

Chapter 1: Ethics and Due Diligence

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

About the Author

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Tax practitioners and individuals representing taxpayers before the IRS are responsible for conducting themselves in an ethical manner. Among the governing rules for professional conduct, as described in Circular 230, is the call for practitioners to exercise due diligence. Due diligence not only permeates throughout the ethical standards in Circular 230 but is also found throughout provisions of the Code. Thus, the practice of due diligence is a crucial component of ethical conduct to which practitioners must adhere.

Despite being an integral component of professional conduct for tax practitioners, due diligence is not explicitly defined in either Circular 230 or the Code. However, examining **Circular 230, §10.22 (Diligence as to Accuracy)**, one may extrapolate a definition of due diligence. Section 10.22(b) states that due diligence is exercised if the practitioner uses **reasonable care** in engaging, supervising, training, and evaluating a person upon whose work the practitioner relies. The reasonable care standard can therefore be applied to §10.22(a), which outlines the general principles of due diligence with regard to accuracy in the following areas.

- Preparing, approving, and filing tax returns and related documents for matters concerning the IRS
- Determining the accuracy of representations, both written and oral, made to the IRS by the practitioner
- Determining the accuracy of representations, both written and oral, made to a client by the practitioner

When determining what constitutes reasonable care, treasury regulations define reasonable care as “the standard of care that a reasonably prudent person would use under the circumstances in the course of its business.” Applying this standard in the context of a practitioner, due diligence could be defined as a practitioner applying a standard of care that a reasonably prudent person would use when practicing before the IRS. While not explicit, this constructed definition can help practitioners develop a framework of exercising due diligence in their practice, and what considerations should be undertaken while working within the profession.

Because due diligence is not clearly defined in the context of practicing before the IRS, examining a variety of scenarios a tax practitioner may encounter in their practice may help illustrate a practitioner’s responsibilities in exercising due diligence. This chapter explains standards for practicing due diligence, identifies challenges where due diligence is necessary, and provides discussion on what lengths a practitioner should go to prove exercising due diligence in a variety of circumstances.

CLAIMING TAX CREDITS

While taxpayers are responsible for the information on their tax returns, they rely on the **knowledge and expertise** of their tax practitioner to prepare their returns, including credits which can be claimed to offset tax liability. Practitioners must ensure claimed tax credits are correct and appropriate. This section discusses processes and considerations for tax practitioners to follow when assisting their clients with claiming tax credits on their income tax returns.

Note. This section discusses due diligence requirements as required under Treas. Reg. §1.6695-2, which explicitly pertains to the child tax credit (CTC), the American opportunity tax credit (AOTC), and the earned income credit (EIC). However, such requirements and processes can and should be applied when assisting taxpayers with claiming other tax credits. Following and documenting these practices can support a practitioner’s position and adherence to due diligence requirements under Circular 230.

ASKING QUESTIONS

Circular 230, §10.33 (Best Practices for Tax Advisors), discusses establishing facts, determining which facts are relevant, and evaluating the reasonableness of any assumptions or representations. Practitioners establish facts from obtaining supporting documentation from their clients, but they also establish facts by asking their clients questions. Asking clients questions can occur through conversations or client meetings, as well as requesting clients fill out questionnaires or tax organizers.

Asking a client questions regarding an income tax credit may appear relatively straightforward. For example, when claiming an education credit, a practitioner would ask questions about the educational institution, the student's enrollment, and the amount of tuition and qualifying expenses the taxpayer incurred. However, practitioners must be mindful of credit eligibility criteria beyond what is presented on a supporting tax information form, such as Form 1098-T, *Tuition Statement*. For example, to claim the AOTC, the student must:¹

- Be pursuing a degree or other recognized education credential,
- Be enrolled at least half-time for at least one academic period beginning in the tax year,
- Not have finished the first four years of higher education at the beginning of the tax year,
- Not have claimed the AOTC or the former Hope credit for more than four tax years, or
- Not have a felony drug conviction at the end of the tax year.



Practitioner Planning Tip

Inquiring about potential criminal convictions is a delicate conversation that practitioners must face. Framing the question within the context of **eligibility requirements** may reduce any perceived judgment or intrusion of privacy by the client. Additionally, the practitioner can offer alternative options in their question, such as the lifetime learning credit, which does not have the same eligibility requirements as the AOTC.²

Some of this information is not available on the Form 1098-T, and therefore requires the practitioner to ask additional questions.

¹. IRC §25A(b)(2).

². IRC §25A(c).

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Discussion Scenario 1

Dylan Jenson is a CPA who works for a small accounting firm consisting of five practitioners. During a meeting with Sarah, one of his clients, she mentions that her eldest son, Jordan, entered college in the tax year. Dylan tells Sarah about various education credits that may be available. Dylan instructs Sarah to provide him with a copy of the issued Form 1098-T and he will take care of the rest. After Sarah provides him with a copy of the Form 1098-T, Dylan prepares Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)*, claiming the AOTC.

What questions should Dylan have asked Sarah regarding Jordan's eligibility for the AOTC? _____

By solely using information on Form 1098-T when claiming the credit, what other reporting information or potentially beneficial qualifying expenses is Dylan missing? _____

Does Dylan's due diligence require him to perform additional research on Jordan's potential convictions if he does not find Sarah to be credible? _____

OBTAINING SUPPORTING DOCUMENTS

In addition to asking questions, practitioners must perform follow-up procedures to satisfy the **knowledge requirement** when preparing returns claiming tax credits. These procedures consist of the following.³

- Document the taxpayer's responses to questions regarding tax credits and meeting eligibility requirements.
- Review and assess responses to inquiries along with supporting documentation to determine whether eligibility requirements are satisfied to ensure the proper calculation of the credit.

Supporting documentation consists of documents the taxpayer provides to substantiate their eligibility for claiming a tax credit and corroborate assertions. For example, when claiming the CTC, practitioners must verify the residency of a qualifying child or children. Practitioners may rely on some of the following documents for such verification.⁴

- School records or tuition statements
- Medical records
- Healthcare or childcare provider statements
- Place of worship statement

³. Treas. Reg. §1.6695-2(b)(3).

⁴. Instructions for Form 8867.

Practitioners must discern whether the documents provided by the taxpayer are appropriate, authentic, and adequately address the intended issue. In the instance of the CTC, school records or tuition statements are examples of supporting documentation upon which a practitioner may rely, and should, at a minimum, list the claimed child's name and the taxpayer's address listed. Additionally, a date or time period should be present to prove residency during the applicable tax year. Consequently, to exercise due diligence, the practitioner must ensure the documents clearly support the taxpayer's claim for the credit.

RETAINING DOCUMENTATION

Practitioners must retain documentation to support the accuracy of taxpayer claims for tax credits. Along with copies of the documentation, practitioners must maintain records of how and when they obtained such documents, including the following.⁵

- The identity of the person or entity who furnished the information
- Copies of each completed worksheet for calculating the tax credit

Note. If practitioners are required to prepare and file Form 8867, *Paid Preparer's Due Diligence Checklist*, the document retention rules require them to retain copies of completed Forms 8867.⁶ Practitioners must complete Form 8867 for preparing tax returns involving the EIC, CTC, AOTC, and head of household (HoH) filing status.⁷

Practitioners must retain supporting documentation for three years from the **latest** of the following dates.⁸

- The tax return's due date (without extension)
- For electronically filed returns, the tax return's filing date
- For paper-filed returns, the date when the tax return was presented to the taxpayer to sign

Note. For **nonsigning** tax preparers who assist with and are responsible for a portion of a tax return, the document retention period is three years from the later of the tax return's due date (without extension) or the date the nonsigning tax preparer submitted their responsible portion of the tax return to the signing tax return preparer.⁹

⁵. Treas. Reg. §1.6695-2(b)(4)(i)(C).

⁶. Treas. Reg. §1.6695-2(b)(4)(i)(A).

⁷. Treas. Reg. §1.6695-2(a).

⁸. Treas. Reg. §1.6695-2(b)(4)(ii).

⁹. Treas. Reg. §1.6695-2(b)(4)(ii)(D).

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Practitioner Planning Tip

Practitioners should refer to Forms 886-H-AOC, *Supporting Documents to Prove American Opportunity Credit*, and 886-H-EIC, *Documents You Need to Send to Claim the Earned Income Credit on the Basis of a Qualifying Child or Children for Tax Year 2022*, for questions necessary to consider whether a taxpayer qualifies for the AOTC and EIC. For years following 2022, Form 886-H-EIC is an interactive questionnaire that can be accessed at **uofi.tax/25x1x1** [www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/form-886-h-eic-toolkit].

Discussion Scenario 2

Trent is a CPA and is the signing tax preparer of the 2025 tax return for Jonathan and Martha Kenton. The Kentons provide Trent with supporting documentation for claiming the AOTC. Trent makes a timely filed extension of the return and electronically files it on June 15, 2026.

What is the earliest date Trent can delete supporting documentation for the Kentons' AOTC claim on their 2025 tax return?

If Trent was not the signing tax return preparer and only assisted with preparing Form 8863, what is the earliest date through which Trent must retain supporting documentation for the Kentons' AOTC claim on their 2025 tax return, given that Trent provided Form 8863 to the signing tax return preparer on February 15, 2026, and the tax return was electronically filed on June 15, 2026?

Personally Identifiable Information

The due diligence requirement to retain documents presents an ethical consideration regarding personally identifiable information (PII). PII consists of information where the identity of an individual can be known or inferred. PII may be non-sensitive, such as a person's name, business address, and occupation, while other PII may be sensitive, such as a social security number, medical information, tax return information, and other data elements that may result in harm if compromised.¹⁰ Practitioners are responsible for protecting sensitive PII when such information is in their possession under **Circular 230, §10.51 (Incompetence and Disreputable Conduct)**. Consequently, practitioners must consider their responsibility for protecting information contained in supporting documentation they collect and retain for purposes of meeting due diligence requirements.

Note. For more information on threats to PII and ways to mitigate them, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 1: Ethics.

¹⁰ *Guidance on the Protection of Personal Identifiable Information*. DOL. [www.dol.gov/general/ppii] Accessed on Jan. 7, 2025.

Discussion Scenario 3

Becka is a practitioner assisting Blaire, who is claiming the CTC for her 5-year-old daughter, Crystal. Blaire provides a copy of Crystal's birth certificate, which includes Crystal's name, date and place of birth, and the names of Crystal's father and mother.

Is the information on the birth certificate sufficient for Becka to determine that Crystal meets the residency criteria for claiming the CTC? Why or why not? What necessary information is present, and what necessary information is missing, if any? _____

Should Becka require that her clients physically bring their child with them to her office to confirm the child's existence? _____

Does the due diligence requirement compel Becka to maintain a copy of the birth certificate in Blaire's file? What ethical dilemmas would retaining documents with PII present? _____

Does Becka's due diligence responsibility change if Blaire is not married to Crystal's father and Becka does not prepare his income tax return? How? _____



Practitioner Planning Tip

Practitioners should refer to Form 14815, *Supporting Documents to Prove the Child Tax Credit (CTC) and Credit for Other Dependents (ODC) for 2018–2025*, to help identify and submit the required supporting documents to verify eligibility for the CTC and the credit for other dependents (ODC).



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PENALTIES

A practitioner who determines a taxpayer's eligibility for the HoH status or any of the following credits and who fails to satisfy the due diligence requirements is subject to penalties under IRC §6695(g).¹¹

- CTC and additional CTC¹²
- Refundable portion of the AOTC¹³
- EIC¹⁴

Practitioners are also subject to the penalty for:¹⁵

- Failing to complete Form 8867,
- Failing to complete applicable worksheets for credit calculations,
- Failing to have or obtain knowledge as to the accuracy of such claims, and
- Failing to retain records supporting documentation.

For tax returns filed in 2025, the penalty as adjusted for inflation is \$635 per failure, with no limit on the maximum penalty.¹⁶

Firms employing tax practitioners who are subject to the due diligence failure penalty are also subject to the penalty if any of the following are true.¹⁷

- Principal management participated in or knew about the failure of complying with due diligence requirements.
- The firm did not have in place reasonable or appropriate procedures for ensuring compliance with due diligence requirements.
- The firm did not follow or disregarded its reasonable and appropriate compliance procedures with willful, reckless, or grossly indifferent intent.

A tax practitioner may receive an exception from a due diligence penalty subject to the satisfaction of the IRS if the practitioner can demonstrate **both** of the following.¹⁸

- The practitioner's normal office procedures are reasonable in design and routinely followed; and
- The failure was isolated and inadvertent.

While tax practitioners may receive an exception to the due diligence failure penalty by demonstrating the aforementioned criteria, such relief is not available to accounting firms subject to the due diligence failure penalty.¹⁹

¹¹. Treas. Reg. §1.6695-2(a).

¹². As defined under IRC §24.

¹³. As described under IRC §25A(i).

¹⁴. As defined under IRC §32.

¹⁵. Treas. Reg. §§1.6695-2(a) and (b).

¹⁶. Rev. Proc. 2023-34, 2023-48 IRB 1287.

¹⁷. Treas. Reg. §1.6695-2(c).

¹⁸. Treas. Reg. §1.6695-2(d).

¹⁹. Ibid.

MATERIALITY

Under **Circular 230, §10.22 (Diligence as to Accuracy)**, tax practitioners are required to exercise due diligence to prepare tax returns that are accurate and correct. However, a practitioner could spend hours tracking down information to verify the assertions and numbers provided by a taxpayer, but the impact on the return of any specific error may be so minimal as to not significantly impact the overall return. This concept demonstrates **materiality**, which is defined as the quality or state of having real importance or great consequences.²⁰ As a practical matter, practitioners must assess the materiality of the assertions or provided information on the overall tax return for determining whether additional verification or the need to obtain supporting documentation are reasonable or necessary.

Because materiality is not explicitly defined in Circular 230, practitioners can look to the penalties imposed under IRC §6694 to illustrate the concept. IRC §6694 imposes a penalty for an understatement of a taxpayer's liability by a preparer due to an unreasonable position that the preparer knew or reasonably should have known. This penalty can be severe, with understatements due to willful or reckless conduct equaling the greater of \$5,000 or 75% of the income derived by the tax return preparer for the return or claim.²¹ Willful or reckless conduct is described as comprising the following behaviors exhibited by the tax return preparer.²²

- Willfully attempting to understate a tax liability; or
- Recklessly or intentionally disregarding rules or regulations.

Among other factors of consideration in determining whether to assert a penalty under §6694, the IRS looks at the **materiality** of the errors in relation to the correct tax liability. The IRS will generally not consider the preparer negligent "if the understatement is of a relatively immaterial amount." However, materiality of the errors is disregarded if such errors are obvious, flagrant, or numerous.²³

It is reasonable that practitioners may apply the IRS guidance in this context to determine the materiality of assertions or numbers provided by a client. When evaluating client assertions or numbers, practitioners should look to see if any information is obviously false or erroneous. While there is objectivity in determining whether or not something is obvious, a practitioner could make a case for demonstrating due diligence by proving they are looking for obvious errors that a **reasonable person** would detect in reviewing or evaluating taxpayer assertions. Likewise, a similar argument may be made for a practitioner looking for malicious or numerous errors. If such errors are not apparent, the practitioner may proceed to evaluate the materiality of the assertions in relation to the overall tax return.

The Code, treasury regulations, and the IRS do not provide a calculation, bright-line test, or other specific guidance for practitioners to use in calculating or determining materiality. Consequently, practitioners determine materiality on their own, using the applicable facts and circumstances, client-specific knowledge, and informed judgment.

²⁰ *Materiality*. Nov. 5, 2024. Merriam-Webster. [www.merriam-webster.com/dictionary/materiality] Accessed on Nov. 13, 2024; *Material*. Nov. 13, 2024. Merriam-Webster. [www.merriam-webster.com/dictionary/material] Accessed on Nov. 13, 2024.

²¹ IRC §6694(b)(1).

²² IRC §6694(b)(2).

²³ Rev. Proc. 80-40, 1980-2 CB 774.

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Discussion Scenario 4

In preparing the 2025 individual tax return for one of her married clients, Clarice compiles the supporting documents she received from the client for claiming the AOTC. In addition to the Form 1098-T disclosing tuition expense of \$10,500 and scholarships received of \$7,500, Clarice also received a handwritten paper with an itemized list of books, supplies, and equipment expenses totaling \$1,000. The client's adjusted gross income is \$103,500 and will take the standard deduction of \$31,500.

If Clarice calculates her client's AOTC to be \$1,500 and a refundable credit of \$1,000, are the books, supplies, and equipment expenses material? Should Clarice ask for additional supporting documentation for these expenses, and if so, what type of documentation should she request? _____

Assuming a tax liability of around \$8,500 (excluding the AOTC), is the AOTC material to the overall tax return? What considerations should Clarice take into account when determining the materiality of the AOTC compared to the overall tax return? _____

SUBSTANTIALITY

In the context of exercising due diligence, practitioners must ensure that the positions they take on tax returns are supported by substantial authority, although "substantiality" does not explicitly appear in Circular 230.

Under **Circular 230, §10.34 (Standards with Respect to Tax Returns and Documents, Affidavits and Other Papers)**, practitioners are prohibited from willfully, recklessly, or negligently signing a tax return containing a position that both lacks a reasonable basis or is unreasonable in nature. A tax position can generally be defined as the conclusion derived from the application of tax law, regulations, or other guidance to a transaction or set of facts and circumstances.²⁴ Therefore, any and every input on a tax return thereby represents a position. Furthermore, omissions from a tax return represent a position.²⁵ The Code identifies an unreasonable position as one lacking in substantial authority.²⁶ Consequently, practitioners must assess whether a tax position has substantial authority.

²⁴ *Interpretations of Statement on Standards for Tax Services No. 1, Tax Return Positions*. Apr. 30, 2018. AICPA. [www.aicpa-cima.com/resources/download/interpretations-of-statement-on-standards-for-tax-services-no-1-tax-return] Accessed on Nov. 14, 2024.

²⁵ *A substantial-authority scorecard and example for excluding Sec. 1202 gain for a carried partnership interest*. Wise, Dan. Jan. 1, 2019. AICPA. [www.thetaxadviser.com/issues/2019/jan/substantial-authority-scorecard.html] Accessed on Nov. 14, 2024.

²⁶ IRC §6694(a)(2)(A).

Only the following sources of law, IRS guidance, and other information are considered sources that provide substantial authority.²⁷

- Applicable provisions of the IRC and other statutory provisions
- Temporary and final treasury regulations construing such statutes
- Revenue rulings
- Revenue procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent, as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation
- Letter rulings and technical advice memoranda issued after October 31, 1976
- Actions on decisions and general counsel memoranda issued after March 12, 1981
- IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin

Caution. Substantial authority does not include conclusions reached in treaties, legal periodicals or opinions, and opinions from tax practitioners. However, the underlying authority used to reach such conclusions or expressions of opinion may constitute substantial authority where applicable to the facts of a particular case.²⁸

Practitioner Planning Tip

Practitioners should document all substantial authority used to determine any tax position taken on a return. Although IRS frequently asked questions (FAQs) generally cannot be relied upon as substantial authority, FAQs may provide practitioners with penalty protection in some cases. The IRS will consider reasonable reliance on an FAQ (even one that is subsequently updated or modified) in determining whether certain penalties apply. Taxpayers and practitioners who can demonstrate that they relied in good faith on an FAQ and that their reliance was reasonable based on all the facts and circumstances will not be subject to a penalty that provides a reasonable cause standard for relief. This includes a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax.²⁹

²⁷ Treas. Reg. §1.6662-4(d)(3)(iii).

²⁸ Ibid.

²⁹ *General overview of taxpayer reliance on guidance published in the Internal Revenue Bulletin and FAQs*. Dec. 5, 2024. IRS. [www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs] Accessed on May 28, 2025.

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There is substantial authority for a tax treatment only if the weight of the authority supporting the treatment is substantial in relation to the weight of any contrary authority.³⁰ Tax practitioners must take all relevant authorities into account when determining whether substantial authority exists. The weight of the authority is determined based on the facts and circumstances. Substantial authority is objective and thus a practitioner's belief that an item has substantial authority is not relevant in determining whether there is substantial authority for that treatment.

Note. For more information on the evaluation of substantial authority, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 10: Rulings and Cases.

Discussion Scenario 5

Lawrence is a tax practitioner who is preparing the 2025 income tax return of his client, Sandra. Sandra's husband, Elliot, passed away in 2025. Elliot had an intentionally defective grantor trust where he had "gifted" assets to the trust. During 2025, Sandra, as the beneficiary of the trust, sold trust assets. Lawrence needs to know the basis in the assets to calculate the capital gain or loss on the sale. Lawrence notes that the IRS issued a private letter ruling³¹ in 2012 stating assets in a grantor trust receive a step up in basis when the grantor dies. During his research, he notices a revenue ruling³² in early 2023 where the IRS took the position that there is no step up in basis because the property was not a bequest, devise, or inheritance from the decedent.

Because the trust assets in Elliot's grantor trust have greatly appreciated in value over time, Lawrence concludes that Sandra would receive a significantly favorable tax outcome if the basis of the sold assets receives a step up in basis to the fair market value (FMV) at the time of Elliot's death. Therefore, Lawrence takes the position that the FMV of the assets as of Elliot's date of death is equal to the sale proceeds on Sandra's tax return. He does not make any additional disclosures regarding the position.

On what substantial authority did Lawrence rely for taking the position regarding the basis of sold trust assets on Sandra's tax return? What factors are relevant when determining whether Lawrence had substantial authority for his position? _____

What is the likelihood of Lawrence's position being challenged by the IRS? What arguments are likely to weigh against Lawrence for taking the position that he did? _____

³⁰ Treas. Reg. §1.6662-4(d)(3)(i).

³¹ Ltr. Rul. 201245006 (Nov. 9, 2012).

³² Rev. Rul. 2023-2, 2023-16 IRB 658.

Would it matter if Lawrence identifies multiple authorities that are lower in the hierarchy to counter an IRC or treasury regulation that take a contrary position? _____

What is a reasonable amount of time for Lawrence to research the topic? Does that depend on how material the gain or loss would be to the overall return? _____

ADEQUATE DISCLOSURE³³

Practitioners may take a position that is lacking in substantial authority or is contrary to a regulation. In these circumstances, practitioners must identify and disclose these positions to the IRS to avoid understatement of tax penalties imposed under §6694. Generally, a preparer makes adequate disclosure of a position or item on a return if it is shown on a properly completed Form 8275, *Disclosure Statement*. This form must be attached to the return or amended return.³⁴ If the position is contrary to a **regulation**, practitioners must use Form 8275-R, *Regulation Disclosure Statement*, instead of Form 8275.³⁵

Note. Special disclosure rules exist for recurring items, carrybacks, carryovers, and pass-through entities. See Treas. Reg. §1.6662-4(f) for further guidance on adequate disclosure in these areas.

