezonov pro sese v. Comm., TCM 2022-40, where taxpayer didn’t even claim he performed 750 hours managing properties.

Daniel P and Leigh L. Whoriskey pro sese v. Comm., TCSO 2021-30 where firefighter failed to show enough hours to surpass two 24-hour shifts worked per week.

Zaid Hakkak and Layia Naji v. Comm., TCM 2020-46, where a personal injury lawyer also failed to provide credible proof of hours for real estate professional status.

Philip and Leanna Rose v. Comm., TCM 2019-73, where “guesstimates” of hours included 18 hours on Thanksgiving and 16 hours on New Year’s Day.

Ronnie and Gloria Hairston, pro sese v. Comm., TCM 2019-104, where the court, upon examining calendars submitted by the taxpayers, determined all the handwriting on the entries seemed to be identical and probably made all at the same time. The entries were also deemed to be inflated.

**Material Participation in Rental Activities for RE Professionals**

After determining if the taxpayer is a real estate professional, the real estate professional must prove he or she materially participated in managing the real estate rentals. This is again a time test, but different, and more restrictive, than the 50%/750-hour test. An individual is treated as participating “materially” for the taxable year if the individual’s participation meets one of the seven enumerated material participation tests (§1.469-5T(a)(1)-(7)). The three most common ways that real estate investors meet this “material participation” test are by:

- managing and operating the rental real estate activity for more than 500 hours during the year,
- doing substantially all the work required to manage and operate the rental real estate during the year (probably more than 70% of the total business hours are performed by the landlord), or
- working more than 100 hours during the year with no one (including nonowner employees and independent property managers) participating more than the landlord (§1.469-5T(a)(1)-(3)).

**Owner can “tack” spouse’s time.** Any participation by one spouse is attributed to the other spouse, even if no joint return is filed and/or the participating spouse has no ownership interest in the activity. In effect, therefore, material participant status of both spouses is determined as though the two spouses were one individual (§1.469-5T(f)(3)).

**When management does not count.** Management time is disregarded when determining participation if:

- It is not a type “customarily performed” by owners and one of the principal purposes of such work is avoiding the PAL rules (§1.469-5T(f)(2)(I)).
• The total amount of the taxpayer’s involvement is studying and reviewing financial statements or preparing or compiling summaries or analyses of the finances or operations for the individual’s own use (§1.469-5T(f)(4)).

Eligible Corporations

A closely held C corporation satisfies the eligibility test if, during the tax year, more than 50% of the gross receipts of the corporation are derived from real property trades or businesses in which the corporation materially participates (§469(c)(7)(D)(I)).

Tax practitioner planning. This relief provision does not apply to estates, trusts, or limited partnerships owning real estate rentals. It only grants relief to closely held corporations.

Aggregation of Rental Real Estate by a Real Estate Professional

Each rental is a separate activity unless all rentals are combined. Each interest of the taxpayer in rental real estate is to be considered as a separate activity, but a taxpayer may elect to treat all interests in real estate, including real estate held through pass-through entities, as one activity (§469(c)(7)(A)).

Tax practitioner planning. The aggregation option permits the taxpayer to meet the material participation test after cumulatively materially participating (e.g., working 100 hours or 500 hours) in all the real estate rentals. Without the aggregation option, the investor would be required to materially participate (i.e., spend 100 hours or 500 hours) in each activity, probably an impossible task for investors owning more than four rentals!

The election must be properly made. The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer’s facts and circumstances. The taxpayer makes the election by filing a statement with his or her original income tax return. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to §469(c)(7)(A) (§1.469-9(g)).

Sample election language. “In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under §469(c)(7) and elects under §469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity.”

Real Estate Professionals May Make Late Election To Group Rental Activities (Rev. Proc. 2011-34)

Eligibility for relief. A taxpayer is eligible for an extension of time to file this election late (under §1.469-9(g)) if the taxpayer represents on a statement, under penalties of perjury, that he or she meets all of the following requirements:

• The only reason the aggregation election wasn’t made is because the taxpayer didn’t file the required statement with his or her income tax return the first year the taxpayer became a real estate professional.
• The taxpayer filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective, and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.
• The taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

• The taxpayer has reasonable cause for his or her failure to meet these requirements (§1.469-9(g)).

**Requesting relief on amended return.** The taxpayer must attach the following statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file his or her current year tax return.

**Wording For Filing a Single Rental Real Estate Activity Election**

<table>
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<tr>
<th>LATE ELECTION FILED PURSUANT TO REV. PROC. 2011-34.</th>
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| • "In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under §469(c)(7) and elects under §469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity."
| • This election is being filed late because . . . (e.g., the taxpayer relied on a tax professional who failed to advise him or her of the availability and benefits of this election).
| • This election applies to year _____ (i.e., the taxable year to which the taxpayer wishes the late election to apply).
| • "Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete."
| • Signed and dated by the taxpayer.

**The benefit.** Any taxpayer receiving relief under this revenue procedure is treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity as of the taxable year for which the late election was requested.

**Tax practitioner planning.** These procedures are in lieu of a letter ruling request, so user fees do not apply.

**Late Election Granted For Tax Preparer Error (PLR 202308003)**

A married couple who files their tax returns jointly claimed that they were in a real property business as defined by §469 and were qualified to elect to treat all interests in rental real estate as a single rental real estate activity under §469(c)(7)(A) and (B).

In their PLR request, the taxpayers also claimed to have relied on a qualified tax professional. However, they were not advised by their tax professional that the election under §469(c)(7) was available to them. As a result, the couple inadvertently failed to make this election for the year in question when they did not include the statement required under §1.469-9(g)(3) with their joint return filed for year.
IRS granted an extension of time of 120 days from the date of its letter to make an election under §469(c)(7)(A) to treat all their interests in rental real estate as a single rental real estate activity. The election must be in the form of the statement required by §1.469-9(g)(3) and attached to an amended return. A copy of PLR should be attached to the election.

**IRS Chief Counsel Says Late Grouping Election May Be Made While At Appeals**

The IRS Chief Counsel has advised that, if an appeals officer otherwise has the authority to accept amended returns from a taxpayer, the appeals officer may accept the amended return required by Rev. Proc. 2011-34, §4.02 during the appeals process. See CCA 201321021.

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**THE RECHARACTERIZATION RULES & SELF-RENTED PROPERTY**

**Net Profit from Self-Rental Property Can’t Be Used Against Other Passive Losses**

*Taxpayer renting property to the taxpayer’s own business will have to recharacterize income.* Gross rental income equal to net rental income (including any income from a sale) is recharacterized as active income if the property is rented to a trade or business activity in which the taxpayer materially participates for the taxable year (without regard to the limited partner rules) so long as the property is not property rented incidental to a development activity (§1.469-2(f)(6); §1.469-2(f)(9)(iii)).

**Warning.** This rule negatively impacts more taxpayers than any other recharacterization rule. It is intended to deter taxpayers from attempting to generate passive rental income and active business rental deductions by establishing rental arrangements between their own businesses. It does that and more.

**The “heads IRS wins, tails taxpayer loses” rule:** Although rental income is generally characterized as “passive,” the self-rental rule provides that income from rental realty is not passive income if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the tax year (§1.469-2(f)(6)).

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**REAL ESTATE DEPRECIATION**

**What Is A Cost-Segregation Study (CSS)?**

A cost-segregation study is a valuation process that separates business personal property and shorter-lived business real property improvements from the 27½-year and 39-year building. The CSS does not create more depreciation deductions over the long term, but it does provide deductions sooner, which may provide a positive cash flow to help the client pay for the building or even purchase a bigger building.

**Why do a cost-segregation study?** The underlying incentive for preparing these studies is the significant tax benefits derived from utilizing shorter recovery periods and accelerated depreciation methods for computing depreciation deductions. Allocating more to personal property results in faster depreciation deductions as it moves property from the 39-year or 27½-year straight line method to the 15-year 150% DB method for land improvements and the five-year and seven-year 200% DB method for personal property. Faster depreciation deductions provide earlier tax benefit and a net present value (NPV) savings.
When Should A Cost-Segregation Study Be Prepared?

For new construction, almost anytime. Investors may find new construction the easiest property on which to prepare a CSS since the architect and construction documents are readily available. Another source of this information is the builder who has detailed cost information in its bid sheets. Ask the builder for the “G702 payment application form.”

On existing buildings at time of purchase. When economically feasible, the fiscally conservative investor may want a CSS to be prepared when the property is acquired. Studies can be, and often are, done on property placed in service in prior years (whether by the client or by another owner).

On existing buildings after year of purchase. Even if the client acquired the property in a prior year, a CSS may, in addition to increasing the current and future amount of depreciation, allow the client to take catch-up deductions in the current year for depreciation not claimed in prior years. As if a gift from IRS heaven, the §481(a) adjustment for missed depreciation can be claimed in the current year without the need for filing amended returns, worrying about the statute of limitations for prior years, or paying for a letter ruling, as this change in method of accounting is free and automatic. Use Form 3115 to catch-up missed depreciation.

Cost Seg Analysis Denied for Lack of FINAL Appraisal (Duane Pankratz v. Comm., TCM 2021-026)

In 2008, Dr. Duane Pankratz was approached by his CPA, Casey Peterson, to talk about cost segregation. The CPA believed that the positions Pankratz took on his older returns were too conservative and “left a lot of money on the table.” A cost-segregation study, he explained, would allow Dr. Pankratz to depreciate some of his business assets faster and thus lower his tax bill. After a few pointed questions to make sure such a study was legitimate and would pass muster if the IRS audited, Pankratz agreed to have a cost-segregation study prepared for several of his businesses.

The court explained: “A cost-segregation study breaks out the costs of certain assets to justify their depreciation faster than the rate they would be eligible for as a part of real property.” Alvin Arnold, Real Estate Professional’s Tax Guide, sec. 4:29 (2020); see also Peco Foods, Inc. & Subs. v. Comm. [Dec. 58,920(M)], TCM 2012-18, 103 T.C.M. (CCH) 1120, 1122 (2012), aff’d [2013-2 USTC ¶50,412], 522 F. App’x 840 (11th Cir. 2013).

Pankratz hired BDO USA, LLP for the cost-segregation study because his CPA gave the firm a glowing recommendation. Raymond Kuiper, a cost-segregation specialist, and manager with BDO, completed seven cost-segregation studies for seven different Pankratz businesses.

“Kuiper does his work with care.” The court stated: “He starts by visiting the property to take notes and pictures, and then he interviews the owner. Once he gets all the information, he places it into a spreadsheet that lists specific building components called units of property. These units are building components such as footings, foundations, and structural steel, as well as any masonry, carpentry, electrical, HVAC, and plumbing. When Kuiper did the studies for Pankratz’s businesses, he had complete access to any records he wanted and Pankratz gave him all the information that he asked for.”

BDO puts its initial drafts through peer review. Kuiper would then send the study to his senior director who completed a final review, and finally to a CPA for a section 481 adjustment review. Kuiper and BDO took all these steps for Pankratz’s cost-segregation studies. Casey Peterson received the draft cost-segregation studies to review in 2008.”

The court says “no” to the extra depreciation. The court disallowed the changes to the 2008 depreciation that resulted from the cost-segregation studies. “There was only one glitch — these were draft studies. BDO didn’t put them into final form until 2010, yet the CPA, Casey Peterson, used the draft studies to
prepare Pankratz’s 2008 tax return. In 2010, after all the internal review was finally done, BDO provided Pankratz with a written tax opinion on which he could undoubtedly rely. And we do specifically find that there were only insubstantial changes between the 2008 draft and the final 2010 tax opinion”.

**Comment.** Did Judge Holmes get this opinion wrong? If BDO did its study in 2008, wouldn’t those numbers be applied to the 2008 return, even if the report was finalized in 2010?

**Incorrect Depreciable Life for Commercial Property Results in Huge Penalty** (John R. and Judith E. Johnson v. Comm., TCM 2023-116)

John Johnson has been engaged in the business of buying, selling, and leasing real estate for more than 50 years. In 2006 he purchased the Lawton Hotel property for $4,126,005. This purchase price was allocated using a cost segregation study, and $2,120,250 was allocated to the commercial buildings.

The Johnsons improperly claimed depreciation deductions from 2006 to 2013 amounting to 100% of the value of the commercial buildings on the Lawton Hotel property. They accomplished this by applying a seven-year depreciation period to the commercial buildings, which should have been subject to a 39-year depreciation period. This amounted to a total depreciation deduction of $2,120,250 between 2006 and 2013, while the correct method would have yielded a total deduction over that period of only $595,811. The correct 39-year depreciation period would have produced a deduction of $54,364 for each full year. The method the Johnsons actually used produced a deduction of $519,249 for 2007 alone with deductions for other years varying between $94,563 and $370,832 according to the MACRS seven-year method. They sold the Lawton Hotel property in 2016 for $5 million.

Because of the Johnsons’ improper depreciation deductions claimed between 2006 and 2013, IRS made a §481 method of accounting adjustment for 2015 of $1,969,976. Since the depreciation adjustment affected their basis in the Lawton Hotel property at the time of sale in 2016, IRS also adjusted the amount of gain that they realized on the 2016 disposition of the Lawton Hotel. IRS also proposed a number of adjustments as appropriate for the other mistakes on their returns for tax years 2015-2018 such as mortgage interest and charitable deductions.

Because of the adjustments made, the Johnsons owed approximately $1.1 million additional tax for 2015-2018 and the Court upheld the IRS’s assessment of the §6662(a) accuracy-related penalty of $196,000.

**Also see.**

Gary and Janice Pinkston v. Comm., TCM 2020-44, where taxpayers depreciated $2.1 million of a $2.7 million Hawaii rental condo purchase over only 5 years.

**LIKE-KIND EXCHANGES - §1031**

**Like-Kind Exchanges Allowed For Real Property Only**

The Tax Cuts and Jobs Act (TCJA) modified the provision providing for nonrecognition of gain in the case of like-kind exchanges by limiting its application to real property that is not held primarily for sale. The provision generally applies to exchanges completed after Dec. 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before Dec. 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

**Example.** In 2023, Sharon trades in her old business truck for a new business truck. She receives a $10,000 trade-in allowance. Since §1031 only applies to the exchange of real property, Sharon must recognize gain on her trade-in. The gain is ordinary income to the extent of depreciation recapture.
**Tax practitioner planning.** A client who has a cost segregation study at the acquisition of his property may well need another at the exchange, so that he can establish the sales price of the personal property.

**Final Regulations Clarify Exchanges Involving Cost Segregation Studies**

In December 2020, the IRS issued final regulation changes for §1031 to help clarify eligible property following the limitations set out in the TCJA. Specifically, the IRS clarified that property acquired as part of a building or structure, but separately depreciated as §1245 property, would still be considered real property for purposes of post-2017 exchanges:

“The rules provided in this section concerning the definition of real property apply only for purposes of section 1031. No inference is intended with respect to the classification or characterization of property for other purposes of the Code, such as depreciation and sections 1245 and 1250. For example, a structure or a portion of a structure may be section 1245 property for depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or the portion of the structure is real property under this section.”

**Example.** To increase his depreciation allowances, Vern had a cost segregation study of his shopping center in 2017. In 2023, Vern exchanged his shopping center for an office building. The exchange of the shopping center building and land for the office building and land qualifies as a tax-deferred exchange, generally including the items identified for shorter depreciation under §1245. However, the exchange of personal property used in the shopping center that is not a part of the building or land is not qualified §1031 property, and a taxable transaction will result.

**Section 1031 and the Related Regulations Lay out The Following Rules Related to Exchanges**

- No gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment (§1031(a)(1)).
- To the extent of cash or other “boot” (not like-kind property) received, gain is recognized (§1031(b)).
- Net relief of the transferor taxpayer’s mortgage debt is considered boot received (§1.1031(b)-1).
- Amount of boot received is decreased by the taxpayer’s exchange expenses (§1.1031-(d)-2, Ex. (2)).

**Gain Recognized**

Gain to be recognized on an exchange is the sum of:

- Money or Other Boot Received
- Reduced by Exchange Expenses
- Plus: Net Mortgage Relief
- Gain Recognized

**Tax practitioner planning.** Money or other boot given can offset mortgage relief. However, an increase in mortgage does not offset cash or other boot received.
Like-Kind Properties

The “Qualified Use” Requirement - What Property Qualifies For A Tax-Free Exchange?

**Requirement.** As mentioned previously, both the property given up and the property received by the taxpayer must be held for *productive use in a trade or business or for investment* (§1031(A)(1)). For confusion’s sake, §1031 does not define *business or investment*; therefore, conventional wisdom assumes that the terms have the same meaning as elsewhere in the code, which is discussed below.

**Tax practitioner planning.** The qualified use test is determined by the use of each property, both given and received, *in the taxpayer’s hands*. Therefore, the use of either property in the hands of the other party involved in the exchange is irrelevant (Rev. Rul. 75-291).

**“Held for productive use in trade or business.”** Qualifying property must be used in a trade or business in which the taxpayer is engaged (§162; §1231). For example, trade or business property would include buildings owned and used by a business, office buildings, apartment houses, machinery and equipment, business trucks, and automobiles.

Confusion reigns in this area. Rental units are business property. For tax and exchange purposes, rental units are considered to be business property, *not* investment property. Most investors think rentals are investments, which is not true. Investment property has the negative result of creating a capital loss, whereas business property creates a fully deductible ordinary loss. So, what is included in the very limited definition of investment property?

**“Held for investment.”** This probably refers to property held for future use or future appreciation in value (§212). Examples of investment property include unimproved raw land, recreational property, and possibly second homes and/or condominiums.

**Personal residences and certain vacation homes don’t qualify.** A personal residence (or a vacation home not held for investment) is not qualified use property because it is being used for personal purposes, not for business or investment purposes ([Barry E. Moore and Deborah E. Moore v. Comm., TCM 2007-134](https://www.irs.gov/)).

**Tax practitioner planning.** The IRS has provided a safe harbor when an exchange involves a dwelling unit. The IRS will not challenge whether a dwelling unit qualifies under §1031 if the relinquished property was rented at fair rental value for at least 24 months immediately before the exchange (and was not used personally more than 14 days or 10% of the days rented) and the replacement property was rented for at least 24 months immediately after the exchange (and was not used personally more than 14 days or 10% of the days rented) (Rev. Proc. 2008-16).

Transferable Development Rights are Like-Kind to Real Property ([PLR 202335002 (September 1, 2023)](https://www.irs.gov/))

A limited partnership owns real property that has been held for productive use in a trade or business or for investment within the meaning of §1031. The partnership intends to sell the property and acquire transferable development rights (TDRs) as part of a like-kind exchange structured as a reverse exchange.

Treas. Reg. § .1031(a)-3 defines the term “real property” for purposes of §1031 and the regulations under §1031. Under § 1.1031(a)-3(a)(1), real property includes land and improvements to land and, under
§1.1031(a)-3(a)(5), an intangible interest in real property of a type described in §1.1031(a)-3(a)(1) is real property for purposes of §1031. Section 1.1031(a)-3(a)(5) further provides that intangible assets that are real property for purposes of §1031 include land development rights. Finally, §1.1031(a)-3(a)(6) provides that, with certain exceptions not relevant to Taxpayer’s facts, property that is real property under State or local law is real property for purposes of §1031.

Based on the above authorities and the facts and representations that were submitted, IRS ruled that the TDRs are, within the meaning of §1.1031(a)-1(b), of like kind to the real property.

Exchange Property Does Not Include Partnership Interests  

( Laurence Gluck and Sandra Prusock v. Comm., TCM 2020-66, aff’d 2nd Cir., No. 21-867, Mar. 17, 2022 )

On June 30, 2012, Laurence Gluck sold a condominium unit in New York City for $10,214,000. He wished to defer recognition of gain on this sale under §1031. Treating the condominium unit as the “relinquished property,” he began a search for “replacement property” that would qualify for like-kind exchange treatment. Consistent with the regulations, he deposited the proceeds from the sale of the condominium unit into a “qualified escrow account” with Royal Abstract Deferred, LLC (Royal Abstract), which acted as an escrow agent.

On Sep. 5, 2012, Mr. Gluck identified 145 East 74th Street in Manhattan (Property), a rental apartment building, as a possible replacement property. He thereafter formed 145 East 74th Owner, LLC (Gluck LLC), a single-member limited liability company. Gluck LLC was treated as a disregarded entity for Federal income tax purposes.

Replacement property a Tenant in Common interest – or was it? On Nov. 29, 2012, Gluck LLC executed a contract in which it acquired, for $4,625,000, a 12.5% interest in the Property. The contract lists the purchaser as Gluck LLC and the seller as the estate of Arthur D. Emil. The contract describes the asset thus acquired as an “undivided interest of 12.5% as a Tenant in Common” in the Property, including the land and the building. On Nov. 29, 2012, Gluck LLC entered into a substantially similar contract with Judy Tenney in which it acquired, for $4,625,000, another 12.5% interest in the Property.

M. Gluck and Ms. Prusock jointly filed Form 1040 for 2012. They included in this return Form 8824, Like-Kind Exchanges. This form stated that they had engaged in a like-kind exchange, described the replacement property as “145 East 74th Street,” and stated that the gain deferred under §1031 was $10,042,886.

But Greenberg & Portnoy (G&P), a partnership for federal income tax purposes, reported that it owned the Property and that Gluck LLC in 2012 acquired a partnership interest in G&P, as opposed to a direct ownership interest in the apartment building.

Partnership issued K-1 for 2012. For 2011 and 2012—and apparently for many years previously—G&P filed a return on Form 1065, U.S. Return of Partnership Income. The Schedule K-1 that G&P issued to Gluck LLC reported that, for 2012, Gluck LLC had contributed capital of $17,802,894, that it had received distributions of $62,500, and that its share of the partnership’s net rental real estate income was $65,570.

Gluck and Prusock acknowledge receipt of this Schedule K-1. However, they did not report their distributive share of G&P’s income on their 2012 Form 1040. Nor did they file with the IRS Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR). Taxpayers are instructed to file Form 8082 if they “believe an item was not properly reported on the Schedule K-1 you received from the partnership.”
IRS disallows exchange. Because the G&P partnership was considered to be a TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) partnership, its presumption was that absent Form 8082 (Notice of Inconsistently Treatment), the partnership reporting was correct. Therefore, IRS determined that Gluck and Prusock exchanged real property for disqualified property, namely a partnership interest (§1031(a)(2)(D)). Both the Tax Court and the Court of Appeals agreed with IRS, invalidating the exchange.

**Tax Practitioners’ Note.** Because of the TEFRA presumption, it is critical that Form 8082 be filed whenever the taxpayer takes a position contrary to the partnership’s K-1. This is not an “automatic audit” flag...in fact, in this case the taxpayers might have preserved their §1031 exchange if they had filed Form 8082.

Also see.

Charles and Yvonne Breland v. Comm., TCM 2019-59, where taxpayers were required to furnish documentation of original basis of property exchanged, then further exchanged, and eventually disposed.

Patrick A. and Jill M. Reesink v. Comm., TCM 2012-118, where the taxpayer used §1031 to defer a $429,000 gain on the sale of rental property by exchanging into a new rental home. The taxpayer moved into the home acquired in the exchange eight months after the exchange was completed, having never rented the home. The court ruled that because the taxpayer’s intent was good, the §1031 exchange was valid, and no tax was due.

William P. Adams v. Comm., TCM 2013-7, where the taxpayer exchanged a rental home for a residence where his son could live. The taxpayer admitted the son paid below fair market value rent, but the court agreed that because the son performed all maintenance on the home, the discounted rent was justified and ruled that the residence was not a personal home.

**Delayed Exchanges**

**Exchange, Not Sale, Must Be Planned**

The escrows should be part of an integrated plan showing that the exchanger wishes to affect a §1031 exchange. This is evidenced by showing that an integrated plan for a like-kind exchange is conceived and implemented, the exchanger’s actions are consistent with exchanging, the conditions required to effect that intent are met, the contracts providing for the necessary series of transfers are interdependent, and no cash proceeds from the sale of the original property are actually or constructively received by the exchanger (Garcia v. Comm., 80 TC 491 (1983), acq. 1984-1 CB 1).

**How to Structure the Delayed Exchange Properly**

Because the above escrow instructions give little assurances as to how an exchanger can, or cannot, structure a successful transaction, the IRS suggested three safe-harbor entities to be used to close exchanges (§1.1031(k)-1(g)). Use of these safe-harbor rules results in a determination that the taxpayer is not, either directly or through an accommodation that may be an agent, in actual or constructive receipt of money or other property. By far the most popular is the use of a qualified intermediary.

**Qualified accommodators.** This safe harbor uses intermediaries as qualified accommodation’s participation in the exchange to prevent the taxpayer from constructively receiving the purchase money. Deferred
Exchanges are permitted to be facilitated by the use of a qualified intermediary if the taxpayer’s rights to receive the money or other property held by the accommodation are limited by the previously discussed rules on substantial limitations or restrictions (§1.1031(k)-1(g)(4)(vi)). In this case, the qualified accommodation is not considered the agent of the taxpayer (an agent is normally a disqualified person) (§1.1031(k)-1(g)(4)(i)).

**Qualified Intermediary’s Participation**

A “qualified” intermediary is one who (§1.1031(k)-1(g)(4)):

- is not the taxpayer, related to the taxpayer, or an agent of the taxpayer in the past two years; and
- acts to facilitate a deferred exchange by entering into a written agreement (called the exchange agreement) and, as required by the exchange agreement, (1) acquires the relinquished property from the taxpayer, (2) transfers the relinquished property to the buyer, (3) acquires the replacement property from the seller, and (4) transfers the replacement property to the taxpayer.

Also see. 

*Frank J. Blangiardo, pro se v. Comm., TCM 2014-110*, where the taxpayer couldn’t use his attorney son as a qualified intermediary even if the money was held in a trust account.

*CCA 201325011*, where directing a qualified intermediary to pay debts was not actual or constructive receipt of sales proceeds.

**Reverse Starker Exchanges**


**Reverse Starker exchanges.** To facilitate reverse like-kind exchanges, taxpayers have engaged in a wide variety of transactions including so-called “parking” transactions (i.e., one of the properties is “parked” with an accommodation party). In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes. Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

**Replacement property is owned by accommodation.** In some situations, the desired replacement property is “parked” with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee.

**Relinquished property is owned by accommodation.** In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter, holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee.
Safe harbor for qualified exchange accommodation arrangements (Rev. Proc. 2000-37). The IRS will not challenge the qualification of property as either “replacement property” or “relinquished property” (as defined in §1.1031(k)-1(a)), or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes if the property is held in a Qualified Exchange Accommodation Arrangement (QEAA). For purposes of this revenue procedure, property is held in a QEAA if all of the following six requirements are met:

1. Ownership not vested in taxpayer or disqualified person;
2. Intent to qualify under §1031;
3. Written agreement within five days;
4. Identification of relinquished property within 45 days;
5. Transfer within 180 days; and
6. Maximum time in QEAA is 180 days.