Among the information disclosed on Form 8275, the filer must disclose **any rule** to which their position is contrary (whereas for Form 8275-R, the filer must disclose the **regulation** to which their position is contrary).³⁶ Rules may comprise statutory provisions or revenue rulings. The filer must also identify and describe, in detail, the items of disclosure, the dollar amount of the reported items, and the location where those items are reported on the tax return, including the line item of the schedule or form. If the taxpayer uses the same tax treatment for a group of similar items, the filer may disclose those items as a group instead of separately stated items. For each item or item grouping, the filer must provide a statement describing the relevant facts affecting the tax treatment for each item or item grouping that includes the following.³⁷

- Information for the IRS to ascertain the identity the item or item grouping
- The amount of each item or item grouping
- A description of the nature of the existing or potential controversy (including legal issues presented by the facts if applicable)

A copy of page 1 of Form 8275 follows for reference.

³³ Treas. Reg. §1.6662-4(e).

³⁴ Treas. Reg. §1.6662-4(f)(1).

³⁵ Ibid.

³⁶ Instructions for Form 8275-R.

³⁷ Instructions for Form 8275.

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Form **8275**

(Rev. October 2024)

Department of the Treasury
Internal Revenue Service

Name(s) shown on return

Disclosure Statement

Don't use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement.

Attach to your tax return.

Go to www.irs.gov/Form8275 for instructions and the latest information.

OMB No. 1545-0889

Attachment
Sequence No. **92**

Identifying number shown on return

If Form 8275 relates to an information return for a foreign entity (for example, Form 5471), enter:

Name of foreign entity _____

Employer identification number, if any _____

Reference ID number (see instructions) _____

Part I General Information (see instructions)

(a) Rev. Rul., Rev. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
1					
2					
3					
4					
5					
6					

Part II Detailed Explanation (see instructions)

1 _____

2 _____

3 _____

4 _____

5 _____

6 _____

Part III Information About Pass-Through Entity. To be completed by partners, shareholders, beneficiaries, or residual interest holders.

Complete this part only if you are making adequate disclosure for a pass-through item.

Note: A pass-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).

1 Name, address, and ZIP code of pass-through entity	2 Identifying number of pass-through entity
	3 Tax year of pass-through entity / / to / /
	4 Internal Revenue Service Center where the pass-through entity filed its return

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 61935M

Form **8275** (Rev. 10-2024)

Positions with the following attributes are **unable** to avoid understatement of tax penalties.

- Lack a reasonable basis,
- Are attributed to a tax shelter,³⁸ or
- Are not properly substantiated, or the taxpayer did not keep adequate books or records with respect to the position.

Reasonable basis is a relatively high standard of tax reporting (i.e., significantly higher than not frivolous or not patently improper). Practitioners cannot satisfy the reasonable basis standard by taking a return position that is merely arguable or that is merely plausible. Rather, the standard is generally met if the position is **reasonably based** on one or more of the substantial authorities listed earlier, considering the relevance and persuasiveness of such authorities. Consequently, it is possible for a position to satisfy reasonable basis standards while simultaneously failing to meet substantial authority standards.³⁹

Note. The **reasonable basis** standards under Treas. Reg. §1.6662-3(b)(3) differ from the **reasonable cause** and good faith exception under §6694(a)(3). A return position may satisfy a reasonable cause and good faith exception even if failing to satisfy the reasonable basis standard.⁴⁰

Discussion Scenario 6

Use the same facts as **Scenario 5**, except that Lawrence prepares and files Form 8275 along with Sandra's tax return. Lawrence discloses that he used the FMV of the assets at the date of Elliot's death as the basis of assets sold on Sandra's Schedule D (Form 1040), *Capital Gains and Losses*, and that he relied on PLR 201245006 issued in 2012 by the IRS in taking such a position.

Did Lawrence provide adequate disclosure of his position on the basis for the trust assets sold? Why or why not? _____

Did Lawrence have substantial authority for the position he took regarding the basis in trust assets? What ethical issues are there with Lawrence's research and the subsequent position that he took? _____

What other issues could Lawrence face if his position is challenged besides a potential understatement in tax? _____

³⁸ As defined in IRC §6662(d)(2)(C)(iii) and Treas. Reg. §1.6662-4(g).

³⁹ Treas. Reg. §1.6662-3(b)(3).

⁴⁰ Ibid.

COMPETENCE

Circular 230, §10.35 (Competence) requires practitioners to possess the “appropriate level of knowledge, skill, thoroughness, and preparation necessary” to engage in practice before the IRS. Furthermore, **Circular 230, §10.51, (Incompetence and Disreputable Conduct)**, warns practitioners that they are subject to sanctions if found to have exhibited incompetence or disreputable conduct while practicing before the IRS. Specifically, practitioners providing a false opinion through **gross incompetence** or regularly providing incompetent opinions on federal tax laws are subject to sanctions. Consequently, it is critical for practitioners to practice due diligence in obtaining the necessary competency to advise their clients and support tax positions taken on the returns they prepare.

While it goes on to state that practitioners may obtain competency by consulting with experts or conducting research, Circular 230 does not provide specific criteria or examples of what constitutes an appropriate level of competence. As such, practitioners may need to look to other publications or sources to determine a framework to evaluate and assess competency. However, such alternative resources may not necessarily provide protection or a defense against a challenge of competency by the IRS.

Many professional organizations maintain a professional code of conduct that defines competence. For example, the code of professional conduct for the American Institute of Certified Public Accountants (AICPA) includes competency requirements and criteria for its members. The AICPA’s code defines competence as the level of knowledge required to provide services with an aptitude for the subject matter and exercise sound judgment in performing the necessary duties.⁴¹ The code clarifies that competency is obtained through a combination of education and experience gained through the duration of a practitioner’s career.⁴² The following are provisions addressed specifically to AICPA members who practice public accounting.⁴³

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

Notably, both Circular 230 and the AICPA code of professional conduct identify that practitioners are allowed to obtain competency during the performance of an engagement, and that not possessing such knowledge does not preclude them from accepting engagements.

⁴¹ See §0.300.060 of *AICPA Code of Professional Conduct*. Dec. 2023. AICPA. [pub.aicpa.org/codeofconduct/Ethics.aspx] Accessed on Nov. 17, 2024.

⁴² Ibid.

⁴³ See §1.300.010 of *AICPA Code of Professional Conduct*. Dec. 2023. AICPA. [pub.aicpa.org/codeofconduct/Ethics.aspx] Accessed on Nov. 17, 2024. Although specific to AICPA members, non-members can use these provisions to establish their own criteria for competence.

Obtaining knowledge or having access to resources, such as research software or colleague expertise, is an integral part of developing and **maintaining** competency. Obtaining competency involves more than taking the required amount of coursework or hours of continuing education to maintain a license to practice before the IRS. This notion is supported by the lack of defined hours or specified coursework in Circular 230 or the AICPA code of professional conduct. Rather, the focus on competency requirements is the practitioner having the necessary and reasonable level of knowledge on the subject matter at hand. As such, obtaining and maintaining competency is a continual practice, particularly when practitioners are faced with ever-changing laws, procedures, and guidance surrounding federal taxation.

Discussion Scenario 7

Heather is a CPA preparing the 2025 tax return for Cliff, one of her newer clients. In 2025, Cliff exercised stock options he received from his employer. Cliff alerts Heather to this transaction when providing her with his tax documents for the year. Heather, having not previously worked on a tax return where a taxpayer exercised stock options, knows that she needs to research how to properly account for and disclose the exercise of stock options on a tax return. Heather agrees to prepare Cliff's return and plans to sign the return after researching stock option treatment.

Is Heather considered competent enough to prepare Cliff's tax return for 2025? Why or why not? _____

How can Heather assess whether she has suitable competence to sign Cliff's 2025 tax return after researching the taxability of stock options? What other actions could Heather take to ensure competency requirements are met? _____

Should Heather withdraw from the engagement? Why or why not? _____

RELIANCE ON OTHERS

A practitioner's lack of competence may also require the involvement and advice of another party who possesses adequate competence. Circular 230, §10.22 specifies practitioners relying upon the work of another party are presumed to have exercised due diligence as to accuracy when the practitioner uses reasonable care in the following areas.

- Engaging the other party
- Supervising the work of the other party
- Training the other party
- Evaluating the other party

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Practitioners can only rely on the advice of others when the advice is reasonable and in good faith based on the facts and circumstances. **Circular 230, §10.37(b) (Requirements for Written Advice)**, identifies situations in which reliance on the advice of others does not meet the reasonableness standard.

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

While practitioners are allowed to rely on the advice of outside parties, they must consider who is providing the advice. Practitioners must exercise due diligence in assessing the competence and qualifications of the person providing the advice and consider any potential **conflicts of interest** that exist or may arise before relying on outside advice. Conflicts of interest are present when the representation of one client is directly adverse to another client or there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.⁴⁴

Discussion Scenario 8

Use the same facts as **Scenario 7**, except Heather contracts with one of her EA friends, Grant, who works for a different firm, to assist her with the stock option exercise treatment on Cliff's tax return. Heather knows that Grant has worked on tax returns where clients have exercised stock options and feels confident that Grant is qualified. She prepares Cliff's return before handing it off to Grant to handle the stock option portion of the return, receives it back from Grant, and after a cursory look over the return, signs it.

What should Heather consider when relying on Grant to handle the stock options portion of Cliff's tax return? Is she able to rely on Grant's work and advice? Why or why not? _____

What types of conflict of interest may arise from this scenario? What other factors, including any possible relationship between Grant and Cliff, could create a conflict of interest? _____

Is Heather required to inform Cliff that she is outsourcing part of the return to another preparer? If yes, should she get his written consent? _____

⁴⁴ Circular 230, §10.29.

How material to the income of the overall return should the stock options be before Heather should consider having Grant's firm sign Cliff's return? _____

USE OF AI

A growing technology that has seen increased use in various businesses and industries, including the accounting profession, is the use of artificial intelligence (AI). AI technology allows computer programs and applications to produce output that simulates human reasoning, and can be trained to refine results. The latest version of AI is often referred to as **generative AI**, describing learning models with the ability to create complex original content based on input prompts.⁴⁵

Accounting firms use AI programs for a multitude of tasks including drafting client communication, performing data analysis, and conducting tax research.⁴⁶ These are tasks that can be outsourced quickly and reliably and that require very little subjectivity. However, there are several considerable risks associated with this new technology that practitioners must consider when deciding to implement AI into their practice. Consequently, practitioners must exercise due diligence when using AI to ensure they are compliant with the ethical standards mandated in Circular 230.

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

ACCURACY IMPLICATIONS

While AI programs can perform requested tasks quickly, they are not consistently reliable. AI **hallucinations** refer to a phenomenon where a program's perception of patterns yields an inaccurate or false response.⁴⁷ For example, a user prompting an AI program to provide an IRC section to support a position on a specific concept could receive a citation that, upon inspection, does not contain the information the user was searching. In some cases, the program could provide a Code section that does not exist. This phenomenon has also resulted in AI programs providing fictitious court cases as support for precedent, resulting in at least one instance where a judge considered imposing sanctions on a lawyer who presented fake cases to a court that were generated by AI hallucinations.⁴⁸

⁴⁵ *What is artificial intelligence (AI)?* Stryker, Cole and Kavlakoglu, Eda. Aug. 16, 2024. IBM. [www.ibm.com/topics/artificial-intelligence] Accessed on Dec. 10, 2024.

⁴⁶ *How do different accounting firms use AI?* Jun. 3, 2024. Thomson Reuters. [tax.thomsonreuters.com/blog/how-do-different-accounting-firms-use-ai] Accessed on Nov. 17, 2024.

⁴⁷ *What are AI hallucinations?* 2024. IBM. [www.ibm.com/topics/ai-hallucinations] Accessed on Nov. 17, 2024.

⁴⁸ *Lawyer Used ChatGPT In Court — And Cited Fake Cases. A Judge Is Considering Sanctions.* Bohannon, Molly. Jun. 8, 2023. Forbes. [www.forbes.com/sites/mollybohannon/2023/06/08/lawyer-used-chatgpt-in-court-and-cited-fake-cases-a-judge-is-considering-sanctions] Accessed on Nov. 18, 2024.

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Practitioners should be cautious when using AI software and research the algorithms used to generate results. AI algorithms determine how AI trains itself, defines the parameters of the program, and determines the results. Similar to researching tax software, insurance policies, and other resources used in a tax practice, it is necessary to understand the data resources used. A practitioner may trust tax software to prepare returns, but they must review the results to ensure the returns are accurate. The same must be done with any AI software used. The practitioner is held accountable under Circular 230 for AI-generated information provided to clients and reported to the IRS.

Some AI programs have access to data, or receive training on data, that is only current as of a **cutoff date**. Therefore, the AI-generated results may not include data from after the cutoff date.⁴⁹ For example, a user performing tax research may be using an AI program whose data cutoff date is prior to Congress passing tax legislation, potentially resulting in the program providing outdated information.

While not explicitly stated in Circular 230, practitioners who use information from AI programs could have an accuracy issue if the user does not verify the information the program outputs. This could be a violation of the §10.22 due diligence requirements.



Practitioner Planning Tip

With AI's potential lack of reliable results, practitioners may best use these tools as a starting point for asking questions and gathering information. The practitioner should **verify any and all output** from the program against the Code, IRS guidance, and other authoritative guidance.

Discussion Scenario 9

Late one night during tax season, Cody finishes preparing a tax return and starts going through his inbox to address any client emails. One email is from a client asking about medical expenses, and what mileage is deductible. Wishing to answer the question as quickly as possible, Cody uses an AI program to draft a response, asking it to provide the medical mileage rate. Cody copies and pastes the response from the program into an email response to the client and proceeds to the next email message in his inbox.

Did Cody fail any due diligence requirements by forwarding the AI-generated response to his client? Why or why not? How could Cody address any accuracy issues present in the situation? _____

Particularly with mileage rates changing each year, to what limitations could the AI program be subject when generating responses to tax information questions? What specific information should Cody ask for when writing a tax-related prompt to an AI program? _____

⁴⁹ *Demystifying Knowledge Cutoff: Why it Matters for AI Models*. Jan. 9, 2024. Toolify.ai. [www.toolify.ai/ai-news/demystifying-knowledge-cutoff-why-it-matters-for-ai-models-396770] Accessed on Nov. 18, 2024.

Discussion Scenario 10

Jessica is responsible for the accounting firm's monthly newsletter that is sent out to hundreds of their clients. She asks an AI program to compose an article on the mileage rate for medical travel for the upcoming year. The AI-generated response cites IRC §213(f), a Code section that does not exist, and provides the rate in effect for the current year, rather than the upcoming year.

Does it matter whether Jessica is a licensed preparer or in an auxiliary department that is not responsible for preparing returns? Is it the firm's responsibility to verify the accuracy of information it disseminates to clients? _____

Unlike **Scenario 9**, Jessica's reliance on AI results in an error that was sent to multiple clients, rather than a specific client. How does that change Jessica's due diligence? _____

SUBSTANTIALITY IMPLICATIONS

AI programs gather training data from internal sources, such as customer data, and external sources, which can include the Internet.⁵⁰ With a wide range of Internet sources from which to collect data, it is possible for AI programs to pull information from substantial authority. However, other sources that AI programs collect data from do not represent substantial authority, like a blog post, and such data could be used by the AI program to generate a response to a user request that appears authoritative. Regardless, AI programs themselves do not represent substantial authority.⁵¹ Consequently, practitioners are unable to rely on the AI technology for substantiality on tax return positions. While a practitioner asking an AI program what position they should take on a given tax return item may result in a quick response, the position in that response may be contrary to rules and regulations. Such an outcome would unlikely hold up against a challenge from the IRS.

**Practitioner Planning Tip**

For AI programs that do not cite the source of information used to generate a response, tax practitioners should prompt the AI program to provide a Code section, treasury regulation, or other substantial authority source to support its answer. Alternatively, a practitioner may alter their prompt to ask where in the Code, treasury regulations, or other substantial authority, the answer to their question was found. As with any AI-generated response, a practitioner should always verify that the provided source agrees with the information provided in the response.

⁵⁰ *What data is used to train an AI, where does it come from, and who owns it?* 2024. Potter Clarkson. [www.potterclarkson.com/insights/what-data-is-used-to-train-an-ai-where-does-it-come-from-and-who-owns-it] Accessed on Nov. 18, 2024.

⁵¹ As evidenced from AI programs' exclusion from the list of substantial authority under Treas. Reg. §1.6662-4(d)(3)(iii).

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Discussion Scenario 11

Nora is preparing a tax return for her client who has a sole proprietorship and files a Schedule C (Form 1040), *Profit or Loss From Business*. Among the list of expenses provided by the client, she sees \$4,500 for “membership dues.” Unsure of whether such expenses are deductible, Nora uses an AI program to ask whether membership dues are tax deductible. The AI program responds that membership dues are often ordinary and necessary business expenses and are therefore deductible. Nora proceeds to enter \$4,500 as a deductible expense on the Schedule C and files the return accordingly.

What due diligence requirements, if any, did Nora fail to fulfill in this situation? What information did Nora, and consequently the AI program, not have in taking the tax position of deducting the membership dues? _____

How could Nora better use the AI program to guide her on how to proceed with the treatment of the membership dues? What could Nora have done differently in this situation that would have resulted in her position having adequate substantiality? _____

COMPETENCY IMPLICATIONS

A practitioner’s reliance on an AI program to answer technical tax questions without verifying the responses generated may result in deficiencies of competence under **Circular 230, §10.35 (Competence)**, because the practitioner is relegating the appropriate level of knowledge and skill to the program. However, **Circular 230, §10.37 (Requirements for Written Advice)**, permits practitioners to rely on the advice of others if such reliance is **reasonable**. As discussed earlier, a practitioner must exercise due diligence when relying on opinions or statements of fact. Accordingly, a practitioner is prohibited from taking an opinion or statement of fact without substantiation. If under review, the IRS will assess the reasonableness of a practitioner’s reliance on others by applying a reasonable practitioner standard.⁵² While §10.37 does not explicitly identify AI programs as an “other individual or party,” the same principles of due diligence should nevertheless apply.



Practitioner Planning Tip

Considering the infancy of AI technology and complexity of how such technology analyzes data in performing tasks, it is unlikely the IRS will determine a reasonable practitioner would rely on data output from an AI program without verifying its accuracy. As a best practice, practitioners should research and check that an AI program’s output is accurate before relying on the advice for a tax position. Documenting such practices and steps taken can help practitioners defend their reliance and positions if challenged by the IRS. Practitioners should also consider keeping a log of the prompts they use when researching on an AI program.

⁵² Circular 230, §10.37(c)(1).

Discussion Scenario 12

Use the same facts as **Scenario 11**, except that Nora does not immediately deduct the membership dues on the tax return. Instead, she prompts the AI program to ask where in the Code or IRS guidance is the deductibility of membership dues addressed. The program directs Nora to IRC §274 — Disallowance of certain entertainment, etc., expenses and IRS Pub. 535, *Business Expenses*. After reading through §274 and the IRS publication, Nora proceeds to ask the client for more information about the nature of the membership dues and how they relate to the business.

Did Nora take sufficient steps in obtaining competency regarding the deductibility of membership dues? Why or why not?

Is Nora's reliance on the AI program in this situation reasonable? Why or why not? How do her actions after using the AI program factor into whether her reliance was or was not reasonable?

PII IMPLICATIONS

AI programs process and store large amounts of data. Depending on the program, that data may include information users enter into the AI program to complete the requested task. The use and storage of data can result in breaches of confidentiality concerning PII. For instance, the AI program could use PII from one request as training data to generate output in response to another user's request. In another instance, AI requests may be subject to human review by employees of the business hosting the program.⁵³ For example, Google warns users not to enter confidential information when using their AI program, Gemini, as conversations with the program are subject to human reviewers.⁵⁴ Additionally, data that an AI program retains is outside of the user's control and is subject to a data breach.⁵⁵

As practitioners are tasked with due diligence in protecting client PII, they must consider the possibility and implications of unauthorized disclosures when using AI programs. Although the IRS and other professional organizations have not yet provided any guidance pertaining to the use of AI programs, the general principles of data protection still apply. Consequently, practitioners must take reasonable steps to ensure client confidentiality is maintained and PII is secure when using AI programs.

⁵³ *How Does AI Use the Data You Give it?* Gray, Jake. Dec. 20, 2023. Ifrah Law. [www.ifrahlaw.com/ftc-beat/how-does-ai-use-the-data-you-give-it] Accessed on Nov. 18, 2024.

⁵⁴ *Gemini Apps Privacy Hub*. Nov. 14, 2024. Google. [support.google.com/gemini/answer/13594961?hl=en&ref_topic=15280100] Accessed on Nov. 18, 2024.

⁵⁵ *How Does AI Use the Data You Give it?* Gray, Jake. Dec. 20, 2023. Ifrah Law. [www.ifrahlaw.com/ftc-beat/how-does-ai-use-the-data-you-give-it] Accessed on Nov. 18, 2024.

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Practitioner Planning Tip

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

Discussion Scenario 13

Larry uses an AI program to draft an email to his client to let them know that their tax return is ready for their signature and to provide them with a summary of their tax outcome. In his prompt to the AI program, Larry instructs the program to draft an email to Mike and Marsha Reese. The email should let the Reeses know their tax return is ready to sign, and that they are receiving a refund of \$2,200 to be directly deposited into their checking account #12345678 at Savvy Savor Bank. Larry is satisfied with the program's output and copies and pastes it to his email that he sends his clients.

What potential unauthorized disclosure did Larry make when using an AI program to draft an email to his client? Why should Larry be concerned about his client's data being used in this regard? _____

What could Larry have done differently to better safeguard his clients' PII? Should Larry use AI technology for this purpose? _____

Discussion Scenario 14

Axel uses an AI note-taking program in his practice. The program "listens" to his meetings and then provides a summary of the topics discussed.

What PII implications are there if Axel informs his client that the AI program is recording their conversation? _____

What PII implications are there if Axel neglects to inform his client that the AI program is recording their conversation? _____

BALANCING CUSTOMER SERVICE WITH DUE DILIGENCE

Practitioners must balance their due diligence responsibility with providing good customer service. While being diligent to ensure an accurate and correct tax return is in the best interest of the client, practitioners must also weigh how best to exercise their due diligence without overwhelming their clients. The IRS provides the following best practices for practitioners to provide high quality representation concerning federal tax on behalf of their clients.⁵⁶

- Knowing the client
- Exchanging engagement agreements and letters
- Accessing historical tax information
- Confirming books and records, and substantiation

KNOWING THE CLIENT

The flow of an engagement is improved significantly when a practitioner knows the client and their situation. A practitioner equipped with client-specific knowledge can apply that knowledge to produce an accurate tax return and also maintain a more personal relationship with the client.

A client organizer can help the practitioner acquire this information. The answers to organizer questions are the basis of many representations the preparer makes to the IRS. Therefore, it is critical that clients take completion of an organizer seriously, particularly when false or invalid declarations are subject to penalties of perjury.⁵⁷

Practitioner Planning Tip

Having a client complete an organizer or an interview at the beginning of the engagement prior to the tax return preparation process makes it more likely that the practitioner will not need to request as much information from the client later in the process. Clear and direct communication between the practitioner and the client generally results in more efficient time spent on the engagement and less of a perceived burden on the client.