Example. Arnold wants to exchange his four-plex for an upscale duplex. Unfortunately, he finds the duplex of his dreams before he finds a buyer for the four-plex. A qualified exchange accommodation titleholder may acquire ownership of the duplex and hold it for Arnold until he finds a buyer for his property. Once Arnold finds a buyer (must be within 180 days), he will exchange the four-plex for the duplex. Providing the requirements of Rev. Proc. 2000-37 are met, Arnold’s Reverse Starker exchange qualifies under §1031.

Permissible agreements. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arms’ length bargaining between unrelated parties with respect to such arrangements:

- Exchange accommodation titleholder may be qualified intermediary.
- Taxpayer may guarantee debt to buy property.
- Taxpayer may loan funds to buy property.
- Taxpayer may use property.
- Taxpayer may improve or service property.
- Predetermined price okay.
- Taxpayer may or must cover fluctuations in value.

Tax practitioner planning. A legal document, generally called an exchange agreement, must exist evidencing the relationship between the exchanger and the accommodation.

Also see.

Estate of George H. Bartell, Jr., Deceased, et al. v. Comm. (147 TC No. 5 (Aug. 10, 2016); AOD-2017-6, Aug. 25, 2017), where local drugstore chain acquires and renovates replacement property before identifying and selling relinquished store. However, the IRS issues non-acquiescence notice.
Like-Kind Exchanges with A Related Party (§1031(F))

Disposition within Two Years of Exchange Triggers Deferred Gain

If a taxpayer exchanges property with a related party (as defined below), the original exchange will not qualify for tax deferral if either of the exchanged properties is sold or disposed of within two years of the transfer. Interestingly, the postponed gain becomes taxable at the time of the disqualifying disposition and applies to both parties. It is important to note that exchanges between related parties may still use the tax-free benefits of §1031, provided the two-year waiting period and other requirements listed below are met (§1031(f) and (g)).

Who Is a Related Party? Related parties include:

Family members. Brothers, sisters, spouse, ancestors, and lineal descendants as well as C or S corporations and over 50% shareholders, corporate controlled members, and grantors and fiduciaries of trusts (§267(b)).

Partnership-partner. The related party definition also includes over 50% partner-to-partnership attribution rules (§707(b)).

Exceptions Exist to the Two-Year Rule

Certain dispositions within two years of an exchange will not invalidate §1031 treatment (§1031(f)(2)). This includes dispositions:

- after the earlier of the death of the taxpayer or the death of the related person,
- in an involuntary conversion if the exchange occurred before the threat or imminence of such conversion, or
- that the taxpayer can establish to the satisfaction of the Secretary that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The Conference Report gives three examples of this non-tax-avoidance exception: (1) transactions involving certain exchanges of undivided interests in different properties that result in each taxpayer’s holding either the entire interest in a single property or a larger undivided interest in any of the properties; (2) dispositions of property in nonrecognition transactions (e.g., §1033); and (3) transactions that do not involve the shifting of basis between properties.

If risk of loss is diminished (§1031(g)). The running of the two-year holding period will be suspended during any period when a party’s risk of loss with respect to the property is substantially diminished, such as: (1) the holding of a put with respect to the property; (2) the holding by another person of a right to acquire the property; or (3) a short sale or any other transaction.

Example. Dan and George, who are brothers, exchange like-kind property in a §1031 transaction. The realized gain on the exchange is postponed. Dan sells the property he received 18 months after the exchange. The result is that an unqualified like-kind exchange is deemed to have occurred as of the date Dan sold the property. When Dan disposes of the property, it causes all of the postponed gain to be recognized as of the date of the disposition. Not only does Dan have to recognize the gain, but George also has to recognize the gain he postponed.
What happens if Dan, 18 months after the exchange, enters into another §1031 exchange with an unrelated party? Even in this case, the second §1031 exchange is treated as a sale and will cause Dan and George to recognize the postponed gain from the first exchange.

**Tax practitioner planning.** Therefore, advance tax planning is required. Strong controls must exist between the related parties to prevent unexpected tax consequences created by the unilateral actions of just one of the parties. The legal documents should include a provision specifying that if either of the parties triggers the recognition of the postponed gain within the two-year period, the innocent party will be reimbursed for the tax consequences.

**Related Parties Who Exchange Must File IRS Form 8824 For the Next Two Years!**

If the exchange is made with a related party, the taxpayer must file Exchange Form 8824 in the year of the exchange and for the two following years.

**Also see.**

[PLR 201834010](#), where a multimember LLC qualifies for non-tax-avoidance exception on secondary exchange since the dispositions were in nonrecognition transactions and the taxpayer received neither cash nor other consideration that would trigger gain in the dispositions. The dispositions are, under §1031(f)(2)(c), ignored in determining whether §1031(f) applies to require gain recognition in the initial exchange.

**Real Estate: Dealer vs. Investor**

**Who Is A Dealer?**

Excluded from the definition of a capital asset is “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” (§1221(a)(1)).

**Nine standards are used to determine if a taxpayer is a dealer or investor in real estate.** Those that hold property primarily for sale to customers in the ordinary course of business are dealers. This analysis is purely factual, and to make the determination, courts must look to the taxpayer’s intent at the time of the disposition of the property. The dealer-versus-investor issue must be decided on a property-by-property basis and not an individual-by-individual basis. The Sixth Circuit Court of Appeals stated: “It is true * * * that a taxpayer may hold lands primarily for sale to customers in the ordinary course of his trade or business and, at the same time, hold other lands for investment” ([Stewart Mathews v. Comm.](https://www.irs.gov/external/tax Court/63-1USTC ¶9360) 315 F.2d 1963, aff’d, TCM 1961-213). There are no specific factors, or even a combination of factors, in the Code that are controlling for deciding the dealer-versus-investor issue. The courts have traditionally used the following factors ([Winthrop, Ada Belle v. Tomlinson](https://www.irs.gov/external/tax Court/56-2USTC ¶9686, 417 F.2d 905):

- The reason and purpose the property was acquired and/or disposed,
- The length of time the property was held,
- The number and frequency of sales, usually annually,
- The continuity of sales or sales-related activity over a period of time,
- Overall reluctance to sell the property,
• The substantiality of the gain obtained on the sale,
• The extent to which the taxpayer or his or her agents engaged in sales activities by developing or improving the property, soliciting customers, or advertising,
• The substantiality of sales when compared with other sources of the taxpayer’s income, and
• The desire to liquidate unexpectedly obtained land holdings (such as by inheritance).

**May a real estate broker or agent also be an investor?** Sure. It is possible for the same person to simultaneously be a dealer and an investor in real estate. A dealer in real estate must be distinguished from a real estate broker or a real estate agent. A dealer has ownership interest in property, whereas a real estate broker or agent brings together a buyer and a seller of property for a fee or commission ([Williford v. Comm.](https://www.irs.gov/pub/irs-ty/tcm90-1-44)), [TCM 1992-445](https://www.irs.gov/pub/irs-ty/tcm90-1-44).

**Dealer vs. investor — Why do we care?** There are several provisions in the Code that provide tax advantages to real estate investors. Most of these tax advantages are not available to real estate dealers. Real estate dealers:

• May not use the like-kind exchange provisions regarding nonrecognition of gain or loss on exchange of real property because they hold real property as stock-in-trade (inventory) and not for productive use in business or for investment ([§1031(a)(2)](https://www.irs.gov/individuals/like-kind-exchange-for-real-property)).
• May not use the installment sales method of accounting for gains and losses on real estate sales.
• May not use the reduced capital gain tax rates applicable for sales of real estate by investors.

**Self-employment tax.** Real estate sales by dealers are considered sales of inventory and are taxed at ordinary income tax rates. Such sales are also subject to self-employment tax.

**Tax practitioner planning.** Generally, recently subdivided real estate may not be traded tax-free for other real estate, subdivided or otherwise, as the property being traded is property held primarily for sale and, therefore, is nonqualifying property. Special rules allow the investor to subdivide property and be exempt from dealer status ([§1237](https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax/self-employment-tax)).

**When Property Is, and Is Not, Treated as a Capital Asset**

A capital asset is defined as “property held by the taxpayer * * * but does not include * * * property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” To determine whether a real estate asset is a capital asset, the court analyzes the facts and circumstances, including factors such as the “number, extent, continuity, and substantiality of the sales * * * [and] the extent of subdividing, developing, and advertising.” No specific factor or combination of factors is controlling ([§1221(a)(1)](https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax/self-employment-tax)); [US v. Winthrop, 417 F.2d 905 (5th Cir. 1969)](https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax/self-employment-tax); [Biedenharn Realty Co. v. US, 526 F.2d 409 (5th Cir. 1976)](https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax/self-employment-tax).


Robert Di Giorgio was a mortgage lender and real estate salesman who specialized in distressed properties. He failed to report substantial income from those and other activities for 2005 through 2007. With his unreported income, Mr. Di Giorgio led a lavish lifestyle with extravagant vacations, including one to the Philippines where he met his second wife. During their marriage, he kept her in the dark about their true
financial situation. Through a bank deposits analysis, the IRS determined income tax deficiencies, additions to tax, and civil fraud penalties.

The Di Giorgios challenged the IRS’s determinations, and Ms. Di Giorgio asserted that she was entitled to innocent spouse relief under §6015.1 The Court found that the IRS established by clear and convincing evidence that Mr. Di Giorgio underreported his income. Using a bank deposit analysis, and despite determining that a significant portion of the deposits were nontaxable, already reported, or included in other adjustments, the examiner determined taxable deposits from Mr. Di Giorgio’s S Corporation (Radius CA) of $1,158,273 and $5,267,876 for 2005 and 2006, respectively. And he determined other taxable deposits of $2,404,793, $1,374,340, and $1,409,068 for 2005, 2006, and 2007, respectively.

**Fraud penalties, but wife gets innocent spouse relief.** The Court found that Di Giorgio underpaid his tax, and that those underpayments were due to fraud. Ms. Di Giorgio established that she is entitled to relief from joint and several liability.

**Long-Time Investor Did Not Become a Dealer Overnight** *(William E. Jr. and Melissa Musselwhite v. Comm., TCM 2022-057)*

William Musselwhite is a personal injury lawyer in North Carolina. Having successfully invested in real property in the past, in 2005 William formed a partnership with David Stephenson, a developer. For 2005 through 2012 the partnership (DS & EM Investments) reported the nature of its business a real estate investment.

In 2006 the partnership acquired four undeveloped lots that it hoped to market and sell. Unfortunately, when the real estate market tumbled in 2007, the partnership could not sell the lots and was being pressured by its bank regarding loans made to acquire the property.

In the light of the continued depressed housing market, the bank’s mounting pressure with respect to the four lots, and both Mr. Musselwhite’s and Mr. Stephenson’s personal debt exposure with respect to other property owned, Mr. Musselwhite and Mr. Stephenson agreed that it was prudent to distribute or convey to each other some of their properties (including properties of DS & EM Investments), dividing up the debt. Accordingly, on July 27, 2012, it distributed the four lots to Mr. Musselwhite. Using a licensed real estate broker, William sold the four lots in November 2012, recognizing a $1,022,726 loss.

William claimed the loss on Schedule C, listing the sales proceeds as the only revenue and the adjusted cost basis of the lots as cost of goods sold. 2012 was the first and only year he filed a Schedule C regarding his real estate transactions. Examining his history with real estate, prior treatment of real property as an investment, and lacking any evidence to the contrary, the IRS concluded, and the Tax Court agreed that William incurred a capital loss from the transaction.

**Also see.**

*BARRY G. AND BRIDGET H. CONNER V. COMM., TCM 2018-6 (JAN. 23, 2018)* where property was held for multiple years without engaging in development-related activities and no effort was made to sell the property until a third party made an unsolicited offer to buy it.

*JEFFREY EVANS V. COMM., TCM 2016-7*, where intent to develop property without a history of regular development business was not enough for the taxpayer to claim loss on foreclosure as ordinary.

*VICTOR FARGO AND VIRGINIA KING V. COMM., TCM 2015-96*, where dormant development coupled with a long-term holding period did not change the nature or character of intent in determining “dealer” property. The taxpayer undertook substantial efforts and costs to preserve and enhance the development plans in place as well as spending energies in an attempt to obtain financing for the exclusive purpose of development.

Hisham Ashkouri is an architect and the sole member of Cold Spring Green, LLC, which developed a condominium project on Beacon Street in Newton, Massachusetts, consisting of two units. The LLC’s sole purpose and function was to acquire, hold, develop, operate, and sell the condominium complex. The LLC sold one of the units in 2011 for $1,250,622. Hisham reported a gain on sale of $15,945 as a §1231 gain from the sale of assets used in a trade or business, and thus, a long-term capital gain. The IRS argued, and the Tax Court agreed, that the property was held “for sale to customers in the ordinary course of its trade or business.” As a result, the gain was ordinary income.

IRS Updates Guidance on Accounting for Common Improvements (Rev. Proc. 2023-9)

The IRS provided new rules and conditions for implementing the optional safe harbor method of accounting for real estate developers to determine when common improvement costs may be included in the basis of individual units of real property in a real property development project held for sale to determine the gain or loss from sales of those units (Alternative Cost Method). Under this revenue procedure, the Alternative Cost Method is a method of accounting under §§446 and 481 of the IRC and is an alternative to the general requirements under §461(h).

Under the Alternative Cost Method, a developer includes the share of the estimated cost of common improvements allocable to the units sold in the basis of such units regardless of whether the costs have been incurred under §461(h), subject to the alternative cost limitations set forth in this revenue procedure. This revenue procedure also provides guidance on the application of the Alternative Cost Method to contracts accounted for under §460 and the regulations thereunder.

CANCELLATION OF DEBT

Exclusion From Income — Generally (§108(A))

Cancellation of Debt (COD) is excludable from income if it occurs:

- In bankruptcy (§108(a)(1)(A)),
- To an insolvent borrower (§108(a)(1)(B)), but only to the extent of insolvency (§108(a)(3)),
- With qualified farm debt (§108(a)(1)(C)),
- With qualified real property business debt (for taxpayers other than C corporations (§108(a)(1)(D); Rev. Rul. 2016-15),
- In discharge of qualified principal residence indebtedness between Jan. 1, 2007, and Dec. 31, 2025 (§108(a)(1)€),
- With seller financing (§108(e)(5)),
- When payment of the debt would result in a tax deduction to the borrower (§108(e)(2)),
- With certain student loans (§108(f); Rev. Rul. 2008-34), or
- As part of a bona fide dispute.
Reduction Of Certain Future Tax Benefits (Tax Attributes) [§108(b)(1)]

The exclusion of COD as a result of bankruptcy or insolvency requires a corresponding reduction of future tax benefits [§108(b)]. The price (or curse) for excluding COD from current gross taxable income under any of the above three exclusions is that the borrower loses certain future tax benefits, such as net operating loss carryover and future depreciation deductions (§108(b)). However, prior to decreasing these future tax benefits, the borrower may elect to reduce the basis of his or her depreciable property. This reduction is done at the beginning of the tax year following the tax year of the debt discharge.

Order of reduction rule (§108(b)(2)). In the absence of an election to first reduce depreciable basis, future tax benefits (tax attributes) of the borrower shall be reduced to the extent of debt discharge income (or its equivalent) in the following order:

- **Net operating losses**: Reduce net operating losses (NOLs) dollar for dollar.
- **General business credit**: Reduce at a 33.3% rate for each $1 of COD excluded.
- **Alternative minimum tax credits**: Reduce the minimum tax credits as of the beginning of the tax year immediately after the tax year of the discharge.
- **Capital losses**: Reduce dollar for dollar.
- **Basis reduction**: Reduce, dollar for dollar, the basis of both depreciable and non-depreciable property. But this basis cannot be reduced below total liabilities immediately after the discharge (§108(b)(2)(D)).
- **Tax practitioner planning**: The taxpayer may elect to first reduce depreciated basis, then basis can be reduced below total liabilities all the way to zero (108(b)(5)).
- **Tax practitioner planning**: The election to first reduce depreciable basis (#5) may cause tax benefits to be pointlessly eliminated when the total liabilities remaining after the COD are high in relationship to the property’s basis (LTR 201718023).
- **Passive activity losses (and credits)**: Reduce the passive activity losses and credit carryovers from the tax year of the discharge.
- **Foreign tax credit carryovers**: Reduce (at a 33.3% rate for each $1 of COD excluded).

IRS Updates Audit Technique Guide (ATG) on Foreclosure and Cancellation of Debt

In August 2021, the IRS updated its audit technique guide (ATG), which discusses the tax consequences for real estate property that is disposed of through foreclosure, short sale, deed in lieu of foreclosure, and abandonments. Although the term foreclosure is used throughout the document, the tax treatment also applies to short sales, deed in lieu of foreclosures, and abandonments. A discussion is also devoted to cancellation of debt income exclusions that are most commonly applicable to these types of dispositions and community property considerations. The guide primarily focuses on tax consequences for individual taxpayers.

IRS Website Includes Interactive Calculator for Cancellation of Debt Income on Foreclosure of Home (Do I Have Cancellation of Debt Income on My Personal Residence?)

The IRS website now includes an interactive calculator for determining taxable COD income on the foreclosure, loan modification, or short sale of a personal residence.
Section 108 Exclusion for Cancellation of Acquisition Indebtedness on Principal Residences Extended Through Dec. 31, 2025 (§108(a)(1)(E))

A taxpayer subject to foreclosure might end up homeless and still face a nasty tax bill from Uncle Sam for cancellation of debt income. To address this frightening tax dilemma, Congress temporarily added a §108 exclusion to cancellation of debt income. Effective for discharges of indebtedness on or after Jan. 1, 2007, and before Jan. 1, 2026 (as extended by the Consolidated Appropriation Act (CAA 2021)), this excludes from a taxpayer’s gross income any discharge (in whole or in part) of qualified principal residence indebtedness (§108(a)(1)(E)).

Qualified Principal Residence Indebtedness

Principal residence. For these purposes, the term “principal residence” has the same meaning as under §121. It does not include the taxpayer’s vacation home, rental, or investment property.

Qualified principal residence indebtedness means debt which is incurred in the acquisition, construction, or substantial improvement of the principal residence by the individual and is secured by the residence (see §163(h)(3)(B)), except that the dollar limit is $2 million ($1 million in the case of a separate return) through Dec. 31, 2020. Beginning Jan. 1, 2021, the dollar limit is $750,000 ($375,000 in the case of a separate return), as provided in CAA 2021. Qualified principal residence indebtedness does not include home equity indebtedness.

When a portion of the mortgage is acquisition indebtedness. If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to the amount discharged that exceeds the portion of the debt which is not qualified principal residence indebtedness.

Cancelled Debt Was Includible in Gain on Sale (George G. & Julia A. Parker v. Comm., TCM 2023-104)

George Parker was the sole shareholder of the S-Corporation Exterra Realty Partners, LLC in 2012. The entity sold a property, held for development, in Livermore, CA. The original purchase in 2007 was financed through a series of loans totaling $34.2 million. In 2012, Exterra sold the property for $40.6 million debt and accrued interest assumed by the buyer. The lender also cancelled $12.7 million of additional nonrecourse debt.

Exterra ultimately claimed a sale price of $50.6 million and declared $2.7 million cancellation of debt income, excluded on Form 982 under the insolvency exclusion of §108(a)(1). This treatment resulted in Exterra reporting -0- net income from the disposition of the property.

Nonrecourse debt forgiven is not eligible for §108 exclusion. When a taxpayer sells or otherwise disposes of property encumbered by nonrecourse debt, the amount of the outstanding debt is typically included in the amount realized (Treas. Reg. § 1.1001-2(a)(2)). To the extent that the amount realized exceeds the taxpayer’s basis in the property, the taxpayer has gain (§1001(a)). In contrast, a COD that is not part of a sale or exchange of property generally results in COD income, which may then be subject to certain statutory exclusions. The court held that the $2.7 million was includible in Exterra's amount realized on the sale of the Livermore property.
Taxpayer Must Reduce Basis in Year of Sale for Discharge of Qualified Real Property Business Debt (%Richard S. Hussey v. Comm., TC No. 19249-18, 156, No. 12., June 24, 2021%)

In 2012, Richard Hussey sold 16 of 27 investment properties he originally acquired in 2009. Of the 16 properties sold in 2012, 15 were short sales. All the loans on Richard’s properties were held by the same bank, and in 2012 the bank issued 15 Forms 1099-C, Cancellation of Debt, which stated he had a total discharge of debt of $754,054.

Richard also sold seven of his remaining properties in 2013, and although the bank agreed to a loan modification reducing his debt by $529,665, it did not issue any Form 1099-C for 2013.

Which year to adjust basis? Section 108(a)(1)(D) provides an exclusion from income for forgiveness of qualified real property business indebtedness (QRPBI). When that exclusion applies, the taxpayer must reduce his or her bases in the depreciable real properties according to §108(c)(1). The IRS agreed that Richard’s indebtedness on the 15 investment properties sold short in 2012 was QRPBI. It also agreed that Richard may exclude the discharge of his QRPBI from income. Finally, both the IRS and Richard agreed that he must reduce his bases in the depreciable real properties as a result of that exclusion. However, the parties disputed the year for which the basis reductions must be made. Richard contended that the basis reductions must be made for 2013. The IRS contended they must be made for 2012.

Applying §1017 to determine year of basis adjustment. IRC §1017(a) states generally that basis reductions resulting from the discharge of QRPBI are made the year after the debt is discharged. If §1017(a) applies here, the basis adjustments at issue would be made in 2013. However, §1017(b)(3)(F) provides three additional rules which govern reduction of basis following discharge of QRPBI:

1. Real property, the aggregate bases of which are considered under §108(c)(2)(B), includes only depreciable real property.
2. The depreciable real property may not be held as inventory.
3. §1017(b)(3)(F)(iii) provides that, in the case of “property taken into account under section 108(c)(2)(B), the [basis] reduction with respect to such property shall be made as of the time immediately before [the] disposition if earlier than the time under” §1017(a) (i.e., the year following the discharge).

Application of the third rule requires consideration of whether “property [was] taken into account under section 108(c)(2)(B);” and if it was, then the “reduction with respect to such property shall be made as of the time immediately before [the] disposition [e.g., sale] if earlier than the time under” §1017(a).

The property referred to in §108(c)(2)(B) is ascertained before the debt is discharged. The court found that when §1017(b)(3)(F)(iii) refers to the properties identified in §108(c)(2)(B), that reference is to a set group of properties that is fixed once the debt is discharged. Selling properties from that group triggers §1017(b)(3)(F)(iii) with respect to the bases of the properties sold regardless of the remaining bases in the properties not sold. Nowhere in §1017(b)(3)(F)(iii) or §108(c)(2)(B) is there a reference to the “remaining” bases after the sale (i.e., disposition) of properties. Thus, Richard was required under §1017(b)(3)(F)(iii) to reduce his bases immediately before the sale of the investment properties in 2012.

IRS Will Not Acquiesce to Court Ruling in Insolvency Calculation (%AOD 2021-1%)

In %David W. and Janet L. Schieber v. Comm., TCM 2017-32%, the court held that the taxpayer’s defined benefit plan under CalPERS (California Public Employees’ Retirement System) was not an asset for purposes
of calculating insolvency. David, a retired police officer for the city of Bakersfield, California, was receiving monthly payments from his pension. He could not convert his interest in the pension plan into a lump-sum cash amount, assign the interest, sell the interest, borrow against the interest, or borrow from the plan.

In its Action on Decision, the IRS believes the court misapplied language from §108’s legislative history rather than from the statute itself when it ruled that the “test” for whether something is an asset “is whether it gives the taxpayer the ‘ability to pay an immediate tax on income’ from the cancelled debt — not to pay the tax gradually over time.” Accordingly, the IRS will not follow Schieber in excluding assets from the definition of asset under §108(d)(3) on the grounds that they cannot be converted into a lump-sum cash amount, sold, assigned, or borrowed against.

Also see. 

Mary Bui v. Comm., TCM 2019-54, May 21, 2019, where taxpayer was allowed to use both insolvency and principal residence acquisition debt exclusion to reduce COD income.

GAIN ON SALE OF RESIDENCE - §121

THE $250,000/$500,000 EXCLUSION RULE

Up to $250,000 of gain ($500,000 for married filing jointly) realized on the sale or exchange of a principal residence on or after May 7, 1997, is not taxable (not just deferred) if certain prerequisites are satisfied. This permanent exclusion is allowed each time a homeowner meets the eligibility requirements, but generally no more frequently than once every two years (§121). But this provision is denied to disqualified expatriates (§121(e); §877(a)(1)).

Where Is the Principal Residence?

Only one “principal” residence is possible. One taxpayer cannot own two principal residences simultaneously because principal is defined as “the most important” (McDowell v. Comm., 40 TCM 301 (1980)).

Determined by the facts and circumstances. There is no IRS bright-line test to identify the principal residence for sellers who have more than one residence. Whether property is used by the taxpayer as the taxpayer’s residence and whether the property is used as the taxpayer’s principal residence is a question of facts and circumstances (§1.121-1(b)(2)).

Normally, this is easy to determine. A taxpayer’s principal residence is the land and building where the taxpayer principally domiciles, based upon all the facts and circumstances in each case, including the good faith of the taxpayer. It may even be located in a foreign country (Rev. Rul. 54-611, 1954-2 CB 159). As there is no requirement that a principal residence be owned, a motel room or rental apartment may end up being a principal residence (Rev. Rul. 60-189; Rev. Rul. 73-529; Marvin Ziporyn v. Comm., TCM 1997-151).

When multiple homes are owned, the principal residence generally will be where the taxpayer spends the “majority of the time.” In the case of a taxpayer using more than one property as a residence, if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily, but not necessarily, be considered the taxpayer’s principal residence (§1.1211(b)(2)). In order to meet the two-year use requirement, occupancy (with the exception of short temporary
absences) of the residence is required (§1.121-1(c)(2)). In addition to the taxpayer’s use of the property, relevant factors in determining a taxpayer’s principal residence include but are not limited to the:

- taxpayer’s place of employment;
- principal place of abode of the taxpayer’s family members;
- address listed on the taxpayer’s federal and state tax returns, driver’s license, automobile registration, and voter registration card;
- taxpayer’s mailing address for bills and correspondence;
- location of the taxpayer’s banks; and
- location of religious organizations and recreational clubs with which the taxpayer is affiliated (§1.1211(b)(2)(I) - (iv); also see Rev. Rul. 71-247).

Also see.

_Lawrence L. and Mary J. Wickersham v. Comm., TCM 2011-178_, a tale of two homes — where's the primary residence?

Taxpayers Meet Ownership But Not Use Test (Steven W. and Catherine S. Webert v. Comm., TCM 2022-32)

Steven and Catherine Webert purchased their home in Mercer Island, Washington, in 2005. Because of Mrs. Webert’s health issues and mounting medical bills, the couple began to try to sell the home in 2009. However, because of the housing market crash, the Weberts were unable to sell.