⁵⁶ *Circular 230 and Ethics in Tax Practice: How You Can Stay Out of Trouble*, slide 17. Jun. 27, 2023. IRS. [www.irs.gov/pub/taxpros/2023ntf-10-circular-230-and-ethics-in-tax-practice.pdf] Accessed on Nov. 18, 2024.

⁵⁷ IRC §6065.

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ENGAGEMENT AGREEMENTS AND LETTERS

Circular 230 identifies best practices relating to communication from practitioners to their clients. Section 10.33(a)(1) advocates clearly communicating the terms of the engagement between the parties. A client should understand the type and scope of services the practitioner will provide, as well as the associated fee structure. The engagement scope and terms should be in a written engagement letter and the clients should sign the document to acknowledge they read, understood, and agree with the described terms. Such a practice can help practitioners achieve the following objectives.⁵⁸

- Reduce potential for client misunderstandings
- Set expectations and responsibilities for both the practitioner and client
- Satisfy professional liability insurer requirements

When drafting engagement letters, practitioners should be mindful of laws and professional rules and regulations that include, but are not limited to, the following.

- Circular 230
- IRC §7216 requirements for disclosure or use of information by return preparers
- The privacy rule of the Gramm-Leach-Bliley Act (GLBA)⁵⁹
- The GLBA safeguards rule⁶⁰
- American Bar Association Model Rules of Professional Conduct⁶¹
- AICPA Code of Professional Conduct⁶²
- National Association of Enrolled agents (NAEA) Code of Ethics and Rules of Professional conduct⁶³
- Relevant state laws (e.g., state licensing requirements, state board of accountancy rules, disclosure of finance charges, etc.)

Note. Practitioners can use the default engagement letter that comes from their tax software, but should customize it to match their specific needs when dealing with clients.

⁵⁸ See *The importance of engagement letters for small firms*. Sawyers, Roby B. CPA, Ph.D. Nov. 1, 2018. AICPA. [www.thetaxadviser.com/issues/2018/nov/importance-engagement-letters-small-firms.html] Accessed on Jan. 7, 2025.

⁵⁹ *Financial Privacy Rule*. Mar. 6, 2020. FTC. [www.ftc.gov/legal-library/browse/rules/financial-privacy-rule] Accessed on Nov. 18, 2024.

⁶⁰ *Safeguards Rule*. Sep. 16, 2022. FTC. [www.ftc.gov/legal-library/browse/rules/safeguards-rule] Accessed on Nov. 18, 2024.

⁶¹ *Model Rules of Professional Conduct - Table of Contents*. 2024. ABA. [www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents] Accessed on Nov. 18, 2024.

⁶² *AICPA Code of Professional Conduct*. Dec. 2023. AICPA. [pub.aicpa.org/codeofconduct/Ethics.aspx] Accessed on Nov. 18, 2024.

⁶³ *Code of Ethics and Rules of Professional Conduct*. Jan. 20, 2025. NAEA. [www.naea.org/wp-content/uploads/2025/03/NAEA-Code-of-Ethics-and-Professional-Conduct-Updated-Jan-2025.pdf] Accessed on May 16, 2025.

Discussion Scenario 15

Melanie has prepared the tax returns for the Millers for the past three years. They have always enjoyed a cordial relationship, provided all the necessary information, and paid their bill in a timely manner. This year, the Millers mail in all their documents, but neglect to return a signed copy of the engagement letter. Melanie notices that for the first time, Mr. Miller includes a Form 1099-DA, *Digital Asset Proceeds From Broker Transactions*. Having never prepared one of these forms before, Melanie spends a couple hours researching and gaining the necessary competence to properly report the income. As a result of her additional research, and the additional form she needed to complete, her bill is \$250 higher than the prior year.

Was Melanie obligated to wait until she had a signed engagement letter to start preparing the Millers' returns? Was her behavior reasonable if she had three years of prior signed engagement letters? _____

If Melanie's professional liability insurance requires her to have signed engagement letters, what are some risks to which she is exposed without having one in the current year from the Millers? _____

At what point of the engagement should Melanie have communicated to the Millers that the scope of the engagement changed? If the income from digital assets was material, was she justified in not informing the Millers of the potential additional fee? _____

Considering that she has three previous years of signed engagement letters, does Melanie have any due diligence to ask the Millers if they sold any digital assets in prior years? _____

HISTORICAL TAX INFORMATION

A client's historical tax information ensures proper carryovers, depreciation schedules, and prior use of credits are considered in preparing the tax return for the current year. Additionally, historical tax information can help a practitioner familiarize themselves with a client's overall tax situation, where the focus is not solely on a current-year outlook but a long-term overview. A practitioner may also use historical tax returns as a tool to identify missing information, such as the client having bank interest, dividends, or wages in the prior year for which they have not supplied any Forms 1099 for the current year.

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Practitioner Planning Tip

Even if not required, practitioners may consider completing Schedule L, *Balance Sheet per Books*, for business returns they prepare. This schedule can help a practitioner compare current year account balances with those in the prior year. Furthermore, an analysis of a balance sheet can lead to the discovery of additions to a client's fixed assets, which may result in depreciation expenses the client did not calculate or miscalculated. Practitioners may notice liability balances remaining the same, which could uncover liability payments recorded on the income statement instead of a portion reducing the liability on the balance sheet. Analyzing a client's retained earnings and ensuring that it rolls forward from the prior year's balance can flag prior period adjustments the client made after the prior period tax return was filed that should be incorporated into the current tax return.

By completing Schedule L for business clients, practitioners can both help ensure and document compliance with due diligence requirements as to accuracy as well as provide a customer service to their clients in helping them maintain a record of balance sheet disclosure.

Discussion Scenario 16

Serena acquires a new client, Thomas, who is the sole shareholder of a small S corporation. Thomas has not completed Schedule L in the past, and his business has been in operation for 10 years. Serena recognizes the benefits of completing a Schedule L, even though it is not required.

Can Serena complete a yearend Schedule L without calculating a beginning-of-year Schedule L? What factors should she consider before deciding? _____

If Serena produces a yearend Schedule L, is she obligated to recreate all the previous 10 years to track assets, depreciation, loans, etc. to ensure the schedule is accurate? _____

If Thomas comes to his first appointment with Serena and has been completing Schedules L for the last eight years of the 10 he has been in business, is Serena obligated to verify the beginning amounts? Does it matter if Thomas has all 10 years? _____

What are the risks and benefits of preparing a balance sheet and not putting it on Schedule L? _____

CONFIRMATION OF BOOKS AND RECORDS

While taxpayers are responsible for their tax returns and the information they provide to practitioners, practitioners should nevertheless exercise due diligence in ensuring that the books and records provided by the client are accurate. There is subjectivity in determining to what extent a practitioner verifies and confirms taxpayer information, aside from the explicit provisions under Treas. Reg. §1.6695-2. Practitioners should attempt to gauge **reasonableness** from the IRS's perspective in determining to what extent they confirm and verify information provided by the taxpayer.

Discussion Scenario 17

Charlie is a first-year client of Emma. He brings in his various paperwork for his tax return, which includes a Form W-2, *Wage and Tax Statement*, his prior year return, and a variety of handwritten notes for his Schedule C (Form 1040) activity. The handwritten notes summarize Charlie's income, mileage, taxes, professional fees, and supplies. There are a few receipts attached to the notes supporting Charlie's claims.

What are some steps that Emma should take to ensure that the amounts reported on Charlie's tax return are accurate? Should she request support/receipts for all the potential deductions? _____

Charlie offers Emma a copy of his date book for the past year that reflects all the trips he took to support his mileage deduction. Is Emma responsible for calculating the total mileage based on his date book? Does it matter if he took 10 trips or 100 trips? _____

When Emma flips through Charlie's date book, she sees several appointments that seem personal in nature during the times he was supposed to be on work trips. Is she required to ask Charlie how much of the trips were personal versus work? And what does Emma do next if she does not believe his answer? _____

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Emma has another client, Spencer, in the same profession as Charlie. Spencer's income for a similar number of hours worked is twice as much as Charlie is claiming. Emma requests that Charlie provide support for his income. How does she know that Charlie is providing all the Forms 1099 that he was issued? What other steps should Emma take to confirm Charlie is not underreporting income? _____

Does Emma's due diligence requirements change if Charlie has been her client for 15 years and has never received a notice from the IRS? Should she still demonstrate the same level of professional skepticism as if he were new? _____

Practitioners must generally return a client's records to them upon request.⁶⁴ Not only is this practice required by Circular 230, but it reduces the practitioner's burden of diligently protecting such documents from unauthorized disclosure or theft of PII by relinquishing the documents to its rightful owners.

Note. A practitioner is not relieved of the responsibility to return client records, even if the practitioner and the client dispute fees. However, the term "client records" for this purpose does not include any return, claim for refund, schedule, affidavit, appraisal, or any other document prepared by the practitioner.⁶⁵ Therefore, practitioners can withhold such prepared documents (but not source documents) from clients.

THIRD-PARTY INFORMATION

Practitioners often require taxpayer information supplied from third parties. For individual taxpayers, copies of Forms 1099 issued by employers, financial institutions, and other parties ensure consistent reporting between a taxpayer's tax return and information filed with the IRS. Sometimes, further information is needed to report a tax item or address missing information on a Form 1099, such as basis information for assets the taxpayer sold in a tax year. For business taxpayers, information may be needed from business associates, partners, or shareholders, such as income and expenses from a joint venture, partner or shareholder PII for tax return disclosure, including information from a Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, and Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.* For fiduciary taxpayers, beneficiary PII is needed for tax return disclosure and preparation of Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*

Third parties may resist providing information to a tax practitioner they do not know or with whom they have not worked. In determining the practitioner's diligence requirements and responsibility in obtaining information from other parties, the fact that **taxpayers** are ultimately responsible for their tax return cannot be overstated. By providing their signature on the "under the penalties of perjury" provision on the return, taxpayers declare that the information within the return, to the best of their knowledge, is true, correct, and complete.⁶⁶ **A taxpayer is unable to delegate this responsibility to a practitioner or another party.** When the practitioner signs a return, their declaration is based on information of which the preparer has knowledge.

⁶⁴ Circular 230, §10.28.

⁶⁵ Ibid.

⁶⁶ IRC §6065; page 2 of Form 1040, *U.S. Individual Income Tax Return*.

While taxpayers are responsible for the information disclosed in a tax return and for providing necessary information to their practitioners, practitioners can provide good customer service by assisting taxpayers with requesting and obtaining information from third parties. While a tax practitioner may have varied success reaching out directly to the other party for information, they can coach their clients on best practices in requiring the disclosure of necessary information from other parties before engaging in business or activities with them. For example, a practitioner could recommend that their clients obtain a Form W-9, *Request for Taxpayer Identification Number and Certification*, from a subcontractor before accepting the work engagement or before rendering payment to them.

KNOWLEDGE OF CLIENT OMISSIONS

While practitioners are responsible for information of which they have knowledge, an ethical issue emerges when practitioners are aware of omissions in a tax return. **Circular 230, §10.21, (Knowledge of Client's Omission)**, requires practitioners who are aware of an omission to inform the taxpayer of the law, the error in question, and the potential consequences of not resolving the error or failing to comply with the law.

Note. Circular 230 uses the term “knows” in the context of §10.21. This term is often expanded relative to this provision to include the phrase “have reason to know.” It is therefore critical for practitioners to become familiar with their clients’ situations and to ask probing questions. Additionally, §10.21 specifically requires practitioners to **advise** their clients of the consequences of the error or noncompliance. However, there is no requirement that practitioners force their clients to **correct** the error. Furthermore, there is also no requirement for practitioners to report such noncompliance to governmental representatives. In fact, reporting noncompliance to the IRS may be considered a breach in confidentiality.⁶⁷

Discussion Scenario 18

Terra is assisting Zach with the preparation of his 2025 tax return. While comparing the draft of the 2025 tax return with a copy of Zach’s filed 2024 tax return, Terra notices that Zach’s income reported on Schedule E, *Supplemental Income and Loss*, is significantly lower in 2025 compared to 2024. Upon closer inspection, Terra discovers this variance is due to Zach not reporting any income from Yellow River Properties, a joint tenancy, in 2025.

When Terra asks Zach why the income is missing, Zach informs Terra that, while still a joint tenant in 2025, relations between himself and the other owner have soured. Zach is unable to obtain any financial information regarding the joint tenancy from the other owner, who maintains the books and financial records of the venture. Moreover, Zach does not want to communicate or have anything more to do with the other owner. He believes the amount of income earned in 2025 would be immaterial anyway, as he thought income was lower and expenses were higher for the year. Terra has substantial doubts as to Zach’s suppositions regarding the financial performance of the joint venture, considering he is not involved in the financial operations or bookkeeping of the venture.

What are Terra’s due diligence responsibilities regarding Zach’s omission of income activity from Yellow River Properties on Zach’s 2025 tax return? What are Terra’s options on addressing the omission, and how best should she proceed in preparing Zach’s 2025 tax return? _____

⁶⁷ Circular 230, §10.51(c); IRC §6103.

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How should Terra balance being subject to potential understatement of tax penalties without overstepping her due diligence responsibilities pertaining to known omissions and avoiding a breach of client confidentiality? What are some ways Terra can mitigate her risk to both misconduct considerations? _____

Is Terra allowed to reach out directly to Zach's partner to request information without Zach's written consent? Would it be different if she reached out to the partner's tax preparer? _____

What are some other ways Terra could get the necessary information? If Zach refuses to provide the information, what are Terra's options for this engagement? _____

APPENDIX: CIRCULAR 230

Paragraph 1. The authority citation for 31 CFR, part 10 continues to read as follows:

Authority: Sec. 3, 23 Stat. 258, secs. 2-12, 60 Stat. 237 et. seq.; 5 U.S.C. 301, 500, 551-559; 31 U.S.C. 321; 31 U.S.C. 330; Reorg. Plan No. 26 of 1950, 15 FR 4935, 64 Stat. 1280, 3 CFR, 1949-1953 Comp., p. 1017.

§ 10.0 Scope of part.

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

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

Subpart A — Rules Governing Authority to Practice

§ 10.1 Offices.

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

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

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

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

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

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

§ 10.2 Definitions.

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

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

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

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

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

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

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

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

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

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

§ 10.3 Who may practice.

(a) *Attorneys*. Any attorney who is not currently under suspension or disbarment from practice

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

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

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

(d) *Enrolled actuaries*.

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

(2) Practice as an enrolled actuary is limited

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

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

(e) *Enrolled retirement plan agents* —

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

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

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

(f) *Registered tax return preparers.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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employment, or excise taxes.

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

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

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

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

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

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

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

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

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

(d) Compliance and suitability checks.

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

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

(e) Temporary recognition. On receipt of a properly executed application, the Commissioner, or delegate, may grant the applicant temporary recognition to practice pending a determination as to whether status as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer should be granted. Temporary recognition will be granted only in unusual circumstances and it will not be granted, in any circumstance, if the application is not regular on its face, if the information stated in the application,

if true, is not sufficient to warrant granting the application to practice, or the Commissioner, or delegate, has information indicating that the statements in the application are untrue or that the applicant would not otherwise qualify to become an enrolled agent, enrolled retirement plan agent, or registered tax return preparer. Issuance of temporary recognition does not constitute either a designation or a finding of eligibility as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer, and the temporary recognition may be withdrawn at any time.

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

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

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

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

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

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

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

(d) *Renewal.*

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

(2) *Renewal period for enrolled agents.*

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

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

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effective April 1, 2004.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(iii) *Enrollment during enrollment cycle —*

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

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

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

(f) *Qualifying continuing education —*

(1) *General —*

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

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

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

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

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

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

(iii) *Registered tax return preparers.* To

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

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

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

(2) *Qualifying programs —*

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

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

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

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

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

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

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

(B) Provide a means for measuring successful completion by the participants (for example, a written

examination), including the issuance of a certificate of completion by the continuing education provider;

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

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

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

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

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

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

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

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

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

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

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(g) *Measurement of continuing education coursework.*

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

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

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

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

(h) *Recordkeeping requirements.*

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

(i) The name of the sponsoring organization;

(ii) The location of the program;

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

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

(v) The dates attended;

(vi) The credit hours claimed;

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

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

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

(i) The name of the sponsoring organization;

(ii) The location of the program;

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

(iv) The dates of the program; and

(v) The credit hours claimed.

(i) *Waivers.*

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

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

(ii) Extended active military duty;

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

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

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

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

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

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

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

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

(j) *Failure to comply.*

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

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

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

(4) Individuals placed in inactive status and individuals ineligible to practice before the Internal Revenue Service may not state or imply that they

are eligible to practice before the Internal Revenue Service, or use the terms enrolled agent, enrolled retirement plan agent, or registered tax return preparer, the designations “EA” or “ERPA” or other form of reference to eligibility to practice before the Internal Revenue Service.

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

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

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

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

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

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

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

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

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

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

(c) *Limited practice —*

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

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

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

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

(iv) A bona fide officer or a regular full-time employee of a corporation (including a

parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group.

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

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

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

(2) *Limitations.*

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

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

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

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

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

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

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

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

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

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

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

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§ 10.9 Continuing education providers and continuing education programs.

(a) *Continuing education providers —*

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

(i) Be an accredited educational institution;

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

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

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

(2) *Continuing education provider numbers —*

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

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

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

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

(ii) Program subject matter must be current;

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

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

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

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

(4) *Program numbers* —

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

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

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

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

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

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

§ 10.20 Information to be furnished.

(a) *To the Internal Revenue Service.*

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

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

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

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

faith and on reasonable grounds that the record or information is privileged.

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

§ 10.21 Knowledge of client's omission.

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

§ 10.22 Diligence as to accuracy.

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

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

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

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

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

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

§ 10.23 Prompt disposition of pending matters.

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

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

A practitioner may not, knowingly and directly or indirectly:

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

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

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

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

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

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

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

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

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

(b) *General rules* —

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

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

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

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

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

(c) *Firm representation* —

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

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

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

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

§ 10.26 Notaries.

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any Treasury Department Circular No. 230

matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

§ 10.27 Fees.

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

(b) *Contingent fees* —

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

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

(i) An original tax return; or

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

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

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

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

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

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

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

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

§ 10.28 Return of client's records.

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

(b) For purposes of this section — Records of the client include all documents or written or electronic

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

§ 10.29 Conflicting interests.

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

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

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

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

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

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

(3) Each affected client waives the conflict of

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

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

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

§ 10.30 Solicitation.

(a) *Advertising and solicitation restrictions.*

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

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation

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of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) *Fee information.*

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

- (A) Fixed fees for specific routine services.
- (B) Hourly rates.
- (C) Range of fees for particular services.
- (D) Fee charged for an initial consultation.

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

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

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

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

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

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

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

§ 10.31 Negotiation of taxpayer checks.

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

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

§ 10.32 Practice of law.

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

§ 10.33 Best practices for tax advisors.

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

(1) Communicating clearly with the client

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

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

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

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

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

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

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

(a) *Tax returns.*

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

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

(A) Lacks a reasonable basis;

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

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

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

(A) Lacks a reasonable basis;

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

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

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

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

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

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

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

(ii) That is frivolous; or

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

(c) *Advising clients on potential penalties* —

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

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

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

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

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

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

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

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

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

§ 10.35 Competence.

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

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

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

§ 10.36 Procedures to ensure compliance.

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

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

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

(2) The individual through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that firm procedures in effect are properly followed, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a

pattern or practice, in connection with their practice with the firm, of failing to comply with this part, as applicable; or

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

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

§ 10.37 Requirements for written advice.

(a) *Requirements.*

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

(2) The practitioner must—

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

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

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

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

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

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

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

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

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

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

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

(c) *Standard of review.*

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

(2) In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all

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facts and circumstances, with emphasis given to the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances, when determining whether a practitioner has failed to comply with this section.

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

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

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

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

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

§ 10.38 Establishment of advisory committees.

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

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

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Subpart C — Sanctions for Violation of the Regulations

§ 10.50 Sanctions.

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

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

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

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

(c) *Authority to impose monetary penalty —*

(1) *In general.*

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

paragraph (a) of this section.

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

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

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

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

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

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

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

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

§ 10.51 Incompetence and disreputable conduct.

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

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

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

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

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

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

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

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

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

(9) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the

official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.

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

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

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

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

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

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

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

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

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

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

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

§ 10.52 Violations subject to sanction.

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

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

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

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

§ 10.53 Receipt of information concerning practitioner.

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

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

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

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

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

Subpart D — Rules Applicable to Disciplinary Proceedings

§ 10.60 Institution of proceeding.

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

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

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

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

§ 10.61 Conferences.

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

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(b) *Voluntary sanction* —

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

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

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

§ 10.62 Contents of complaint.

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

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

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

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

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

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

(a) *Service of complaint.*

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

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

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

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

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

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

as determined under section 6212 of the Internal Revenue Code and the regulations thereunder.

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

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

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

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

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

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

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

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

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

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

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

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

§ 10.64 Answer; default.

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

(b) *Contents.* The answer must be written and contain a statement of facts that constitute the respondent's grounds of defense. General denials are not permitted. The respondent must specifically admit or deny each allegation set forth in the complaint, except that the respondent may state that Treasury Department Circular No. 230

the respondent is without sufficient information to admit or deny a specific allegation. The respondent, nevertheless, may not deny a material allegation in the complaint that the respondent knows to be true, or state that the respondent is without sufficient information to form a belief, when the respondent possesses the required information. The respondent also must state affirmatively any special matters of defense on which he or she relies.

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

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

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

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

§ 10.65 Supplemental charges.

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

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

(2) It appears that the respondent has knowingly

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introduced false testimony during the proceedings against the respondent.

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

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

§ 10.66 Reply to answer.

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

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

§ 10.67 Proof; variance; amendment of pleadings.

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

§ 10.68 Motions and requests.

(a) *Motions* —

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

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

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

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

(c) *Oral motions; oral argument* —

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

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

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

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

§ 10.69 Representation; ex parte communication.

(a) *Representation.*

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

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

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

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

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

§ 10.70 Administrative Law Judge.

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

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

- (1) Administer oaths and affirmations;
- (2) Make rulings on motions and requests, which rulings may not be appealed prior to the close of a

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hearing except in extraordinary circumstances and at the discretion of the Administrative Law Judge;

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

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

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

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

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

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

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

(10) Make decisions.

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

§ 10.71 Discovery.

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

- (1) Depositions upon oral examination; or
- (2) Answers to requests for admission.

(b) *Depositions upon oral examination —*

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

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

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

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

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

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

(2) It will unduly delay the proceeding;

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

(4) It is frivolous or abusive;

(5) It is cumulative or duplicative;

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

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

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

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

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

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

§ 10.72 Hearings.