In 2009, they moved to another property owned by Mr. Webert and began renting out the Mercer Island home in 2010. It remained rented for 2010 through 2013 and for most of 2014 and part of 2015. During that time, the Weberts did not use the house personally.

When the property sold in 2015 at a gain of $194,752, the Weberts reported the gain and then excluded it, citing §121. Although they met the “two-out-of-five” ownership test, they failed to meet the similar use test.


John and Kimberlie Forte purchased their Windsong Lane home in Utah in 2000 and lived there until 2005. In September 2005, they sold the Windsong Lane home, carrying back on seller-financed notes some of the sales price. They moved into their newly constructed home on Snow Forest Cove in December 2005.

Although the Fortes were struggling financially in 2005, their situation got worse, compounded by a high interest rate on the construction loan for Snow Forest and their inability to collect on the seller-financed notes from the sale of Windsong Lane. Finally, in September 2007, they sold the Snow Forest home at a substantial gain.

Although an IRS Revenue Agent allowed a partial §121 gain exclusion for “unforeseen circumstances,” the US sued for summary judgment, citing that the Fortes’ financial difficulties were not unforeseen at the time they moved into Snow Forest. The Fortes cross-claimed for summary judgment that their inability to collect the remaining proceeds from the sale of Windsong Lane was unforeseen. In the end, the court found that there are genuine issues of material fact on both sides and denied both motions for summary judgment.
OTHER REAL ESTATE DEVELOPMENTS

Timeshares

A timeshare provides partial ownership in a vacation property. You can even think of it as owning shares of stock in the vacation rental. Owners pay an upfront price to purchase a unit and then an annual maintenance fee. What’s actually “owned” is access to the property for a certain period of time, which is usually the same time slot each year. Outside of that time period (one week, two weeks, etc.) others owning similar interest use- the unit.

The average sales price for a one-week timeshare today is approximately $23,000, with an average annual maintenance fee of $640 to $1,290, according to the American Resort Development Association (ARDA). Most timeshare agreements are indefinite contracts, meaning that one is obligated to pay the maintenance fee indefinitely, which is a big financial commitment.

Terminating the ownership contract can be difficult or impossible. Recent years have seen a rapid growth in companies advertising help for consumers to sell or terminate their timeshare arrangements.


Through Donate for a Cause, a nonprofit with tax exempt status, James Tarpey pitched an attractive offer to customers looking to get rid of timeshares: donate your unwanted property to us, we’ll get it appraised, and you’ll claim a charitable contribution deduction on your federal tax return. There was just one hitch. The timeshare donation business was really more of a bogus tax scheme. The IRS assessed penalties under §6700 for promoting an abusive tax shelter. The district court concluded that Tarpey was liable for the entirety of his timeshare donation scheme and, after a bench trial, ordered a penalty amount of $8.465 million plus interest.

Breaking up is hard to do. DFC facilitated the donation of timeshares for timeshare owners who no longer wanted to pay timeshare fees or otherwise wanted to dispose of their timeshare properties. Tarpey promised potential customers that they could receive generous tax savings from donating their unwanted timeshares to DFC. Tarpey himself appraised the value of some of the properties donated to DFC, and other properties were appraised by his sister, Suzanne Tarpey, and real property appraisers Ron Broyles and Curt Thor. Donors paid a donation fee to DFC plus shouldered the timeshare transfer fees. DFC accepted at least 7,600 timeshare donations during the period at issue, 2010-2013.

In a prior proceeding, the United States alleged that Tarpey was operating a “bogus tax scheme.” The government alleged Tarpey was using conflicted appraisers who overstated the value of the timeshares and that Tarpey “falsely told customers that they could deduct the full appraised amount of the timeshare, conducted by DFC, and the associated processing fees.” Between 2016 and 2017, the district court entered six orders permanently enjoining Tarpey, his sister, Broyles, Thor, Resort Closings, and DFC from continuing to appraise and accept timeshare donations. The consent judgment against Tarpey permanently enjoined him from preparing property appraisals in connection with federal taxes, encouraging others to claim charitable contribution deductions on their taxes, and promoting any plan regarding charitable contribution deductions claimed on Federal tax returns.
Monetized Installment Sales

A monetized installment sale is a special kind of installment sale where the seller of an appreciated asset defers recognizing gain on the sale, even though receiving cash, usually in the form of a “loan.” These are generally arranged through a “dealer” who specializes in such transactions.

Example. Karen has a piece of real property valued at $500,000 with an adjusted basis of $50,000. Sharon is willing to buy it for fair market value. Instead of selling directly to Sharon:

1. Karen sells to a monetized installment sale dealer and receives a 30-year note, interest payable currently, with the $500,000 principal due at maturity.

2. The dealer sells the property to Sharon for her $500,000 cash.

3. The note is collected through an escrow account, usually interest paid monthly.

4. An “intermediary” agrees to make a loan to Karen for $500,000 (actually, some percentage of that, say 90%-95%), payable from the above escrow account, interest only, principal at maturity in 30 years.

5. And thus, Karen receives nearly all of the $500,000 sales price up front without actually recognizing the gain on sale.

IRS Issues Advisory on Monetized Installment Sale Transactions (CCA202118016)

While practitioners have long remained skeptical of monetized installment sale transactions, the IRS has been silent on the subject except for a memo from 2012 (CCM 20123401F) that is often cited by dealers and promoters. In the new CCA, the Service addresses both why it believes the theory is flawed and why the prior memo is generally not applicable.

While there are some variations in the way transactions are structured, there do seem to be common features that the IRS cites that make the transactions problematic. According to the CCA, the IRS generally agrees that the theory on which promoters base the arrangements is flawed. The advisory claims the general structure raises a number of issues including, but not limited to, the following:

No genuine indebtedness. At least one promoter contends that the seller receives the proceeds of an unsecured nonrecourse loan from a lender, but a genuine nonrecourse loan must be secured by collateral. A “borrower” who is not personally liable and has not pledged collateral would have no reason to repay a purported “loan.” Therefore, the loan proceeds would be income.

Debt secured by escrow. In one arrangement, the promoter states that the lender can look only to the cash escrow for payment. It appears that, in effect, the cash escrow is security for the loan to the taxpayer. If so, the taxpayer economically benefits from the cash escrow and should be treated as receiving payment under the “economic benefit” doctrine for purposes of §453.

Debt secured by dealer note. Alternatively, the monetization loan to the taxpayer is secured by the right to payment from the escrow under the installment note from the dealer. This would result in deemed payment under the pledging rule, under which loan proceeds are treated as payment of the dealer note (§453A(d)).

Section 453(f). The intermediary does not appear to be the true buyer of the asset sold by the taxpayer. Under §453(f), only debt instruments from an “acquirer” can be excluded from the definition of payment and thus not
constitute payment for purposes of §453. Debt instruments issued by a party that is not the “acquirer” would be considered payment, requiring recognition of gain.

**Cash Security.** To the extent the installment note from the intermediary to the seller is secured by a cash escrow, the taxpayer is treated as receiving payment irrespective of the pledging rule. Treas. Reg. §15a.453-1(b)(3): “Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent . . . will be treated as the receipt of payment.”

**NSAR 20123401F is distinguishable.** The case addressed in the memorandum did not involve an intermediary. Further, loans to a disregarded entity wholly owned by the seller were secured by the buyer’s installment notes, but the pledging rule of §453A(d) was not applicable. There is an exception to the pledging rule for sales of farm property, which applied in the case.

**IRS Issues Proposed Regulation Naming Monetized Installment Sales as Listed Transactions [IR-2023-139 (Aug. 4, 2023)]**

The Department of the Treasury and the IRS issued proposed regulations identifying certain monetized installment sale transactions and substantially similar transactions as listed transactions – abusive tax transactions that must be reported to the IRS.

Material advisors and certain participants in these listed transactions are required to file disclosures with the IRS and are subject to penalties for failure to disclose these transactions.

The IRS listed monetized installment sales this year as part of the agency’s [Dirty Dozen](https://www.irs.gov/newsroom/irs-lists-taxes-2023-dirty-dozen) list of common tax scams and schemes.
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BUILD BACK BETTER ACT REINCARNATED IN BIDEN BUDGET PROPOSAL

The Biden Administration issued its 2024 Budget Proposal (and Treasury Greenbook), which includes many of the Build Back Better Act (BBBA) proposals reincarnated, while modifying others, and adding some new items. Given the divided Congress, major changes in advance of the 2024 election results are not expected. Most provisions, if enacted, are scheduled to be effective Jan. 1, 2024. Others (including the changes proposed to grantor trust taxation and changes proposed to deny valuation discounts in many family transfers) are proposed to be effective on the date of enactment. That may be months away if it happens at all.

Client Planning Discussions

Planning suggests that we need to be mindful of the proposals, have discussions with clients, and advise clients of the need to meet with their estate tax attorney to identify what should and can be done and the necessary actions to be taken if new laws are passed and enacted. Even if there is no new tax legislation in 2023, relevant provisions of the 2017 law known as the Tax Cuts and Jobs Act (TCJA) are scheduled to sunset Dec. 31, 2025, so planning will be necessary in any event.

Perhaps the change with the widest impact on traditional estate planning strategy would be new §2901. These provisions would apply to trusts created on or after the date of enactment (other than revocable trusts, or to that portion of a grandfathered trust attributable to contributions made after that date). The proposed section has three key provisions:

1. When the deemed owner of a grantor trust dies, the assets of that grantor trust are part of the deemed owner’s gross estate.
2. Any distribution from a grantor trust to someone other than the grantor, the grantor’s spouse, or to discharge a debt of the grantor will be treated as a taxable gift from the grantor to the person receiving the distribution.

3. If the trust ceases to be a grantor trust during the grantor’s life, it will be treated as a gift by the grantor of all trust assets.

Defective Grantor Trusts. If §2901 is enacted, so-called defective grantor trusts and sales to intentionally defective trusts would no longer be viable transactions. The exclusion of the appreciated trust property from the grantor’s estate would no longer be allowed. A gift of the property prior to death would also be taxed.

Grantor Retained Annuity Trusts. If §2901 is codified, it appears grantor retained annuity trusts (GRATs) will no longer be beneficial. At the end of the annuity term, if a GRAT transfers assets to a continuing grantor trust, the assets will still be subject to estate tax. If assets pass to a non-grantor trust or to the grantor’s children, the transferor will be treated as making a gift equal to the value of the transferred property. In either event the benefit to creating a GRAT would be eliminated if these legislative proposals become law. If appreciated assets are used to make the required annuity payment to the Grantor, under proposed §1062, that payment would trigger a deemed sale and an unwanted capital gains event. Zeroed-out GRATs (GRATs with no gift tax element) would be prohibited, along with the technique called the “99 Year GRAT.” Planning for clients suggests addressing these planning opportunities while they remain viable and available.

Insurance Trusts. Insurance trusts are almost always grantor trusts. They are designed to ensure the insurance death benefit is not subject to estate tax. The premium payments owed on the insurance policy are generally paid by making annual gifts to the trust. Existing insurance trusts will be grandfathered, but the payment of future insurance premiums by the insured may be treated as an additional contribution to the trust, resulting in some portion of the insurance death benefit being estate taxable. Tracking this portion will be challenging for many taxpayers. Going forward, if a new life insurance trust is created and is a grantor trust, the death benefit on any trust-owned insurance will be subject to estate tax. It will be difficult to craft an insurance trust that is not considered a grantor trust with respect to the insured or the trust beneficiaries. This provision was in the BBBA proposals but was not in the Greenbook. It is not clear if this will be brought up again.

Spousal Lifetime Access Trust. A SLAT is a trust for one’s spouse and descendants. In general, naming one’s spouse as a trust beneficiary results in that trust being classified as a grantor trust. As a result, going forward, it will be difficult to create an irrevocable trust for the benefit of a spouse without subjecting the assets of that trust to estate tax. A “SLANT” is a spousal lifetime access non-grantor trust. Such a trust must include a beneficiary adverse to the grantor or a deemed grantor who must consent to the grantor (or deemed grantor) receiving a trust distribution. Where such an adverse interest is present, the trust is not a grantor trust.

Given the broad political differences about tax policy, the professional advisor needs to “stay tuned” and see what, if anything, emerges. The best advice is get ahead of the changes that may come and take advantage of favorable laws while they are still available.

2023 ESTATE TAX EXCLUSION AMOUNTS

For taxpayers dying in 2023, Form 706 must be filed by the executor for the estate of every U.S. citizen or resident whose gross estate and adjusted taxable gifts and specific exemption are more than $12,920,000. The filing requirement is based on the total value of the gross estate (before deductions allowed) and
adjusted taxable gifts. Therefore, use of deductions, such as the marital deduction, deduction for debts, and even contingent liabilities, charitable deductions, and administration expenses, may together eliminate any estate tax liability. Form 706 is used to calculate the estate tax levied on the entire taxable estate (not just on shares of a particular beneficiary). The Form is also used to compute the generation-skipping transfer (GST) tax on direct skips (transfers to skip persons of interests in property included in the decedent’s gross estate).

<table>
<thead>
<tr>
<th>Year of Decedent’s Death</th>
<th>Basic Exclusion Amount</th>
<th>Unified Credit Amount</th>
<th>Top Marginal Estate Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$5,000,000 or no estate tax if modified carryover basis elected</td>
<td>$330,800</td>
<td>35% or no estate tax if election made</td>
</tr>
<tr>
<td>2011</td>
<td>$5,000,000</td>
<td>$1,730,800</td>
<td>35%</td>
</tr>
<tr>
<td>2012</td>
<td>$5,120,000</td>
<td>$1,772,800</td>
<td>35%</td>
</tr>
<tr>
<td>2013</td>
<td>$5,250,000</td>
<td>$2,045,800</td>
<td>40%</td>
</tr>
<tr>
<td>2014</td>
<td>$5,340,000</td>
<td>$2,081,800</td>
<td>40%</td>
</tr>
<tr>
<td>2015</td>
<td>$5,430,000</td>
<td>$2,117,800</td>
<td>40%</td>
</tr>
<tr>
<td>2016</td>
<td>$5,450,000</td>
<td>$2,125,800</td>
<td>40%</td>
</tr>
<tr>
<td>2017</td>
<td>$5,490,000</td>
<td>$2,141,800</td>
<td>40%</td>
</tr>
<tr>
<td>2018</td>
<td>$11,180,000</td>
<td>$4,417,800</td>
<td>40%</td>
</tr>
<tr>
<td>2019</td>
<td>$11,400,000</td>
<td>$4,505,800</td>
<td>40%</td>
</tr>
<tr>
<td>2020</td>
<td>$11,580,000</td>
<td>$4,577,800</td>
<td>40%</td>
</tr>
<tr>
<td>2021</td>
<td>$11,700,000</td>
<td>$4,625,800</td>
<td>40%</td>
</tr>
<tr>
<td>2022</td>
<td>$12,060,000</td>
<td>$4,769,800</td>
<td>40%</td>
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<tr>
<td>2023</td>
<td>$12,920,000</td>
<td>$5,113,800</td>
<td>40%</td>
</tr>
<tr>
<td>2024</td>
<td>$13,610,000</td>
<td>$5,389,800</td>
<td>40%</td>
</tr>
</tbody>
</table>

The deceased spouse’s unused exemption (DSUE) may be added to the basic exclusion amount of a surviving spouse to arrive at the applicable exclusion amount for decedents dying in 2011 and later. DSUE is not inflation-adjusted.

**Example.** Donna is a wealthy single individual. She dies in 2023, leaving an estate of $10,000,000. Her estate will owe no estate taxes. If Donna had died in 2017, the estate would have owed $1,804,000 of estate tax.

**Example.** Pat is married to Chris. Pat dies in 2023 with a $5,000,000 estate. Pat’s estate will owe no estate taxes. Later in the year, Chris dies, leaving an estate of $15,000,000. With a portability election in place from Pat’s estate, Chris’s estate will pay no estate taxes. If Pat and Chris had died in 2017, their estates would have owed $3,608,000 of estate tax.
Estate Tax Planning Changed for Some Taxpayers

1. Estates and trusts should be reviewed with an estate tax attorney to see what updates are required because of the TCJA’s doubling of the estate tax exemption and the law’s temporary nature. The coming sunset of the 2017 Act after 2025 is expected to reduce the current basic exclusion by half. For wealthier clients, this possible change in the law should be anticipated and addressed through planning. For small estates, life insurance may no longer be needed to fund estate taxes but pay attention to the sunset and what may be considered a “small estate” in the future.

2. Additional gifting for large estates will protect assets from the expiration of the increased exemption for a decedent dying after 2025. A wealthy taxpayer who had already used the full gift tax exclusion by 2017 and not made further reportable gifts can gift an additional $7,430,000 ($12,920,000 less $5,490,000) to an individual in 2023.

3. For persons with smaller estates, gifting will not be as important to their estate planning until the sunset of the 2017 Act in 2026 approaches, unless there are political changes and revised exclusions sooner.

4. Non-grantor trusts may be useful for charitable gifting (charitable remainder trusts or charitable lead trusts).

Planning Still Required for Big and Small Estates

Of course, planning for the disposition of one’s estate is still required, regardless of tax law changes! Advise clients that there is a distinction between estate tax planning and estate planning. Estate planning is required for large and small estates:

- A will is required to make sure assets go according to the decedent’s wishes.
- Avoiding probate may still necessitate trusts.
- Mixed (blended) families may require trusts to protect the children from a prior marriage.
- If trusts are utilized, make sure that new property, bank accounts, and stock accounts are titled properly.
- A special needs trust should be considered if there is a family member that will require additional protections.
- Beneficiary designations, formula clauses and fiduciary choices must be reviewed and updated annually.

Business owners need a succession plan, not only to save estate taxes, but also to make sure that the business survives beyond the death of the owner, even if just for the several months that it may take a surviving spouse or children to sell the business.

Don’t Forget State Estate and Inheritance Taxes

While most states do not have an independent estate tax, certain states do. They are said to be “decoupled” from the federal estate tax, as they have their own applicable exclusions. Listed below are the 2023 estate tax exemption amounts for each state imposing an estate tax. At the present time, only the exemption amounts of Hawaii and Maryland are portable.
<table>
<thead>
<tr>
<th>State</th>
<th>2023 Estate Tax Exemption Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>$12,920,000</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>$4,594,000</td>
</tr>
<tr>
<td>Hawaii</td>
<td>$5,490,000</td>
</tr>
<tr>
<td>Illinois</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Maine</td>
<td>$6,410,000</td>
</tr>
<tr>
<td>Maryland</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Minnesota</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>New York</td>
<td>$6,580,000</td>
</tr>
<tr>
<td>Oregon</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>$1,733,264</td>
</tr>
<tr>
<td>Vermont</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Washington</td>
<td>$2,193,000</td>
</tr>
</tbody>
</table>

### GIFT TAX CHART

<table>
<thead>
<tr>
<th>Year of Gift or Lifetime Transfer</th>
<th>Basic Exclusion Amount</th>
<th>Unified Credit Amount</th>
<th>Top Marginal Gift Tax Rate</th>
<th>GST Lifetime Exemption*</th>
<th>Top Marginal Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$1,000,000</td>
<td>$330,800</td>
<td>35%</td>
<td>$5,000,000</td>
<td>0%</td>
</tr>
<tr>
<td>2011</td>
<td>$5,000,000</td>
<td>$1,730,800</td>
<td>35%</td>
<td>$5,000,000</td>
<td>35%</td>
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<td>40%</td>
<td>$13,610,000</td>
<td>40%</td>
</tr>
</tbody>
</table>

DSUE may be added to the basic exclusion amount of a surviving spouse to arrive at the applicable exclusion amount for decedents dying in 2011 and later.

The basic exclusion amount is annually adjusted for inflation, but DSUE is not.

DSUE does not apply to the GST tax, and the GST tax is not portable.
INCOME TAX RATES FOR ESTATES AND TRUSTS

Marginal Tax Rates on Taxable Income of Estates and Trusts

<table>
<thead>
<tr>
<th>Taxable Income of Estates and Trusts</th>
<th>Marginal Tax Rates</th>
<th>Taxable Income of Estates and Trusts</th>
<th>Marginal Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $2,900</td>
<td>10%</td>
<td>$0 to $3,100</td>
<td>10%</td>
</tr>
<tr>
<td>$2,901 - $10,550</td>
<td>24%</td>
<td>$3,101-11,150</td>
<td>24%</td>
</tr>
<tr>
<td>$10,551 - $14,450</td>
<td>35%</td>
<td>$11,151 - $15,200</td>
<td>35%</td>
</tr>
<tr>
<td>$14,450 and above</td>
<td>37%</td>
<td>$15,200 and above</td>
<td>37%</td>
</tr>
</tbody>
</table>

AMT. The AMT exemption and threshold amounts are not changed by the 2017 Act. They are now indexed for inflation. The 2023 exemption for trusts and estates is now $28,400.

Compression of trust tax brackets makes distributions attractive. The trust tax brackets hit the top 37% tax rate at $14,450 of taxable income in 2023. A single individual hits the top tax rate at $578,125 ($693,750 for MFJ) in 2023. Distributing income to beneficiaries in lower tax brackets may result in lower overall tax being paid.

Mailing Address Change for Estate and Gift Tax Returns

See Filing Estate and Gift Tax Returns for information on new mailing addresses.

Form 1041 E-Filing

When e-filing Form 1041, use either Form 8453-FE, US Estate or Trust Declaration for an IRS e-File Return, or Form 8879-F, IRS e-File Signature Authorization for Form 1041. Form 8879-F can only be associated with a single Form 1041. Form 8879-F can no longer be used with multiple Forms 1041.

ESTATE TAX UPDATE FOR TAX PRACTITIONERS — WHAT’S NEW

Stepped-Up Basis Not Available at Grantor’s Death for Assets Held in Irrevocable Grantor Trust (Rev. Rul. 2023-2, 2023-16 I.R.B.)

On March 29, 2023, the IRS released Revenue Ruling 2023-2, which clarified that no basis adjustment is available at the grantor’s death under §1041(a) for assets transferred by the grantor to a trust, where the transfer is considered a completed gift for gift tax purposes and the assets are not included in the grantor’s estate (generally irrevocable grantor trusts). Under the facts considered, the assets did not fall within any of the seven types of property listed in §1014(b) deemed to have been “acquired or passed from a decedent” for purposes of §1041(a).

Revenue Ruling 2023-2 is consistent with the position long taken by many estate planners, despite the fact that grantor trusts are generally disregarded as a separate tax entity by the IRS and treated as
indistinguishable from the grantor for income tax purposes. Because the step up in basis is not available for irrevocable grantor trusts, “the basis of [the asset held in the irrevocable grantor trust] immediately after [the grantor’s] death is the same as the basis of [the asset] immediately prior to [the grantor’s] death.” Rev. Rul. 2023-2, at 2, 2023-16 I.R.B.

Transcript Delivery Service Available for Estate Tax Accounts

The Transcript Delivery Service (TDS), which provides authorized practitioners the ability to view and print instant account transcripts for estate tax returns, is now available on IRS.gov.

To register for the TDS, access e-Services — Online Tools for Tax Professionals

1. Select “GO” under Transcript Delivery System (TDS)
2. Sign up or log in

If you have difficulty registering online via Secure Access, or you are an existing e-Services user and need exception processing, call the e-Help desk at 1-888-841-4648, 7:30 a.m. to 7 p.m. Eastern. For step-by-step instructions on securing an estate tax transcript, access Transcripts in Lieu of Estate Tax Closing Letters on IRS.gov.

Easy Closing Confirmation for an Estate (CLOSING LETTER FAQS)

The IRS announced in Notice 2017-12 that an alternative to requesting an estate tax closing letter (Letter 627) is relying upon the tax account transcript. Since June 1, 2015, estate tax closing letters are only issued upon request, by calling (866) 699-4083. However, an account transcript which includes the transaction code “42” and the explanation “Closed examination of tax return” indicates the IRS is finished looking at the estate tax return. Therefore, it is the functional equivalent, and has the same force as a closing letter.

Closing letters are available online to registered tax professionals using the Transcript Delivery System (TDS) or to authorized representatives making requests using Form 4506-T. Requests for either a transcript or a closing letter should be made no earlier than four months after filing the estate tax return.

Starting Oct. 28, 2021, a $67 user fee will apply to any estate that requests a closing letter for its federal estate tax return. Procedural details are at the IRS website (85 FR 86871) (Dec. 31, 2020).

Tax practitioner planning. It is the IRS’s hope that within four months of receipt of Form 706, it will have “classified” the estate tax return and made a decision whether or not to conduct an exam. If the return is selected for exam, it will be much longer than four months before the closing letter, or transcript with the appropriate indicator, is available.

Full Value of GRAT Assets Included in Grantor’s Estate (Badgley v. US, NO 18-16053 (9th CIR.2020))

In Badgley, the court affirmed that the assets of a GRAT were includible in the estate of the decedent who died before the end of the GRAT term.

GRAT reserving annuity payments. The decedent created a 15-year GRAT reserving annual annuity payments. She died before the GRAT term ended. The court held that the GRAT assets were includible in her estate under §2036, even though annuities are not specifically mentioned in that statute. The court found that the grantor derived substantial economic benefits from the GRAT property in the form of the annuity
payments, so there was a retained enjoyment of the property by the decedent under §2036(a)(1). It was not relevant to the court whether the annuity payments came from the trust’s income or principal. Since the property in the GRAT generated a benefit, and the taxpayer retained the right to that benefit, the fair market value of the GRAT property was part of her estate under §2036.

Remaining unpaid annuity or FMV? What is somewhat “curious” about this case is why the inclusion in the decedent’s estate was not limited (as it usually is) to the amount necessary to provide the remaining unpaid annuity at the time of the decedent’s death as provided in Reg. 20.2036-1(c)(2)(i), rather than the fair market value of the GRAT property as the court determined here. It appears from the court opinion that the argument for valuing the inclusion at the amount of the unpaid annuity was not properly raised by the taxpayer’s counsel.

ESTATE TAX — CONSISTENT BASIS REPORTING

Consistent Basis Required Between Estate and Person Acquiring Property (H.R. 3236: Transportation Act of 2015)

Property acquired from a decedent. The beneficiary’s basis is required to be consistent with the basis reported on the estate tax return (§1014 as amended). The beneficiary’s basis cannot exceed (1) in the case of property, the final value which has been used for purposes of the estate tax on the estate of such decedent, and (2) in the case of property not described in (1) above and with respect to which a statement has been furnished to the beneficiary under §6035(a) identifying the value of such property.

Tax practitioner planning. Previous law did not require a beneficiary to provide that the basis in inherited property was the same as that reported by the estate.

Information Reporting Required for Property Transferred by Estate to Beneficiary (H.R. 3236: TRANSPORTATION ACT OF 2015)

The executor of the estate is now required to file an information return under §6018(a) with the IRS and to each person acquiring any interest in property included in the decedent’s gross estate for federal estate tax purposes (new §6035). The statement must identify the value of each interest in such property as reported on the estate return and any other information with respect to the inherited interest as the IRS may prescribe.