(a) *In general* —

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

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

(3) *Procedural requirements.*

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

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

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

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

(A) The Internal Revenue Service withdraws the complaint;

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

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

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

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

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

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

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

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

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

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

(4) A list of undisputed facts.

(d) *Publicity* —

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

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

(3) *Returns and return information* —

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

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proceeding and only to the extent that the Secretary of the Treasury, or delegate, determines that the returns or return information are or may be relevant and material to the action or proceeding.

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

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

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

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

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

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

(4) *Protective measures* —

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

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

(ii) *Authorized orders.*

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

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

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

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

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

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

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

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

§ 10.73 Evidence.

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

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

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

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

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

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

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

§ 10.74 Transcript.

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

§ 10.75 Proposed findings and conclusions.

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

§ 10.76 Decision of Administrative Law Judge.

(a) *In general* —

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

(2) *Summary adjudication*. In the event that a motion for summary adjudication is filed, the Administrative Law Judge should rule on the motion for summary adjudication within 60 days after the party in opposition files a written

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response, or if no written response is filed, within 90 days after the motion for summary adjudication is filed. A decision shall thereafter be rendered if the pleadings, depositions, admissions, and any other admissible evidence show that there is no genuine issue of material fact and that a decision may be rendered as a matter of law. The decision must include a statement of conclusions, as well as the reasons or basis for making such conclusions, and an order of censure, suspension, disbarment, monetary penalty, disqualification, or dismissal of the complaint.

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

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

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

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

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

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§ 10.77 Appeal of decision of Administrative Law Judge.

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

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

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

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

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

the Secretary of the Treasury, or delegate deciding appeals.

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

§ 10.78 Decision on review.

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

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

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

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

§ 10.79 Effect of disbarment, suspension, or censure.

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

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

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

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

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

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

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

(a) *In general*. On the issuance of a final order censuring, suspending, or disbarring a practitioner or a final order disqualifying an appraiser, notification of the censure, suspension, disbarment or disqualification will be given to appropriate officers and employees of the Internal Revenue Service and interested departments and agencies of the Federal government. The Internal Revenue Service may Treasury Department Circular No. 230

determine the manner of giving notice to the proper authorities of the State by which the censured, suspended, or disbarred person was licensed to practice.

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

§ 10.81 Petition for reinstatement.

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

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

§ 10.82 Expedited suspension.

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

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

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

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

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

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

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

(i) Instituting or maintaining proceedings primarily for delay;

(ii) Advancing frivolous or groundless arguments; or

(iii) Failing to pursue available administrative remedies.

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

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

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

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

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

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

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

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

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

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

(f) *Suspension—*

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

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

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

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

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

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

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

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

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

Subpart E — General Provisions

§ 10.90 Records.

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

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

(2) Enrolled agents, including individuals —

(i) Granted active enrollment to practice;

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

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

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

(3) Enrolled retirement plan agents, including individuals —

(i) Granted active enrollment to practice;

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

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

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

(4) Registered tax return preparers, including individuals —

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

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

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

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

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(5) Disqualified appraisers.

(6) Qualified continuing education providers, including providers —

(i) Who have obtained a qualifying continuing education provider number; and

(ii) Whose qualifying continuing education number has been revoked for failure to comply with the requirements of this part.

(b) *Other records.* Other records of the Director of the Office of Professional Responsibility may be disclosed upon specific request, in accordance with the applicable law.

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

§ 10.91 Saving provision.

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

§ 10.92 Special orders.

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

§ 10.93 Effective date.

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

John Dalrymple,
Deputy Commissioner for Services and Enforcement

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

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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

On July 4, 2025, President Donald Trump signed into law the One Big Beautiful Bill Act (OBBBA), now codified as PL 119-21. As a sweeping budget reconciliation measure, the legislation represents one of the most consequential federal tax and spending overhauls in recent history. The OBBBA includes wide-ranging provisions that reshape individual and business taxation, adjust federal spending priorities, and raise the statutory debt limit.

This section explores the major income tax provisions of the OBBBA, organized into two categories: those affecting individual taxpayers and those impacting business entities. Each subsection highlights relevant background information, key changes, and anticipated implications for tax compliance and planning. Additionally, the appendix at the end of the chapter summarizes the provisions covered in this workbook.

Caution. The IRS continues to clarify and refine the application of OBBBA. Several provisions, such as those referencing tax return due dates, remain ambiguous, particularly regarding whether extensions are included. Further guidance is expected soon.

Note. Several provisions of the OBBBA have specific impact on farmers. Those are discussed in the 2025 *University of Illinois Federal Tax Workbook*, Chapter 11: Agricultural Issues and Rural Investments.

PROVISIONS IMPACTING INDIVIDUALS

The OBBBA introduces several new deductions and extensions aimed at reducing the tax burden for working Americans, seniors, and families. These provisions are effective for tax years 2025 through 2028 unless otherwise noted.

EXTENSION OF REDUCED INDIVIDUAL INCOME TAX RATES¹

The OBBBA makes permanent the reduced tax rates introduced by the Tax Cuts and Jobs Act (TCJA) in 2018.² The pre-TCJA higher rates, which were scheduled to return on January 1, 2026,³ will not return.

The new tax legislation continues using the chained consumer price index (C-CPI-U) for all urban consumers.⁴

- The **10% and 12% brackets** will now be indexed from **2016**.
- The **22%, 24%, 32%, 35%, and 37% brackets** continue to be indexed from **2017**.

This change allows one more year of inflation adjustments for the 10% and 12% brackets. The inflation adjustment changes are effective for tax years beginning **after December 31, 2025**.

EXTENSION OF INCREASED STANDARD DEDUCTION⁵

The OBBBA extends and provides an additional increase to the standard deduction starting in tax year 2025. The standard deduction is a fixed amount that taxpayers can subtract from their adjusted gross income (AGI) based on their filing status, thereby reducing their taxable income. Alternatively, a taxpayer can elect to reduce their taxable income by the sum of their allowable itemized deductions, which may be greater. The standard deduction is found under IRC §63.

The standard deduction amounts for 2025 are as follows, along with the 2024 amounts for comparison.

Filing Status	2024 Amount	2025 Amount
Married filing jointly (MFJ) and qualifying surviving spouse (QSS)	\$29,200	\$31,500
Single	14,600	15,750
Head of household (HoH)	21,900	23,625
Married filing separately (MFS)	14,600	15,750

Note. For years after 2025, the standard deduction continues to be annually adjusted for inflation.

¹ *One Big Beautiful Bill Act*, PL 119-21, §70101.

² IRC §1(j).

³ *Tax Cuts and Jobs Act*, PL 115-97, §11001, amending IRC §1(j) for tax years beginning before January 1, 2026.

⁴ *Table 5. Chained Consumer Price Index for All Urban Consumers (C-CPI-U) and the Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, all items index*. Jun. 11, 2025. Bureau of Labor Statistics. [www.bls.gov/news.release/cpi.t05.htm] Accessed on Jul. 10, 2025.

⁵ *One Big Beautiful Bill Act*, PL 119-21, §70102.

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TERMINATION OF DEDUCTION FOR PERSONAL EXEMPTIONS⁶

The TCJA suspended personal exemptions for tax years 2018 through 2025.⁷ The OBBBA permanently sets the exemption amount to \$0 after December 31, 2017.

TEMPORARY DEDUCTION FOR SENIORS⁸

Beginning in 2025, the OBBBA introduces a temporary personal deduction for qualified taxpayers age 65 and older. This is in addition to the standard deduction and the existing age-based additional deduction under §63(f). This deduction is available from 2025 through **2028**.

Qualifying taxpayers are entitled to an additional deduction of \$6,000. Individuals qualify if they turn 65 by the end of the year, file their tax returns with the social security number (SSN) assigned to them, and have modified adjusted gross income (MAGI) under the threshold. If both spouses are age 65 or older and file a joint return, they may claim a combined additional deduction of \$12,000. These amounts are not indexed for inflation.

Note. The taxpayer's SSN must appear on the tax return. If omitted, the IRS can treat it as a mathematical or clerical error,⁹ thereby avoiding the need to issue a notice of deficiency.¹⁰ Math error notices will only give the taxpayer 60 days to respond before becoming final.¹¹

MAGI is equal to a taxpayer's reported AGI plus any amount of the exclusions resulting from the following.

- Foreign earned income and housing cost¹²
- Income sourced within and connected with Guam, American Samoa, and the Northern Mariana Islands¹³
- Income sourced within Puerto Rico¹⁴

The senior deduction begins to phase out once a taxpayer's MAGI exceeds certain thresholds.

- **Single filers.** Phase-out begins at **\$75,000** and is fully phased out at **\$175,000**
- **MFJ.** Phase-out begins at **\$150,000** and is fully phased out at **\$250,000**
- **MFS.** Not eligible for the deduction

For every dollar of MAGI above the threshold, the deduction is reduced by **6%**. This gradual reduction means that the deduction is completely eliminated once income exceeds the upper limit for the taxpayer's filing status.

Taxpayers aged 65 and older **may qualify** for several deductions that significantly reduce their taxable income. These may include the following.

- The **standard deduction** under §63(c)
- The **additional deduction for age or blindness** under §63(f)
- The new **temporary senior deduction** introduced by the OBBBA, available from 2025 through 2028

⁶ Ibid., §70103.

⁷ *Tax Cuts and Jobs Act*, PL 115-97, §11041.

⁸ *One Big Beautiful Bill Act*, PL 119-21, §70103.

⁹ IRC §6213(g)(2).

¹⁰ IRC §6212(c)(1).

¹¹ IRC §6213(g)(2).

¹² IRC §911.

¹³ IRC §931.

¹⁴ IRC §933.

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Together, these provisions can provide substantial tax relief for eligible seniors. The total available deduction depends on filing status and age eligibility. For tax year 2025, the total deductions available are as follows.¹⁵

Single filer (age 65 or older):

Standard deduction	\$15,750
Age-based additional deduction	2,000
Potential blindness additional deduction	2,000
OBBBA senior deduction	6,000
Total potential deductions	\$25,750

MFJ (both spouses age 65 or older):

Standard deduction	\$31,500
Age-based additional deduction	3,200
Potential blindness additional deduction	3,200
OBBBA senior deduction	12,000
Total potential deductions	\$49,900

MFS (both spouses age 65 or older):

Standard deduction	\$15,750
Age-based additional deduction	1,600
Potential blindness additional deduction	1,600
OBBBA senior deduction	0
Total potential deductions	\$18,950

Example 1. In 2025, Rose, age 71, a single taxpayer, receives \$40,000 in social security benefits and \$18,000 in other income. Her income from all sources is \$58,000. The taxable portion of her social security benefits is \$7,900¹⁶ and her AGI is \$25,900 (\$18,000 pension income + \$7,900 taxable social security).

Rose qualifies for the following deductions in 2025.

Standard deduction	\$15,750
Additional deduction for age	2,000
OBBBA senior deduction	6,000
Total deductions	\$23,750

Rose's taxable income after deductions is \$2,150 (\$25,900 AGI - \$23,750 deductions). Rose's 2025 tax liability is \$215. Using the same income for 2024, her tax liability was \$938. The OBBBA provisions saved Rose \$723.

Caution. There are several misconceptions about how the OBBBA impacts seniors. Some people believe that social security is not taxable or have drawn the conclusion that seniors are getting a \$6,000 credit when it is actually a deduction subject to income limitations.

¹⁵ Rev. Proc. 2024-40, 2024-45 IRB 1100.

¹⁶ See IRC §86 to calculate taxable social security benefits. A discussion of calculating taxable social security benefits is beyond the scope of this chapter.

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CHILD TAX CREDIT¹⁷

The OBBBA makes several changes to the child tax credit (CTC) under IRC §24, effective beginning in 2025. These changes build on the framework established by the TCJA.

Starting in 2025, the CTC is increased to a maximum of **\$2,200** per qualifying child (previously, this amount was \$2,000 per child). Starting in 2026, the credit amount is annually indexed for inflation. To qualify for the CTC, a qualifying child must meet the following requirements.

- Be under age 17
- Be a U.S. citizen, national, or resident alien
- Have a valid SSN issued before the tax return's due date

Additionally, the credit is subject to limitations if the taxpayer's MAGI exceeds certain threshold amounts. These amounts are unchanged from prior law.

- \$200,000 for single filers, HoH, and other non-joint filers
- \$400,000 for MFJ

For every \$1,000 (or part thereof) over the threshold, the credit is reduced by **\$50**. These thresholds are not indexed for inflation and are **made permanent by the OBBBA**. The OBBBA also implemented a new requirement that at least one parent must have a valid SSN by the due date of the return.

A partially refundable credit, also known as the **additional CTC**, is also available. For 2025, the maximum additional CTC is **\$1,700** and will be indexed annually for inflation (this amount is unchanged from 2024).¹⁸ If a taxpayer does not owe any federal income tax, they may still receive a portion of the credit as a refund. This refundable portion is calculated based on earned income.

In summary, beginning in 2025, the CTC will undergo the following **permanent** changes.

- **Increases** the nonrefundable CTC to a maximum of \$2,200 **starting in 2025**.
- **Annually indexes** the credit amount for inflation **starting in 2026**.
- Requires a valid SSN for at least one parent (if filing a joint return) and the qualifying child (or certain legal residency) by the due date of the return.

Note. For a more thorough description of the provisions enacted in TCJA for the CTC, see the 2018 *University of Illinois Federal Tax Workbook*, Chapter 1: New Legislation — Individual Concerns. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

¹⁷ *One Big Beautiful Bill Act*, PL 119-21, §70104.

¹⁸ Rev. Proc. 2024-40, 2024-45 IRB 1100.

Example 2. The Johnson family has two children, ages 10 and 12, and the parents file jointly. Their MAGI is \$100,000, and everyone has valid SSNs. The following table compares the amount of CTC the Johnsons received in 2024 before the OBBBA, and in 2025 after its enactment.

Feature	2024 (Pre-OBBBA)	2025 (OBBBA via §70104)
Credit per child	\$ 2,000	\$ 2,200
Refundable portion per child	1,700	1,700
Phase-out threshold (MFJ)	400,000	400,000
Total CTC (2 children)	4,000	4,400
Refundable amount (if no tax)	Up to 3,400	Up to 3,400

In 2024, the Johnsons received \$4,000 in total CTC. In 2025, under the new law, they would receive \$4,400, a \$400 increase. Because their income is well below the phase-out threshold, they receive the full credit. If their tax liability is less than the credit, they could receive up to \$3,400 as a refund (same as before but indexed in future years).

Example 3. The Parkers file jointly and have two children, ages 7 and 11. Their MAGI is \$420,000 and all members of the family have valid SSNs. Because the Parkers' MAGI exceeds the \$400,000 threshold, their CTC is partially phased out. The \$20,000 excess (\$420,000 MAGI – \$400,000 phase-out threshold) is phased out \$50 per \$1,000 over the threshold, or \$1,000 ($\$20,000 \div \$1,000 \times \$50$). The maximum CTC of \$4,400 (\$2,200 credit $\times$ 2 children) is reduced by \$1,000 for a final CTC of \$3,400.

In 2024, the Parkers received a CTC of \$3,000 ($(\$2,000 \times 2 \text{ children}) - \$1,000 \text{ MAGI reduction}$). The Parkers will receive \$400 more in 2025 under the new legislation.

OTHER DEPENDENT CREDIT¹⁹

The OBBBA makes the nonrefundable other dependent credit of \$500 permanent. However, this amount is not indexed for inflation.

ESTATE AND GIFT TAX EXEMPTION INCREASE²⁰

The OBBBA makes permanent the increased basic exclusion amounts applicable to federal gift and estate taxes, originally enacted under TCJA.

The following provisions under the OBBBA take effect beginning in **2026**.

- The basic exclusion amount is set at \$15 million per individual, applicable to both lifetime gifts and estate transfers.
- For married couples, the combined exclusion is effectively \$30 million.
- The excluded amount will continue to be **indexed for inflation** beginning in **2027**.

Note. For more information about the increase in the amount excluded from gift and estate tax by the OBBBA, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 9: Various Specialized Trusts.

¹⁹ Ibid.

²⁰ *One Big Beautiful Bill Act*, PL 119-21, §70106.

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ALTERNATIVE MINIMUM TAX EXEMPTION THRESHOLDS²¹

Starting in 2026, the OBBBA includes a revision to the alternative minimum tax (AMT) for individuals. The OBBBA does not change the increased AMT exemption amounts introduced by TCJA but modifies the phase-out mechanism, which may **increase** AMT liability for higher-income taxpayers. These changes are intended to provide relief to more middle-income taxpayers from AMT liability while increasing the effective tax burden on higher-income individuals. The higher exemption amounts reduce the number of taxpayers subject to AMT, but the steeper phase-out rate may result in larger AMT liabilities for those above the threshold.

The OBBBA returns the AMT exemption phase-out thresholds to their 2018 levels, indexed for inflation.

- \$1 million for MFJ or QSS
- \$500,000 for single filers and MFS

Additionally, the **phase-out rate** is increased from 25% to 50% of the amount by which the taxpayer's AMT income (AMTI) exceeds the applicable threshold. The OBBBA does not change AMT exemption amounts, which remain at the following levels.²²

- \$137,000 for MFJ and QSS
- \$88,100 for single filers who are not a QSS
- \$68,500 for MFS

Note. This change replaces the TCJA's 25% phase-out rate and is expected to increase AMT exposure for higher-income taxpayers, particularly those with large preference items such as incentive stock options or high state and local taxes.

MORTGAGE INTEREST DEDUCTION²³

The OBBBA **permanently** extends the limitations on mortgage interest deduction. The TCJA limited acquisition debt to up to \$1 million (\$500,000 for MFS) for mortgage debt taken out before December 15, 2017, and \$750,000 (\$375,000 for MFS) for mortgage debt taken out after December 15, 2017.²⁴ Mortgage insurance premiums (MIP, also known as private mortgage insurance (PMI)) were not deductible.²⁵ The TCJA provisions were set to sunset at the end of 2025.

Beginning in tax year 2025, the key changes that are in effect are as follows.

- The \$750,000 (\$375,000 for MFS) acquisition debt cap for mortgage loans remains in effect for **post-**December 15, 2017, mortgages.
- The \$1 million (\$500,000 for MFS) acquisition debt cap for mortgage loans remains in effect for **pre-**December 15, 2017, mortgages.
- MIPs that are paid for qualified mortgage insurance are deductible as mortgage interest, subject to income phase-outs and other limitations under IRC §163(h)(3)(E). This provision, previously temporary, is now **permanently extended**. This applies to taxable years beginning after December 31, 2025.

²¹ Ibid., §70107.

²² Rev. Proc. 2024-40, 2024-45 IRB 1100.

²³ *One Big Beautiful Bill Act*, PL 119-21, §70108.

²⁴ *Tax Cuts and Jobs Act*, PL 115-97, §11043.

²⁵ Private mortgage insurance means mortgage insurance other than mortgage insurance made available under the National Housing Act, title 38, or title V of the Housing Act of 1949. See 12 USC §4901(11).

CASUALTY LOSS DEDUCTION MODIFICATIONS²⁶

The OBBBA reinstates and expands the personal casualty loss deduction under IRC §165. Beginning in 2025, taxpayers may deduct unreimbursed personal casualty losses only if they are attributable to a federally declared disaster. Starting in 2026, this relief extends to state-declared disasters. A **state-declared disaster** is “any natural catastrophe (including any hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, or drought), or, regardless of cause, any fire, flood, or explosion, ... which ... causes damage of sufficient severity and magnitude to warrant” allowance of a deduction.²⁷

In the absence of a federally or state-declared disaster, individual taxpayers may only deduct nonbusiness casualty losses to the extent of their casualty **gains**.²⁸

Note. For more information on the OBBBA impact on casualty losses deductions, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 6: Individual Taxpayer Issues.

For more information on disaster relief provisions, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 8: New Developments.

TERMINATION OF MISCELLANEOUS ITEMIZED DEDUCTIONS (OTHER THAN EDUCATOR EXPENSES)²⁹

The TCJA suspended miscellaneous itemized deductions subject to the 2% AGI threshold through 2025.³⁰ These suspended deductions included unreimbursed employee expenses, investment advisory fees, union dues, tax preparation fees, hobby expenses, and safe deposit box fees.

Beginning in **2026**, miscellaneous itemized deductions subject to the 2% AGI threshold are terminated. IRC §67(g) has been amended to remove the expiration date.

The educator expense deduction, which now includes expenses incurred by interscholastic sports administrators and coaches, is considered a miscellaneous itemized deduction but is **not subject to the 2% AGI floor**. IRC §62(a)(2)(D) remains in effect. Educators are still allowed the \$300 above-the-line deduction for qualified expenses.

LIMITATION ON TAX BENEFIT OF ITEMIZED DEDUCTIONS³¹

TCJA suspended the Pease limitation on itemized deductions starting in 2018 through the end of 2025.³² The Pease limitation reduced the itemized deduction benefit for high-income taxpayers by up to 80% of the deductions otherwise allowable. The adjustment is designed to align the marginal benefit of itemized deductions with that of the 35% bracket, effectively limiting the tax savings for high-income filers.

Note. For more information on the Pease limitation, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 12: Planning for the Sunset of the TCJA.

Beginning in **2026**, the OBBBA replaces the Pease limitation with a new formula under revised IRC §68. Taxpayers in the 37% tax bracket reduce their itemized deduction by ²/₃₇ of the lesser of:

- The taxpayer’s total itemized deductions, or
- The amount by which their taxable income exceeds the 37% bracket threshold for their filing status.

²⁶ *One Big Beautiful Bill Act*, PL 119-21, §70109.

²⁷ IRC §165(h)(5)(C)(i), as added by *One Big Beautiful Bill Act*, PL 119-21.

²⁸ IRC §165(h)(5)(B)(i).

²⁹ *One Big Beautiful Bill Act*, PL 119-21, §70110.

³⁰ IRC §67(g) as added by *Tax Cuts and Jobs Act*, PL 115-97, §11045.

³¹ *One Big Beautiful Bill Act*, PL 119-21, §70111.

³² *Tax Cuts and Jobs Act*, PL 115-97, §11046, amending IRC §68.

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For example, if this rule had been applied in 2025, single taxpayers with taxable incomes equal to or greater than \$626,350, and MFJ taxpayers with taxable income equal or greater than \$751,600, would have been affected.

To prevent unintended interactions, the OBBBA clarifies that this new limitation does not affect the determination of taxable income for qualified business income deduction (QBID) purposes. Similarly, this section does not affect the qualified business income (QBI) of patrons of specified agricultural cooperatives.

Example 4. In 2026, Jordan, a single taxpayer, has taxable income of \$700,000 and claims \$60,000 in itemized deductions. Assuming the 37% tax bracket begins at \$662,050 for a single taxpayer in 2026, Jordan falls under the revised rules in §68.

Because Jordan's income exceeds the threshold, the new limitation applies. The law reduces the value of itemized deductions by $\frac{2}{37}$ of the lesser of:

- Jordan's total itemized deductions (\$60,000), or
- The amount by which Jordan's income exceeds the 37% threshold (\$700,000 taxable income – \$662,050 beginning of the 37% tax bracket, or \$37,950).