Beneficiary-estate consistency requirement. Property received by a beneficiary may be subject to a consistency requirement, meaning that the beneficiary cannot use a value higher than the value reported on Schedule A of Form 8971 as the beneficiary’s initial basis in the property.

Report on Form 8971, Estate Basis to Beneficiary (Form 8971 and Form 8971 Instructions (Reg127923-15; Notice 2016-27))

Who must file? An executor of an estate or other person(s) required to file Form 706 (Form 706-NA or Form 706-A), whether or not that form is filed timely, is also required to file Form 8971 with attached Schedule(s) A with the IRS and to provide each beneficiary listed on the Form 8971 with that beneficiary’s Schedule A.
**Tax practitioner planning.** Provide each beneficiary only with a copy of that beneficiary’s own Schedule A. Do not provide a copy of the Form 8971 with or without attached Schedule(s) A to any beneficiary.

Executor must have proof of delivery to beneficiary. The executor of the estate (or other person required to file) must certify on Form 8971, Part II, Column D, the date on which Schedule A was provided to each beneficiary and should keep proof of mailing, proof of delivery, acknowledgment of receipt, or other information relevant for the estate’s records. In cases where a trust or another estate is a beneficiary and has multiple trustees or executors, providing Schedule A to one trustee or executor is enough to meet the requirement.

Form 8971 and each attached Schedule A must be completed in its entirety. A form or schedule filed with the IRS without entries in each field will not be processed.

**Tax practitioner planning.** A form with an answer of “unknown” will not be considered a complete return.

When to file Form 8971. Form 8971 (including all attached Schedule(s) A) must be filed with the IRS no later than the earlier of:

- The date that is 30 days after the date on which Form 706 is required to be filed (including extensions) with the IRS; or
- The date that is 30 days after the date Form 706 is actually filed with the IRS.

Even when Form 706 is filed late. If the first Form 706 is filed after the Form’s due date (including extensions), the Form 8971 and Schedule(s) A are due 30 days after the filing date.

Where to file. File Form 8971, including all Schedule(s) A, at:

| Department of the Treasury |
| Internal Revenue Service Center |
| Mail Stop #824G |
| Cincinnati, OH 45999 |

Form 8971 must be filed separately from Form 706. Form 8971 is a separate filing requirement from the estate’s Form 706 and should not be attached to the associated estate tax return. The Form 8971 and attached Schedule(s) A must be filed with the IRS separate from any and all other tax returns filed by the estate.

When Form 8971 is not required to be filed — if the value of the estate is less than the exclusion amount. The filing requirement for Form 8971 does not apply to an executor of an estate that is not required to file an estate tax return because the gross estate plus adjusted taxable gifts is less than the basic exclusion amount, but who does file a return for the sole purpose of making an allocation or election respecting the GST tax.

Portability election. Also exempt from the Form 8971 reporting requirements are estates that file an estate tax return just to claim portability of a deceased spouse’s unused exemption (DSUE).
Exclude marital or charitable deduction property. If Federal estate tax is due, property that qualifies for the marital or charitable deduction is excluded because this property does not increase Federal estate tax liability.

**Warning.** These assets must still be reported on the Form 8971, if applicable (§6035).

Penalty for failure to file correct Forms 8971 with the IRS by the due date (§6721). If the executor of an estate or other person required to file Form 8971 fails to file a correct Form 8971 and/or Schedule A with the IRS by the due date and reasonable cause is not shown, a penalty may be imposed. The penalty applies if there is a failure to file a timely return, a failure to include all information required to be shown on the form or schedule, a failure to include correct information on the form or schedule, or a failure to file a correct supplemental Form 8971 and/or Schedule A by the due date.

**Tax practitioners planning.** A complete Form 8971 includes all Schedule(s) A.

**Penalty for failure to furnish correct Schedule(s) A to beneficiaries by the due date (§6722).** If the executor of an estate or other person required to file Form 8971 fails to provide a correct Schedule A to a beneficiary and does not show reasonable cause, a penalty may be imposed. The penalty applies if there is a failure to provide the Schedule A by the due date, a failure to include all information required to be shown on the Schedule, a failure to include correct information on the Schedule, or a failure to provide a correct supplemental Schedule A by the due date. The penalty applies for each Schedule A required to be provided.

*Only one penalty will apply for all failures relating to a single filing of a single Form 8971 and the Schedule(s) A required to be filed along with it.* Each filing of Form 8971 with Schedule(s) A is a separate filing, regardless of whether the filing is of the initial Form 8971 and Schedule(s) A or a supplemental Form 8971 and Schedule(s) A. The amount of the penalty depends on when the correct Form 8971 with Schedule(s) A is filed.

<table>
<thead>
<tr>
<th>2023 Penalties for §6721 Failure to File and §6722 Failure to Furnish Correct Statements</th>
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</thead>
<tbody>
<tr>
<td><strong>Time of Filing</strong></td>
</tr>
<tr>
<td>Not more than 30 days late</td>
</tr>
<tr>
<td>31 days late–Aug. 1</td>
</tr>
<tr>
<td>After Aug. 1</td>
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<tr>
<td>Intentional Disregard</td>
</tr>
</tbody>
</table>

*P.L. 114-27* increased the penalty amounts for returns required to be filed after Dec. 31, 2015. P.L. 113-295, provided that penalty amounts be annually adjusted for inflation for returns required to be filed in a calendar year beginning after 2014.

Increased penalty amounts may apply in the case of certain failures in the case of intentional disregard (see §6721(e)(2)).

**Note.** All penalty amounts shown are subject to adjustment for inflation.
**Reasonable cause.** The penalties for failing to file correct Form 8971 and Schedule(s) A with the IRS and for failing to provide correct Schedule(s) A to beneficiaries will not apply to any failure that is shown to be due to reasonable cause and not to willful neglect. In general, it must be shown that the failure was due to an event beyond the taxpayer’s control or due to significant mitigating factors. It must also be shown that the executor or other person required to file acted in a responsible manner and took steps to avoid the failure.

**Penalties for inconsistent filing.** Beneficiaries who report basis in property that is inconsistent with the amount on the Schedule A may also be liable for a 20% accuracy-related §6662 penalty.

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**FORM 706 AND PORTABILITY**

**Form 706**

Form 706 is annually revised and is year specific. Practitioners must ensure that the form year is the same as the year of death when required by the form instructions. The most recent revision of Form 706 was the 2019 Form, but new instructions issued each year bring the rules up to date. Recent changes to Form 706 include:

- A section was added to calculate the portability amount.
- The credit for transfers made by gift was unified with the credit for transfers made at death. Both receive a $12,920,000 exclusion (2023). For spouses a combined estate amounts to $25,840,000 (2023).
- The applicable exclusion for 2023 now consists of a basic exclusion amount of $12,920,000 plus, in the case of a surviving spouse, the DSUE amount.
- Executors must provide documentation of their status.
- Prior gifts must be calculated at the tax rate in effect at the decedent’s date of death.
- For decedents dying in 2023, the ceiling on reducing the value of the estate by special-use valuation is $1,310,000, and the amount used in computing the 2% portion of estate tax payable in installments is $1,750,000.


Surviving spouses may utilize a deceased spouse’s unused exclusion (DSUE) in addition to his or her own exemption amount (§2010(c)(2)(B)). The deceased spouse’s estate must make an election to have the portability provisions apply (§2010(c)(5)).

Portability election must be made by filing Form 706 timely (§20.2010-2(a)(2)). Executors intending to make the portability election must “timely,” including extensions, file a “complete and properly prepared” Form 706, regardless of whether or not the gross estate has a value in excess of the exclusion amount or is otherwise not obligated to file Form 706. Filing Form 706 constitutes the required election. Nothing further need be done.

Timely is within 15 months of decedent’s date of death. If the estate representative did not file an estate tax return within nine months after the decedent’s date of death, or within 15 months of the decedent’s date of death (if an automatic six-month extension of time for filing the estate tax return had been
obtained), the availability of an extension of time to elect portability of the DSUE amount depends on whether the estate has a filing requirement, based on the filing threshold.

“Complete and properly prepared” information that must be included to elect portability. Form 706 includes: (1) a section specifically designed to determine whether or not portability has been elected, (2) the calculation of the DSUE (discussed later), and (3) other information pertinent to portability.

Extensions Granted To Elect Portability (§301.9100-3; Rev. Proc. 2017-34, Sec. 2.02; Rev. Proc. 2022-32)

The executor of an estate not otherwise required to file Form 706 may seek a private letter ruling to be granted an extension of time under §301.9100-3 to elect portability under §2010(c)(5)(A). Under §301.9100-3, relief will be granted if the taxpayer establishes to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. The IRS user fee to obtain this ruling is now $12,600. In addition, as discussed later, a simplified method had allowed two years from the date of death to make a portability election without the need to obtain the IRS ruling (Rev. Proc. 2017-34). This simplified method has now been extended to five years from date of death as the result of Rev. Proc. 2022-32. However, if Form 706 was required to be filed (the decedent’s estate was greater than the applicable exclusion amount), there is no extension to permit a late portability election beyond the six-month extension already allowed by law.

Does the entire Form 706 have to be completed to elect portability? Not necessarily (§20.2010-2(a)(7))!

Form 706 is considered complete and properly prepared for purposes of making the portability election if the return is prepared in accordance with the “simplified” instructions issued for the estate tax return.

Marital and charitable deduction. The value of marital deduction property and charitable deduction property is not required to be reported, but executors must include the description, ownership, and the beneficiary of marital or charitable deduction property, along with all other information necessary to establish the right of the estate to such deduction(s). The value of marital deduction property or charitable deduction property is required if:

1. The value of such property relates to, affects, or is needed to determine the value passing from the decedent to another recipient;
2. The value of such property is needed to determine the estate’s eligibility for the provisions of §2032, §2032A, §6166, or another provision of the Code;
3. Less than the entire value of an interest in property includible in the decedent’s gross estate is marital deduction property or charitable deduction property; or
4. A partial disclaimer or partial qualified terminable interest property election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

Statement required on the return. The preceding paragraph applies only if an executor exercises due diligence to estimate the fair market value of the gross estate. Executors must, unless otherwise provided in Form 706 instructions, include their best estimate of the estate's gross value, rounded to the nearest $250,000 (or such other amount as is provided in the Form 706 Instructions) on the estate tax return (or attachment thereto).

Example. Harold, who died in 2023, is survived by his wife, Susan. Harold’s gross estate is less than $12,920,000, and he never made any gifts in excess of the annual exclusion limit. The assets inclu-
dible in Harold's gross estate consist of a parcel of real property and bank accounts held jointly with Susan with rights of survivorship, a life insurance policy payable to Susan, and a survivor annuity payable to Susan for her life. Harold’s executor files Form 706 solely to make the portability election.

When completing Form 706, the executor identifies the estate’s assets on the proper schedule but does not provide any date of death values. To establish the estate’s entitlement to the marital deduction, the executor includes, with the estate tax return, evidence to verify the title of each jointly held asset confirming that Susan is the sole beneficiary of both the life insurance policy and the survivor annuity and to verify that the annuity is exclusively for Susan’s life. The executor also certifies on the estate return the best estimate, exercising due diligence, of the fair market value of the gross estate. The estate tax return is considered complete and properly prepared, and the executor has elected portability.

**Estates may elect to opt out of portability.** Executors of estates that qualify for portability, but wish to opt out of portability, must either:

1. affirmatively elect on a timely filed estate tax return, or in an attachment to that estate tax return, that the estate is not electing portability under §2010(c)(5), (there is a box to check on Form 706); or
2. not timely file an estate tax return.

**Computation of DSUE must be included in Form 706.** The executor is required to include a computation of the DSUE amount on the estate tax return to elect portability (§20.2010-2(b)).

**DSUE computation (§20.2010-2(c)).** A decedent’s DSUE is the lesser of:

- the basic exclusion amount in effect in the year of the decedent’s death, or
- the decedent’s exclusion amount less the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent’s estate is determined under §2001(b)(1).

**Example.** Kurt made his first taxable gift valued at $1 million in 2002. He reported the gift on a timely filed gift tax return. Because the amount of the gift was equal to the applicable exclusion amount for that year ($1 million), $345,800 was allowed as a credit against gift tax, reducing the gift tax liability to zero. Kurt died in January 2023 and was survived by his wife, Calli. The value of Kurt’s assets owned at death was $1 million, and his executor timely filed the estate tax return and elected portability, thereby allowing Calli to benefit from Kurt’s DSUE amount.

**Calculation.** Kurt’s executor computed the DSUE amount to be $10,920,000 (the lesser of the 2023 basic exclusion amount of $12,920,000, or the excess of Kurt’s $12,920,000 applicable exclusion less the sum of the $1 million assets owned at death and the $1 million amount of adjusted taxable gifts).

**Special rule to consider gift taxes paid by decedent.** Solely for purposes of the DSUE computation, the amount of adjusted taxable gifts of the decedent is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift.

**Variation.** Assume the same facts as above except that the value of Kurt’s taxable gift in 2002 was $2 million. After application of the applicable credit amount, Kurt paid gift tax on $1 million, the amount of the gift in excess of the applicable exclusion amount for 2002.
**Calculation.** Kurt’s executor computes the DSUE amount to be $10,920,000 (the lesser of the 2023 basic exclusion amount of $12,920,000, or the excess of Kurt’s $12,920,000 applicable exclusion amount over the sum of the $1 million assets owned at death and the $1 million adjusted taxable gifts). Kurt’s adjusted taxable gifts of $2 million were reduced for purposes of this computation by $1 million, the amount of taxable gifts on which gift taxes were paid.

**Special rule in case of property passing to qualified domestic trust (QDOT).** When property passes for the benefit of a non-citizen surviving spouse in a QDOT (§2056A(a)), the decedent’s DSUE is computed in the same manner as previously discussed, except that the DSUE amount is subject to subsequent adjustments. The final DSUE amount of a decedent must be redetermined on the occurrence of the final distribution or other event (generally the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which estate tax is imposed under §2056A.

**Portability election irrevocable.** Portability elections are irrevocable once the due date for the estate tax return has passed. Executors may amend a Form 706 to change the portability election as long as the amended Form 706 is submitted no later than the due date, including extensions actually granted (§20.2010-2(a)(4)).

**Tax practitioner planning.** The IRS is anticipating that most married couples will choose to take advantage of the portability election, resulting in a tremendous increase in the number of Forms 706 filed by the estates of decedents. Many of these returns will be filed by estates with values well below the applicable exclusion amount. Thanks for the simplification!

**Who may make the election?** Only an executor or administrator of an estate that is appointed, qualified, and acting within the meaning of §2203 may elect portability (or elect out of portability). If there is no appointed executor, any person in actual or constructive possession of any property of the decedent may make the election (§20.2010-2(a)(6)).

**Only one’s last deceased spouse may pass on a DSUE amount to a surviving spouse.** A decedent’s DSUE amount is included in determining a surviving spouse’s applicable exclusion amount only if such decedent is the last deceased spouse of such surviving spouse on the date of the death of the surviving spouse and the executor of the decedent’s estate elected portability (§2010(c)(4)(B)(I); §20.2010-3).

**Example.** Sara passed away in 2012, widowing her husband, Bruce. Sara’s taxable estate was valued at $2 million. The executor elected to transfer the $3 million DSUE amount to Bruce (the 2012 exclusion was $5 million). In 2023, when his estate’s value is $20 million, Bruce dies. His estate will pay estate tax on $4,080,000 (total estate value of $20 million less the sum of Bruce’s applicable exclusion amount of $12,920,000 and the $3 million DSUE amount from Sara’s estate).

**Example.** Use the same facts as above, except assume that Bruce marries Nancy after Sara dies. Nancy dies in 2023, when the value of her estate is $10,000,000. Nancy’s estate was left to her children. Nothing was left to Bruce. Bruce may no longer consider Sara’s DSUE in computing his own exemption. Sara is no longer Bruce’s last deceased spouse. Only Nancy’s unused DSUE amount of $2,920,000 may be added to Bruce’s exclusion amount, assuming Nancy’s executor properly elects to do so.

**Identity of last deceased spouse unchanged by subsequent marriage or divorce.** A decedent is the last deceased spouse of a surviving spouse even if, on the date of the death of the surviving spouse, the surviving spouse is married to another (then-living) individual. If a surviving spouse remarries and then divorces, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. The divorced spouse, not being married to the surviving spouse at death, is not the last deceased spouse (§20.2010-3(a)(3)).
**No set length of time that the surviving spouse must survive decedent spouse.** Any portability election made by an executor of a decedent’s estate applies as of the date of the decedent’s death. Any related DSUE amount is included in the applicable exclusion amount of the decedent’s surviving spouse and will be applicable to transfers made by the surviving spouse after the decedent’s death (§20.2010-3(c)).

**No statute of limitations if portability elected.** The IRS may examine returns of each of a surviving spouse’s deceased spouses whose DSUE amount is included in the surviving spouse’s applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for any such return. The IRS’s authority to examine returns of a deceased spouse applies with respect to each transfer by the surviving spouse to which a DSUE amount is or has been applied, and the IRS may adjust or eliminate the DSUE amount; however, the IRS may assess additional estate tax on that return only if the period of limitations on assessment under §6501 is still open. *Sower v. Comm., 147 T.C. No. 11* (2017). [Unreported gifts by the first decedent subtracted from DSUE claimed by spouse even though first decedent’s estate received a closing letter and the DSUE adjustment was made more than three years after the first decedent’s death].

**No claw back of DSUE.** The DSUE amount, once established, is not indexed for inflation. However, in the event the applicable exclusion declines in the future, the DSUE amount established at the time of the deceased spouse’s death will not be adjusted and will be fully available to the surviving spouse for transfers during lifetime or at death.


The IRS will not issue Private Letter Ruling requests for an extension of time to make the portability election, filed before the fifth anniversary of a decedent’s date of death because automatic approval procedures have been provided (see *Rev. Proc. 2022-32*).

**IRS Private Letter Rulings Allow Late Portability Elections** *(PLR 202315009, PLR 202217001, PLR 202217002, PLR 202217006, PLR 202217007)*

“For various reasons,” no estate tax return was filed on behalf of a decedent’s estate. The decedent was survived by a spouse. The IRS was requested to grant a late election to report the DSUE amount to the estate of the surviving spouse. Relief was granted under Treasury Regulations §301.9100-3. To the same effect, see PLR 201923014 and PLR 201942006, and many other similar private letter rulings.

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**GIFT TAX UPDATE — §1, §1015 & §2501-§2524**

**2023 Gift Tax Reporting Update**

**Annual exclusion.** The annual 2023 gift exclusion is $17,000 ($18,000 in 2024).

**Annual exclusion for gifts to noncitizen spouses.** The 2023 annual exclusion for gifts made to spouses who are not US citizens is $175,000 ($185,000 in 2024). Gifts to U.S. citizen spouses are eligible for an unlimited marital deduction.

**Large gifts or bequests received from persons.** Section 6093F requires reporting by recipients of gifts or bequests from a nonresident alien individual or estate valued at more than $100,000. Reporting is required if the gift is more than $18,567 (2023) and from corporations or partnerships (including persons related to the corporations or partnerships). Use Form 3520.

**Top rate.** The top rate for gifts and GSTs (generation-skipping tax transfers) is 40%.
Unified credit. The basic 2023 exclusion amount for determining the amount of the unified credit against estate tax is $12,920,000.

Credit allocated to prior gifts. Any unified credit allocated to gifts made in prior periods must be redetermined using current gift tax rates (§302(d)(2)). See Form 709 instructions for worksheets.

Tax practitioner planning. The IRS has created a page on its website for information about Form 709 and its instructions at www.irs.gov/instructions/i709 Information about developments (including legislative changes) are posted to this page.

Tax practitioner planning. If there is a reasonable possibility that a federal estate tax will be due on the client’s death, consider filing Form 709 for all gifts each year, with “adequate disclosure” of gifts and intra-family sales, including valuation determinations. This is the only method of running the gift tax statute of limitations after enactment of the Revenue Act of 1997.

IRS Issues Proposed Regs to Prevent Clawback When Estate Tax Exemption Drops in 2026 (REG-106706-18)

The IRS issued proposed regulations which implement changes made by the TCJA. As a result, individuals planning to make large gifts between 2018 and 2025 can do so without concern that they will lose the tax benefit of the higher exclusion level once it decreases by the sunset of the 2017 Act after 2025. However, a new set of proposed regulations issued in 2022 may limit the protection from “clawback” of a prior gift exclusion.

In general, gift and estate taxes are calculated, using a unified rate schedule, on taxable transfers of money, property, and other assets. Any tax due is determined after applying a credit — formerly known as the unified credit — based on an applicable exclusion amount. The applicable exclusion amount is the sum of the basic exclusion amount (BEA) established in the statute, and other elements (if applicable) described in the proposed regulations. The exclusion is first used during life to offset gift tax, and any remaining exclusion is available to reduce or eliminate estate tax.

The 2017 TCJA temporarily increased the BEA from $5 million to $10 million for tax years 2018 through 2025, with both dollar amounts adjusted for inflation. For 2023, the inflation-adjusted BEA is $12,920,000. In 2026 (absent legislative changes prior to 2026), the BEA will revert to the 2017 level of $5 million as adjusted for inflation (expected to be approximately $6-$7 million in 2026).

To address concerns that an estate tax could apply in the future to gifts exempt from gift tax by the increased BEA, the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA applicable to gifts made during life or the BEA applicable on the date of death.

Example. A decedent made a gift of $11.7 million in 2021, all of which was sheltered from gift tax by the 2021 BEA of $11.7 million. The decedent made no other gifts in his lifetime. If the decedent dies after 2026 when the BEA reverts to old law at approximately $6-$7 million, the credit to be applied in computing the estate tax is based upon the $11.7 million of BEA that was used to compute gift tax payable in 2021.

Tax practitioner planning. From a planning standpoint, the regulation highlights the importance of clients using as much of the basic exclusion amount as they are able while it remains available. The “political risk” of the 2024 election certainly suggests the possibility that the basic exclusion amount could be reduced well before the required “sunset” after 2025. The phrase “use it or lose it” becomes an appropriate warning to clients.
Transfers Targeted by the Proposed Regs to Tax Certain Transfers That Had Been Exempted from the Gift Tax

There are several types of transfers that generally won’t benefit from the anti-clawback rule so that the lower exclusion available at death, not the higher exclusion that had been believed to have been used and secured on the date of a lifetime transfer, will be available. These appear to include:

- Gifts that are includible in the taxpayer’s gross estate under Internal Revenue Code Sections 2035, 2036, 2037, 2038, or 2042.
- Unsatisfied Enforceable Promise Gifts
- Gifts subject to the special IRC Section 2701 valuation rules. These generally related to the valuation of intra-family transfers of entity equity interests when the parent (senior generation) retains certain preferred rights.
- Transfers like a GRIT, where property is pulled back into the gross estate under §2036. If the taxable portion was 5% or less, the taxpayer will still be able to take advantage of the general anti-clawback rule to the extent of the gift (but not the whole amount transferred).
- Certain transfers to grantor-retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs) under §2702.
- The relinquishment or elimination of an interest in any one of the above targeted transactions within 18 months of the decedent’s death.

Two Exceptions in the Latest Proposed Regulations

The proposed regulations provide for two exceptions to the targeted transactions, so the higher exclusion that existed at the date of the initial transfer will continue to apply, instead of a lower exclusion that may exist at the date of death.

1. **The relinquishment or elimination of an interest in any one of the above targeted transactions more than 18 months prior to the decedent’s death.** What if your client sells the asset involved for full and adequate consideration within the 18-month period? It would appear that the anti-clawback benefit wouldn’t apply to this transaction because the proposed regs capture any transfer, whether by gift or as a full consideration sale.

2. **De minimis transfers for which the taxable portion of the transfer is not more than 5% of the total transfer.** So, for example, a taxpayer can use a small amount of excess exemption if a GRAT is created that has been structured to be close to a zero-value gift (so-called “zeroed out” GRAT). But if a GRAT is structured to result in a large current gift so as to use the excess exemption amount, it will not be protected by this 5% rule. Thus, if there were a GRAT to which $20 million was given and the value of the current gift on that funding was $1.2 million, the proposed regulations will ensnare the transfer if the taxpayer dies during the GRAT term. Although this is not analogous to the “artificial” gifts the proposed regs were designed to address, it’s nonetheless caught by them.

Gift Tax Rules *(FAQs on Gift Tax)*

The gift tax applies to the lifetime transfer by gift of any property. The gift tax is a tax on the transfer of property by one individual to another while receiving nothing or less than full value in return. The donor
is generally responsible for paying the gift tax (Publication 559). Under special arrangements, the donee may agree to pay the tax instead. The tax applies when no or inadequate consideration is received by the donor for a transfer, whether the donor intends the transfer to be a gift or not.

“Present interest.” The annual gift tax exclusion only applies to present interests, so care must be taken to ensure qualification via the use of outright gifts. In the event of trust gifts, the trust must have provisions (such as Crummey trust lapsing withdrawal powers given donees or an income interest for the donee) that create a present interest in the gift. The 2023 annual exclusion of $17,000 per year, per donor, per donee, especially when combined with fractional interests in real estate or by using interests in family limited partnerships (FLPs) or LLCs, can be very valuable over a period of years. However, the emerging big issue is whether the §2503(b) exclusion is satisfied in terms of the “present economic interest” — the “present interest” requirement for using the exclusion. See the earlier case of Hackl v. Comm. 118 TC 279 (2000), affirmed on appeal to the 7th Circuit (2003), as well as the more recent case of Price v. Comm., TCM 2010-2. In both of these cases, the restrictions on transfer and lack of entitlement to income distributions of an FLP resulted in no §2503(b) annual present interest exclusions! The taxpayers were more successful in Wim-mer v. Comm., TCM 2012-157, where gifted limited partnership interests qualified for the present interest exclusion since the limited partners received an annual distribution to cover their income tax liability.

What Items Can Be Excluded from Gifts?

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, nontaxable gifts include:

- Gifts of present interests that are not more than the annual exclusion amount for the calendar year.
- Tuition expenses paid directly to an educational institution for someone else (the educational exclusion).
- Medical expenses paid directly to a medical care provider for someone (the medical exclusion).
- Gifts to a spouse.
- Gifts to a political organization for its use.
- In addition, gifts to qualifying charities are deductible from the value of the gift(s) made.

Tax practitioner planning. Need a copy of an old gift tax return? See the IRS instructions to Form 709.

Tuition payments exempt from gift tax. An unlimited gift tax exclusion is allowed for tuition amounts paid directly to a qualified educational organization (as defined at §170(b)(1)(A)(ii)) on behalf of a part-time or full-time student for that individual’s education or training (§2503(e)). The organization need not be a college. There are cases and rulings allowing this exemption for gifts to private and parochial schools. But amounts paid for books, supplies, dormitory fees, board, or other similar expenses are not eligible for this exclusion. These tuition payments do not reduce the availability of the $17,000-per-donee 2023 annual exclusion for gifts of present interests, nor are they subject to GST tax (§2611(b)(1)).