Jordan's reduction is based on the \$37,950 excess. Applying the $\frac{2}{37}$ factor, Jordan's itemized deductions are reduced by \$2,051 ($\frac{2}{37} \times \$37,950$). As a result, Jordan can deduct only \$57,949 of the original \$60,000.

LIMITATION ON WAGERING LOSSES³³

The OBBBA extends and modifies the limitation on wagering losses originally enacted under TCJA. The provision clarifies that all deductions related to wagering transactions, including expenses incurred in the conduct of gambling, are limited to the amount of wagering gains.

For tax year **2026** and beyond, the limitation on wagering loss deduction has the following changes.

- **Loss limitation rule.** A taxpayer may deduct a **maximum of 90%** of the total wagering losses incurred during the year. If gambling winnings are less than the loss, the deduction is allowed up to the amount of the winnings, and then the losses are reduced to 90%.
- **Professional gamblers.** The limitation applies regardless of whether the taxpayer is engaged in the trade or business of gambling. Professional gamblers may no longer deduct expenses or losses over 90% of their actual wagering losses, even if they have sufficient winnings. This includes not only the actual loss but also expenses incurred in carrying out wagering activities, such as travel, lodging, and admission fees.

Example 5. John is a casual gambler. In July 2026, he wins \$4,000 at a casino but has \$5,000 in gambling losses. He can only apply \$4,000 of his gambling losses, because his gambling winnings are less than his losses before the limitation.

John then applies the 90% rule. As such, he can deduct \$3,600 in gambling losses (\$4,000 limited losses $\times$ 90%).

Caution. Even when gambling losses exceed winnings, the 90% limitation rule may result in taxable income without actual cash retained. In **Example 5**, John has \$400 in taxable income after applying the limitation, despite losing money overall. If he has no other income or deductions, he may owe tax on this amount without having the funds to pay it. Taxpayers with limited income or liquidity should be aware that gambling activity can create unexpected tax liabilities, even in a net-loss scenario.

³³ One Big Beautiful Bill Act, PL 119-21, §70114.

MODIFICATIONS TO ABLE ACCOUNTS AND SAVER'S CREDIT³⁴

The Achieving a Better Life Experience Act (ABLE) of 2014 under IRC §529A, allows people with disabilities and their families to set aside money for qualified disability expenses without endangering eligibility for means-tested public benefits such as supplemental security income (SSI) and Medicaid. A qualified disability expense is broadly defined and includes housing, education, transportation, employment supports, health care, assistive technology, basic living expenses, and anything that helps the beneficiary maintain or improve health, independence, and quality of life. To qualify for an ABLE account, a person with disabilities must meet the following criteria.

- Disability onset must be **before age 26**.
- Must meet the social security definition of disability or self-certify under IRC §529.
- Can only have one ABLE account nationwide.

ABLE accounts have the following contribution limits.

- Annual limits tied to the gift-tax-exclusion amount of \$19,000 in 2025.
- If the beneficiary works, the extra ABLE-to-Work amount is the lesser of the federal poverty guideline for a 1-person household or the beneficiary's compensation.
- Lifetime maximum is typically \$200,000 to \$550,000, depending on the state where the ABLE account is held, based on the state's §529 cap.

The tax treatment of ABLE accounts varies between federal regulations and state regulations.

- Contributions are **not deductible** for federal tax purposes; however, some states allow a deduction or credit.
- Earnings grow tax deferred.
- Withdrawals used for qualified disability expenses are exempt from federal income tax.

Note. ABLE accounts are available in nearly all states, and many programs allow nonresidents to open an ABLE account.

Example 6. Jason, age 24, has used a wheelchair since birth. In 2025, he earns \$15,000 in wages and opens an ABLE account. Jason can contribute the annual contribution cap of \$19,000 in 2025, plus an ABLE-to-Work contribution. The ABLE-to-Work contribution maximum is the lesser of \$15,060 (based on the 2025 poverty guideline) or \$15,000 (Jason's reported wages). Therefore, his total contribution is \$34,000 (\$15,000 ABLE-to-Work contribution + \$19,000 annual contribution cap).

His earnings will grow tax-deferred, and if he withdraws funds for a qualified disability expense, such as an accessible wheelchair modification, he will not owe federal tax on the withdrawal.

ABLE accounts have limited impact on SSI and Medicaid.

- The first \$100,000 of ABLE balances is excluded from SSI resource limits.
- No effect on Medicaid eligibility regardless of the balance.

³⁴ Ibid., §§70115, 70116, and 70117.

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Beginning in 2027, individuals who contribute to ABLE accounts may qualify for the federal **saver's credit**, which provides a tax credit for eligible low- and moderate-income savers. The SECURE 2.0 Act included a provision³⁵ to replace the saver's credit with a federal saver's match starting in 2027. However, the OBBBA repeals this provision, meaning the saver's credit remains in effect and is expanded to include ABLE contributions permanently. The maximum credit amount increases from \$2,000 to \$2,100 starting in **2027**.

The following changes are made as a result of the OBBBA.

- Increased contribution limits introduced by TCJA are made permanent and indexed for inflation starting in **2025**.
- The saver's credit is extended to include ABLE account contributions starting in **2027**.
- The maximum credit under the saver's credit increases from \$2,000 to \$2,100 in **2027**.
- The SECURE 2.0 Act, §103(e) is repealed and will not be enacted.



Practitioner Planning Tip

The presence of an adult dependent or a minor child receiving social security disability insurance on a taxpayer's return may indicate that the dependent is eligible to have an ABLE account. Practitioners should ask follow-up questions to determine eligibility.

STUDENT LOAN DISCHARGE: DEATH OR DISABILITY³⁶

Under TCJA, student loan amounts discharged due to death or total and permanent disability were excluded from federal taxable income.³⁷ The American Rescue Plan Act (ARPA) temporarily expanded this exclusion to cover all types of student loan forgiveness, including private loans, for discharges occurring between 2021 and 2025.³⁸

Beginning in 2026, the OBBBA amends IRC §108(f)(5) to make only the death or disability exclusion permanent, and extends it to both federal and private education loans. The taxpayer's SSN must appear on the tax return.

INCREASED STATE AND LOCAL TAX DEDUCTION³⁹

The state and local tax (SALT) deduction is a federal income tax deduction that allows taxpayers to deduct certain taxes paid to state and local governments from their taxable income. It is codified under IRC §164. Taxpayers may deduct state and local income or sales taxes, state and local real estate taxes, and state and local personal property taxes. The SALT deduction is available to individual taxpayers who itemize deductions.

The OBBBA includes significant revisions to the SALT deduction limitation under §164(b)(6). This provision modifies the cap introduced by TCJA, which limited the SALT deduction to \$10,000 for individuals and married couples filing jointly.⁴⁰

³⁵ *SECURE 2.0 Act of 2022*, PL 117-328, §103(e), codified at IRC §25B(g).

³⁶ *One Big Beautiful Bill Act*, PL 119-21, §70119.

³⁷ *Tax Cuts and Jobs Act*, PL 115-97, §11031.

³⁸ *American Rescue Plan Act*, PL 117-2, §9675.

³⁹ *One Big Beautiful Bill Act*, PL 119-21, §70120.

⁴⁰ *Tax Cuts and Jobs Act*, PL 115-97, §11042.

Key Changes Effective for 2025 and Beyond

Beginning in tax year 2025, the SALT deduction has the following changes.

- **Increased cap.** The SALT deduction is temporarily increased starting in 2025.
 - ♦ For all filers except MFS, the cap is \$40,000.
 - ♦ For MFS filers, the cap is \$20,000.
- **Deduction is indexed for inflation through 2029.** For example, the cap increases to \$40,400 in 2026 and continues to rise by 1% annually. However, the provision is temporary — the cap is scheduled to revert to \$10,000 in 2030.
- **Phase-out for high-income taxpayers.** To limit the benefit for higher earners, the OBBBA introduces a phase-out mechanism based on MAGI.
 - ♦ For all filers except MFS, the deduction begins to phase-out at \$500,000 MAGI.
 - ♦ For MFS filers, the deduction phase-out is 50% of the annual threshold.

The deduction is reduced by 30% of the excess MAGI above the applicable threshold. The law also includes a floor that the **SALT deduction cannot be below \$10,000**, regardless of income or filing status.

Note. The OBBBA does nothing to affect the ability of certain passthrough entities to deduct SALT.

QUALIFIED TIPS DEDUCTION⁴¹

The OBBBA enacts a new provision for a deduction for qualified tips effective from **2025 through 2028**. This provision, sometimes referred to as “no tax on tips,” applies **retroactively** to tax years beginning after December 31, 2024. The new provision allows employees and self-employed taxpayers an income tax deduction of **up to \$25,000** for qualified tips. Self-employed individuals with qualifying tips **may not** deduct more than their income before the deduction, and they must be engaged in a trade or business **where tips are earned**. Taxpayers can claim the deduction even if they do not itemize their deductions.

Note. By October 2, 2025, the IRS must publish a list of occupations that “customarily and regularly” received tips on or before December 31, 2024.

Note. A specified service trade or business (SSTB) as defined under IRC §199A(d)(2) is ineligible to take the qualified tips deduction.

Qualified tips are voluntary cash or charged tips received from customers or through tip sharing. Tips cannot be mandatory or required, such as automatically applied tips to large groups. Qualified tips are reported on a Form W-2, *Wage and Tax Statement*, Form 1099-MISC, *Miscellaneous Information*, Form 1099-NEC, *Nonemployee Compensation*, or other specified statements provided to the taxpayer. Taxpayers can also directly report their qualified tips on Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*.

⁴¹ *One Big Beautiful Bill Act*, PL 119-21, §70201; *One Big Beautiful Bill Act: Tax Deductions for working Americans and Seniors*. Jul. 14, 2025. IRS. [www.irs.gov/newsroom/one-big-beautiful-bill-act-tax-deductions-for-working-americans-and-seniors] Accessed on Jul. 17, 2025.

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To be eligible for the deduction, a taxpayer **must** include their SSN on the return. The deduction is not available to married taxpayers filing separately. The deduction phases out if the taxpayer's MAGI exceeds:

- \$150,000 for individuals, or
- \$300,000 for MFJ.

The deduction is reduced by \$100 for every \$1,000 over the threshold, but **not** below zero.

Note. The qualified tips provision does **not** affect a taxpayer's withholdings, including social security and Medicare. This provision only potentially reduces the federal tax on Form 1040, *U.S. Individual Income Tax Return*.

Example 7. Phil, a single filer, is a waiter at a restaurant. His MAGI is \$45,000, and his reported tips on Form W-2 wages are \$18,000. Phil is below the \$150,000 threshold for individuals and qualifies to take the qualified tips deduction. Because the maximum deduction allowed is \$25,000, Phil can deduct his entire \$18,000 in reported tips. His MAGI is now \$27,000.

Example 8. Caden and Minny are a married couple filing jointly. Minny is a self-employed hairdresser, and Caden earns wages reported on a Form W-2. Minny has business income of \$32,000 before taking the qualified tips deduction. Minny's reported tips are \$15,000, and combined, Caden and Minny's MAGI is \$310,000. They are over the \$300,000 MFJ threshold by \$10,000 and must adjust their qualified tips deduction.

Amount of tip income		\$15,000
Amount of MAGI exceeding \$300,000	\$10,000	
	$\div 1,000$	
Number of \$1,000 increments over threshold	10	
\$100 reduction per \$1,000 of overage	$\times 100$	
Total reduction in tips deduction	\$ 1,000	(1,000)
Deduction claimed		\$14,000

Minny's deduction is also limited to her net business income. Because her business income is \$32,000, she can claim the full \$14,000 deduction.



Practitioner Planning Tip

Practitioners should reach out to their self-employed clients in industries where tips are typically received to recommend their bookkeeping allocate their income between tips and other income. Service industries that typically involve tips include food and beverage, hospitality, beauty salons, ride share, and food delivery.

Caution. If the taxpayer is self-employed and qualifies for QBI, §199A(c)(4) is amended to disallow amounts used towards the qualified tips deduction. Any amount over the maximum deduction of \$25,000 that is not used towards the qualified tips deduction can be used towards QBI.

QUALIFIED OVERTIME DEDUCTION⁴²

The OBBBA enacts a new deduction for qualified overtime, sometimes referred to as “no tax on overtime,” effective from 2025 through 2028. This applies **retroactively** to tax years beginning after December 31, 2024. This provision applies to overtime compensation received that **exceeds** the employee’s regular rate of pay, such as the additional 50% if being paid time-and-a-half, or the additional 100% if being paid double-time, etc. The overtime must be required by law and separately stated or determinable. The deduction is not available for voluntary or discretionary bonus pay. Overtime compensation is required by the **Fair Labor Standards Act (FLSA)** and is reported on Form W-2, Form 1099, or other specified statements furnished to the employee. Taxpayers can claim the deduction even if they do not itemize their deductions.

Note. The IRS has announced that it is planning on further clarification for determining how to distinguish FLSA overtime versus other overtime.⁴³ Certain overtime typically paid may not qualify for the overtime deduction; examples could include state-required overtime provisions, collective bargaining agreements, or agricultural employees. In these circumstances, they **do not** comply with FLSA thus will not qualify for the overtime deduction.

The annual **maximum** deduction for qualified overtime is:

- \$12,500 for individuals, and
- \$25,000 for joint filers.

The deduction starts to **phase out** for taxpayers with a MAGI of:

- \$150,000 for individuals, and
- \$300,000 for joint filers.

The deduction is reduced by \$100 for every \$1,000 over the threshold, but **not** below zero.

To be eligible for the deduction, a taxpayer **must** include their SSN on the return. The deduction is not available to married taxpayers filing separately.

Example 9. Joshua is a single construction worker who earns \$50 per hour as his regular rate. He works 750 hours of overtime during the year, for which he is paid time-and-a-half (i.e., \$75 per hour). The portion of his overtime pay that exceeds his regular rate is \$18,750 $((\$75 - \$50 \text{ per hour}) \times 750 \text{ hours})$ and qualifies for the qualified overtime deduction.

Joshua’s MAGI is \$160,250, which exceeds the individual threshold of \$150,000 by \$10,250. Therefore, his deduction is subject to the phase-out calculation.

Amount of overtime worked		\$18,750
Maximum no-tax-on-overtime deduction for Single status		\$12,500
Amount of MAGI exceeding \$150,000 threshold	\$10,250	
	$\div 1,000$	
Number of \$1,000 increments over threshold (rounded down)	10	
\$100 reduction per \$1,000 of overage	$\times 100$	
Total reduction in overtime deduction	\$ 1,000	(1,000)
Deduction claimed		\$11,500

Note. Although Joshua earned \$18,750 in qualifying overtime compensation, the deduction is capped at \$12,500 for single filers and is further reduced due to his income level.

⁴² *One Big Beautiful Bill Act*, PL 119-21, §70202; *One Big Beautiful Bill Act: Tax Deductions for working Americans and Seniors*. Jul. 14, 2025. IRS. [www.irs.gov/newsroom/one-big-beautiful-bill-act-tax-deductions-for-working-americans-and-seniors] Accessed on Jul. 17, 2025.

⁴³ *One Big Beautiful Bill Act: Tax deductions for working Americans and senior*. Jul. 25, 2025. IRS. [www.irs.gov/newsroom/one-big-beautiful-bill-act-tax-deductions-for-working-americans-and-seniors] Accessed on Jul. 30, 2025.

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Example 10. Marin and Katrina are a married couple filing jointly. Both earn overtime pay through their respective jobs, and the portion of their overtime compensation that exceeds their regular rate of pay (i.e., the amount required under the FLSA) is separately reported on their Forms W-2. The total qualifying overtime compensation for the year is \$30,000.

Their MAGI is \$250,000, which is below the \$300,000 threshold for joint filers. Therefore, they are eligible to claim the deduction.

However, the deduction is capped at \$25,000 for joint filers; therefore, Marin and Katrina can only deduct \$25,000 of the \$30,000 in qualifying overtime compensation.

The remaining \$5,000 in qualifying overtime compensation cannot be deducted under this provision. The deduction is available even if Marin and Katrina do not itemize their deductions.

Note. Employers and other payors are required to file information returns with the IRS (or the Social Security Administration) and furnish statements to taxpayers showing the total amount of qualified overtime compensation paid during the year.

CAR LOAN INTEREST DEDUCTION⁴⁴

The OBBBA enacts a new deduction for personal use car loan interest, effective from 2025 through 2028. This applies **retroactively** to tax years beginning after December 31, 2024. It allows taxpayers to deduct up to **\$10,000 per year** in interest paid on a qualified car loan under §163(h)(4). The loan must be used to purchase a qualifying passenger vehicle, must be the **first lien** taken out, and must have originated **after December 31, 2024**. A refinanced loan is eligible only if the refinance amount does not exceed the original loan principal. Taxpayers must include the vehicle identification number (VIN) on their return to claim the deduction.

A qualified vehicle's original use must commence with the taxpayer (**used vehicles do not qualify**⁴⁵). The vehicles include cars, minivans, vans, sports utility vehicles (SUVs), pickup trucks, and motorcycles with at least two wheels. Additionally, the vehicles must have gross vehicle weight rating of less than 14,000 pounds and be classified as a motor vehicle under the Clean Air Act.

Final assembly must occur in the United States. The location of final assembly is typically listed on the vehicle information label attached to each vehicle while it is on a dealership lot. Alternatively, taxpayers may rely on the VIN to identify the manufacturing plant where the vehicle was assembled.⁴⁶

Note. The National Highway Traffic Safety Administration provides a VIN decoder tool that includes the plant of manufacture.⁴⁷ Taxpayers can use this tool by entering the VIN and following the on-screen instructions to verify whether the vehicle was assembled in the United States. This can be accessed at nhtsa.gov/vin-decoder.

⁴⁴ *One Big Beautiful Bill Act*, PL 119-21, §70203.

⁴⁵ *One Big Beautiful Bill Act: Tax deductions for working Americans and seniors*. Jul. 25, 2025. IRS. [www.irs.gov/newsroom/one-big-beautiful-bill-act-tax-deductions-for-working-americans-and-seniors] Accessed on Jul. 25, 2025.

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

The car loan interest deduction has the following limitations.

- Deduction limit is up to \$10,000 per year in interest paid on a qualifying auto loan.
- Interest on loans for fleet sales, commercial-use vehicles, leased vehicles, salvage-title vehicles, or vehicles intended for scrap or parts is **not** deductible. (However, interest on such loans may be deductible under other provisions, such as trade or business expenses.⁴⁸)
- Interest on loans from related parties as defined under IRC §§267(b) or 707(b)(1) are **not** eligible for the deduction.

The deduction also phases out at certain income limits.

- MAGI over \$100,000 for individuals
- MAGI over \$200,000 for MFJ

The deduction is reduced by \$200 for every \$1,000 (or part thereof) over the thresholds.

Note. This deduction is an above-the-line deduction, which means it reduces AGI and is available regardless of whether the taxpayer itemizes.

Example 11. Alicia is a single taxpayer who purchased a new U.S.-assembled SUV in 2025 for her personal use. She took out a qualifying auto loan (first lien, originated after December 31, 2024) and paid \$9,200 in interest during the year. She includes the VIN on her tax return.

Alicia's MAGI for 2025 is \$106,500. Because her MAGI exceeds the threshold for single filers of \$100,000 by \$6,500, her deduction is reduced by \$200 for every \$1,000 (or part thereof) over the threshold. To calculate the reduction, Alicia takes her \$6,500 excess, divides it by \$1,000, and rounds up to 7. She then multiplies the 7 by \$200 to calculate the \$1,400 phase-out reduction.

Alicia's final deduction is \$7,800 (\$9,200 qualifying interest – \$1,400 phase-out reduction).

TRUMP ACCOUNTS⁴⁹

The OBBBA introduces a pilot program for a new class of tax-advantaged individual retirement accounts (IRAs) as defined in IRC §408(a) known as **Trump accounts**. These accounts aim to promote long-term financial independence by encouraging tax-free savings for individuals who have not reached the age of 18 before the end of the calendar year. A parent or guardian can typically elect to establish the accounts.

Beginning in tax year **2025**, Trump accounts include the following features.

- No contributions will be accepted until **after July 4, 2026** (twelve months after the enactment of the OBBBA).
- Must be designated as a Trump account at the time of election.
- For an individual to qualify for an account, they must meet the following criteria.
 - ♦ Has **not attained the age of 18** before the close of the calendar year
 - ♦ Has an SSN issued before the election
 - ♦ Has not made a prior election

⁴⁸ IRC §162.

⁴⁹ *One Big Beautiful Bill Act*, PL 119-21, §70204.

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- The election is made by a person other than the Secretary, typically a parent or guardian, for the establishment of a Trump account if no prior election has been made for the individual.

Note. The phrase “by any person other than the Secretary” refers to the Secretary of the Treasury, which in practice means the IRS. This language seems to be a statutory safeguard to ensure that the election to establish a Trump account is made by a private individual — typically a parent or guardian — not by the government. It prevents the IRS from automatically enrolling individuals or making the election on someone’s behalf, reinforcing that the account must be intentionally established by someone acting in the interest of the child.

- A one-time government-funded deposit of \$1,000 will be made into Trump accounts for qualifying children born after December 31, 2024, and before January 1, 2029.
- Contributions up to \$5,000 per year can be made to a Trump account; however, they can only be made during the years **before the beneficiary reaches** the age of 18.
- These contributions are not deductible on the taxpayer’s return.
- Beginning in 2028, the annual contribution limit will be adjusted for inflation based on a cost-of-living index.
- Trump accounts are classified as a new type of IRA. However, the accounts are neither traditional nor Roth IRAs.
- The accounts are fully portable between financial institutions.

Contributions to these accounts are made using **after-tax dollars** and once inside the account, **earnings grow tax-free**, allowing for compounding growth without annual tax consequences.

An employee’s gross income does not include amounts paid by the employer as a contribution to the Trump account of the employee or their dependent. The annual limit of these contributions will not exceed \$2,500, indexed for inflation after 2027. A Trump account contribution program is a separate written plan of an employer for the exclusive benefit of his employees. As such, it may be subject to additional rules for employer plans.

Note. The contribution made by the employer is a deductible business expense. Using this employer contribution plan results in a tax saving benefit for these Trump account contributions.

Withdrawals from Trump accounts are **generally not permitted** until the beneficiary reaches age 18. Once the beneficiary turns 18, the account is treated similarly to a traditional IRA regarding withdrawals and taxes. The IRS is expected to provide additional guidance on any applicable early withdrawal penalties.

Withdrawals are **tax-free** when used for specific, qualified purposes. These include the following.

- **First-time home purchases**, with a lifetime withdrawal limit of **\$50,000**.
- **Education expenses**, such as tuition, fees, and related costs.
- **Retirement**, beginning at age **60 or older**.
- **Adoption or childbirth expenses**, up to **\$5,000** per qualifying event.
- **Qualified emergency expenses**, up to **\$2,500 per year**.