Example of how not to do it! Andrew transferred $100,000 to a trust, the terms of which required the trustee to use the trust funds to pay tuition expenses for Andrew’s grandchildren. The regulations conclude that Andrew’s transfer to the trust was a completed gift for gift tax purposes but was not a direct transfer to an educational organization and did not qualify for the unlimited exclusion under §2503(e) (see §25.2503-6(c), Ex. 2). PLR 200602002 illustrates how to do it correctly.
Exclusion for medical payments. Section 2503(e) also provides an unlimited gift tax exclusion for direct payments to health care providers for medical care on behalf of a donee. These are excludable for gift tax purposes without regard to the percentage limitations for income tax purposes. This is another possibility for reducing a senior person’s estate in appropriate circumstances.

Warning. The direct transfer gift tax exclusion benefits regarding educational and medical expenses involve the donor’s transfer of capital, and thus income tax on income received from such capital up to the date the gift is incurred by the donor. For example, in the case of medical expenses, the donee may not be able to deduct (if otherwise deductible) the medical expenses paid by the donor directly to the medical provider. Court cases come to different conclusions. See Christina Marie Thompson McGrath v. Comm., TCM 2009-126, where a wedding gift of in vitro fertilization was not deductible by either daughter or papa, and Judith F. Long v. Comm., TCM 2010-286, where the daughter was allowed to deduct medical expenses and property tax paid by her mother.

Carryover Basis for Lifetime Gifts

Property received from a donor of a lifetime gift takes a carryover basis. Carryover basis means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by a lifetime gift also is increased, but not above fair market value, by any gift tax paid on the amount of appreciation of the property by the donor. The basis of a lifetime gift, however, generally cannot exceed the property’s fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis to the donee is the property’s fair market value on the date of the gift.

Gifts in Excess of Annual Gift Amount (§2505(a))

Statute of Limitations Remains Open If Transferred Property Not Reported on Form 709 (CCA 20172801F)

A donor made gifts in years 1, 2, 3, 4, 5, and 6. The donor also made gifts in year 7 and filed a Form 709 for that year. A gift is not adequately disclosed unless it is “reported in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value reported and the method used to value the transferred property” (§301.6501(c)-1(f)(2)).

Here the donor did not file form 709 and did not otherwise report gifts made in years 1-6. Therefore, under §6501(c)(3), the period of limitations on assessing gift tax for years 1-6 has not expired. The donor filed a Form 709 to report gifts in year 7 but did not adequately disclose any of the year 7 gifts because the donor did not describe the transferred property, nor did the donor provide a description of the method used to determine the value of the transferred property. Therefore, under §6501(c)(9), the period of limitations on assessing gift tax on the year 7 gifts has not expired.

Understated Gifts Do Not Extend the Statute of Limitations (CCA 201614036)

Unreported gifts. Section 6501(c)(9) provides an unlimited statute of limitations for the value of the gifts the taxpayer failed to report or to disclose. Thus, if there is any gift tax deficiency for that year, resulting from the unreported and undisclosed gifts, it may be assessed at any time.

Understated gifts. For the gift tax returns for subsequent years when the taxpayer understated the amounts of his prior year gifts, the IRS national office view is that the language in §6501(c)(9) “any tax imposed by
chapter 12 on such gift may be assessed ... at any time” refers to the tax imposed on the omitted gift that is subject to tax on that return (i.e., the current year gift amounts), and it does not refer to omissions or understatements of the prior year gift amount on that return. Accordingly, §6501(c)(9) does not extend the statute of limitations for gift tax returns for subsequent years just because the prior year gift amounts on those returns were understated, even if that resulted in underreported gift tax for those subsequent years.

**Disclosure of gift required to begin tolling of statute.** Section 301.6501(c)-1(f) provides that: “If a transfer of property ... is not adequately disclosed on a gift tax return ... or in a statement attached to the return, filed for the calendar-year period in which the transfer occurs, then any gift tax imposed ... on the transfer may be assessed ... at any time.” Under the regulations, only the failure to disclose a gift on the return for the year of that gift keeps the statute of limitations open, not a failure to accurately report the sum of prior year gifts on a return for a later year. As a result, if the only problem with the subsequent year gift tax returns is understatement of the amounts of prior year gifts, then the understatement of gift tax due for those subsequent years may be assessed only within the normal §6501(a) three-year period.

**Tax practitioner planning.** The six-year statute of limitations for substantial omissions in §6501(e)(2) will not extend the statute of limitations for language “if the taxpayer omits from ... the total amount of the gifts made during the period for which the return was filed.” Gift tax returns are annual returns, even if the taxpayer is required to report prior year gifts and to properly use those when calculating the tax on the current year gifts. Issues with such prior year returns will not extend the statute of limitations for such years.

**Portability Election Impacts Gifting Rules (§25.2505-0T, et seq.)**

When computing a surviving spouse’s gift tax liability, the DSUE amount is included in determining the surviving spouse’s applicable exclusion amount, provided such decedent is the last deceased spouse of such surviving spouse and the executor of the decedent’s estate elected portability (§25.2505-2T).

Order in which DSUE amount is applied. If a surviving spouse makes a taxable gift and a DSUE amount is included in the surviving spouse’s applicable exclusion amount, such surviving spouse will be considered to apply the DSUE amount to the taxable gift before the surviving spouse’s own exclusion amount.

Special rule in case of multiple deceased spouses and previously applied DSUE amounts (§20.2010-3T(b)). A special rule applies to compute the DSUE amount of a surviving spouse who previously has applied the DSUE amount of one or more deceased spouses to taxable gifts. In such circumstances, the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse is the sum of the DSUE amount of:

1. the surviving spouse’s last deceased spouse; and

2. each other deceased spouse of the surviving spouse, to the extent that such amount was properly applied to one or more taxable gifts of the surviving spouse.

**Example.** Stan dies on Jan. 15, 2011, and is survived by his wife, Doris. No taxable gifts were made during Stan’s lifetime. Stan’s DSUE amount was $5 million. On Dec. 31, 2019, Doris made taxable gifts to her children valued at $2 million. Doris is considered to have applied $2 million of Stan’s DSUE amount to the taxable gifts. Doris owes no gift tax, and her remaining applicable exclusion amount entering 2023 is $15,920,000 ($3 million of Stan’s remaining DSUE amount plus her own $12,920,000 basic exclusion amount). Doris marries Bob in January 2023. Bob dies in June 2023, leaving a DSUE amount of $2 million. Doris dies in October 2023.
**Calculation.** The DSUE amount available to Doris’s estate is $4 million, determined by adding Bob’s $2 million DSUE amount and Stan’s $2 million DSUE amount that was applied by Doris to her 2019 taxable gifts. Thus, Doris’s applicable exclusion amount is $16,920,000 (her basic exclusion amount of $12,920,000 plus the $4 million DSUE amount). Her estate tax calculation will take into account the $2 million given away in 2019 as an adjusted taxable gift.

**Getting a Copy of a Gift Tax Return**

The IRS will provide a copy of a gift tax return when Form 4506, Request for Copy of Tax Return, is properly completed and submitted with substantiation and payment. Upon receipt and verification (including matching current taxpayer and taxpayer representative records with the information on the submitted Form 4506-T), a copy of the original tax return will be mailed as requested. A $50 fee per tax return applies.

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**Gift Planning Ideas 2023**

<table>
<thead>
<tr>
<th>The 2023 gift tax exemption is $12,920,000, an increase of $7,430,000 from 2017. Those who have previously used up their exclusion amount may make additional gifts excludable from gift tax. Although transfers will come back into the gross estate as adjusted taxable gifts at death, if death occurs prior to 2026, the higher estate tax credit may cover any tax. There will not be a “clawback” for deaths after 2025, when the law reverts to old numbers, indexed for inflation.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The results of the 2024 election may make a difference in the amount of the gift tax exemption and the timing of its sunset. Discuss proposed changes in the BBBA and Biden’s budget proposals among others and refer the client to their estate attorney.</td>
</tr>
<tr>
<td>Unless the client is uber-wealthy, he or she doesn’t want to give up their access to wealth.</td>
</tr>
<tr>
<td>Suggest that married clients see an estate planning attorney for a discussion of Spousal Lifetime Access Trusts (SLATs). SLATs have the potential of removing assets from the estates of both spouses and providing the spouses access to income and/or principal. There are proposed changes to trusts in the BBBA and Biden’s budget proposals.</td>
</tr>
<tr>
<td>The payment of gift tax reduces the taxable estate (if the donor lives at least three years from the gift). Gift tax is calculated on the value of the property transferred. It is tax exclusive. Estate tax is calculated on the value of the estate before the payment of the estate tax. It is tax inclusive. Paying gift tax results in net tax savings.</td>
</tr>
<tr>
<td>The applicable federal rates (AFR) no longer remain at or near historical lows, as they were several years ago, encouraging low-interest-rate loans between family members. As inflation grows, act before rates increase further. Consider selling appreciating assets to a family member on an installment sale utilizing the current AFR, especially for assets expected to generate cash flow greater than the AFR.</td>
</tr>
<tr>
<td>When a spouse with DSUE remarries and is expected to lose the DSUE when the new spouse dies, consider making gifts to fully utilize DSUE while still available.</td>
</tr>
</tbody>
</table>

**Tax practitioner planning.** Any estate plan must take into consideration the state tax ramifications, as many states do not follow federal estate tax law and have their own death tax with lower exemption levels. Connecticut is the only state that presently has a gift tax. See The Balance’s State Tax Chart as of February 2023 at [https://taxfoundation.org/taxedu/glossary/estate-tax/](https://taxfoundation.org/taxedu/glossary/estate-tax/)
Valuing Disclaimed Life Estate by Terminally Ill Donor ([PLR 201928003])

The IRS has released a Private Letter Ruling that discusses the valuation of disclaimed life estates when the taxpayer was terminally ill at the time of the disclaimer. Generally, the fair market value of life estates transferred by gift is the present value of the interests determined under Reg. §25.2512-5(d).

Taxpayer was diagnosed as terminally ill at the time the gift was made and died five days later. Since Taxpayer was terminally ill within the meaning of Reg. §25.7520-3(b)(3) at the time of the gifts, the mortality component under §7520 for ordinary life estates could not be used to determine the present value of the life estates disclaimed by Taxpayer. A much-reduced life expectancy factor (and larger gift) was required.


Taxpayer (Husband) made a gift of an LLC interest to wife (W), who immediately transferred it to Husband’s children. Tax Court: W never had an interest in the property (no registration in her name, no capital account for her, no mention of her name as an owner on the LLC return, etc.), so the gift was treated as made indirectly by Husband — who had no gift tax exclusion left — so a gift tax of over $1 million due.

Some of Transfers to Son Were Gifts ([Mary P. Bolles Estate, TCM 2020-71])

Transfers made by a decedent to her son over many years were considered loans for the first few years but then were treated as gifts. The decedent transferred funds to her son and his business to pay the business’s bills. From 1985 through 2007, the decedent gave her son nearly $1.06 million, none of which was repaid after 1988. In her estate planning documents, the decedent considered the funds to be loans.

Actual expectation of repayment. To establish that a transfer was a loan in a family transaction, the decedent must have an actual expectation of repayment and an intent to enforce the debt. Based on the evidence, the decedent reasonably believed that the son’s business would become successful until sometime in 1989. After that, the decedent no longer believed that he would be able to repay the loans. As a result, the transfers were considered loans through 1989. Beginning in 1990, the transfers were gifts. In addition, the decedent did not forgive any of the loans, but just accepted that they would not be repaid. Therefore, the value of the amounts transferred after 1989 was included as adjusted taxable gifts in computing the decedent’s tax liability.

Tax practitioner planning. Because the notice of deficiency did not include interest on the alleged gifts, there was no procedural basis to expand the government’s position to include the amount of the transferred funds, plus interest.

Property Purchased at Discount Resulted in Gifts ([Estate of Bernard J. MacElhenny Jr. et al, (TCM 2023-33)])

The court found that the decedent’s children received gifts when they purchased property from the decedent at a discount.

Taxpayer Found to Have Adequately Disclosed Gift of Life Insurance Policy. ([Schlapfer v. cir, TCM 2023-65])

The taxpayer disclosed a gift transfer of a life insurance policy along with other assets on a gift tax return filed in connection with his filing under the Offshore Voluntary Disclosure Program. The Tax Court determined that
the filing constituted adequate disclosure that did not permit the IRS to extend the statute of limitations for auditing the taxpayer’s gift tax return.

**Transfers to “Care Givers” Were Gifts, Not Deductible Expenses. (Estate of Spizzirri, TCM 2023-25)**

A decedent’s estate owes gift tax on payments he made to multiple women. Over the last five years of his life, he paid large sums by check to his daughters and to seven women with whom he was involved. The IRS imposed gift tax on the value of the lifetime gifts less the annual gift-tax exclusion amount. The estate argued the payments were not gifts but were for care and companionship. But the decedent did not issue W-2s or 1099s, nor did he take deductions on his Form 1040. The Tax Court decided they were taxable gifts.


The write-off of advances to an employee with whom the employer had a “personal relationship” was compensation and not a gift where the parties signed a severance agreement, and the employer issued a Form 1099-MISC.

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**TRUST TAX UPDATE**

**The IRS Clarifies Rules Addressing Excess Deductions on Form 1041 in the Year of the Entity’s Termination (TD 9918)**

Prior to 2018, those deductions which exceed the entity's income in the year of termination were called “excess deductions on termination” and could be passed to the beneficiaries (§642(h)(2)). They were included on the personal income tax returns of the beneficiaries as miscellaneous itemized deductions (and subject to the 2% floor on such deductions with respect to those beneficiaries that are individuals). These deductions were reported on Schedule K-1 given to the beneficiary. The excess deductions on termination had to have been used by the beneficiary in the year of termination of the trust or estate, or they were lost. They were not eligible to be carried forward, unlike the net operating losses and capital losses passed through the entity to the beneficiaries which may be carried forward. The repeal of the deduction for miscellaneous itemized deductions effective beginning in 2018 has called this deduction opportunity into question (§67(g)). The IRS issued Notice 2018-61 declaring that this issue was being reviewed. Definitive guidance was awaited.

The promised guidance has now been issued. The IRS released final regulations on Sep. 21, 2020, (IR 2020-117) clarifying that the following deductions allowed to an estate or non-grantor trust are not miscellaneous itemized deductions:

- costs paid or incurred in connection with the administration of an estate or non-grantor trust that would not have been incurred if the property were not held in the estate or trust,
- the personal exemption of an estate or non-grantor trust,
- the distribution deduction for trusts distributing current income, and
- the distribution deduction for estates and trusts accumulating income.
These deductions are not affected by the suspension of the deductibility of miscellaneous itemized deductions for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026.

**Character of deductions does not change.** The regulations also provide guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or non-grantor trust. Specifically, the final regulations clarify that the character of the deductions does not change when succeeded to by a beneficiary on termination of the estate or trust and require the fiduciary to separately identify deductions that may be limited when claimed by the beneficiary. These final regulations affect estates, non-grantor trusts (including the S portion of an electing small business trust), and their beneficiaries.

**Some expenses are not miscellaneous itemized deductions.** The final regulations make it clear that excess deductions incurred by a trust or estate in the year of termination for items such as accounting fees, legal fees, fiduciary fees, cost of appraisals, probate, accountings, fiduciary bonds, etc. may be carried over to the beneficiaries and deducted by the beneficiaries on Form 1040 without being termed miscellaneous itemized deductions on an individual’s tax return.

**Effective date.** While the regulations are said to be effective when they become final, they also state that taxpayers may rely on them for tax years ending after Dec. 31, 2017. Accordingly, an estate or non-grantor trust that did not claim these deductions in 2018 or 2019, or those that did not pass them to beneficiaries on the final returns for 2018 and 2019 — and the beneficiaries of those estates or trusts that did not receive the benefit of the allocation of excess deductions in the year of termination — may now file amended tax returns to gain the benefit of these deductions, assuming the time for claiming a refund has not expired.

**Passive losses are added to basis.** If the estate or trust distributes an asset which is characterized as an interest in a passive activity, the entity’s suspended passive losses do not become available as a deduction to the beneficiaries. Instead, the suspended losses may be used to increase the income tax basis of the passive activity property immediately before the distribution (§469(j)(12)).

**Certain deductions are not “excess deductions.”** Certain deductions to which a trust or estate may otherwise be entitled do not survive the entity.

1. The fiduciary may not claim a personal exemption in its year of termination (§642(h)(2)).

2. Beneficiaries may not deduct any charitable contributions by the trust or estate that are nondeductible by the entity because the contributions exceed the entity’s taxable income in the year of termination (§642(h)(2)). No carryover of these excess contributions is allowed. Consider here making the permitted election to treat a charitable contribution as made in the prior tax year to receive the benefit of the charitable deduction that might otherwise be lost.

3. Investment interest expense carryovers (the excess of investment interest expense over net investment income) are available to trusts and estates until their termination, and then they are lost. Unused investment interest expense carryovers may not be transferred to the beneficiaries.

4. Excess percentage depletion (oil and gas) carryovers are available to trusts and estates until their termination, and then they are lost.
“Stretch Out” Planning — Before and After the SECURE Act

The SECURE Act (Setting Every Community Up for Retirement Enhancement) was signed into law on Dec. 20, 2019, and is effective for deaths occurring in 2020 and beyond. SECURE ACT 2.0 was signed into law in 2022. These Acts are discussed in detail in Chapter 2. Prior to the SECURE Act, upon the death of an IRA or other plan participant, designated beneficiaries were able to take distributions over their life expectancy. This permitted the desirable “stretch out” planning for beneficiaries, particularly children and grandchildren.

New for 2023 DoD. The SECURE Act created new categories of beneficiaries and limits the opportunity to take distributions over one’s life expectancy to only certain beneficiaries. One category is referred to as an “eligible designated beneficiary” (EDB). Persons in this category named as outright beneficiaries or as the sole beneficiaries of trusts for their benefit may continue to take distributions over his or her life expectancy. The law allows for the creation of special needs trusts for disabled and chronically ill individuals.

Eligible designated beneficiaries (EDBs) include:

- A surviving spouse,
- A minor child of the plan participant (until the child reaches age 21),
- A disabled individual,
- A chronically ill individual, and
- An individual who is not more than 10 years younger than the deceased participant or IRA owner.

Other designated or successor beneficiaries. Most other designated or successor beneficiaries must take complete distribution of the benefits by the end of the 10th calendar year following the year of the participant’s death. A different rule applies if the plan participant died before his or her required beginning date without a designated beneficiary. In that case, there must be a complete distribution of benefits by the end of the fifth calendar year following the year of the participant’s death. If the plan participant died without a designated beneficiary after reaching his or her required beginning date, there must be a complete distribution of benefits by the end of the deceased participant’s remaining actuarial life expectancy, as determined by the IRS Single Life Table. Otherwise, subject to proposed regulations described below, all amounts must be distributed by December 31 of the year that contains the 10th anniversary of the date of death. In the interim, no annual distributions are required (for persons who are not EDBs), as long as funds are out of the plan by that deadline.

Proposed regulations. The IRS has issued proposed regulations in 2022 that would require beneficiaries (who are not EDBs) of persons who die after having attained age 73 to use their actuarial life expectancy for the required distributions during the 10-year withdrawal period, with any remaining balance to be withdrawn at the end of the 10th year. This issue in the proposed regulations is controversial and has been criticized, so that it is presently unclear if this provision will be in the final regulations. These proposed rules have been suspended through at least 2023, so that until resolved, no penalty is imposed for not following them.

When an EDB dies, the remaining balance must be distributed within 10 years. A minor child ceases to be an EDB upon reaching majority. Any remaining balance must be distributed within 10 years from the time the minor reaches majority. The exception for a minor child does not include a minor grandchild or any other minor beneficiary. The favorable planning technique of naming grandchildren as beneficiaries with the opportunity for a lengthy stretch out has been eliminated.
Prior to SECURE, Planning Suggested Using a “See Through Trust” — Referred to as a Conduit Trust

Conduit Trusts. A conduit trust requires the trustee to distribute immediately to the beneficiary any plan distributions the trust receives. Prior to the SECURE Act, designating a young beneficiary would achieve a long stretch out for that person’s lifetime, keeping the annual conduit payout of the required minimum distribution relatively small. With the SECURE Act, conduit trusts for designated beneficiaries who are not classified as “EDBs” will force the entire IRA to be paid to the beneficiary in as few as 10 years. In many cases, but not all (per the proposed regulation discussed above) the payment is not required to be made in annual installments. SECURE requires payment within 10 years, allowing deferral to the end of the 10-year period, but a significant taxable payment will result at that time if deferral is chosen. As a result of SECURE, conduit trusts will rarely be a good option to protect a spendthrift beneficiary or protect the beneficiary from creditors. The income tax laws will create a dilemma — since trusts reach the top 37% income tax bracket at $14,450 for 2023 in taxable income, distributing the IRA may save significant income taxes, but bear in mind why the trust may have been created in the first place (i.e., to be protective of a beneficiary who may not be an appropriate inheritor to receive distributions).

Accumulation Trusts. An accumulation trust provides that plan distributions received by the trust are not required to be distributed, but rather may be held in the trust for future distribution to a beneficiary. This trust is typically used to delay distributions until a designated age of a beneficiary is attained, or to provide protection from creditors, or to maximize the benefits of a generation-skipping trust. An accumulation trust will still be available after the SECURE Act, if desired, but there will be the required distribution from the plan to the trust at the end of 10 years (or sooner if desired or required) at the cost of higher income taxes being owed on amounts distributed to the trust and not paid to beneficiaries due to the severely compressed trust income tax rates. The funds can remain in the trust indefinitely after they have been distributed from the IRA or retirement plan if the trust so provides.

What Needs to Be Changed?

The SECURE Act retains the definition of designated beneficiary — so current plans naming beneficiaries remain effective. SECURE does not affect the definition of see-through conduit trusts and accumulation trusts. They are defined in the same way under SECURE as they were under prior law.

But the game changes except for the specified categories of EDBs, for deaths in 2020 or later. Clients are now faced with the choice of continuing a conduit trust plan, with the realization that a substantial payout will be required to be made to a beneficiary within 10 years — possibly more (or much more) than the participant would prefer the beneficiary receive. And the distribution may be taxed to a beneficiary in a high tax bracket, perhaps in peak earning years. Alternatively, compare the accumulation trust for the beneficiary, which will allow more control over the timing of distributions, and withholding distributions from a spendthrift or creditor-concerned beneficiary — with the ordinary income tax “cost” of receiving the plan benefits in a trust without distribution to beneficiaries at the severely compressed trust income tax rates.

Tax practitioner planning. It is anticipated that many clients will consider changing a trust from a conduit trust to an accumulation trust to avoid a rapid forced payout of the plan funds. If the client dies with a conduit trust, it may be possible to modify or reform the trust to make it an accumulation trust. Judicial modification of a trust based on changed circumstances or to accomplish the trust grantor’s objectives is permitted in states that have adopted the Uniform Trust Code. Some state laws may permit modification of the trust by consent of the interested parties, while persons in other states may have to seek judicial reformation. If the client’s state has a decanting statute, the statute may be another way to allow a change to be made.
Planning Alternatives

1. If the plan participant is in a lower income tax bracket than the intended beneficiaries, consider having the participant convert the plan to a Roth IRA. The participant will then pay income tax on the conversion, but the beneficiaries will be able to withdraw the money (still subject to the 10-year rule) without income tax consequences.

2. Some clients may be more receptive to investing in a life insurance policy to be held in an irrevocable trust. Assuming the policy will be excluded from the decedent’s estate, the trust will receive the policy proceeds without estate or income tax, and the trust provisions can provide for a lifetime stretch out of the trust income and principal which the SECURE Act now denies.

Another alternative plan may be to consider the creation of a charitable remainder trust. Such a trust may be created for the lifetime of a non-charitable beneficiary, or for a duration of up to 20 years. While a lifetime trust may be preferred, it may not “work” for young beneficiaries, since the minimum annual payout to the beneficiary must be 5%, and the actuarial value of the remainder interest to the charity must be at least 10% of the value of the trust at its inception. In the current era of rising interest rates, the 10% requirement may be more easily met for a beneficiary with a long actuarial life expectancy, but the calculation must be performed. However, a charitable remainder trust with a duration of 20 years (or less if desired) is a viable option. Retirement plan benefits can be paid tax-free into the charitable remainder trust, which then pays a stream of fixed dollar payments (if a charitable remainder annuity trust) or annually determined payments based on a fixed percentage of the annually determined fair market value of the trust assets (if a charitable remainder unitrust). These payments are taxable to the individual beneficiary, but a 20-year trust term with controlled annual payments may be a preferred alternative to required distributions over a 10-year term, especially if the plan participant is charitably inclined.

SECURE 2.0 was signed into law on Dec. 29, 2022

The Act makes a number of enhancements to retirement plans and planning, including:

Secure 2.0 allows simple IRAs to accept Roth contributions.

- It allows for hardship distribution for 403(b) plans to match existing 401(k) hardship distribution rules so that participants in 403(b) plans will have access to all funds instead of current law that limits it in some cases to only employee contributions without earnings.
- It adjusts elective deferral rules by providing all catch-up contributions to qualified retirement plans by persons with adjusted gross income over $145,000 are subject to Roth tax treatment. However, this requirement of Roth IRA treatment of catch-up contributions has now been delayed until 2026. Notice 2023-62.
- It allows for participants in 401(k), 403(b), and governmental 457(b) plans with the option of receiving matching contributions from their employer on a Roth basis.
- It reduces the excise tax on certain accumulations in qualified retirement plans, including a reduction in the penalty for failure to take the required minimum distribution from 50% to 25%. If that failure is corrected in a timely manner, the excise tax is further reduced to 10%.

Secure 2.0 also provides for:
• Expanding automatic enrollment in 401(k) and 403(b) retirement plans;
• Creating new financial incentives for small businesses to offer retirement plans;
• Increasing and modernizing the existing tax credit for contributions to a retirement plan or IRA;
• Increasing the required minimum distribution age to 73 and later to 75 phased in over several years;
• Creating new opportunities for military spouses to save for retirement;
• Allowing groups of nonprofit organizations to join together to offer retirement plans to their employees;
• Allowing individuals to pay down student loans instead of contributing to a 401(k) while still getting the benefit of the employer match to their retirement plan; and
• Roll over of some 529 plan contributions to Roth IRAs.

Charitable Deduction Is Limited to Amount Passing to Donee (Estate of Dieringer v. Comm., CA-9, No.16-72640 (Mar. 12, 2019))

This case involves the Victoria E. Dieringer Estate. The Dieringer family owns Dieringer Properties, Inc. (DPI), a closely held corporation that manages commercial and residential properties in Portland, Oregon, as well as a Wendy’s restaurant in Texas. Before Victoria’s death, the only shareholders of DPI were Victoria and two sons, Eugene, and Patrick. Victoria owned 425 out of 525 voting shares and 7,736.5 out of 9,220.5 nonvoting shares. Eugene owned the remaining 100 voting shares, and Eugene and Patrick each owned 742 nonvoting shares. According to Victoria’s will, dated Nov. 10, 2000, upon her death, all of her estate would pass to the Victoria Evelyn Dieringer Trust. The Trust provided for Victoria’s children to receive some personal effects, but no other proceeds from her estate. The Trust also provided for $600,000 in donations to various charitable organizations. Any assets remaining in the estate would then pass to the Bob and Evelyn Dieringer Family Foundation, a §501(c)(3) organization, as a charitable contribution. Although valued at a higher number on the estate tax return, DPI bought out the Foundation’s interest at a discounted price.

How is the stock valued for the estate’s charity deduction? At the center of the tax dispute is whether the Estate’s charitable deduction should be valued at the time of Victoria’s death, or whether the post-death events that decreased value of the property delivered to charity should be considered. Deductions are valued separately from the valuation of the gross estate. See Ahmanson Foundation v. United States, (674 F.2d at 772), which says, “The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction.” Separate valuations allow for the consideration of post-death events, as required by Ahmanson and provisions of the Tax Code. In Ahmanson, the decedent’s estate plan provided for the voting shares in a corporation to be left to family members and the nonvoting shares to be left to a charitable foundation. The court held that when valuing the charitable deduction for the nonvoting shares, a discount should be applied to account for the fact that the shares donated to charity had been stripped of their voting power. The fact that a discount was not applied to the value of the nonvoting shares in the gross estate did not impact the holding in Ahmanson.

Deduction limited to discounted value. The Appeals Court agreed with the IRS that a charitable deduction is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity.
The IRS is focused on this issue. The IRS has raised this issue in another recent case and continues to find success in the courts. In *Estate of Miriam Warne v. Comm.*, TCM 2021-17, the decedent’s estate held a 100% interest in an LLC, valued in the estate at full fair market value. The LLC was left 75% to one charity and 25% to another charity. The estate’s claimed deduction of 100% of the value was denied. The court valued the 75% and 25% interests separately, applying discounts to each (27% to the 25% interest and 4% to the 75% interest), resulting in a deduction for the estate of less than the full value of the LLC interest left to the charities.


The trust’s 2004 return reported income of approximately $58.8 million. The return claimed a charitable deduction totaling $20,526,383. This included the donations of real property, as well as $1,851,502 cash donations. The return reported that the Trust’s total adjusted basis in the three donated real properties was approximately $10.7 million and that the properties’ fair market value at the time of donation was approximately $30.3 million. On Oct. 15, 2008, the Trust filed an amended Form 1041 income tax return claiming a refund from the IRS for $3,194,748 in income tax and increasing the Trust’s reported charitable deduction from $20,526,383, as reported on the Trust’s original 2004 income tax return, to $29,654,233. The IRS disallowed the refund, saying that the deduction allowed by §642(c)(1) is limited to the adjusted basis of the donated property.

Note. This is a trust established from the Hobby Lobby fortune.

Contribution paid from gross income of trust. Generally speaking, the Internal Revenue Code treats charitable contributions made by trusts differently than charitable contributions made by individuals and corporations. In particular, §642(c)(1), entitled “Deduction[s] for amounts paid or permanently set aside for a charitable purpose,” sets forth the following special charitable deduction rules for trusts:

> (1) General rule — In the case of an estate or trust (other than a trust meeting the specifications of subpart B), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by §170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in §170(c) (determined without regard to §170(c)(2)(A)).

Unrealized gain doesn’t count. To be deductible, charitable contributions from the trust must be paid from its gross income (as compared to its corpus). The appellate court agreed with the IRS that the amount of the deduction must be limited to the adjusted basis of the property. Because the Trust never sold or exchanged the properties at issue, it never realized the gains associated with their increases in market value and was therefore never subject to being taxed on those gains. Thus, construing §642(c)(1)’s deduction to extend to unrealized gains would be inconsistent with the Code’s general treatment of gross income.

The IRS continues to successfully argue this issue in the courts. In *Glade Creek Partners, LLC v. Comm.*, T.C. Memo 2023-82 (6/29/2023), the Tax Court held that real estate was inventory and therefore the taxpayer’s charitable contribution deduction was limited to the property’s basis.

Tax practitioner planning. Congress extended the charitable deduction for individuals and corporations to include the unrealized gains associated with real property originally purchased with gross income (§170). It did not do the same for trusts.
Sales of Contributed Property by a Charitable Remainder Annuity Trust (CRAT) Does Not Eliminate Gain to be Reported by Non-charitable Trust Beneficiary (Gerhardt v. Comm., 160 TC #9 (Apr. 20, 2023))

The Tax Court rejected a plan by taxpayers to contribute low basis assets to a CRAT, have the CRAT sell the assets and convert the funds to an annuity, and then only report income based on the interest generated by the annuity. The Court held that the basis of the property contributed by the taxpayers and sold by the CRAT is relevant to determine the amount of income received by the taxpayers on distributions. The taxpayers’ claim of a “disappearing basis” was rejected. Similar issues rejecting a disappearing basis were decided against the taxpayer in Furrer v. Comm., TC Memo 2022-100.

IRS WARNS ABOUT MARKETED TRUST ARRANGEMENT SUGGESTING THAT A NON-GRANTOR, IRREVOCABLE, COMPLEX, DISCRETIONARY SPENDTRIFT TRUST REMOVES TRUST INCOME FROM CURRENT TAXATION (AM 2023-006 (Aug. 9, 2023))

The Notice describes in detail a suggested trust arrangement that excludes capital gains and extraordinary dividends from both the trust’s and beneficiaries’ income. It states that the suggested arrangement is a misinterpretation of the trust income and distribution rules, rejects the promoters’ marketing suggestions, and concludes that if the gains and dividends are not distributed they must be taxable to the trust.

Estates and Trusts Are Subject to the 3.8% NII (Net Investment Income) Tax

The highest rate (37%) for estates and trusts in 2023 starts at undistributed taxable income over $14,450. Estates and trusts also must pay the 3.8% NII tax on the lesser of:

- their undistributed NII for the tax year; or
- any excess of its AGI over $14,450 (the estates and trusts highest tax bracket (37%) dollar amount for the 2023 tax year) (§1411(a)(2); (§1.1411-3(a)(1)).

Example — trust distributes income. In his will, Billy Buffett establishes a $10 million trust for Billy, Jr. (who is married), administered by a trustee who has full discretion to pay income or corpus (principal) to Junior. In 2023, the trust generates $200,000 of interest and dividend income and distributes it to Junior. Junior reports all on his Form 1040 but owes no net investment income tax, as his modified AGI is not in excess of $250,000. The trust also owes no such tax because it has no undistributed NII.

Example — trust retains income. Assume, instead, Billy Buffett’s executor decides to accumulate the $200,000 of interest and dividend income. The trust would be taxed on the lesser of $200,000 (its undistributed NII) or $185,550 ($200,000 of AGI minus the $14,450 threshold (in 2023) before the trust hits the highest ordinary tax bracket). The trust owes NII tax of $7,050.90.

Short taxable year. Generally, for an estate or trust that has a taxable year consisting of less than 12 months (short taxable year), the highest tax bracket threshold is not reduced or prorated unless the short taxable year resulted from a change of annual accounting period (but not from an individual’s death) [§1.1411-3(a)(2)].

Calculation of undistributed NII. The computation of certain deductions and the allocation of NII between an estate or trust and its beneficiaries has special rules. Generally, an estate’s or trust’s NII is calculated in the same manner as that of an individual (§1.1411-3(e)(1)). An estate’s or trust’s undistributed NII is:

- its NII reduced by distributions of NII to beneficiaries, and §642(c) deductions for amounts paid or permanently set aside for charitable purposes (§1.1411-3(e)(2)-(4));
• BUT the distribution to the beneficiaries is limited to the lesser of (1) the amount deductible to the estate or trust under §651 (deductions when distributing current income only) or §661 (deduction when accumulating income or distributing corpus), or (2) the NII of the estate or trust.

The §661 rules are also used to allocate distributions between NII and excluded income as defined at §1.1411-(e)(5), similar to §1.661(b)-1. Similar rules exist for the §642(c) deductions for amounts paid or permanently set aside for charitable purposes (see §1.661(c)-1; §1.1411-3(e)(1)-(4); §1.1411-3(f)).

**Tax practitioner planning.** Special rules exist for controlled corporations, passive investment companies, and estates and trusts holding interests in such entities (§1.1411-10(c)).

**S corporations electing small business trusts (ESBTs).** Special computation rules apply to ESBTs. Treat the ESBT’s S portion and non-S portion as two separate trusts when computing undistributed NII and as a single trust on determining the amount subject to the 3.8% tax. Exception: the grantor portion, if any, is included in the grantor’s calculation of NII and not the ESBT’s computation (§1.1411-3(c)(1)(I); Preamble.4.B.iii).

**Computation of tax.** The ESBT formula, with an extensive IRS example, can be found at §1.1411-3(c)(1)(ii) and §1.1411-3(f), Ex 3.

**Charitable remainder trust — annuity or unitrust distributions.** The beneficiary’s annuity or unitrust distribution from a charitable remainder trust includes an amount equal to the lesser of the total amount of the distributions for that year or the current and accumulated NII of the charitable remainder trust. Apportionment between multiple beneficiaries is apportioned based on their respective shares. The accumulated NII is the total amount of NII received by a charitable remainder trust less the total amount of NII distributed (§1.1411-3(c)(2); Preamble.4.B.iv).

**Bankruptcy estates.** A bankruptcy estate in which the debtor is an individual is treated as a married taxpayer filing a separate return. The NII threshold amount applicable to such bankruptcy estate is $125,000 ($1.14113(d)(1); §1.1411-2(a)(2)(iii); §1.1411-2(d)(1)(ii); Preamble.4.D).

**Foreign estates** (§1.411-3(d)(2)). The 3.8% tax should not apply to estates and trusts that have little or no connection to the United States (e.g., if none of the beneficiaries is a U.S. person). However, NII of an estate or trust should be subject to the 3.8% tax to the extent such income is earned or accumulated for the benefit of, or distributed to, U.S. persons. Even though the 3.8% tax does not apply to a foreign estate, the IRS may issue future regulations affecting U.S. beneficiaries of trusts (§1.14113(d)(2); §1.1411-3(b)(6); Preamble.4.C).

**Bypass Trusts**

For decades, bypass trusts (also called credit shelter trusts) have been used as an estate planning tool. The portability provision of the 2010 Tax Relief Act eliminated the need for most purely tax motivated bypass trusts to be set up. However, clients should be reminded that there are many other valid reasons for using a trust for the first to die, including addressing state death tax exclusion amounts, asset protection, limiting the surviving spouse’s access to the decedent’s assets, or GST planning. In addition:

• the deceased spouse’s exemption is not indexed for inflation,
• the unused portion of the deceased spouse’s exemption is lost if the survivor remarries and the “new” spouse dies,
• the growth of the assets in the bypass trust is removed from the survivor’s estate, and
• there is no portability of the GST.
Income Taxation of Trusts and Decedent’s Estates

A trust or decedent’s estate figures its gross income in much the same manner as an individual. Most deductions and credits allowed to individuals are also allowed to estates and trusts. However, there is one major distinction. A trust or decedent’s estate is allowed an income distribution deduction for distributions to beneficiaries. To figure this deduction, the fiduciary must complete Schedule B of Form 1041.

For this reason, a trust or decedent’s estate sometimes is referred to as a “pass-through” entity. The beneficiary, and not the trust or decedent’s estate, pays income tax on his or her distributive share of income. Schedule K-1 (Form 1041) is used to notify the beneficiaries of the amounts to be included on their income tax returns.

Distributable net income (DNI). The income distribution deduction allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries is limited to DNI. This amount is figured on Form 1041, Schedule B, line 7.

Income in respect of a decedent. When completing Form 1041, any items that are income in respect of a decedent (IRD) must be taken into account. In general, IRD is income that a decedent was entitled to receive but that was not properly includible in the decedent’s final income tax return under the decedent’s method of accounting. IRD includes:

- All accrued income of a decedent who reported his or her income on the cash method of accounting,
- Income accrued solely because of the decedent’s death in the case of a decedent who reported his or her income on the accrual method of accounting, and
- Income to which the decedent had a contingent claim at the time of his or her death.
- Retirement plan distributions are income in respect of a decedent. There is no basis adjustment when the decedent dies.
- In Hitchman v. Comm., T.C. Summ. Op. 2023-18 (May 2, 2023), the Tax Court required inclusion in a taxpayer’s income of interest from a savings bond inherited from his father as income in respect of a decedent.

Minimum Income Required for the Filing for Form 1041

The decedent’s estate. The fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic estate that has:

- Gross income for the tax year of $600 or more, or
- A beneficiary who is a nonresident alien.

A trust. The fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic trust taxable under §641 that has:

- Any taxable income for the tax year,
- Gross income of $600 or more (regardless of taxable income), or
- A beneficiary who is a nonresident alien.
Two or more trusts are treated as one trust if the trusts have substantially the same grantor(s) and substantially the same primary beneficiary(ies) and a principal purpose of such trusts is avoidance of tax.

**Trust and Estate Tax Exemptions**

The exemption for a complex trust is $100. If the trust is required to distribute all of its income (a simple trust), the exemption is $300. An estate is allowed an exemption of $600. A qualified disability trust is allowed an exemption of $4,700 (2023).

**Estimated Tax**

Generally, an estate or trust must pay estimated income tax for 2023 if it expects to owe, after subtracting any withholding and credits, at least $1,000 in tax, and it expects the withholding and credits to be less than the smaller of:

- 90% of the tax shown on the 2023 tax return, or
- 100% of the tax shown on the 2022 tax return (110% of that amount if the estate's or trust's adjusted gross income on that return is more than $150,000, and less than 2/3 of gross income for 2022 or 2023 is from farming or fishing).

However, if a return was not filed for 2022 or that return didn’t cover a full 12 months, item two above does not apply.

Exceptions. Estimated tax payments in 2023 are not required from:

- An estate of a domestic decedent or a domestic trust that had no tax liability for the full 12-month 2022 tax year;
- A decedent’s estate for any tax year ending before the date that is two years after the decedent’s death; or
- A trust that was treated as owned by the decedent if the trust will receive the residue of the decedent’s estate under the will (or if no will is admitted to probate, the trust primarily responsible for paying debts, taxes, and expenses of administration) for any tax year ending before the date that is two years after the decedent’s death.

**Deductibility of Gift Tax (§2503, §2035, and §2053)**

The three-year-prior-to-death rule. Lifetime gifts allow donors to take advantage of the annual ($17,000 in 2023) exclusion to each donee from gift tax provided in §2503(b). The value of the taxable estate is determined by subtracting allowable deductions from the value of the gross estate (§2051). The estate tax applies to assets used to pay the tax, while the gift tax does not. (In more technical parlance, the base of the estate tax is “tax inclusive,” while the base of the gift tax is “tax exclusive.”)

To deter taxpayers from making gifts shortly before death to exclude from their estate (and avoid transfer tax on) the property used to pay the transfer tax, a “gross-up” rule exists. The “gross-up” rule adds to a decedent’s gross estate the amount of gift tax paid on gifts made by a decedent within three years of death (§2035(b)). The “gross-up” rule eliminates any incentive to make deathbed transfers to remove an amount equal to the gift taxes from the transfer tax base.
Section 2035(b) provides: “The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under ... §2501 through §2524 ... by the decedent or his estate on any gift made by the decedent or his spouse during the three-year period ending on the date of the decedent’s death.” Section 2053(a) allows a deduction from the gross estate for funeral and administration expenses, claims against the estate, and indebtedness in respect of property included in the decedent’s gross estate. The regulations confirm that gift taxes owed by a decedent’s estate at his death are generally deductible (§20.2053-6(d)) (“Unpaid gift taxes on gifts made by a decedent before his death are deductible”). When the donee of a gift agrees to pay the gift tax resulting from the gift, the full value of the property transferred by the donor to the donee is not treated as a taxable gift. Instead, the taxable gift, determined algebraically, is the difference between the total value of the property transferred and the gift tax paid by the donee on the “net” gift.

The Unlimited Marital Deduction (§2056)

Allowance of marital deduction. The value of the taxable estate shall, except as limited below, be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to the surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate (§2056(a)).

Limitation in the case of life estate or other terminable interest. Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed (1) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money’s worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and (2) if by reason of such passing, such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse; and no deduction shall be allowed with respect to such interest even if such deduction is not disallowed under (1) and (2) above, if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust (§2056(b)(1)).

Valuation of interest passing to surviving spouse. In determining the value of any interest in property passing to the surviving spouse for which a deduction is allowed, (1) there shall be taken into account the effect which the federal estate tax imposed, or any estate, succession, legacy, or inheritance tax has on the net value to the surviving spouse of such interest; and (2) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined (§2056(b)(4)).

The Impact of Debts and Expenses on the Estate’s Marital Deduction (§2056)

As previously discussed, a marital deduction is allowed for “the value of any interest in property which passes or has passed from the decedent to his or her surviving spouse” (§2056(a)). “Value,” for that purpose, means “net value” (§20.2056(b)-4(a)). Thus, property that would otherwise have been distributed to the surviving spouse that is used to satisfy debts of the estate is not included in the allowable marital deduction. Similarly, any debt or claim that encumbers property that the spouse does receive reduces the deduction (§2056(b)(4)(B)). In addition, “[f]or purposes of determining the marital deduction, the value of the marital share shall be reduced by the amount of the estate transmission expenses paid from the marital share” (§20.2056(b)-4(d)(2)). Transmission expenses are those “that would not have been incurred but for the decedent’s death and the consequent necessity of collecting the decedent’s assets, paying the
decedent’s debts and death taxes, and distributing the decedent’s property to those who are entitled to receive it” (§20.2056-4(d)(1)(ii)).

Even when marital assets would otherwise be exempt from debts and expenses under state law or the terms of the decedent’s will, executors may be forced to sell those assets to satisfy debts and or pay expenses if nonmarital assets are insufficient. In such cases, the marital deduction must be reduced by the value of the marital assets used to pay debts or expenses (§20.2056(b)-4(c)(1); Martin v. US, 923 F.2d 504, 506 (7th Cir. 1991); Murray v. US [82-2 USTC ¶13,488], 687 F.2d 386 (Ct. Cl. 1982).

The deduction allowed to an estate for expenses and claims generally cannot “exceed the value, at the time of the decedent’s death, of property subject to claims” (§2053(c)(2)).

Gifts Made Within Three Years of Death; Gift Taxes Paid by Donees; Marital Deduction When Interest Passes to Surviving Spouse (Estate of Sheldon C. Sommers, Deceased v. Comm., 149 TC 209 (2017) No. 9306-07)

Sheldon Sommers transferred artwork to a wholly owned LLC and gifted LLC “units.” What could go wrong with that estate planning? The IRS determined a deficiency in the federal estate tax against the Estate of Sheldon C. Sommers resulting from the inclusion of alleged gift tax on gifts from his art collection Sommers made to his three nieces (the intervenors in this case) in 2001 and 2002, less than three years before his death on Nov. 1, 2002. To reduce any gift tax on the gifts, his attorneys had Sommers transfer the artwork to a newly formed LLC, and then make gifts to his nieces of the LLC “units” with the expectation that the appraised value of the “units” would be less than the value of paintings they represented using aggressive “applicable valuation discounts.” After the appraisal, the attorneys concluded that their plan would not allow for the complete avoidance of gift tax. The nieces “agree[d] to pay the gift taxes (resulting from the 2002 transfers), if any, relating to the gift [of] the ‘units,’ ... ‘units’ that may later correctly be assessed (by the IRS).” “While neither agreement provide(d) for the donee’s assumption of any liability other than gift tax, neither specifically exculpates the donee from other liabilities.”

Adjustments on exam. The IRS examiner increased Sommers’ taxable value from $507 to $494,717. First, the IRS included in the value of Sommers’ gross estate the gift tax determined to be due as a result of the 2002 gifts because he had made those gifts less than three years before his death (as required by §2035(b)). Second, the IRS excluded from Sommers’ gross estate the value the estate had assigned to the artwork that he had transferred to the LLC. And third, the IRS reduced the marital deduction allowable to the estate. The decrease in the allowed marital deduction reflected the IRS’s determination that the estate tax liability of $220,726, resulting from gifts made within three years of death (the §2035(b) inclusion), would have to be paid out of marital assets.

Arguments made by the estate and the IRS. The estate of Sommers argued that the gift tax owed by Sommers on his 2002 gifts and unpaid at his death was deductible under the plain terms of §20.2053-6(d). The estate reasoned that the payment of the gift tax by the three nieces (the intervenors) rather than by the estate did not affect the estate’s entitlement to the claimed deduction because §2502(d) “imposes the obligation to pay gift tax on the donor and the obligation remains on, and is deemed owed and paid by, the donor, even in a ‘net’ gift setting.” The estate did admit that allowing the deduction of the gift tax under §2053 would “eliminate the $273,990 gift tax add-back that takes place under §2035(b) [the three-year rule] on literally a dollar-for-dollar basis.” The IRS argued that the gift tax the three nieces (intervenors) paid on Sommers’ 2002 gifts was not deductible under §2053 because the nieces “received nothing additional from the estate” and thus “did not pay the gift tax in their capacity as beneficiaries of Dr. Sommers’ estate.”

Court conclusion on “net” gifts. The court relied on substance over form principles to reconcile the enforcement of the statute’s underlying policy with its plain terms. Although the three nieces of the “net”
gift directly paid the gift tax, Sommers was the ultimate payor: The nieces served merely as conduits. The court concluded that “[b]ecause the estate would have been entitled to reimbursement of the full amount of the gift tax paid, no deduction can be allowed.”

**The impact of debts and expenses on the estate’s marital deduction.** The estate claimed to be entitled to a marital deduction of $1,698,392, equal to the value of Sheldon Sommers’ nonprobate property that his surviving spouse, Bernice, received or to which she succeeded that, under New Jersey law, was exempt from the estate’s debts and expenses. The estate argued that those assets “are protected from claims including state law debts of the decedent and the expenses of administering the decedent’s estate, to the extent such expenses arise under state law.”

**Court conclusion on marital deduction.** The court found that the estate’s claim of a marital deduction of $1,698,392 was inconsistent with the estate’s deduction of $413,460 of debts and expenses. If the estate was correct “that Bernice received or succeeded to nonprobate assets worth $1,698,392.24 that were exempt, under New Jersey law, from claims against the estate, then the date-of-death value of the property subject to claims was no more than $295,578.05 ($3,744,477.63 − $507.34 − $1,750,000 − $1,698,392.24).” Because the estate’s entitlement to a marital deduction in the amount the estate claimed turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay the reported debts and expenses, the court refused to determine a marital deduction in that amount. “In short, either the allowable marital deduction (was) less than $1,698,392 or the estate (was) not entitled to deduct in full the debts and expenses reported on the estate tax return.”

**Estate of De Muth, Jr. v. Cir** *(3rd Circuit Opinion July 12, 2023)* Gifts of checks made prior to the decedent’s death and not negotiated until after death are included in the decedent’s estate.

The Third Circuit followed a long line of precedent in holding that checks written by the holder of a power of attorney for a decedent and delivered prior to the decedent’s death, but paid after death, were included in the decedent’s taxable estate. Since a check can be revoked until cashed or otherwise negotiated, it is not complete until this occurs. Accordingly, the funds represented by the checks not negotiated as of the decedent’s date of death were included in his estate.

**Relying on Bad Advice From Tax Attorney Was Reasonable Cause for Late Filing of Estate Tax Return** *(The Estate of Esther M. Hake, Ricky L. Hake, and Randy L. Hake, Executors v. US, (DC Pa.), 2017-1 USTC 60,699)*

Ricky and Randy Hake, the executors of their mother’s estate, sued for abatement and reimbursement of a late penalty of $197,868 assessed after they were late in filing the estate’s tax returns. The executors did not simply neglect to comply with a deadline that was known to them. To the contrary, the executors filed the return on the date that their tax attorney advised them that it was due, after the estate had been granted extensions of both its filing and payment deadlines. Indeed, the executors took care to pay the taxes that they believed were owed well before payment was due and in an amount that later proved to be more than $100,000 in excess of what was actually owed. Nevertheless, the executors unquestionably filed the estate’s return approximately six months late, having been incorrectly advised by tax professionals that the return deadline had also been extended for one year, something that was admittedly inaccurate. There was also no dispute between the parties that this advice was incorrect, and that tax law permits only a six-month extension of time to file an estate tax return for domestic executors, whereas it permits up to a one-year extension to pay the taxes owed. The executors’ counsel had candidly acknowledged that the advice he gave his clients was wrong.

The court found that the executors’ reliance upon the advice of their counsel in these particular circumstances regarding the applicable deadlines for filing the estate’s return was reasonable, and, therefore,
the imposition of the penalties and interest was not warranted. In reaching this conclusion, the court acknowledged the United States’ arguments regarding the application of emerging case law from other courts in this field but found that application of authority from the 3rd Circuit to the particular facts of this case compelled this outcome.

**Appeals Conference Rights Lost in Estate and Gift Exams If No Response to Information Document Request (IDR) (SBSE-04-0115-0015) (IRM-Unagreed Procedures)**

IRS estate and gift tax auditors received some interim guidance on procedures concerning the eligibility for an IRS appeals conference. The information (SBSE-04-0115-0015) outlines the options available if the taxpayer does not agree with the auditor’s proposed adjustments. The IRS will issue the 30-day letter with the report of proposed adjustments to the tax return along with the newly created Letter 5262-D, Additional Information Due - Estate and Gift Tax. The taxpayer has 15 days to respond and provide or verify that they do or do not have the information requested.

**If the taxpayer responds to IDR.** The memorandum states that in order for the taxpayer to be eligible for an appeals conference:

- Information requested on Form 4564 or through correspondence must be provided by the taxpayer or a third party, or
- The taxpayer/representative must confirm there is no additional information to resolve the outstanding issue(s). On each applicable lead sheet, the examiner must inquire and document: the discussion, the date and time, the parties to the discussion, and what information was not provided and why it was not available, for each issue.

If the taxpayer has met either of the requirements, the examiner should issue a 30-day letter and provide the taxpayer with the opportunity to request an appeals conference.

**If the taxpayer does not respond to IDR.** If the taxpayer does not respond — and, therefore, is not eligible for an appeals conference — the examiner should issue the initial examination report with Letter 5262-D, Additional Information Due - Estate and Gift, along with:

- the IDR highlighting the information that was not received, or
- a new IDR incorporating the original IDR language and original due date for the previously requested information.

**Warning.** The taxpayer must respond (even if the response is “we have nothing more to provide”) within the 15-day period or the right to an appeals conference is lost.

**Revised Text of Letter 5262-D Dear [Taxpayer]**

*As of the date of this letter, we haven’t received some or all of the information we requested by correspondence or on Form 4564, Information Document Request (IDR), to resolve the issues identified during the examination. You must either provide the information we requested or contact me to confirm you have no additional information to provide by the response due date listed above, or we will close your examination based on the information we have now. If you don’t agree with the proposed changes and we close your case because you didn’t respond, you won’t be able to appeal within the IRS before we issue a notice of...*
deficiency. I am enclosing a copy of the previous request. We may have included more than one Form 4564. If so, be sure to review each one and provide the information requested on each.