Withdrawals that do not meet these criteria may be subject to income tax and penalties, similar to other IRA structures.

Example 12. In 2026, Maria opens a Trump account for her daughter, Ava, who was born in 2025 and received the \$1,000 government-funded deposit. Over the next 15 years, Maria contributes \$5,000 annually to Ava's account. In 2043, at age 18, Ava withdraws \$30,000 from the account to help pay for college tuition. Because the withdrawal is for qualified education expenses, it is tax-free.

Example 13. Eric was born in 2026, and his parents established a Trump account for him in 2027, including the one-time \$1,000 government-funded deposit. Over the years, his parents contributed regularly to the account.

In 2045, at age 19, Eric faces unexpected emergency medical bills and withdraws \$2,000 from his Trump account to cover the costs. Because the withdrawal is for a qualified emergency expense and falls within the \$2,500 annual limit, it is tax-free.

Example 14. In 2035, Jeremy is 22 years old and has a Trump account that was established for him by his parents when he was a child. He decides to withdraw \$4,000 from the account to take a vacation abroad. Because the withdrawal is not for a qualified purpose, it is considered non-qualified.

As a result, the earnings portion of the withdrawal is **subject to federal income tax**. Additionally, an **early withdrawal penalty on the earnings** may also apply, unless an exception is met.

Note. Jeremy can still make qualified withdrawals in the future, but non-qualified withdrawals reduce the long-term tax benefits of the account.

ENHANCEMENT OF THE ADOPTION CREDIT⁵⁰

The adoption credit, established under IRC §23, provides a nonrefundable tax credit for qualified adoption expenses incurred during the legal adoption of an eligible child. Taxpayers may also exclude from income certain employer-provided adoption assistance under a qualified adoption assistance program. The credit and exclusion are subject to income-based phase-outs and other eligibility rules.⁵¹

To qualify, the adopted child must be under the age of 18, unless they are physically or mentally incapable of self-care. Qualified adoption expenses are reasonable and necessary expenses paid to adopt a child, including the following.

- Adoption fees
- Attorney and court costs
- Travel expenses, including meals and lodging
- Home study fees and other expenses directly related

Expenses which **do not qualify** include the following.

- Paid to adopt a spouse's child
- Related to a surrogate parenting arrangement
- Already used for another federal tax benefit
- Reimbursed by an employer or covered by another federal, state, or local program

⁵⁰ Ibid., §70402.

⁵¹ See IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*, and instructions to Form 8839, *Qualified Adoption Expenses*.

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Key Changes Effective for 2025 and Beyond

Beginning in 2025, the adoption credit will have the following changes.

- **Partial refundability.** Up to **\$5,000 per child** is refundable, even if no tax is owed.
- **Increased maximum credit.** The total credit increases to **\$17,280** for 2025.⁵² The refundable portion is indexed separately for inflation beginning in 2026, using 2024 as the base year.
- **Carryforward rules.** Only the **non-refundable portion** of the credit may be carried forward for up to five years. The refundable portion must be used in the year claimed.
- **Phase-out thresholds.** The same MAGI-based phase-out thresholds apply to both the refundable and non-refundable portions.
- **Special-needs determinations.** Federally recognized Indian tribal governments are authorized to determine whether a child qualifies as having special needs, ensuring parity for tribal adoptions.⁵³

Example 15. Trina and Max, a married couple, finalize an adoption of a child in 2025. Their MAGI is \$120,000, and they incur \$17,280 in qualified adoption expenses. Their pre-credit tax liability is \$2,000.

Trina and Max receive the \$5,000 refundable portion of the credit as a refund. The \$2,000 non-refundable portion offsets their tax liability. The remaining \$10,280 of non-refundable credit is carried forward and may be used in future years through 2030.

DEPENDENT CARE ASSISTANCE PROGRAM⁵⁴

The Dependent Care Assistance Program (DCAP), also known as a Dependent Care Flexible Spending Account (DCFSA), is an employer-sponsored benefit that allows employees to contribute pre-tax dollars towards eligible dependent care expenses. Eligible dependents are children under 13, and spouses or older individuals who are physically or mentally incapable of self-care and who live with the employee for more than half the year.

Beginning in **2026**, the annual contribution limits for DCAP will increase from \$5,000 per household (\$2,500 for MFS) to \$7,500 per household (\$3,750 for MFS).

CHILD AND DEPENDENT CARE CREDIT⁵⁵

The OBBBA includes enhancements to the child and dependent care credit (CDCC) under IRC §21. This nonrefundable credit helps offset qualifying childcare and dependent care expenses for taxpayers who maintain a household and work or look for work. To claim the CDCC, the taxpayer must have a **qualifying person**. A qualifying person is one of the following.⁵⁶

- A dependent under age 13 when the care is provided
- A spouse who is physically or mentally incapable of self-care and lives with the taxpayer for more than half the year
- Another individual who is physically or mentally incapable of self-care, lives with the taxpayer for more than half the year, and either:
 - ♦ Is the taxpayer's dependent, or
 - ♦ Would have been the taxpayer's dependent except for certain exceptions (e.g., income threshold, joint return filing, or being claimed by another taxpayer)

⁵² Rev. Proc. 2024-40, 2024-45 IRB 1100.

⁵³ *One Big Beautiful Act*, PL 119-21, §70403.

⁵⁴ *Ibid.*, §70404.

⁵⁵ *Ibid.*, §70405.

⁵⁶ *Child and Dependent Care Credit FAQs*. May 29, 2025. IRS. [www.irs.gov/newsroom/child-and-dependent-care-credit-faqs] Accessed on Jul. 9, 2025.

The maximum CDCC a taxpayer can claim is \$1,500 for one qualifying person and \$3,000 for two or more qualifying persons. The maximum credit amount will remain unchanged. The maximum amount of qualifying expenses remains unchanged at \$3,000 for one and \$6,000 for two or more.

The credit is calculated by applying an **applicable percentage** to these expenses. This percentage determines how much of the eligible expenses can be claimed as a credit. For example, if the applicable percentage is 35%, a taxpayer with \$6,000 in qualifying expenses for two or more qualifying persons could claim a \$2,100 ($\$6,000 \times 35\%$) credit.

Beginning in **2026**, the CDCC will undergo the following permanent changes.

- Increases the maximum applicable percentage from 35% to **50%**.
- Creates a **2-tier phase-out** structure based on AGI.
 - ♦ **Tier 1.** For AGI up to \$15,000, the full 50% applies. The percentage is reduced by one point for every \$2,000 over that amount, but not below 35%.
 - ♦ **Tier 2.** For AGI over \$75,000 (\$150,000 MFJ), the percentage is further reduced by one percentage point for each \$2,000 (\$4,000 MFJ) over the threshold, but not below 20%.

Note. The prior law did not have two tiers and had a maximum credit of 35% with a single phase-out reducing the percentage to 20%.

TAX CREDIT FOR CONTRIBUTIONS TO SCHOLARSHIP-GRANTING ORGANIZATIONS⁵⁷

The OBBBA encourages contributions to organizations that grant scholarships to students attending elementary and secondary schools. It creates IRC §25F that establishes a nonrefundable tax credit for individuals who make **cash** contributions to a scholarship-granting organization (SGO) that provides financial assistance for qualified K–12 education expenses.

This provision is designed to expand access to private and alternative education options by incentivizing charitable giving to educational nonprofits. The newly created IRC §139K provides that the receipt of a K–12 scholarship does not create taxable income for the student or their family.

Beginning in tax year **2027**, the K-12 scholarships exclusion allows for the following.

- **Credit amount.** A nonrefundable credit of up to \$1,700 per year is available for cash contributions made by individuals to eligible SGOs. Any credit available on a state income tax return reduces the \$1,700 limit dollar-for-dollar.
- **Eligible students.** A qualifying student is eligible to enroll in a public elementary or secondary school and reside in a household with an income at or below 300% of the area’s median income, as defined for the low-income housing tax credit (LIHTC).⁵⁸
- **Qualified expenses.**⁵⁹ Scholarships must be used for tuition, fees, academic tutoring, books, supplies, or equipment required for enrollment or attendance at a qualified K–12 school, including public, private, and religious institutions.
- **Carryforward.** Unused credit amounts may be carried forward for up to five years.⁶⁰
- **Limitations.** The credit is not available for contributions made to organizations that restrict scholarships based on the donor’s direction or benefit.

⁵⁷ *One Big Beautiful Bill Act*, PL 119-21, §70411.

⁵⁸ IRC §42(d)(5)(B)(ii)(I).

⁵⁹ IRC §530(b)(3)(A).

⁶⁰ IRC §25F(f).

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Example 16. Living in a state with no income tax, Stephen donates \$1,500 in 2027 to a qualified nonprofit that provides scholarships to low-income students attending private elementary schools. He makes this contribution shortly after his state elects to participate in the program. He claims a \$1,500 nonrefundable credit on his federal return.

Example 17. In 2027, Madelyn donates \$2,000 to a qualifying SGO. Her state allows a 5% credit against taxpayers' state income tax obligations for cash contributions to SGOs in that year. Her federal credit is limited to \$1,600 (\$1,700 maximum credit – 5% × \$2,000).

EXPANDED QUALIFIED EXPENSES FOR §529 PLANS⁶¹

The OBBBA expands the definition of qualified higher education expenses under §529 to include a broader range of K–12 education and postsecondary credentialing expenses. These changes apply to distributions made after July 4, 2025, and preserve the tax-free treatment of §529 plan withdrawals when used for approved purposes.

A §529 plan is a tax-advantaged savings plan designed to encourage saving for future education costs. Earnings in a §529 account grow tax-free, and withdrawals are tax-free when used for qualified education expenses under §529(e)(3).

Prior to the OBBBA, only up to \$10,000 per year in **K–12 tuition** was allowed. The new law **expands both the types of expenses and the annual cap to \$20,000 for tax years beginning after December 31, 2025.**

Key Provisions Effective for 2025 and Beyond

Beginning July 4, 2025, the OBBBA expands qualifying §529 plan distributions to now include K–12 qualified expenses (not just tuition). Up to \$20,000 per year per beneficiary may be used for the following.

- Tuition at public, private, or religious schools
- Books, curriculum, and instructional materials
- Online educational content
- Tutoring and supplemental classes (must be provided by a non-relative who is a licensed teacher, experienced educator, or subject matter expert)
- Testing fees and dual enrollment costs
- Educational therapies for students with disabilities (e.g., occupational, behavioral, physical, and speech-language therapies provided by licensed or accredited professionals)

The OBBBA also expands qualifying §529 plan distributions to postsecondary expenses. Up to \$20,000 per year per beneficiary may be used for the following.

- Tuition, fees, and materials for approved training programs. Approved training programs must:
 - ♦ Be on the state-approved list through the Workforce Innovation and Opportunity Act.
 - ♦ Be listed in the Veterans Benefits Administration Web Enabled Approval Management System directory.
- Testing fees for credential or licensed exams provided:
 - ♦ The exam is administered by a recognized credentialing organization
 - ♦ The program is certified by the Treasury or Labor Department

⁶¹ *One Big Beautiful Bill Act*, PL 119-21, §70413.

- Credentialing types include:
 - ♦ Industry-recognized certificates or licenses
 - ♦ Apprenticeship completion certificates
 - ♦ Occupational or professional licenses
 - ♦ Credentials recognized under the Workforce Innovation and Opportunity Act

Note. Distributions used for these expanded purposes remain excluded from gross income, preserving the tax-free growth and withdrawal benefits of §529 plans.

CHARITABLE CONTRIBUTIONS: NON-ITEMIZER DEDUCTION AND AGI FLOORS⁶²

The OBBBA makes significant changes to the rules governing charitable cash contribution deductions for individuals. For the first time since the temporary Coronavirus Aid, Relief, and Economic Security Act (CARES) Act provisions,⁶³ **non-itemizers** are granted a permanent above-the-line deduction for certain charitable contributions. At the same time, **itemizers** face a new limitation: a 0.5% of AGI floor that must be exceeded before any charitable contributions become deductible. These provisions are effective for tax years beginning after December 31, 2025.

Under IRC §170, individuals may deduct charitable contributions made to qualified organizations, subject to the following general rules.

- **Itemization required.** Prior to the OBBBA, charitable contributions were deductible only if the taxpayer itemized deductions on Schedule A (Form 1040), *Itemized Deductions*.
- **Contribution type and limits.**
 - ♦ **Cash contributions** to public charities were generally limited to 60% of AGI.
 - ♦ **Non-cash contributions** (e.g., property) had lower limits, typically 30% or 20% of AGI, depending on the recipient organization and type of property.
- **Carryforward.** Contributions exceeding the annual limit could be carried forward for up to five years.
- **Qualified organizations.** Contributions must be made to qualified organizations, such as IRC §501(c)(3) public charities. Contributions to private foundations, donor-advised funds, or political organizations are generally not deductible.
- **Documentation requirements.**
 - ♦ Contributions of \$250 or more require a written acknowledgment from the charity.
 - ♦ Non-cash contributions may require appraisals or Form 8283, *Noncash Charitable Contributions*.

⁶² Ibid., §§70424 and 70425.

⁶³ *Coronavirus Aid, Relief, and Economic Security Act*, PL 116-136, §2204.

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Key Changes Effective for 2026 and Beyond

Beginning in tax year **2026**, the charitable contributions deduction has the following changes.

- **Above-the-line deduction for non-itemizers.** Taxpayers who do not itemize can claim a permanent above-the-line deduction for cash contributions to qualified public charities (excluding donor-advised funds and private foundations), subject to the following limits.
 - ♦ \$2,000 for MFJ filers
 - ♦ \$1,000 for all other filers
 - ♦ Only current-year contributions are eligible
- **0.5% AGI floor for itemizers.** Taxpayers who elect to itemize must now meet a 0.5% of AGI floor before they can deduct charitable contributions. The following rules apply.
 - ♦ Only the portion of contributions exceeding 0.5% of their AGI is deductible.
 - ♦ The 60% of AGI limit for cash contributions is made permanent.
 - ♦ Carryforward of excess contributions is allowed for up to five years.
 - ♦ Contributions are applied in a specific order, with cash contributions applied last, increasing the likelihood of carryforward.

Note. This is similar to the floor for the medical expense deduction on Schedule A.

Example 18. Wanda, a single taxpayer, donates \$800 in cash to a qualified charity in 2026. She does not itemize her deductions and therefore is entitled to deduct up to \$1,000. She is limited to a \$800 above-the-line deduction.

Caution. If Wanda had made the donation in 2025, she would have no deduction because she does not itemize.

Example 19. In 2026, Carlos has an AGI of \$100,000 and donates \$400 in cash to a qualified §501(c)(3) charity. He makes no other charitable contributions during the year and has no carryforwards of past contributions. His 0.5% of AGI floor is \$500, which is greater than his donation. Even though Carlos elects to itemize his deductions, he has no charitable deduction.

Note. The rules for contributions made by C corporations have also changed. These changes are covered later in this chapter.

SUNSETTING OF THE GREEN ENERGY CREDITS⁶⁴

The Inflation Reduction Act of 2022 enhanced green energy tax credits for individuals investing in renewable energy technologies. These credits were available to taxpayers who invested in renewable energy for their homes such as solar, wind, geothermal, fuel cells, or battery storage technology. These credits also included clean vehicle credits and energy efficiency credits for residential and commercial buildings.

⁶⁴ *One Big Beautiful Bill Act*, PL 119-21, §§70501-70515.

The OBBBA repeals or phases out many of these credits beginning in late 2025.

- **After September 30, 2025**
 - ♦ Clean vehicle credit⁶⁵
 - ♦ Previously owned clean vehicle credit⁶⁶
 - ♦ Qualified commercial clean vehicles credit⁶⁷
- **After December 31, 2025**
 - ♦ Energy-efficient home improvement credit⁶⁸
 - ♦ Residential clean energy credit (e.g., solar panels, geothermal, battery storage)⁶⁹
- **After June 30, 2026**
 - ♦ Alternative fuel vehicle refueling property credit⁷⁰
 - ♦ Energy-efficient commercial building deduction⁷¹
 - ♦ New energy-efficient home credit⁷²
- **Leased property provisions**
 - ♦ The clean electricity credit for leased residential property is repealed for taxable years beginning after 2025.⁷³

SSN REQUIREMENT FOR EDUCATION TAX CREDITS⁷⁴

Beginning in 2026, a student must have a valid SSN issued by the due date of the return (including extensions) to claim the American opportunity tax credit (AOTC) or the lifetime learning credit. This provision aligns the education credits with existing SSN requirements for the CTC and earned income tax credit.⁷⁵

Beginning in **2026**, the SSN requirement for AOTC and lifetime learning credits is as follows.

- The student for whom the credit is claimed must have a valid SSN issued by the return due date (including extensions). This applies **per student**, not per taxpayer.
- Students with only an individual taxpayer identification number (ITIN), adoption taxpayer identification number, or other temporary identification **do not** qualify.
- For the AOTC, the taxpayer **must** also include the employer identification number (EIN) of the educational institution. The EIN is usually located on the student's Form 1098-T, *Tuition Statement*.
- If the student receives an SSN after the return due date, the taxpayer cannot amend the return to claim the credit retroactively.

⁶⁵. IRC §30D.

⁶⁶. IRC §25E.

⁶⁷. IRC §45W.

⁶⁸. IRC §25C.

⁶⁹. IRC §25D.

⁷⁰. IRC §30C.

⁷¹. IRC §179D.

⁷². IRC §45L.

⁷³. IRC §§45Y and 48E.

⁷⁴. *One Big Beautiful Bill Act*, PL 119-21, §70606.

⁷⁵. IRC §§25A(i)(6) and (g)(9).



Practitioner Planning Tip

Practitioners should advise clients to apply for SSNs as early as possible to preserve eligibility.

Example 20. In 2027, Carl attempts to claim the lifetime learning credit for his daughter Katie, who is attending a qualifying institution. Katie does not have an SSN, but instead has an ITIN. Carl is **not eligible** to claim the credit for her.

INCLUDING BRONZE AND CATASTROPHIC PLANS WITH HEALTH SAVINGS ACCOUNTS⁷⁶

The OBBBA expands the scope of health insurance plans that can be treated as a high-deductible health plans (HDHP) for the purpose of health savings accounts (HSAs). An HSA is a tax-advantaged savings account designed to help individuals with HDHPs save and pay for qualified medical expenses. HSAs are beneficial because the contributions are tax-deductible, earnings grow tax-free, and qualified withdrawals for medical expenses are excluded from taxable income.

Bronze-level health insurance plans are established under the Affordable Care Act (ACA) to categorize Marketplace health insurance options.⁷⁷ Bronze plans are designed to cover approximately 60% of total healthcare costs, while the enrollee pays the remaining 40% through deductibles, copayments, and coinsurance. These plans typically have lower monthly premiums, making them attractive to individuals who want basic coverage and expect to use minimal healthcare service. Bronze plans usually come with high deductibles, meaning individuals pay more out-of-pocket before insurance starts covering costs. Additionally, there are annual limits on what expenses individuals can pay out-of-pocket for in-network care.⁷⁸

A **catastrophic** health insurance plan is a type of coverage available through the ACA that is designed to protect individuals from very high medical costs in worst-case scenarios.⁷⁹ Catastrophic plans are available to individuals under age 30 and also those who qualify for a hardship or affordability exemption, meaning they cannot afford other ACA-compliant plans. These plans typically have low monthly premiums and very high deductibles. Individuals pay all medical costs out-of-pocket until they meet the deductible, except for certain preventive service.⁸⁰

⁷⁶ *One Big Beautiful Bill Act*, PL 119-21, §71307.

⁷⁷ *Patient Protection and Affordable Care Act*, PL 111-148, §1302(d)(1)(A).

⁷⁸ *Understanding Bronze Plan Health Insurance*. Anthem. [www.anthem.com/individual-and-family/insurance-basics/health-insurance/what-is-a-bronze-health-plan] Accessed on Jul. 25, 2025.

⁷⁹ As defined in the *Patient Protection and Affordable Care Act*, PL 111-148, §1302(e); IRC §§5000A(e)(1) and (5).

⁸⁰ *Catastrophic Health Insurance: What Is It And How Does It Work?* Masterson, Les. Jun. 17, 2024. Forbes. [www.forbes.com/advisor/health-insurance/catastrophic-health-insurance] Accessed on Jul. 25, 2025; *How to pick a health insurance plan*. HealthCare.gov. [www.healthcare.gov/choose-a-plan/catastrophic-health-plans] Accessed on Jul. 25, 2025.

Key Changes Effective for 2026 and Beyond

Starting in **2026**, more individuals will be eligible to open and contribute to HSAs due to expanded definitions of what qualifies as an HDHP.

- **Bronze-level health insurance plans qualify for HSAs.** Effective for months beginning on or after January 1, 2026, all Bronze-level plans offered through the ACA Marketplace will be treated as HDHPs for HSA purposes.

Note. Individuals enrolled in Bronze plans can now open HSAs, even if the plan did not previously meet the IRS's HDHP criteria. This change broadens access to HSAs and their triple tax advantages: tax-deductible contributions, tax-free growth, and tax-free withdrawals for qualified medical expenses.

- **Catastrophic health insurance plans also qualify for HSAs.** Individuals under 30 who are eligible to purchase catastrophic health insurance but not a qualified comprehensive health insurance plan may open an HSA. Recognizing them as HDHPs allows more low-income or young individuals to benefit from HSA tax savings.

PROVISIONS IMPACTING BUSINESS ENTITIES

The OBBBA introduces a series of reforms and incentives aimed at enhancing business investment, simplifying compliance, and promoting domestic economic growth. These provisions affect taxation of income from corporations, partnerships, and other business entities, and are generally effective for tax years beginning in 2025 unless otherwise specified.

EXTENSION OF THE DEDUCTION FOR QUALIFIED BUSINESS INCOME⁸¹

The OBBBA makes the QBID under §199A permanent beginning in **2026**. Originally enacted by TCJA⁸², QBID allows eligible taxpayers, including sole proprietors, partnerships, S corporations, and certain trusts, to deduct up to 20% of their QBI from domestic businesses.

Phase-in thresholds determine when certain limitations begin to apply to the QBID. Taxpayers **below the threshold** can generally claim the **full 20% QBID** without limitation. Taxpayers **within the phase-in range** may have their QBID **partially limited** based on a formula that gradually applies the Form W-2 wage and unadjusted basis immediately after acquisition (UBIA) tests. The limitation for taxpayers above the phase-in range depends on whether the taxpayer is an SSTB. For SSTBs, the QBID is completely disallowed. For non-SSTBs, the deduction is limited to the greater of 50% of the Form W-2 wages paid by the business or 25% of the Form W-2 wages, plus 2.5% of UBIA of qualified property.⁸³

Beginning in **2026**, the QBID is made permanent and will undergo the following changes.