**Tax practitioner planning.** Remind the client that the appeals conference is meant to deal with disputes in law, not to be for a finding of facts. Documents need to be submitted to the examiner, not to the appeals officer.

**Tax practitioner planning.** Advise the client that the IRS requires prompt responses, in writing, to all information requests, even if the response is to say, “we are gathering the requested information and need additional time to comply.”

**Executor Held Liable for Unpaid Estate Tax (US v. Kohls, 2020-1 USTC 60,719 (District Court, Ohio, Jan. 2, 2020))**

An executor of a decedent’s estate was personally liable for unpaid federal estate tax after he distributed property to himself and other beneficiaries before paying the estate tax. After the executor had transferred estate property to himself and others, the estate was unable to pay its tax debt. The executor was personally liable for the unpaid tax because he was legally obligated to pay the tax and had notice of the tax liability and the demand for payment (§6324).

The IRS notified the estate that its federal estate tax return was under review regarding a qualified family-owned business interest deduction claimed on the return. In the years that the return was under review, the executor represented to the probate court that estate assets could not be distributed due to the IRS review.

However, several properties were transferred to the executor and other beneficiaries. Once the review was complete, the executor signed Form 890, consenting to the immediate assessment and collection of the estate tax deficiency.

**Tax practitioner planning.** This case is another example of similar cases decided throughout the country that the IRS generally wins. Executors and administrators of estates need to be aware that the IRS will hold them personally liable for unpaid federal estate taxes where the estate has ample assets to pay the tax but distributions by executors and administrators before paying all of the tax due leaves the estate short of funds. The law does not prohibit distributions to beneficiaries prior to settling all tax obligations, but executors and administrators must retain sufficient assets to pay the tax obligations when due, or risk being held personally liable for any shortfall in tax payments.

**Beneficiaries Held Liable for Estate Tax (US v. Donna Ringling, et al., DC SD, 2019-1 USTC 60,709 (Feb. 21, 2019))**

Harold Arshem bequeathed his estate in equal parts to his three daughters. Arshem also made substantial gifts to his grandson shortly before Arshem’s death.

The estate tax return was filed Apr. 14, 2008, eight years after Arshem’s death. The IRS made assessments against the estate totaling $65,874. The estate tax owed was $28,939, the late filing penalty was $6,511, the failure to pay penalty was $7,235, and the interest was $23,189. On that same day, the IRS sent the estate a notice of assessments and demanded payment. The issue is whether the beneficiaries are liable for the estate tax. The court said “yes.”
Defendants received property included in the estate. Each defendant is liable for unpaid estate tax based on the property each defendant received from the estate to the extent of the property’s value measured at the time of the decedent’s death (§6324(a)(2)).

Property received from the estate:

- The three daughters each jointly owned property with Arshem at the time of his death. The gross estate includes all property the decedent and any other person held as joint tenants with right of survivorship except such property that has been shown to originally belong to the joint owner and never was received or acquired by the joint owner from the decedent for less than adequate and full consideration (§2040(a)).

- Shortly before his death on Dec. 24, 1999, Harold Arshem forgave Kory Standy, his grandson, a debt arising from the purchase of property; conveyed the family farm to Kory (retaining a life estate and the right to receive the rent income and profits during his lifetime); paid to Kory proceeds from the redemption of a certificate of deposit; and gifted Kory approximately 6,000 bushels of corn. These gifts were includible in the gross estate under §2035 because the transfers were made within three years of Arshem’s death (only one month before Arshem died). Also, because Arshem retained a life estate, the family farm was includible in the gross estate and was considered §6324(a)(2) property.

Also see.

In *United States v. Paulson, et.al.*, 68 F. 4th 528 (9th Cir. 2023), where a similar result was reached finding the beneficiaries liable for the unpaid estate tax by a decedent’s estate. Here, the estate failed to properly complete a deferred installment payment of the federal estate tax under IRC Section 6166. The beneficiaries who had received substantial distributions from the estate years earlier were found liable for the unpaid estate taxes.

**COMPANY VALUE INCREASED BY PROCEEDS OF LIFE INSURANCE POLICY.**

In *Connelly v. United States*, 70 F. 4th 412 (8th Cir. 2023) a three-judge panel of the Eighth Circuit held that the value of a company is increased by the proceeds of a life insurance policy taken out by the company against the life of a deceased shareholder and intended to be used to purchase the interest of the deceased shareholder. The Court found that there was no fixed or determinable price or formula for the decedent’s shares in the company. Failure to include the life insurance proceeds in the value of the company would have resulted in a windfall for the surviving shareholder. The taxpayer has filed an appeal to the U.S. Supreme Court on the grounds that the decision of the Eighth Circuit conflicts with contrary decisions of the Ninth and Eleventh Circuit holding that corporate-owned life insurance proceeds intended for redemption of a shareholder’s stock are not includable in the estate of a deceased shareholder. *Estate of Blount v. Comm.*, 428 F.2d 1342 (11th Cir. 2005); *Estate of Cartwright*, 183 F.3d 1034 (9th Cir. 1999).

**IRS Issues Proposed Regulations on Calculating Deductible Amounts of Certain Estate Expenses**

Proposed regulations (Reg-130975-08) were issued June 24, 2022, under IRC 2053. They provide guidance on the proper use of present value principles in determining deductions for funeral and administration expenses and claims against the estate. They address the calculation of the present value of deductible expenses that are not paid or expected to be paid before the third anniversary of a decedent’s death.
The proposed regulations also eliminate the interest deduction when the decedent’s planning has created an illiquid situation and created the need to borrow because the illiquidity was caused by lifetime planning.

The proposed regulations provide that interest on late taxes and penalties is not always deductible in cases where the taxpayer took tax aggressive positions or was involved in negligence, disregard of rules, or fraud.

Some estates obtain loans to pay estate tax and other liabilities during the administration of the estate. The expense is deductible if:

- The interest accrues pursuant to an instrument or contractual arrangement that constitutes indebtedness under applicable income tax regulations and general principles of federal law;
- Both the interest expense and the loan on which the interest expense accrues meet bona fide requirements of Reg. §20.2053-1(b)(2); and
- The loan on which the interest accrues and the loan’s terms are actually and necessarily incurred in the administration of the estate and are essential to the proper settlement of the estate.
- The proposed rules provide that a claim founded upon a decedent’s agreement to personally guarantee a debt of another must be bona fide and in exchange for adequate and full consideration in money or money’s worth. The guarantee cannot exceed the decedent’s interest in an entity.
- Intra-family loans will receive special scrutiny if interest deductions are claimed.
- Post-death events occurring before a deduction is claimed as well as events reasonably anticipated to occur must be taken into account for valuing the deduction.
- It is unclear if Graegin loans will be respected going forward, because these loans cannot be prepaid and may not have terms comparable to an arms’ length transaction.

No Marital or Charitable Deduction Allowed Where There Is Trustee Discretion to Distribute Between a Spouse and Charity (CCA 202233014)

A testamentary charitable remainder unitrust (CRUT) allowed the trustee to have discretion to distribute the trust property between charity and the decedent’s spouse. The IRS determined that no estate tax deduction was allowed either under §2055 (charitable) or §2056 (marital) for the discretionary portion of the trust. The IRS cited Estate of Turner v. Comm., 138 T.C. 306, 316 (2012) which requires clarity to determine if property is clearly passing to the deductible recipient.

Trusts, Trustees and Beneficiaries: Get ready for compliance with the Corporate Transparency Act (CTA)

The CTA is intended to help prevent and combat money laundering, terrorist financing, corruption, tax fraud and other illicit activity. Reporting Companies (defined below) created before Jan. 1, 2024, must file reports with the Financial Crimes Enforcement Network by Jan. 1, 2025. Those created on or after Jan. 1, 2024, must file within 30 days of creation.

A “Reporting Company” is any entity formed by a filing with a Secretary of State or any entity registered to do business in the U.S. by a filing with a Secretary of State. It includes corporations, LLCs, limited partnerships and limited liability partnerships, but typically not general partnerships, sole proprietorships, and trusts because these entities do not require a filing to be brought into existence. A Reporting Company...
must identify beneficial owners who exercise substantial control over the Reporting Company and those who are 25% owners of the Reporting Company.

Importantly, a trustee who can dispose of trust assets is deemed to own an interest in a Reporting Company held in the trust. A beneficiary of a trust is deemed to own an interest in a Reporting Company held in the trust if the beneficiary is the sole income and principal beneficiary or has the right to withdraw substantially all of the trust assets. A grantor will be considered to own the assets of a trust if the trust is revocable or if the grantor can otherwise withdraw the trust assets.

Therefore, pending further guidance, it appears that a trust and/or beneficiary holding an interest in a Reporting Company either where control can be exercised or where 25% is owned, must file the required reports under the CTA. The forms for filing have not yet been issued, and there are no regulations addressing trust obligations. The suggestion is, however, that practitioners who created trusts or who are trustees, or who have clients that are grantors, beneficiaries or trustees should begin alerting those persons to what may become a rather significantly burdensome filing obligation.

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**FAMILY LIMITED PARTNERSHIPS**

**With Tax Reform, FLPs Might Be Useful for Other Reasons Than Estate Tax Planning**

The estate tax exemption was doubled by the TCJA. Does that mean that the Family Limited Partnership (FLP) is obsolete? The FLP is useful for many more reasons than estate tax planning.

**Eight Reasons Why the FLP Is Still Important ... Even With the Large Estate Tax Exemption**

1. The FLP allows for the orderly transfer of assets. This is especially meaningful when transferring a closely held business.

2. The FLP allows for the orderly transfer of management (leadership in the closely held business).

3. The FLP allows for a potential income shifting (and perhaps its resultant tax savings) when income producing assets are transferred to limited partners.

4. The FLP allows for the consolidation of assets for easier management (and perhaps a more cost-effective ability to hire professional management).

5. The FLP allows a method to protect children from a prior marriage with the transfer of assets to their FLP.

6. The FLP can facilitate keeping separate property separate — protecting the prenuptial assets from co-mingling claims.

7. The FLP can be a component of an asset protection plan.

8. The FLP can provide for the segregation of assets for another level of liability protection.
IRS Audit Rules Have Changed for FLPs

Under new streamlined partnership audit rules that took effect in 2018, if the IRS determines that tax on an FLP’s income was underreported, it collects the tax from the FLP itself, not the partners. In this scenario, the FLP generally pays tax at the rate of the highest taxed individual. Certain partnerships can elect out of the new regime entirely, but the typical FLP will not qualify to do so because it often has an LLC as its general partner. The opt-out provision is not available if even one partner is a disregarded entity (a single-member LLC), a partnership, or a trust.

An FLP can elect to “push out” the tax liability to partners for the year under audit. The “push out” election is made by the partnership representative, “who is a partner or other person designated in accordance with the partnership agreement”. This election has to be made on a timely filed Form 1065.

Advice for Clients Considering FLPs and LLCs

For decades, the use of pass-through entities, including FLPs, LLCs, and S corporations, has been a useful and cutting-edge approach to equity sharing within the family, management control, and also estate tax reduction via valuation adjustments (discounts) for gift and estate tax purposes. However, as this section evidences, the IRS has, over the past 15 years, mounted attacks on the reality of such entities, especially as to FLPs and LLCs. Yet, they continue to be popular. This section focuses on how accountants can properly and effectively advise their clients and how to work with attorneys and appraisers to ensure the validity and beneficial results of such entities.

Which is better for estate planning: an FLP or FLLC? In considering the selection of a pass-through entity, comparison of the limited partnership and the limited liability company is appropriate for non-tax reasons relating to asset protection. The general partner of an FLP is personally liable for partnership debts not paid by the entity, whereas, generally, the managing member of the FLLC is not personally liable. Thus, since under the “check-the-box” treasury regulations an LLC usually is taxed as a pass-through entity (partnership under subchapter K of the Code), LLCs now generally are preferred over traditional FLPs.

Gift Tax Strategy Using the FLP

Clients may wish to give family members gifts of property that are difficult to value, making the potential tax on the gift difficult to determine (e.g., a partial interest in a business, building, land, etc.). FLPs are sometimes utilized to hold, and incrementally transfer, property to family members. Interests in the FLP (and the property that it holds) are gradually transferred to the next generation by giving away shares or percentages of the FLP. Since there is generally no real market for a percentage of a family partnership, it is possible for the courts to allow a 30% to 40% valuation discount on interests in a limited partnership, even when the FLP is comprised mostly of liquid assets. The IRS may scrutinize the value placed on the gifts and the amount of gift tax due and will often suggest a discount percentage well below 30%.

Tax practitioner planning. When determining valuation discounts, it is imperative that the client retain an experienced, credible business valuation appraiser to determine both the “enterprise value” and the level of discounts for gifts of fractional interests in the FLP or FLLC. This will avoid the IRS asserting undervaluation penalties against the client and even tax practitioners. In the Biden Administration budget for 2024, legislation has been proposed limiting or eliminating valuation discounts where there are transfers to family members, especially of passive (non-operating business) assets.
What Is Included in the Gross Estate — As Seen Through the Eyes of an FLP

**Estate inclusion rule.** A decedent’s gross estate includes the value of any interest in property transferred by the decedent, whether in trust or otherwise (except to the extent that the transfer was a bona fide sale for an adequate and full consideration in money or money’s worth), if the decedent retained or reserved (1) for his life, (2) for any period not ascertainable without reference to his death, or (3) for any period which does not, in fact, end before his death (a) the use, possession, or enjoyment of, or the right to the income from, the property (§2036(a)(1)), or (b) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the transferred property or its income (§2036(a)(2)).

**Tax practitioner planning.** Section 2036 is very broad, and it underscores the estate tax tension between lifetime transfers within the family and the senior generation’s desire to keep control and benefits from the transferred property. The *Schauerhamer* case began the IRS use of §2036 against FLPs and FLLCs in the estate tax area. Even for valid FLPs or FLLCs, the “battle of the appraisers” as to the level of valuation discounts still is the subject of litigation in many estate and gift cases.

**Two exceptions to the estate inclusion rule.** As mentioned previously, two major exceptions exist that allow a transfer to escape the operation of §2036(a):

1. **Bona fide sale for full and adequate consideration.** If the transfer is a bona fide sale for full and adequate consideration, then §2036(a) does not apply (see §20.2036-1(a), §20.2043-1(1)). First, what is required for the transfer by the taxpayer to an FLP to qualify as a bona fide sale is that it be a sale in which the decedent/transferee actually parts with his or her interest in the assets transferred, and the partnership/transferee actually parts with the partnership interest issued in exchange. Second, in order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. When the transfer is not for full and adequate consideration, the entire value of the property transferred is includible in the estate. In cases where the decedent received partial, but insufficient, consideration, only the excess of the property’s fair market value over the consideration received is includible.

2. **Right to enjoy.** If the transfer is not a bona fide sale for full and adequate consideration, then the transfer may still be excluded from the estate of the decedent under the second exception if the decedent did not retain either (1) the possession, enjoyment, or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property ([Estates of Stone v. Comm., TCM 2003-309](http://www.irs.gov/)). Therefore, what the decedent can’t do after transferring his or her assets to the FLP is retain the lifetime possession and enjoyment of those assets pursuant to an expressed or implied understanding or agreement.

The lifetime enjoyment and possession of transferred property may be retained by implied agreement. The court will examine whether the decedent’s relationship to his or her assets changed following their transfer to the FLP (e.g., did the general partner of the FLP treat the decedent differently or the same?). When an individual conveys all or nearly all of his or her assets to a trust or partnership, thereby leaving few liquid assets on which to live, the likelihood of an implied agreement allowing the individual to keep using the assets is the greatest (see *Estate of Reichardt v. Comm.; Estate of Hillgren v. Comm., TCM 2004-46; Estate of Strangi v. Comm., 417 F.3d 477*). The courts will also ask if the terms and conditions of the transfer of decedent’s assets to the FLP would have been the same if an unrelated party had been involved in the same transfer; e.g., the estate doesn’t want the court to conclude: “in fact, we find it hard to conceive an unrelated party would have engaged in such a transaction” ([Estate of Rosen v. Comm., TCM 2006-115](http://www.irs.gov/)).
The case of *Powell v. Comm.*, 148 T.C. 392 (May 18, 2017), raises additional concerns for taxpayers. Here, the decedent who transferred interests to a partnership merely owned a limited partnership interest at death. Nevertheless, the Tax Court found that any “string” of a possible controlling interest (all limited partners had to consent to certain transactions) would be enough to require estate inclusion under Code §2036(a)(2). Practitioners are expressing concern that the IRS may try to extend *Powell* to other gifting situations where the donor retains some interest in the transferred property.

Must have a nontax reason. In addition, the family limited partnership must be able to prove to the court’s satisfaction that it was formed for a legitimate and significant non-tax reason (see *Estate of Bongard v. Comm.*, infra; *Estate of Strangi v. Comm.*, infra, “the proper inquiry is whether the transfer in question was objectively likely to serve a substantial non-tax purpose”; *Estate of Thompson v. Comm.*, 382 F.3d 367 (3d Cir. 2004), discussing the lack of “legitimate business operations” in concluding that a transfer to a family entity was not a bona fide sale). The courts often look for a non-tax business purpose to justify the transfer.

Example of FLP provision illustrating purpose was primarily nontax — See **David A. Kimbell, Sr., Executor of Ruth A. Kimbell v. US (CA-5) 2004-1 USTC ¶60,486.** “Under the stated terms of the Partnership Agreement, the purposes of the Partnership were to increase Family wealth; establish a method by which annual gifts can be made without fractionalizing Family Assets; continue the ownership and collective operation of Family Assets and restrict the right of non-Family members to acquire interests in Family Assets; provide protection to Family Assets from claims of future creditors against Family members; prevent transfer of a Family member’s interest in the Partnership as a result of a failed marriage; provide flexibility and continuity in business planning for the Family not available through trusts, corporations or other business entities; facilitate the administration and reduce the cost associated with the disability or probate of the estate of Family members; promote the Family’s knowledge of and communication about Family Assets; provide resolution of any disputes which may arise among the Family in order to preserve Family harmony and avoid the expense and problems of litigation; and consolidate fractional interests in Family Assets” (paragraph numbers omitted). These purposes were supported by the deposition testimony of David Kimbell and Michael Elyea, Mrs. Kimbell’s business advisor. The term of the Partnership was 40 years.

Adjustments for gifts made within three years of decedent’s death. If the decedent transferred an interest in property or relinquished a power with respect to property within three years of his or her death and the value of the property would have been includible in the decedent’s gross estate under §2036, §2037, §2038, or §2042 (because the transferred interest or relinquished power had been retained by the decedent), the gross estate includes the value of any property interest that would have been so included (§2035(a)). Also, gifts of life insurance policies fall within this three-year rule.

Not all gifts made within three years of death must be recaptured. However, an outright gift (e.g., corporate shares or a fractional interest in real estate) is not prohibited under §2035, and such an outright gift, if properly documented and completed, does not come within §2036. This means properly designed and implemented “deathbed gifts” may reduce the estate tax. In the Tax Court’s opinion in *Estate of James Mitchell v. Comm.*, TCM 2011-94, the principal issue involved valuation of real property and artworks. A second issue involved James Mitchell’s obvious “deathbed” gifts of 5% interests in a California ranch and a beachfront residence made just six days before his death. The court determined that these co-tenancy transfers were agreed to be valid by the estate and the IRS, resulting in substantial valuation discounts both for the gifted interests and to the 95% interests in the real property still owned by the decedent at his death.

Recapture rule. Some assets transferred prior to death must be recaptured by the estate. By recapturing these transfers into the estate, §2035 and §2036 prevent the circumvention of the federal estate tax by the use of inter vivos transactions, which do not remove the lifetime enjoyment of property purportedly transferred by a decedent (*Estate of Wyly v. Comm.*, 80-1 USTC ¶13,332 (5th Cir.)). “Section 2036 is part of
a Congressional scheme to tax the value of property transferred at death, whether the defendant accomplishes the transfer by will, by intestacy, or by allowing his substantial control over the property to remain unexercised until death so that the shifting of its economic benefits to the beneficiary only then becomes complete” ([Estate of Lumpkin v. Comm.], 73-1 USTC ¶12,909, 1097 (5th Cir)).

What Are the “Factors for Success” We Might Identify in the Use of FLPs and FLLCs?

IRS red flags. An IRS estate and gift tax manager (Lee Schwemer, Texas) at the Heckerling Institute on Estate Planning identified the red flags seen by the IRS in this area:

- near-death formation and/or funding of the entity;
- assets contributed to the entity being only from the senior generation;
- co-mingling of personal and entity assets;
- non pro rata distributions from the entity, favoring the decedent;
- leaving the decedent without sufficient assets for support;
- contribution of personal assets, such as personal residence;
- failure to observe partnership formalities; and
- using entity assets to pay decedent’s estate tax liability.

Factors for Success

- Use the §704(e) family partnership safe harbor, meet precisely all state law requirements, and establish the FLP or FLLC properly, with all necessary documentation in place prior to funding the entity with contributed assets.
- Verify that the contribution of assets meets all requirements for legally completed title transfers to the entity and that contemporaneous accounting records are maintained with partner capital accounts properly set up and tracked both at fair market value and income tax basis.
- Follow entity formalities and pay attention to requirements per the relevant partnership or operating agreement, such as for financial reports, meetings, and the like.
- Where possible, have family members other than the senior generation contribute property to the entity, and at least offer younger generation partners or members the opportunity for independent legal counsel.
- Consider having persons other than the senior generation as managing partners or members, at least in a co-manager role.
- If the liquid assets of the entity are needed by the decedent’s estate to pay estate taxes, use a fully documented loan arrangement to accomplish this result.
- In all events, in considering assets to transfer to the entity, allow the senior generation to maintain sufficient assets to cover normal expenses of its support during lifetime.
- In dealing with the valuation, for gift and estate tax purposes, of entity interests transferred, retain a competent, credible, and communicative business valuation appraiser.
- Take great care in meeting Form 709 (gift tax return) and Form 706 (estate tax return) instructions and requirements for proper and adequate disclosure of family-controlled entity and trust transactions, as well as the levels of valuation discounts claimed.
IRS ADDRESSES A VARIETY OF PROCEDURAL ISSUES

**PALERMO V. U.S. (August 7, 2023)** In a District Court case, the trustee of a Qualified Personal Residence Trust (QPRT) was denied a refund claim because the claim was filed on the wrong IRS Form (Form 843 was used, instead of Form 1041 which was the correct Form to have been used). The taxpayer’s claim for injunctive relief was also denied as barred by the Anti-Injunction Act.

**GIBBONS V. U.S. (July 20, 2023)** A District Court determined that trust property was liable for IRS tax liens when a disclaimer by the trust beneficiary (against whom the tax liens had been filed) left another individual as the sole trust beneficiary with control over the trust.

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**RECENT VALUATION CASES**

**Court Affirms Taxpayer Valuation Discount on 99.8% Transfer** *(Pierson M. Grieve v. Comm., TCM 2020-28)*

Court affirms taxpayer’s valuation discount. The issue was the fair market values of Pierson Grieve’s 99.8%-member interest in Rabbit 1, LLC (Rabbit), transferred to the Pierson M. Grieve 2013 Grantor Retained Annuity Trust (GRAT) on Oct. 9, 2013, and his 99.8%-member interest in Angus MacDonald, LLC (Angus), transferred to the Grieve 2012 Family Irrevocable Trust (Irrevocable Trust) on Nov. 1, 2013. Said another way, this involved the gift tax value of the 99.8% nonvoting interests in LLCs comprised predominantly of marketable assets gifted from a revocable trust to a two-year GRAT and to an irrevocable trust in exchange for a single life private annuity.

The Tax Court rejected the IRS valuation approach, which was based on the notion that a willing buyer of the nonvoting shares would attempt to additionally purchase the 0.02% voting shares in the LLCs, which would have negated any discounts for lack of control and lack of marketability. The IRS has used this valuation approach in other cases to advance what the court criticized as “imaginary scenarios” making assumptions about future taxpayer behavior. Instead, the Tax Court confirmed the taxpayer’s valuation, which utilized the market approach and income approach methods and approved the discounts claimed for lack of control and lack of marketability in determining the fair market value for gift tax purposes.

**Tax practitioner planning.** It is likely that this case will be cited as a favorable precedent for taxpayers claiming valuation discounts for gifts from family partnerships and LLCs to a variety of estate planning vehicles.

**Court Agrees Estate Undervalued and Lifetime Gifts Not Reported** *(Estate of Howard V. Moore v. Comm., TCM 2020-40)*

**Tax practitioner planning.** This is another case in the long line of IRS victories in the Tax Court over taxpayers who purportedly create a family partnership nearing the time of death and retain the use and enjoyment of the partnership assets until death. The key to taxpayer success in these cases is to establish a bona fide business purpose for the creation of the family partnership apart from tax saving considerations. That was not done here.

**Continued possession and enjoyment.** Nearing death and in hospice care at age 89, Howard Moore engaged an attorney and established trusts and a limited partnership and contributed his farm into the partnership. But after the partnership received the farm, Moore sold the farm but continued possession and enjoyment of it until his death. Moore had the partnership distribute $500,000 checks to each of his children, but in the form of promissory notes to be paid back with interest. However, no efforts were ever
made to collect on the notes. The court found the “notes” to be gifts. The children had no involvement in the partnership transactions. There were no meetings, no bargaining, and no negotiations. The children did not hire their own lawyers. After examining the estate tax return, the IRS issued a notice of deficiency for undervaluing the estate and not reporting lifetime gifts.

**Sale to FLP not bona fide.** The court determined that the transfer of four-fifths of the farm to the partnership was not a bona fide sale for full and adequate consideration. Moore did not have legitimate nontax reasons for forming the partnership. He kept possession and enjoyment of the farm, continuing to live on it even after its sale. He used the partnership income to pay his personal expenses. The court rejected several non-tax claims for forming the partnership such as creditor protection and resolving family discord. There was no business to run. There was no credible evidence presented that anyone involved in the transaction had any creditor issues. The court also determined that Moore had at least an implied agreement to maintain possession or enjoyment of the farm even after its sale.

**IRS wins.** Accordingly, the Tax Court found that there was a gift tax deficiency as the result of including the purported note transfers as actual gifts, and an estate tax deficiency as the result of the decedent retaining an interest in the purportedly transferred property.

**Improper Valuation of a Transfer to a GRAT Disallowed**

In [CCA 202152018](#), the appraised value of property transferred to a GRAT used an appraisal from seven months earlier that failed to take into account the taxpayer’s pending (and valuable) merger that would have significantly enhanced the value of the property being transferred to the GRAT. Rather than adjust the value of the GRAT transfers, the IRS determined that the GRAT transaction was not recognized at all, resulting in a significant taxable gift. However, a contrary result was determined in the granting of summary judgment in favor of the taxpayer in *Baty v. Comm.*, USTC Docket No. 122-1621 (March 24, 2022) where the court indicated that events taking place subsequent to a gift cannot be used to value the gift in hindsight. Merger negotiations were not deemed relevant to the value of public shares used to fund a GRAT. Subsequent events did not change the valuation of assets used to fund the GRAT.