- **Expanded phase-in thresholds.** The OBBBA increases the **phase-in ranges** that determine when income-based limitations begin to apply to the QBID.
 - ♦ **MFJ.** Increased from \$100,000 to \$150,000
 - ♦ **Single filers.** Increased from \$50,000 to \$75,000
- **New minimum deduction for active businesses.** A new minimum QBID of \$400 (indexed for inflation beginning in **2027**) is added for qualifying taxpayers that meet the following criteria.
 - ♦ **Must** have at least \$1,000 in business income
 - ♦ Business must be an **active business that the taxpayer participates in**, as defined by IRC §469(h)

^{81.} *One Big Beautiful Bill Act*, PL 119-21, §70105.

^{82.} *Tax Cuts and Jobs Act*, PL 115-97.

^{83.} IRC §199A.

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Example 21. Linda is a single taxpayer who operates a small crafting business out of her home. She materially participates in the business, has no other income, and files a Schedule C (Form 1040), *Profit or Loss From Business (Sole Proprietorship)*, with her individual tax return. In 2025, Linda has a QBI of \$1,500 and receives a 20% deduction of \$300 ($\$1,500 \times 20\%$).

In 2026, assuming her QBI remains the same, Linda qualifies for the new minimum \$400 deduction, an increase of \$100 over 2025.

Note. For a more thorough discussion of QBI and calculating the QBID, see the 2018 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Legislation — Individual Concerns. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

QUALIFIED TRANSPORTATION FRINGE BENEFITS⁸⁴

Employer-provided transportation benefits under IRC §132(f) assist employees with the cost of commuting to and from work. These benefits may include pre-tax deductions for transit passes, parking, or ride-share arrangements.

Beginning in **2026**, the exclusion for **qualified bicycle commuting reimbursements** is **repealed**, meaning these benefits are no longer excludable from employee income. Employers may still offer bicycle-related reimbursements, but they must be treated as **taxable compensation**.

In addition to reinstating bicycle benefits in taxable compensation, the OBBBA updates the inflation indexing base year from 1998 to 1997 for consistency with other tax provisions. Furthermore, IRC §274 has been amended to completely disallow employer deductions for transportation fringe benefits.

RETURN OF FULL EXPENSING FOR CERTAIN BUSINESS PROPERTY⁸⁵

IRC §168(k) governs **bonus depreciation**, also known as **additional first-year depreciation**. It allows businesses to deduct a large portion, or all, of the cost of qualifying property in the year it is placed in service, rather than depreciating it over several years. To qualify for bonus depreciation under §168(k), property must meet the following criteria.

1. Be modified accelerated cost recovery system (MACRS) property with a recovery period of 20 years or less
2. Be acquired by purchase (not inherited or gifted)
3. Be new to the taxpayer
4. Not be acquired from a related party (as defined in §§267 and 707)

The TCJA expanded eligibility to **used property** if it was new to the taxpayer and not acquired from a related party. It also introduced a phase-out schedule where the percentage allowable decreased from 100% in 2022 down to 0% by 2027.⁸⁶

After January 19, 2025, businesses may once again deduct 100% of the cost of qualified property in the year it is placed in service. This includes **used property**, provided it is new to the taxpayer and **not acquired from a related party**.

Businesses can also elect for slower cost recovery, as the OBBBA allows for a transitional election for reduced expensing, 40% in the first year for most IRC §1231 property and 60% for long-production-period or transportation property.

^{84.} *One Big Beautiful Bill Act*, PL 119-21, §70112.

^{85.} *Ibid.*, §70301.

^{86.} *Tax Cuts and Jobs Act*, PL 115-97, §13201.

Key Changes Effective for 2025 and Beyond

For purchases after **January 19, 2025**, the OBBBA makes the following changes.

- **Permanent full expensing.** IRC §168(k)(2)(A) is amended to remove the phase-out schedule that was set to reduce bonus depreciation after 2023 and eliminate it by 2027. As a result, **100% expensing is now permanent** for qualified property.
- **Transitional election for reduced expenses.** Taxpayers may elect to apply reduced rates for property placed in service in the first **taxable year ending after January 19, 2025**.
 - ♦ 40% for most properties having a recovery period of 20 years or less
 - ♦ 60% for long-production-period property or certain transportation assets
- **Used property eligibility.** The OBBBA retains the language introduced by the TCJA allowing full expensing provisions for used property, provided that the property is new to a taxpayer, and they did not acquire it from a related person.
- **Special rule for certain fruit- and nut-bearing plants.** Full expensing applies to qualifying plants planted or grafted after **January 19, 2025**.

Note. Application of the new rule for full expensing is based on whichever came first: the date the taxpayer acquired the property or the date they signed a contract to acquire it. If either happened before January 20, 2025, it would **not** qualify for full expensing. For example, capital property would **not** qualify for 100% expensing if the taxpayer signed a contract to acquire the property before January 20, 2025, even if it was acquired after January 19, 2025.

FULL EXPENSING OF DOMESTIC RESEARCH AND EXPERIMENTAL EXPENDITURES⁸⁷

The OBBBA makes significant changes to the treatment of research and experimental (R&E) expenditures under the new IRC §174A.

R&E expenditures are those incurred by a trade or business that “represent research and development costs in the experimental or laboratory sense.”⁸⁸ To qualify for full expensing under §174A, the research or experimental activity must be conducted in the United States, Puerto Rico, or a U.S. possession.⁸⁹

The OBBBA introduces the new §174A and significantly revises the treatment of R&E expenditures. Key changes include the following.

- **Full expensing of domestic R&E.** Taxpayers may fully deduct qualified domestic R&E expenditures in the year they are paid or incurred, beginning with tax years starting after **December 31, 2024**.⁹⁰ Under TCJA, taxpayers were required to amortize these expenses over five years beginning in 2022.⁹¹
- **Capitalization election.** Taxpayers may elect to capitalize and amortize domestic R&E over a period of at least 60 months, beginning with the month in which benefits were first realized. This election must be made by the return due date and applies to future years unless revoked with IRS consent.

⁸⁷ *One Big Beautiful Bill Act*, PL 119-21, §70302, establishing IRC §174A.

⁸⁸ Treas. Reg. §1.174-2(a)(1).

⁸⁹ IRC §41(d)(4)(F), to which IRC §174A(b) refers.

⁹⁰ IRC §174A(a).

⁹¹ *Tax Cuts and Jobs Act*, PL 115-97, §13206(e).

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- **Retroactive relief for small businesses.** Small businesses that meet the gross receipts test under IRC §448(c) may retroactively apply full expensing to domestic R&E incurred in 2022, 2023, and 2024.⁹² Amended returns must be filed by July 6, 2026.
- **Software development expenditures included.** Expenditures for software development are explicitly included as eligible R&E under §174A and may be fully expensed if conducted domestically.
- **Catch-up deduction for all taxpayers.** All taxpayers may deduct unamortized pre-2025 domestic R&E in 2025, or elect to spread the deduction over two years (2025 and 2026).

Note. Foreign R&E expenditures are still capitalized. Capitalization and a 15-year amortization period still apply to expenditures undertaken outside the United States, Puerto Rico, or U.S. possessions, consistent with prior law.

MODIFICATIONS TO BUSINESS INTEREST DEDUCTIONS⁹³

Under §163(j), the deduction for business interest expense is generally limited to 30% of adjusted taxable income (ATI), plus business interest income and floor plan financing interest. However, businesses with average annual gross receipts under **\$31 million** (adjusted for inflation) over the prior three years are **exempt** from this limitation.

Historically, the definition of ATI has shifted. From 2018 to 2021, taxpayers could add back depreciation, amortization, and depletion to ATI. Starting in 2022, this addback was disallowed, effectively reducing the amount of deductible interest for many businesses.

The OBBBA introduces several changes to §163(j) that apply to tax years beginning on or after **January 1, 2025**, that may increase allowable business interest deductions, particularly for moderate-sized businesses.

- **Permanent addback for depreciation, amortization, and depletion.** The limitation under §163(j)(8)(A)(v) no longer excludes depreciation, amortization, and depletion for years after 2021. Some small businesses may decide to file amended returns for subsequent years that are still open.
- **Expanded floor plan financing.** Trailers and campers designed for recreational or seasonal use now qualify for floor plan financing interest, which is effectively excluded from the limitation.
- **Capitalized interest now included.** IRC §163(j) now applies to all business interest, whether currently deductible or capitalized under IRC §§263A(f) or 263(g). The amount of deductible interest allowed under §163(j) must first be applied to capitalized interest before being applied to currently deductible interest. Additionally, disallowed interest that is carried forward is no longer subject to capitalization rules.
- **Carryforward interest excluded from future capitalization.** Disallowed interest carried forward is not subject to future capitalization, even if it would have been capitalized in the year paid.
- **Foreign income exclusions.** The definition of ATI is modified to exclude foreign income inclusions, such as global intangible low-taxed income (GILTI)⁹⁴ and controlled foreign corporations (CFC) income,⁹⁵ aligning ATI more closely with domestic taxable income.

⁹² IRC §448(c) defines “small taxpayers,” thereby establishing an upper limit of \$31 million in average gross receipts over 2023-2025.

⁹³ *One Big Beautiful Bill Act*, PL 119-21, §§70303, 70341, and 70342.

⁹⁴ IRC §951A.

⁹⁵ IRC §§951-965.

PAID FAMILY AND MEDICAL LEAVE CREDIT⁹⁶

TCJA introduced the paid family and medical leave (PFML) credit as a tax incentive to employers who offer paid family and medical leave to qualifying employees. To qualify for the credit, the employer must have a written policy that provides for the following.⁹⁷

- At least two weeks of paid leave annually
- A minimum of 50% of the employee's regular wages
- The employee must have worked for the employer for at least one year (reduced to six months beginning in 2026)
- The employee's annual compensation **must not exceed** the threshold of \$93,000 for 2025 (adjusted annually for inflation)
- The leave must be taken for a qualifying reason outlined by the Family and Medical Leave Act, such as caring for a new child, a family member with a serious health condition, or the employee's own serious health condition

The credit is claimed using Form 8994, *Employer Credit for Paid Family and Medical Leave*, and Form 3800, *General Business Credit*. The credit is **non-refundable** but can be carried forward. Employers must reduce the employee compensation deduction by the amount of the credit.

The credit equals:

- 12.5% of wages paid for leave at 50% of regular pay,
- Up to 25% for leave paid at 100% of regular wages, and
- May also apply to PFML insurance premiums.

Key Changes Effective for 2025 and Beyond

Beginning in 2025, the PFML will undergo the following changes.

- For employers opting for the insurance-based credit method, the credit can be calculated based on the rates established in the insurance policy. Employers **may qualify** for the credit by making benefits available, **regardless** of whether employees take leave.
- Typically, entities linked under IRC §§414(b) or (c) are treated as one employer for PFML policy purposes. However, an employer may opt out if it can demonstrate a substantial and legitimate business reason, such as structuring employees according to their actual legal employer. Routine practices, such as grouping staff by job role, pay grade, or local jurisdictional requirements, do not qualify as valid grounds to bypass aggregation.
- Employers **must account** for state or local PFML benefits when setting the total leave available to employees, and those benefits do not count toward the tax credit. Only the leave expenses paid directly by the employer qualify for the credit, ensuring the tax advantage applies solely to employer-funded leave.
- Updated employee eligibility includes the following.
 - ♦ Minimum six months of service (down from one year)
 - ♦ Regularly works at least 20 hours per week (part-time prorated)
 - ♦ Earns no more than 60% of the highly compensated employee threshold⁹⁸
- Employers **may not** deduct the amounts used to compute the credit for PFML insurance premiums.

⁹⁶ *One Big Beautiful Bill Act*, PL 119-21, §70304.

⁹⁷ IRC §45S.

⁹⁸ IRC §414(q).

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BUSINESS MEAL DEDUCTION⁹⁹

The OBBBA introduces targeted changes to the business meals deduction, primarily affecting employer-provided meals in specific industries and locations. A business meal deduction allows a taxpayer to deduct a portion of qualifying meal expenses under §274. A taxpayer may claim a 50% deduction for qualifying business-meal costs, provided each of the following conditions on the meal is satisfied.¹⁰⁰

- **Ordinary and necessary; not lavish or extravagant.** The cost must be reasonable considering the facts and circumstances and meet the “ordinary and necessary” standard of IRC §162.
- **Taxpayer (or employee) presence.** The taxpayer, or an employee of the taxpayer, must be present when the food or beverages are furnished.
- **Business purpose.** The meal must be directly connected to, or associated with, the active conduct of the taxpayer’s trade or business (e.g., a substantive business discussion occurs during, immediately before, or immediately after the meal).
- **Provided to a business associate.** The food or beverages must be offered to a “business associate,” which is a term defined in Treas. Reg. §1.274-12(b)(3) to include current or prospective customers, clients, suppliers, employees, agents, partners, or professional advisers of the taxpayer.

When these criteria are met, 50% of the meal cost (including tax and reasonable tips) is deductible while the remainder is disallowed under §274(n)(1). Food and beverages provided at an entertainment activity must be separately purchased or stated on the invoice to be potentially deductible (subject to the 50% limit).

Certain meal expenses may be 100% deductible, such as when one of the following situations applies.¹⁰¹

- Meals treated as **taxable compensation** to employees
- Meals reimbursed by a third party under an **accountable plan**
- Recreational or social activities for the **benefit of employees**
- Meals **available to the public** to advertise or promote goodwill
- Meals sold to **customers**

Beginning in **2026**, the business meals deduction will be changed in the following ways.

- IRC §274(o) now permits deductions for meals that are **included in employee compensation** under §274(e)(8).
- **Meals provided on certain maritime vessels and remote fish-processing facilities** are now explicitly included in the 100% deduction category.
- Meals provided in employer-operated cafeterias or for the employer’s convenience **will no longer be deductible** after **December 31, 2025**, unless they fall under the new exceptions (e.g., vessels, oil rigs, remote camps).

⁹⁹. *One Big Beautiful Bill Act*, PL 119-21, §70305.

¹⁰⁰. IRS Notice 2018-76, 2018-42 IRB 667.

¹⁰¹. *Ibid.*

PERMANENT INCREASE IN IRC §179 EXPENSING LIMIT¹⁰²

The OBBBA permanently increases the limit of property that can be expensed under §179. Previously, taxpayers could deduct up to \$1 million, plus an inflation adjustment. For 2025, the inflation-adjusted amount was \$1.25 million.

For property placed in service on or after **January 1, 2025**, the OBBBA makes the following changes.

- The **maximum §179 deduction** is permanently increased to **\$2.5 million**, with annual cost-of-living adjustments based on IRC §1(f)(3).
- The **phase-out threshold** begins at **\$4 million** in 2025. This means:
 - ♦ If a business places more than \$4 million of §179 property in service during the year, the deduction is reduced dollar-for-dollar.
 - ♦ If more than **\$6.5 million** of §179 property is placed in service, **no §179 deduction is allowed**.
 - ♦ Both the deduction limit and phase-out threshold will be adjusted for inflation in future years.
- The OBBBA **does not change** the special rules for SUVs under §179. A separate limit applies to passenger vehicles weighing less than 14,000 pounds. For **2025**, the **SUV limit remains at \$31,300**, subject to inflation adjustments.

ENHANCEMENT OF THE ADVANCED MANUFACTURING INVESTMENT CREDIT¹⁰³

The OBBBA enhances the advanced manufacturing investment credit under IRC §48D. This credit supports investments in facilities that manufacture semiconductors or semiconductor manufacturing equipment.

The credit applies only to semiconductor manufacturing. The provisions of §48D permit its application only to property used in manufacturing, not to a building or a portion of a building that is used for “offices, administrative services,” or unrelated functions.¹⁰⁴

Key Changes Effective for 2025 and Beyond

Although an investment tax credit for semiconductor manufacturing equipment is already in place, it becomes more generous in 2026.

- **No change for 2025.** For property placed in service during 2025, the credit remains at 25% of qualified investment costs.
- **35% credit begins in 2026.** The 35% investment tax credit can be applied to property used in the manufacture of semiconductors that is placed in service on or after January 1, 2026. This enhancement applies only to qualified advanced manufacturing facilities, specifically those involved in the production of semiconductors or related equipment.

Note. Because of the long lead times generally needed to implement semiconductor manufacturing equipment, planning for these investments should begin immediately.¹⁰⁵

- **Scope of eligible property.** As under existing §48D rules, the credit applies only to **qualified tangible property** used in manufacturing. It **excludes** buildings or portions of buildings used for offices, administrative services, or other non-manufacturing functions.

¹⁰² *One Big Beautiful Bill Act*, PL 119-21, §70306.

¹⁰³ *Ibid.*, §70308.

¹⁰⁴ IRC §48D(2)(B)(ii).

¹⁰⁵ *Tooling up to the CHIPS Act: How to fast-track your new fab equipment ramp*. Hamling, Dan. Deloitte. [www.deloitte.com/us/en/Industries/tmt/articles/fabrication-equipment-ramp.html] Accessed on Jul. 11, 2025.

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ENHANCEMENT OF EMPLOYER-PROVIDED CHILDCARE CREDIT¹⁰⁶

The employer-provided childcare credit, codified in IRC §45F, is a general business credit designed to encourage employers to invest in childcare support for their employees. The credit is available to businesses that incur qualified expenses to provide childcare services, either directly or through third-party arrangements.

To qualify for the credit, a taxpayer must incur **qualified childcare expenditures**, which include the following.

- Construction, acquisition, or rehabilitation of property used as part of a qualified childcare facility.
- Operating costs of a qualified childcare facility, including employee training, scholarship programs, and enhanced compensation for trained childcare staff.
- Payments under contract with a qualified childcare facility to provide services to employees.

A **qualified childcare facility** must meet the following requirements.

- Be used principally to provide childcare assistance.
- Comply with all applicable state and local licensing requirements.
- Be open to employees of the taxpayer and not discriminate in favor of highly compensated employees.

The credit also includes 10% of qualified resource and referral expenditures, such as contracts to provide childcare referral services to employees.

Historically, the credit was limited to 25% of qualified childcare expenditures and 10% of resource and referral costs, with a maximum annual credit of \$150,000. The credit is nonrefundable; however, unused amounts may be carried forward for up to five years.

Beginning in tax years starting **after December 31, 2025**, the employer-provided childcare credits have the following enhancements.

- **Increased credit rate**
 - ♦ For all businesses: the credit rate increases to 40% of qualified childcare expenditures.
 - ♦ For eligible small businesses:¹⁰⁷ the rate increases to 50%.
- **Higher annual cap**
 - ♦ The maximum credit increases to \$500,000 for most businesses.
 - ♦ For small businesses, the cap increases to \$600,000.
- The credit limits are **indexed for inflation** beginning in **2027**.
- Eligible expenses now include on-site childcare subsidies, third-party childcare contractors, and employee childcare stipends.
- However, if the childcare facility does not continue in operation for at least **11 years**, the taxpayer must **recapture some portion of the child tax credit**. If the facility is not operated for at least three years, the entire childcare tax credit must be recaptured.

^{106.} *One Big Beautiful Bill Act*, PL 119-21, §70401.

^{107.} Generally, the small business test is shown in IRC §448(c), although gross revenues cannot exceed \$31 million and are averaged over five years instead of three.

Example 22. Beta Corporation spends \$400,000 in 2026 to build and operate an on-site childcare facility, which is placed in service during the year. Its gross receipts averaged over the past five taxable years exceed the level for qualified small businesses. Beta is eligible for a childcare tax credit of \$160,000 (40% maximum credit × \$400,000 investment in childcare facility). Because this is less than the new \$500,000 maximum allowable credit, Beta can take the full amount of the credit.

EMPLOYER PAYMENTS OF STUDENT LOANS¹⁰⁸

Employer-provided student loan repayment assistance is now permanently excluded from gross income under IRC §127(c), effective for tax years beginning in 2025. To qualify under §127, the employer must establish an educational assistance program that meets the following criteria.

- **Written.** The program must be a formal written plan created for the exclusive benefit of employees.
- **Nondiscrimination.** The plan must not discriminate in favor of highly compensated employees (as defined in §414(q)) or their dependents.
- **Ownership limits.** No more than 5% of the total benefits can be provided to individuals who are more than 5% owners of the business (including their spouses or dependents).
- **No cash alternatives.** The program cannot offer employees a choice between educational assistance and other taxable compensation (e.g., cash or bonuses).
- **No funding requirement.** The program does not need to be pre-funded; employers can pay benefits as they go.
- **Employee notification.** Employers must provide reasonable notification to employees about the availability and terms of the program.

Qualified payments must be for **qualified education loans** as defined in IRC §221(d) — loans incurred by the employee for their own higher education. Payments can be made directly to the employee or to the loan servicer. The maximum exclusion is \$5,250 per calendar year, and this applies to the combined total of tuition assistance and loan repayment assistance. The excluded amount is not subject to federal income tax or employment taxes for the employee.

Key Provisions for 2025 and Beyond

For tax year **2025**, the employer payments of student loan deduction has been made permanent. For tax years beginning after **2026**, the \$5,250 amount will be increased by an amount equal to:

- Such dollar amount, multiplied by the cost-of-living adjustment determined under §1(f)(3) for the calendar year in which the taxable year begins.
- If any increase is not a multiple of \$50, such increase shall be rounded to the nearest multiple of \$50.

Example 23. In 2025, the Acme Corp. pays \$4,000 directly to a loan servicer on behalf of Patricia, an employee, to reduce her student loan balance. Because the \$4,000 is below the maximum exclusion of \$5,250 for 2025, her employer does not include the \$4,000 in Patricia's gross income.

Example 24. ABC Corp. provides \$6,200 in student loan repayment assistance to Tom, an employee, in 2025. His employer excludes \$5,250 from Tom's income and the remaining \$950 is taxable.

^{108.} *One Big Beautiful Bill Act*, PL 119-21, §70412.

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PERMANENT RENEWAL AND ENHANCEMENT OF OPPORTUNITY ZONES¹⁰⁹

The qualified opportunity zone (QOZ) program, originally enacted under the TCJA,¹¹⁰ was designed to spur long-term investment in economically distressed communities. The program provided an incentive for real estate, small business, or infrastructure development. It provided three key tax incentives for investors who reinvest capital gains into qualified opportunity funds (QOFs).

1. **Deferral** of capital gains reinvested in a QOF until the earlier of either the QOF investment's sale or **December 31, 2026**.¹¹¹
2. **Partial exclusion** of deferred gains (10% after five years, 15% after seven years) for investments made early enough to meet the holding thresholds before 2026.¹¹²
3. **Exclusion of post-investment appreciation** if the QOF investment is held for at least 10 years.¹¹³

The original TCJA legislation required taxpayers to make elections for QOZ funds before 2027.¹¹⁴

The OBBBA extends and expands QOFs including the following changes.