**2021 Valuation Case: Estate of Michael Jackson v. Comm., TCM 2021-48**

The IRS overvalued the worth of Michael Jackson’s estate by hundreds of millions of dollars, the Tax Court held in a ruling on the estate’s years-long tax fight.

In a 271-page ruling, the court found that the pop star’s image and likeness and other assets were worth about $111 million — less than a fourth of the $481 million the IRS determined. Jackson’s publishing rights to songs by various other artists were also significantly overvalued by the agency, the court held. The ruling means the ultimate tax bill for Jackson’s estate is lower than what the IRS determined. The ruling also could significantly impact how hard-to-value assets of entertainment figures get taxed when they die.

In valuing Jackson’s assets, the court said it needed to look at how much each asset was worth as if “in the decedent’s hands at the time of its transfer by death. He went deeply into debt to keep his life as it had been. Those debts increased; the interest on them rose; bankruptcy was a foreseeable outcome. These troubles affect our fact finding.”

The Tax Court said the IRS’s projection of Jackson’s future revenue streams — one of the factors used in the valuations — were unforeseeable due to the artist’s reputation as a person, especially in the last two years before his death. The Tax Court found that the estate wasn’t liable for any of the penalties levied against it.

**Tax practitioner planning.** A key takeaway from the case is that valuation must be based on the facts existing at the time of death, not the prospective value of the decedent’s legacy.
APPENDIX

Author’s Note. The following Client Letters and Administration Checklist are free to utilize. However, please make sure to thoroughly review each document for any updates in laws and variations specific to your resident state prior to use.

CLIENT LETTER AT THE LOSS OF A FAMILY MEMBER

Dear xxxxx,

I am sorry that you lost your (Mom, uncle, niece). I want to share some general steps that you may need to take after the death of your family member. Please note that while I can offer general advice, it’s important to consult with an attorney who specializes in estate planning to get tailored advice based on your specific circumstances. Here are some general items to consider:

Notify immediate family and close friends: Begin by informing immediate family members and close friends of the passing. They may provide support during this difficult time and assist you with various tasks.

Contact the executor or personal representative: If your family member appointed an executor or personal representative in their will, notify them of the death. If they established a trust, notify the trustee. This person is responsible for managing the deceased person’s estate and ensuring their wishes are carried out. They will guide you through the legal and administrative processes.

Obtain multiple copies of the death certificate: You’ll need multiple copies of the death certificate for various purposes, such as settling financial matters, claiming insurance benefits, and transferring assets. Contact the funeral home or local government office to obtain these copies.

Notify relevant institutions and government agencies: Contact the deceased person’s employer, banks, insurance companies, investment firms, and any other relevant institutions. Provide them with a certified copy of the death certificate, as they may require it to update account ownership or proceed with claims.

Determine if probate is necessary: Probate is the legal process of validating a will and transferring the ownership of assets. Consult an attorney to determine if probate is necessary based on the size and nature of the estate and local laws. If probate is required, there may be restrictions on actions plus specific timelines and deadlines to follow.

Identify and secure assets: Gather information about the deceased person’s assets, such as bank accounts, retirement accounts, real estate, investments, and personal property. Take steps to secure these assets to protect their value and prevent unauthorized access.

Review and address debts and liabilities: Identify any outstanding debts or liabilities your family member had. Notify creditors of the death and make arrangements to settle outstanding balances.

File necessary tax returns: Consult with our office to determine if you need to file any tax returns on behalf of the deceased person. This may include a final income tax return, estate tax return, or other applicable filings. Tax deadlines and requirements can vary, so it’s important to seek professional advice.

Review beneficiary designations: Assess the beneficiary designations on the deceased person’s retirement accounts, life insurance policies, and similar assets. Custodians will only deal with beneficiaries so be sure that the beneficiaries know that they’re beneficiaries.
While there may not be specific timelines for all actions, it’s generally recommended to address these matters as promptly as possible. Some tasks, such as filing tax returns and initiating probate, may have specific deadlines dictated by local laws.

Remember, this is a general overview, and the specific actions you need to take may vary depending on your individual circumstances and applicable laws. Consulting with professionals experienced in estate matters is crucial to ensure you’re following the correct procedures and meeting all necessary requirements.

Regards,
CLIENT LETTER DEATH OF A SPOUSE

Dear xxxx,

I am sorry that you lost your husband/wife/spouse. I know that this is a difficult time for you. Please accept my sincere condolences.

Here is some general guidance as to steps that you may need to take after the death of your husband/wife/spouse. Please note that while I can offer general advice, it’s important to consult with an attorney who specializes in estate planning to get tailored advice based on your specific circumstances. General steps to consider include:

Obtain multiple copies of the death certificate: You will likely need multiple copies of the death certificate as you navigate various administrative processes, such as filing claims and transferring assets. Contact the funeral home or your local government office to request these copies.

Review your spouse’s will, trust and estate plan: Understand the provisions outlined in your spouse’s will, trust or estate plan. The documents may specify how assets should be distributed, who will be the guardian of any minor children, and other important directives.

Contact the executor of your spouse’s will: If your spouse appointed an executor in their will, reach out to that person. The executor is responsible for managing the deceased person’s estate and ensuring their wishes are carried out.

Notify relevant institutions: Contact your spouse’s employer, banks, insurance companies, investment firms, and any other relevant institutions to inform them of the death. They will guide you on the necessary steps for transferring or updating accounts and provide due dates.

Determine if probate is necessary: Probate is the legal process of validating a will and transferring the title to assets. Consult an attorney to determine if probate is required based on the size of the estate, the nature of the assets and applicable laws in your jurisdiction.

Assess and gather assets and debts: Create a comprehensive list of your spouse’s assets and debts, including bank accounts, retirement funds, investments, real estate, loans, and outstanding bills. This information will be useful for the probate process, administering the trust, and settling the estate.

File necessary tax returns: Consult with a tax professional to determine if you need to file any tax returns on behalf of your spouse, such as a final income tax return or an estate tax return. Estate tax laws can be complex, and professional guidance is essential in navigating them properly.

Review beneficiary designations: Check the beneficiary designations on your spouse’s retirement accounts, life insurance policies, and other similar accounts. If you are the beneficiary, determine your options. The death of your spouse may indicate that you should update beneficiary designations on your accounts if necessary to reflect your current wishes.

Consider seeking professional help: Dealing with the legal, financial, and emotional aspects of a loved one’s death can be overwhelming. Engaging an attorney who specializes in estate and trust matters can provide you with invaluable guidance and support throughout the process.

Remember, this is just a general overview, and the specific actions you need to take may vary depending on your individual circumstances and applicable laws. It’s crucial to consult with professionals to ensure you’re making informed decisions.

Regards,
## CHECKLIST OF ESTATE ADMINISTRATION ISSUES AND RESPONSIBILITIES

### I. To Be Done as Soon as Possible After a Death

<table>
<thead>
<tr>
<th>A. Consider Immediate Family Needs</th>
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<tbody>
<tr>
<td>Review sources of cash for family maintenance before probate.</td>
</tr>
<tr>
<td>Joint bank accounts. Surviving joint tenant may be able to withdraw some or all bank balances upon presentation of a death certificate before probate.</td>
</tr>
<tr>
<td>Pension and profit-sharing benefits payable to an individual beneficiary other than the estate.</td>
</tr>
<tr>
<td>Social Security and Veterans’ survivor benefits (spouse and minor children).</td>
</tr>
<tr>
<td>Life insurance proceeds payable to an individual beneficiary may be payable upon presentation of death certificate and completed claim form.</td>
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<tr>
<td>Consider custody of children if orphans.</td>
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<tr>
<td>Explain to the immediate family that probate and estate and trust administration take time and can be involved.</td>
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<tr>
<td>Order a sufficient number of death certificates.</td>
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<tr>
<td>Ascertain whether the decedent has communicated wishes for disposition of remains.</td>
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</tbody>
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<tr>
<th>B. Income Tax and Gift Tax Returns</th>
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<tbody>
<tr>
<td>Are returns due? Are returns overdue?</td>
</tr>
<tr>
<td>Are payments due? Are payments overdue? (Note that quarterly estimates of personal income taxes are suspended by death for the decedent, but not for the surviving spouse.)</td>
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<tr>
<td>Have extensions been requested?</td>
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<tr>
<td>Has a new employer identification number (EIN) been obtained for the estate or trust?</td>
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<th>C. Secure the Property</th>
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<tbody>
<tr>
<td>Secure the decedent’s residence and private offices. Remove valuables for safekeeping.</td>
</tr>
<tr>
<td>Secure the decedent’s computer, if appropriate, and determine who has passwords and access to business and financial records. Also, consider the value of proprietary domain names.</td>
</tr>
<tr>
<td>Consider care and protection of pets and perishable assets.</td>
</tr>
<tr>
<td>Have tangible personal property inventoried and appraised. Consider multiple appraisals of rare or valuable articles.</td>
</tr>
<tr>
<td>Review insurance coverage for real estate, automobile, tangible property, and liability exposure. Check ownership, payment of premiums, and expiration dates of policies.</td>
</tr>
<tr>
<td>Take possession of bank and brokerage statements, checkbooks, and passbooks for three prior years plus year of death. Cancel credit cards. Locate safe deposit boxes.</td>
</tr>
<tr>
<td>Get control of mail.</td>
</tr>
<tr>
<td>Check maturity dates for investments, such as bonds, certificates of deposit, and time deposits. Check deadlines for corporate tender offers.</td>
</tr>
<tr>
<td>Review outstanding leases, including real property, vehicles, and equipment, including rights to cancel or renew or extend the terms, or to assign or sublet.</td>
</tr>
<tr>
<td>Review other outstanding contractual obligations.</td>
</tr>
<tr>
<td>Notify SSA and Veterans’ Administration if the decedent was receiving benefits or if the estate or family is entitled to benefits.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>D. Commence Probate or Administration Proceedings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Locate the will. If the original will is in the decedent’s safe deposit box, obtain an order to open the box if required.</td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>Review the will for its dispositive scheme and for information as to assets, beneficiaries, and witnesses. The will may “pour over” assets to a trust. Review the trust agreement.</td>
</tr>
<tr>
<td>Identify any potential probate or construction problems, such as duplicate wills, interlineations, or mutilations.</td>
</tr>
<tr>
<td>Resolve issues of the decedent’s domicile if there was more than one residence.</td>
</tr>
<tr>
<td>Identify distributees and other persons required to be cited in probate proceedings; contact witnesses if there is no self-proving affidavit or if a will contest is contemplated; and prepare and file necessary papers. State laws require that estate and trust beneficiaries and creditors be notified.</td>
</tr>
<tr>
<td>Review any prenuptial or postnuptial agreements affecting the rights of the surviving spouse. Determine whether there is a potential right-of-election by the surviving spouse, especially where “elective share” has been put into a trust or where a QTIP trust has been established for most of the estate.</td>
</tr>
<tr>
<td>Consider whether the state Attorney General must be notified of probate because of the existence of a bequest in trust to charity or a residuary bequest to charity.</td>
</tr>
<tr>
<td>Consider whether the state Attorney General must be notified because there is no distributee or beneficiary or the facts are unknown.</td>
</tr>
<tr>
<td>Where an attorney is also named as executor, look for an attorney disclosure statement if local practice requires this.</td>
</tr>
<tr>
<td>Apply for letters testamentary.</td>
</tr>
<tr>
<td>Consider use of small estates provisions as an alternative to probate, if applicable under local rules. Present the will for probate.</td>
</tr>
<tr>
<td>Determine whether ancillary probate is required in another jurisdiction for tangible personal property or real estate.</td>
</tr>
</tbody>
</table>

### II. Within 30 Days

<table>
<thead>
<tr>
<th>A. Marshall the Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Locate assets.</td>
</tr>
<tr>
<td>Confer with the family.</td>
</tr>
<tr>
<td>Check the decedent’s attorney’s records.</td>
</tr>
<tr>
<td>Open the decedent’s safe deposit box</td>
</tr>
<tr>
<td>Determine title of all assets: JWROS, Trust, Community property etc.</td>
</tr>
<tr>
<td>Prepare an inventory and have valuables appraised.</td>
</tr>
<tr>
<td>Write to the decedent’s banks inquiring as to other accounts or safe deposit boxes.</td>
</tr>
<tr>
<td>Review checkbooks and income tax returns for information about assets.</td>
</tr>
<tr>
<td>Search the residence(s) and office.</td>
</tr>
<tr>
<td>Search the computer files.</td>
</tr>
<tr>
<td>Determine employer-provided retirement and death benefits and locate IRAs.</td>
</tr>
<tr>
<td>Are there assets in foreign countries? Has the income been reported?</td>
</tr>
<tr>
<td>Gain control of assets.</td>
</tr>
<tr>
<td>Register bank accounts and securities in the estate name, not in the fiduciary’s personal name. The fiduciary should be identified in the title.</td>
</tr>
</tbody>
</table>
Collect proceeds of life insurance payable to the estate. Ask for IRS Forms 712 if an estate tax return is required and assist with the collection of life insurance proceeds payable to named beneficiaries.

Make private medical insurance, major medical and Medicare claims, and applications for refunds on cancellation of any health or property insurance or prepaid services.

Determine whether there are any decedent-held employee stock options that must be exercised within a specific time after death.

Are there claims of the decedent or the decedent’s family, such as wrongful death claims or pending contract claims?
Determine status of outstanding leases, including real estate, auto, equipment, etc. Can any be canceled if desired?

### Value the assets.

a. Have real property appraised. Use a formal real estate appraisal rather than a letter from a realtor, especially if there will be any estate tax to pay.

b. Obtain valuations of securities. (Note that the value of securities is the mean between high and low on the date of death, not the closing price.) The broker may provide this, or an outside service may be necessary.

c. Obtain date-of-death values on bank accounts from the banks. Bank accounts should be reconciled because of outstanding checks at date of death.

d. Is there a marital trust from a predeceased spouse? Was portability involved?

e. Is there income due from a marital or non-marital trust from a predeceased spouse or a parent or other relative?

### B. Begin Estate Administration

Determine estate cash requirements, and circulate to executors and, if appropriate, to residuary beneficiaries.

Determine funeral expenses and obtain a receipted funeral bill. If the funeral was paid for by a relative, they must be reimbursed.

Determine balances due at death on mortgages and loans – this includes interest accrued to date of death.

Review mail for current bills.

Estimate administration expenses, including attorney’s fees and commissions, appraisal fees, accountant’s fees.

**Make a preliminary determination of estate taxes owed and proper apportionment of estate tax liability under the will.**

a. Determine state estate taxes in state of domicile.

b. (Determine estate taxes in any other state or in any foreign country.

c. Are available assets subject to capital gains taxes on sale, despite the general rule of step-up in basis? Are there assets classified as income in respect of a decedent for which there is no basis adjustment?

d. Are there any assets inherited from a spouse or other testator who died in 2010, which is when carryover basis applied, if elected?

e. Are there any assets held in trust with historic basis?

Are there lawsuits pending or other claims against the decedent or potentially against the estate?

Determine total dollar amount of cash bequests under the Will.
Review whether the beneficiaries will need access to the assets of the residuary estate during the period of estate administration, for their support or any business use.

Does the will or living trust set up a disclaimer option for the surviving spouse? Make preliminary calculations of the optimum disclaimer. Note the nine-month filing deadline. Arrange for counseling of surviving spouse and children. A disclaimer is available even if not mentioned in the documents but the potential disclaimant cannot benefit from assets before disclaiming or try to direct who will receive those assets.

Determine if the estate plan includes any directed trusts. If so, contact the persons named as having directing authority.

C. Business Needs and Estate Liquidity

Business needs: Review the will/trust agreement as to the fiduciary’s powers and duties.

Does the executor/trustee have authority to continue the decedent’s business?

Will the executor/trustee retain assets or sell them and reinvest?

Who is managing the investments?

Who is the responsible accountant?

Apply to the court if required to continue the decedent’s business if the decedent was the sole owner and the will/trust agreement does not authorize continuation.

Determine the estate liquidity.

Consider sales of assets, including common stocks and non-income-producing assets.

Withdraw funds from time deposits without penalty for early withdrawal and make certain that a penalty is not imposed.

Consider the possibility of an IRC Section 303 redemption of the decedent’s stock in a closely held business.

Consider provisions for deferring the payment of estate taxes.¹

Consider valuing farm or closely held business real property in accordance with the qualified use value under IRC Section 2032A.

Consider the desires of residuary beneficiaries for the retention of assets.

a. Liquidate assets that beneficiaries do not want to receive in kind.

b. Consider obtaining an indemnification from beneficiaries to protect the fiduciary from a loss in value before distribution.

Consider appropriate short-term reinvestments.

D. Tax Filings

Apply for an estate identification number from the IRS, using Form SS-4 or on the IRS website.

File a notice of fiduciary relationship (IRS Form 56).

Apply for federal and state releases of liens on real estate before their sales, using IRS Form 4422 and the appropriate state form.

Review gift tax filings, especially filings for large gifts. Request copies of previous Forms 709 if not available. File any missing gift tax returns.

Is the decedent liable for gift taxes, employer taxes, or other lifetime taxes?

¹ See IRC Section 6166 regarding closely held business and IRC Section 6161 regarding reasonable cause or undue hardship.
Are there any pending audits of previously filed income tax or gift tax returns?

For a decedent with more than one home, is any state challenging the decedent’s claimed residence? Is there a pending audit relating to the residence?

Regarding S corporations, does the will or trust affect the Subchapter S election?

If S corporation shares are left to a QST or ESBT Trust, file the required elections within 2½ months.

### III. Within Three Months

A. Raise Cash Requirements
   - Sell marketable securities.
   - List real estate with a broker.
   - Deliver works of art to be sold to a dealer or auction house.
   - Reinvest the sale proceeds in income-producing assets.

B. Develop Post-Mortem Tax Plans
   **Income Taxes**

   **Determine whether to use the calendar year or a fiscal year.**
   - For trusts, use of the calendar year is mandatory, but combined temporary filing of the trust as a Qualified Revocable Trust (IRC Section 645) with executor as an estate may permit use of a fiscal year. Calendar year is still available with this election.\(^2\)
   - For estates, use of a fiscal year or the calendar year is permitted. Use of a short fiscal year is also permitted.

   **Determine the timing of deductions and distributions.**
   - With the new, larger U.S. estate tax exemption, it may become common to elect to take deductions on the income tax return, rather than for estate tax purposes.
   - Income tax deductions are generally available *only* in the year the expenses are incurred.
   - Timing of deductions may become a significant element of estate administration. For example, it may be wise to consider advance payment of executors’ commissions rather than paying all commissions in one year at the end of the administration of the estate. If probate is required, often commissions are deferred but electing accrual basis may resolve.
   - Consider the timing of distributions to beneficiaries and income-splitting between the estate and residuary beneficiaries.
   - Fiduciary income tax rates on Form 1041 are generally higher than the beneficiaries’ personal income tax rates on Form 1040.
   - Consider the impact of the 3.8% tax on net investment income.
   - Consider whether capital gains can be distributed to beneficiaries at the discretion of the trustee, or whether capital gains are limited by a strict definition of principal.
   - Address the distinction between allowable deductions to the estate or trust which can be passed to beneficiaries as deductible expenses on the final return of the entity and miscellaneous itemized deductions which cannot be deducted by the estate or trust and cannot be distributed as deductible expenses to the beneficiaries.

Assess whether to deduct the decedent’s medical expenses on the decedent’s final income tax return or on the estate tax return. Those paid within one year of death can be claimed on the final income tax return.

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\(^2\) IRC Section 645.
Assess whether to report accrued interest on U.S. savings bonds on the decedent’s final income tax return.

Pensions and IRAs.
Consult with the family and the family accountant.

**Review methods of payment from qualified plans and IRAs:**

- **a.** Income taxes
- **b.** Estate taxes

Consider the different tax needs of different beneficiaries. Consider outright distributions, inherited IRAs, spousal rollover opportunities. Has the decedent’s plan been updated to take into account the provisions of the SECURE Acts?

Payment of debts and legacies.

Pay undisputed debts. Pay legacies if the estate is solvent.

If the estate may not be solvent, review the priority of payment of debts.

Pay special attention to an estate fully disposed of by specific bequests and devises.

Consider whether an informal (non-judicial) accounting is permitted by local rules and whether it would be acceptable to beneficiaries. Be sure to reserve ample funds for all applicable taxes before making any distributions to beneficiaries. Fiduciaries risk personal liability if taxes are not satisfied after distributions have been made. Liabilities presented after the claims period should only be paid if the attorney agrees.

Begin to prepare the final accounting for eventual presentation to beneficiaries and/or the court.

Are all beneficiaries also executors? Are they taking equal responsibility?

Will the attorney, accountant, or executor prepare an accounting if required? Will accountings be required in more than one court?

Use official forms of the local court or a format required by the local court.

Begin to enter data. List assets already received, list income as it is received, and list disbursements as they are made.

### IV. Within Six Months

#### A. Estate Tax Returns

Prepare draft IRS Form 706 and state return, if applicable.

**Assemble additional papers to be filed with returns.**

- **a.** Forms 712 from life insurance companies for policies owned by the decedent or policies on the life of the decedent or payable to the estate.
- **b.** Balance sheets for the previous five years for closely held businesses in which the decedent had an interest, including family partnerships, S Corporations or LLCs.
- **c.** Appraisals of real and personal property.
- **d.** Is there unified credit available from a predeceased spouse: “portability”? Will, death certificate, trust agreements.
- **f.** Assemble an “audit file” for papers an IRS agent may wish to examine on audit.
- **g.** Collect pre-death checkbook records, bank and brokerage statements, and income tax returns for year of death and three years prior to death.
h. Collect verification for debts claimed as deductions.

i. Collect gift tax returns.

Plan to obtain alternate valuations of estate assets if the estate will be taxable. Determine if electing the alternate valuation date is available and advantageous. (Note that the estate tax value will become the basis of the decedent’s assets for determining future capital gain or loss on sales.)

Does the will/trust agreement take advantage of the decedent’s unified credit and/or generation-skipping tax exemption? Review QTIP Trust provisions carefully to determine if a reverse QTIP election is contemplated. If so, be sure to complete Form 706 to make the election.

Consider the U.S. tax implications in contrast to the state tax implications and reach a final decision as to a possible disclaimer by the surviving spouse.

V. Within Nine Months


Complete and file Form 706 and any applicable state return.

Many estates are no longer taxable and will not require the filing of an IRS Form 706. Nevertheless, consider filing Form 706 to take advantage of portability. Alternate valuation may be elected only on a timely filed return and only if the election reduces the value of the estate assets and the estate tax, not merely for the purpose of increasing the basis of assets.

If necessary, file a six-month extension of time to file.3

Pay any estate taxes due, regardless of whether the returns are filed. If necessary, apply for an extension of time to pay the tax.4

Consider an application for discharge of the fiduciary from personal liability for the estate tax, Form 5495, to take effect nine months after the return is filed.5

Consider requesting a prompt assessment of the federal estate tax from the IRS. File Form 4810.

Consider the availability of the credit for tax paid on prior transfers from a prior decedent.

Review and refine the post-mortem tax plan.

Advise the executor with respect to how much of the residuary estate to distribute and how much to hold as a reserve against the possibility of an estate tax audit or other contingencies. File the required basis form when less than 100% of the assets go to the surviving spouse.

Have discounts been taken with respect to any interests in property owned by the decedent?

Did the decedent own real estate, art works, or other assets that are inherently hard to value?

B. Advise Beneficiaries with Regard to Disclaimer

Consider disclaimers by beneficiaries other than the surviving spouse, including wealthy children or children exposed to claims, such as doctors. Review alternative will provisions that would apply to disclaimed property.

A “qualified” disclaimer must be made within nine months of death, to avoid federal gift tax consequences.6 (Note that an extension of time to file estate tax returns does not extend the time for filing a disclaimer. For U.S. gift tax purposes, a beneficiary who is under age 21 is allowed nine months after his or her 21st birthday to make a qualified disclaimer.)

3. IRS Form 4768.

4. IRC Section 6161 et seq.

5. IRC Section 2204.

6. IRC Section 2518.
### Fiduciaries may waive commissions.

If the fiduciaries are beneficiaries or family members and if there is no U.S. estate tax, the acceptance of commissions may create an income tax obligation without a corresponding estate tax deduction. (Note that there will be many more estates with no U.S. estate tax.)

A waiver should be in writing and signed on a timely basis before estate tax returns are filed; otherwise, the fiduciary risks constructive receipt of the commissions for income tax purposes.

### VI. Within Other Periods

#### A. File the Decedent’s Final Income Tax Returns

These are due by April 15 of the year after death unless an extension is granted.

No estimated payments need to be made after death for the decedent, but for joint returns, the surviving spouse must continue to make estimated tax payments.

If the decedent had a revocable trust, consider making a Section 645 Qualified Revocable Trust election to have the trust taxed as an estate for income tax purposes for at least two years. File Form 8855.

#### B. File the Decedent’s Final Gift Tax Returns

These are due no later than the earlier of the due date (with extensions) for filing the Form 706, or by April 15 of the year after death or the extended due date granted for filing the donor’s gift tax return.

#### C. File the Estate Income Tax Returns. (Form 1041)

These are due within three and one-half months after the close of the fiscal year chosen by the executor, unless an extension is granted. (Note that the extension for fiduciary income tax returns is now limited to 5½ months.)

#### D. Consider Other Tax Filings

- Apply for a refund of overpayment of U.S. estate tax within three years after a required return was filed or within two years after the tax was paid, whichever period expires later. Consider filing protective refund claims on Schedule PC as part of Form 706.
- Report to the IRS any asset discovered within three years after the U.S. estate tax return was filed or within six years after the return was filed if the omitted asset exceeds 25% of the reported gross estate.
- The estate tax credit for foreign death taxes under IRC Section 2014 is normally allowed only if such taxes are paid and the credit is claimed within four years after filing a required U.S. estate tax return. Proof of payment of the foreign taxes is required.
- Apply for a refund of any overpayment of state inheritance or estate tax.
- If an estate tax return is required to be filed, prepare and file Form 8971 to satisfy the consistent basis reporting obligation. Monitor required amendments to this reporting for subsequent estate administration developments.
- Consider requesting a closing letter from the IRS because such letters will now be issued only upon request. User fee of $67 required.

#### E. Complete the Final Accounting Proceedings

- Complete the accounting after the completion of estate tax proceedings. This should be done as soon as possible and should be done within two or three years after the issuance of permanent letters testamentary to the executors. (Note that there will be many more estates for which a U.S. estate tax return is not required.)
- Obtain receipts and releases from the beneficiaries or commence a formal court proceeding for settlement of the executors’ accounting.
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