- **Permanent extension with new rules.** The QOZ program becomes a permanent part of the Code. However, the original deferral deadline of December 31, 2026, remains unchanged for investments made under the TCJA regime.
- **5-year deferral limit.** For investments made on or after January 1, 2027, capital gains may be deferred for **up to five years**, or until the QOF investment is sold, whichever comes first.
- **10% basis step-up after five years.** Investors in post-2026 QOFs may exclude 10% of the deferred gain if the investment is held for five years.
- **30-year cap on tax-free appreciation.** The 10-year gain exclusion remains, but appreciation is only excludable up to the **30th anniversary** of the investment date
- **Decennial recertification of zones.**¹¹⁵ All QOZ designations must be recertified every 10 years, beginning July 1, 2026, to ensure they continue to meet low-income criteria.
- **The rule allowing contiguous tracts to qualify is repealed.** Only census tracts that independently meet the low-income or poverty thresholds can now be designated, tightening eligibility.
- **New designations of QOZs will last for 10 years from the applicable start date.** This provides a clear investment horizon and aligns tax benefits with a defined development period.
- **Enhanced reporting requirements.** QOFs must now report property-level or business-unit detail annually, improving transparency and oversight.
- **Starting in 2027, not all census tracts in Puerto Rico will be QOZs.** After December 31, 2026, Puerto Rican census tracts follow the same eligibility rules as the rest of the country.¹¹⁶

¹⁰⁹ Ibid., §70421.

¹¹⁰ *Tax Cuts and Jobs Act*, PL 115-97, §13823, creating IRC §§1400Z-1 and 1400Z-2.

¹¹¹ IRC §1400Z-2(b)(2)(A).

¹¹² IRC §1400Z-2(b)(2)(B). A provision allowing an additional 5% required a holding period ending before January 1, 2027.

¹¹³ IRC §1400Z-2(c).

¹¹⁴ IRC §1400Z-2

¹¹⁵ IRC §1400Z-1(c)(2)(C).

¹¹⁶ *How did the One Big Beautiful Bill Act change Opportunity Zones?* Wessel, David. Jul. 8, 2025. The Brookings Institution. [www.brookings.edu/articles/how-did-the-one-big-beautiful-bill-act-change-opportunity-zones] Accessed on Jul. 16, 2025.

- **Annual reporting.** QOFs that make QOZ investments must annually report property-level or business-unit detail.¹¹⁷
- **Creation of qualified rural opportunity zones.** A qualified rural opportunity fund is one that holds at least 90% of its assets in QOZ property located entirely within rural areas.¹¹⁸ These areas are locations outside cities or towns with populations exceeding 50,000 and not adjacent to urbanized areas.¹¹⁹ This provision is designed to channel investment into underserved rural communities and provides enhanced tax benefits, such as an increase in the taxpayer's basis of 30% of the invested amount, provided it is held for five years.¹²⁰ This is a significant enhancement over the 10% basis increase provided in original provision in TCJA.

PERMANENT ENHANCEMENT OF THE LOW-INCOME HOUSING CREDIT¹²¹

The LIHTC, codified in IRC §42, is the federal government's primary tool for encouraging the development and rehabilitation of affordable rental housing for low- and moderate-income households.¹²² Under the program:

- State or local government housing agencies, such as the Illinois Housing Development Authority,¹²³ receive annual credit allocations from the federal government.
- These agencies award credits to developers through a **competitive application process** for new construction or substantial rehabilitation projects.¹²⁴
- Developers typically sell the credits to private investors. A project receiving funds under this competitive bidding process may qualify for a tax credit equal to 9% of the building's qualified basis. The Code also provides for non-competitive credits of up to 4% of a project's cost; this lower credit does not compete for the limited credits awarded to each state.¹²⁵

The LIHTC is calculated as a percentage of a project's qualified basis, which is generally the portion of the building's cost that is attributable to affordable housing units. The step-by-step calculation follows.

1. **Determine the eligible basis.** This includes the cost of new construction or substantial rehabilitation (excluding land). Certain costs may be increased by a **basis boost** (up to 30%) if the project is in a qualified census tract or difficult development area.
2. **Apply the applicable fraction.** The applicable fraction adjusts the eligible basis to reflect the portion of the building that qualifies. This is the lesser of the following.
 - The **percentage of units** that are rent-restricted and occupied by income-qualified tenants
 - The **percentage of floor space** those units occupy

¹¹⁷ IRC §§6039K, 6039L, and 6726.

¹¹⁸ IRC §1400Z-2(b)(2)(C)(i).

¹¹⁹ IRC §1400Z-2(b)(2)(C)(ii).

¹²⁰ *How did the One Big Beautiful Bill Act change Opportunity Zones?* Wessel, David. Jul. 8, 2025. The Brookings Institution. [www.brookings.edu/articles/how-did-the-one-big-beautiful-bill-act-change-opportunity-zones] Accessed on Jul. 16, 2025.

¹²¹ *One Big Beautiful Bill Act*, PL 119-21, §70422.

¹²² *What is the Low-Income Housing Tax Credit and how does it work?* Jan. 2024. Tax Policy Center. [taxpolicycenter.org/briefing-book/what-low-income-housing-tax-credit-and-how-does-it-work] Accessed on Jul. 22, 2025.

¹²³ *LIHTC Database: List of LIHTC-Allocating Agencies Providing Data for the LIHTC Database and their Web Addresses.* Department of Housing and Urban Development, Office of Policy Development and Research. [www.huduser.gov/lihtc/agency_list.htm] Accessed on Jul. 22, 2025; *2025 Affordable Housing Tax Credit.* Illinois Housing Development Authority. [www.ihda.org] Accessed on Jul. 22, 2025.

¹²⁴ *What is the Low-Income Housing Tax Credit and how does it work?* Jan. 2024. Tax Policy Center. [taxpolicycenter.org/briefing-book/what-low-income-housing-tax-credit-and-how-does-it-work] Accessed on Jul. 22, 2025.

¹²⁵ IRC §42(b)(3).

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3. Calculate the qualified basis.

$$\text{Qualified Basis} = \text{Eligible Basis} \times \text{Applicable Fraction}$$

4. Apply the credit rate.¹²⁶

- 9% credit: For new construction or substantial rehab not financed with tax-exempt bonds.
- 4% credit: For projects financed with tax-exempt private activity bonds (PABs).

5. Annual credit amount. This amount is claimed each year for 10 years.

$$\text{Annual Credit} = \text{Qualified Basis} \times \text{Credit Rate}$$

The OBBBA makes two major enhancements to the LIHTC program, effective for calendar years beginning after December 31, 2025.

- **Permanent 12% increase in credit allocations.** The temporary 12% increase in state credit allocations was originally enacted in 2018, but it expired in 2021. The OBBBA makes a 12% increase in the allocation to each state permanent. This raises the per capita credit ceiling for states, enabling more projects to be funded.¹²⁷
- **Reduction of PAB financing threshold.** Projects now qualify for 4% credits with only 25% of financing from PABs,¹²⁸ down from the previous 50% requirement. This change expands eligibility and reduces reliance on limited bond volume caps.

Example 25. A state with 5 million residents previously received \$2.75 per capita in 9% credits. With the 12% increase, the total credit available for the state's housing authority to award to developers is computed as follows.

$$\text{New allocation} = \$2.75 \times 1.12 = \$3.08 \text{ per capita}$$

$$\text{Total credit available} = \$3.08 \times 5 \text{ million} = \$15.4 \text{ million}$$

This increase enables the state to support more affordable housing projects each year.

Example 26. BuildBig Corporation, a developer, plans a \$10 million project that is only attractive to investors if it qualifies for the 4% tax credit. The developer's state housing authority has awarded all the federally available housing tax credits for the year. Under prior law, the developer would have been required to issue tax-exempt bonds for \$5 million (\$10 million $\times$ 50%). Under the new rules, the developer can qualify for the 4% tax credit by issuing tax-exempt bonds covering 25% of the project's cost or \$2.5 million (\$10 million $\times$ 25%).

¹²⁶ These rates are not exactly 9% or 4% in practice — they are published monthly by the IRS, but the 9% credit is now fixed at 9% for eligible projects.

¹²⁷ *Tax provisions in the One Big Beautiful Bill Act.* Nevius, Alistair. Jul. 7, 2025. Journal of Accountancy. [www.journalofaccountancy.com/news/2025/jun/tax-changes-in-senate-budget-reconciliation-bill] Accessed on Jul. 8, 2025.

¹²⁸ Private activity bonds are generally tax-exempt bonds.

BUSINESS CHARITABLE CONTRIBUTIONS¹²⁹

Under IRC §170(b)(2), C corporations may deduct charitable contributions made to qualified organizations, subject to a limit of 10% of taxable income. Contributions exceeding this limit may be carried forward for up to five years. Historically, there was no minimum threshold for deductibility, meaning even small donations could be deducted. The OBBBA introduces a new 1% floor, effective for tax years beginning after December 31, 2024.

The business charitable contribution deduction has the following changes.

- **1% floor on deductions.** A C corporation may deduct charitable contributions only to the extent they exceed 1% of its taxable income, calculated without regard to the charitable deduction and certain other adjustments.
- **Applies to C corporations only.** This rule does not apply to individuals, partnerships, or S corporations. It specifically targets corporate charitable giving under §170(b)(2).
- **The 10% cap remains.** The existing 10% of taxable income limitation on corporate charitable deductions is unchanged. The 1% floor operates in addition to the 10% cap.
- **Carryforward rules unchanged.** Contributions exceeding the 10% cap may still be carried forward for up to five years, but the 1% floor will continue to apply in carryforward years.



Practitioner Planning Tip

Tax practitioners working with C corporations may wish to suggest their clients consider strategic timing of contributions. Corporations may need to bundle contributions or time them strategically to exceed the 1% floor and maximize deductibility. Additionally, C corporations should consider the impact of marginal giving because smaller or routine donations may no longer be deductible, especially for corporations with lower taxable income.

Example 27. The Delta Corporation, a C corporation, has \$500,000 in taxable income. In 2025, they donate \$4,000 to a qualified charity. Because the \$4,000 donation does not exceed the 1% floor of \$5,000 ($\$500,000 \times 1\%$), Delta is not allowed a deduction for 2025.

Example 28. Abba Corporation, a C corporation, has \$1 million in 2025 taxable income, and it donates \$25,000 to a qualified charity, which provides a timely receipt. The \$25,000 donation exceeds the 1% floor of \$10,000 ($\$1 \text{ million} \times 1\%$). Therefore, the deductible amount is \$15,000 (\$25,000 contribution – \$10,000 1% floor).

THIRD-PARTY NETWORK TRANSACTIONS¹³⁰

Under IRC §6050W, third-party settlement organizations (TPSOs) — such as PayPal, Venmo, and other payment platforms — must report payments made to participating payees for goods and services using Form 1099-K, *Payment Card and Third-Party Network Transactions*. Historically, this reporting was required only if the payee received more than \$20,000 and completed more than 200 transactions in a calendar year.

¹²⁹. *One Big Beautiful Bill Act*, PL 119-21, §70426.

¹³⁰. *Ibid.*, §70432.

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The following changes to third-party transaction reporting are effective for calendar years beginning after December 31, 2024.

- **Restoration of original reporting threshold.** TPSOs must issue a Form 1099-K only if payments to a payee exceed **\$20,000** and involve **more than 200 transactions** in a calendar year.
- **Retroactive repeal of ARPA threshold.** The OBBBA **reverses** the ARPA change that lowered the threshold to \$600 with no transaction minimum.
- **Alignment of backup withholding rules.** IRC §3406(b)(8) is amended to apply **backup withholding** only when the payee exceeds both the **\$20,000** and **200 transaction** thresholds.
- **Carryover rule for backup withholding.** If a payee was subject to Form 1099-K reporting in the prior year, **backup withholding may still apply** in the current year, even if the payee does not meet the threshold.

CHANGES IN FORMS 1099-MISC AND 1099-NEC INFORMATION REPORTING¹³¹

Under IRC §6041 and related provisions, businesses must report certain payments to non-corporate recipients using Form 1099-MISC or Form 1099-NEC.¹³² These forms help the IRS match income reported by recipients with amounts reported by payors. The following three categories exist.

1. **Form 1099-MISC with \$10 threshold.** Form 1099-MISC must be filed for any person or entity that, during the calendar year, paid at least \$10 for royalties or broker payments in lieu of dividends or tax-exempt interest.¹³³
2. **Form 1099-MISC with \$600 threshold.** Taxpayers in the course of their trade or business must file Form 1099-MISC when they pay any taxpayer except a corporation \$600 or more during a calendar year for certain reportable transactions.¹³⁴
3. **Form 1099-NEC with \$600 threshold.** Taxpayers in the course of their trade or business must file Form 1099-NEC when they pay at least \$600 in fees, commissions, prizes, awards, or similar compensation to a nonemployee for services rendered during a trade or business.¹³⁵

For payments made **after December 31, 2025**, the threshold for filing Forms 1099-MISC and 1099-NEC increases and are indexed for inflation beginning in 2027.

- **Increased reporting threshold.** The threshold for Form 1099-MISC (e.g., rent, prizes, legal fees) is raised to \$2,000 from \$600 for payments made after December 31, 2025. The threshold for Form 1099-NEC (e.g., contractor payments) also increases from \$600 to \$2,000.
- **Inflation adjustment.** The \$2,000 filing threshold is indexed for inflation beginning in **2027**, using 2025 as the base year.
- **No change to \$10 threshold.** The \$10 threshold for royalties and broker payments in lieu of dividends or tax-exempt interest remains unchanged and is not indexed for inflation.
- **Backup withholding alignment.** IRC §3406(b)(6) is amended to apply backup withholding only when the new \$2,000 threshold is met.

¹³¹. Ibid., §70433.

¹³². Treas. Reg. §1.6041-3(p)(1).

¹³³. IRC §6050N(a); Instructions for Forms 1099-MISC and 1099-NEC.

¹³⁴. IRC §6041(a); Instructions for Forms 1099-MISC and 1099-NEC.

¹³⁵. IRC §6041A(a)(2); Instructions for Forms 1099-MISC and 1099-NEC.

TERMINATION AND RESTRICTIONS ON THE CLEAN ENERGY PRODUCTION CREDIT¹³⁶

IRC §45Y, created by the Inflation Reduction Act of 2022, provides a technology-neutral production tax credit for facilities that generate electricity with zero or negative greenhouse gas emissions. It was designed to replace legacy credits under IRC §§45 and 48, with eligibility beginning in tax years after December 31, 2024, and **phasing out** once national emissions targets are met. The OBBBA significantly narrows this credit's scope.

Key Changes Effective for 2025 and Beyond

The OBBBA shifts toward providing incentives toward traditional and nuclear energy sources and away from the use of energy sources receiving incentives from the Inflation Reduction Act.¹³⁷

- **Termination of tax credit for wind and solar.** Wind and solar facilities placed in service **after December 31, 2027**, are ineligible for credits authorized by §45Y. However, projects that begin construction before **July 4, 2026**, or meet the 5% safe harbor rule (i.e., incur at least 5% of total project costs within 12 months), may still qualify.¹³⁸
- **Foreign entity restrictions.** Facilities beginning construction after **December 31, 2025**, are disqualified from claiming the credit if they receive material assistance from prohibited foreign entities. Prohibited foreign sources are defined broadly to include foreign-controlled or foreign-influenced entities, including those with contractual rights that confer effective control over U.S. energy assets. Companies that begin construction on facilities after 2025 and receive material assistance from foreign-controlled or foreign-influenced entities may not claim the production tax credit under §45Y.
- **Material assistance cost ratio test.**¹³⁹ To measure foreign control, the OBBBA introduces a material assistance cost ratio test that requires increasing domestic content.
- **Expanded eligibility for nuclear energy communities.** Communities that support **advanced nuclear facilities** — through research, manufacturing, storage, disposal, or recycling — are now eligible for enhanced credit treatment.
- **Expanded definitions.** A prohibited foreign entity includes foreign-controlled and foreign-influenced entities.
- **Credit transfer ban.** Credits may not be transferred to specified foreign entities.
- **New penalties.** Accuracy-related penalties apply to disallowed credits, and suppliers face penalties for substantial misstatements.
- **Leasing disqualification.** No credit is allowed for leased residential wind or solar property under IRC §25D.

Note. Changes to clean energy credits that affect individuals are discussed in the provisions impacting individuals section of this chapter.

¹³⁶ *One Big Beautiful Bill Act*, PL 119-21, §70512.

¹³⁷ *Inflation Reduction Act*, PL 117-169.

¹³⁸ *One Big Beautiful Bill Act*, PL 119-21, §70512(a), inserting IRC §45Y(d)(4)(A) and §70512(c), adding IRC §7701(a)(52)(A)-(D).

¹³⁹ *Ibid.*, §70512(c), adding IRC §7701(a)(52)(D)(iv).

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PERMANENT EXTENSION AND MODIFICATION OF EBL LIMITATIONS¹⁴⁰

Under IRC §461(l), an excess business loss (EBL) is the amount by which a taxpayer's aggregate business deductions exceed their aggregate business income or gains, plus a threshold amount. For 2025, the thresholds are \$626,000 for joint filers and \$313,000 for other taxpayers. Amounts above this threshold are not deductible in the current year and are treated as net operating losses (NOLs) for future years.

Passive losses are included in the calculation of an EBL.¹⁴¹ Although this makes rental and other passive activity income subject to the EBL limitation, it also brings potential advantages, such as the ability to group elections and manage the EBL limitation, as well as the passive activity loss limitation.

The OBBBA makes the following changes to EBL limitations, effective for tax years beginning after December 31, 2026.

- **The EBL limitation under §461(l) is now permanent.** The prior sunset date of January 1, 2029, has been removed.
- **The inflation adjustment base year for calculating the EBL threshold is updated to 2025.** This replaces the prior base year of 2018, aligning the threshold with more current economic data, which may result in lower 2026 thresholds.
- **The EBL limitation continues to apply to taxpayers that are not C corporations, including individuals, trusts, and estates.** However, individuals, trusts, and estates may be affected by EBL allocations from ownership interests in partnerships and S corporations.



Practitioner Planning Tip

Tax practitioners may wish to schedule tax planning meetings with clients likely to be affected by the EBL limitation. If the client can adjust the groupings of passive activities, their exposure to the EBL limitation may be reduced.

PARTNERSHIP PAYMENTS TO PARTNERS¹⁴²

The OBBBA aims to **prevent the abuse of partnerships to avoid paying income tax on disguised sales of property and avoid liability for self-employment (SE) tax.** Because partners are subject to SE tax on some income they receive from partnerships, an incentive exists to shift income by shifting ordinary operating income or SE earnings to payments for goods. Generally, payments to partners from the partnership for property are not subject to income tax or SE tax.

IRC §707 provides the general rules for the disguised sales of assets. If a partner contributes property to a partnership and receives a distribution of money or other property within a specified period, the transaction is recharacterized as a sale or exchange. If the transfer of an asset occurs within two years, the transaction is **presumed to be a disguised sale.**¹⁴³ Furthermore, the transaction must be disclosed to the IRS.¹⁴⁴ If the distribution is made within two years of the initial contribution, it is presumed to be a disguised sale of the property contributed to the partnership, although facts and circumstances may indicate otherwise.¹⁴⁵

¹⁴⁰ Ibid., §70601, modifying IRC §461(l).

¹⁴¹ IRC §461(l)(6).

¹⁴² *One Big Beautiful Bill Act*, PL 119-21, §70602, amending IRC §707(a)(2).

¹⁴³ Treas. Reg. §1.707-3(c).

¹⁴⁴ Treas. Reg. §1.707-8.

¹⁴⁵ See Treas. Reg. §1.707-3(c)(2) for three broad conditions requiring disclosure.

However, the wording of §707(a)(2) left an ambiguity in its interpretation. This paragraph began with the phrase “[u]nder regulations prescribed,” which could be interpreted as a condition precedent — if the IRS had not clearly prescribed a regulation, the paragraph could be construed as having no application and being unenforceable.¹⁴⁶

Before the OBBBA provisions went into effect on July 4, 2025, the IRS relied on regulations to enforce these provisions.¹⁴⁷ However, some of the regulations are not yet final, leaving the door open for certain partnerships or partners to contest their enforcement. With the enactment of this OBBBA section, the IRS can scrutinize potential disguised partnership sales by directly applying a statute, rather than relying on a regulation that has not been finalized.¹⁴⁸

Key Changes Effective for 2025 and Beyond

The OBBBA makes the following changes to partnership payments to partners.

- **Disguised payments for services.** The OBBBA section aims to prevent payments to partners from being structured as partnership allocations, which are typically nontaxable, rather than taxable fees.
- **Disguised sales of partnership interests.** The IRS published a Notice of Proposed Rulemaking in 2004 that attempted to clarify the application of these rules to the sales of partnership interests¹⁴⁹ although the proposed rules were withdrawn in 2009.¹⁵⁰ Because taxpayers have argued that the language should be interpreted as meaning the IRS cannot enforce rules prohibiting the disguised sales of partnership interests, the IRS has attempted to interpret §707(a)(2) to mean that this Code section can be enforced in the absence of any supporting regulation. The OBBBA resolves this issue in favor of the IRS.

Caution. Taxpayers should exercise vigilance when contemplating partnership transactions that could inadvertently be viewed unfavorably as disguised sales. The facts and circumstances tests provided in the 2004 proposed regulations may resurface.

Note. For more information about the tax treatment of partnership payments to partners, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Partnership Basics. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

¹⁴⁶. *U.S. House and Senate Finance Committee Reconciliation Bills Modify Partnership “Disguised Sales” Provisions*. Jun. 24, 2025. [www.sidley.com/en/insights/newsupdates/2025/06/us-house-and-senate-finance-committee-reconciliation-bills-modify-partnership] Accessed Jul. 15, 2025.

¹⁴⁷. E.g., Prop. Treas. Reg. §1.707-2.

¹⁴⁸. *IRS Clarifies How It Will Treat Payments From Partnerships To Partners*. Jul. 9, 2025. Schwartz & Schwartz. [www.schwartzschwartz.com/blog/2025/7/9/irs-clarifies-how-it-will-treat-payments-from-partnerships-to-partners] Accessed on Jul. 15, 2025.

¹⁴⁹. 69 Fed. Reg. 68,838 (Nov. 26, 2004).

¹⁵⁰. 74 Fed. Reg. 3,508 (Jan. 21, 2009).

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APPENDIX — SUMMARY OF OBBBA PROVISIONS

The following tables summarize the provisions of the OBBBA discussed in this workbook and identify under which sections of the Code the provisions apply as well as identify the effective beginning and end dates.

PROVISIONS OF THE OBBBA IMPACTING INDIVIDUALS

OBBBA Section	IRC Reference	Description	Effective Beginning Date	Effective End Date
§70101	§1(j)	The reduced tax rates introduced in TCJA are permanent	Beginning after 2017	Permanent
§70101	§1(j)	The 10% and 12% tax brackets receive one additional year's inflation adjustment	Beginning after December 31, 2025	Permanent
§70102	§63(c)(7)	The base standard deduction amount increases for all filing statuses	Beginning after December 31, 2024	Permanent
§70103	§151(d)(5)	Personal exemptions are set to \$0	Beginning after December 31, 2024	Permanent
§70103	§151(d)(5)	A \$6,000 additional deduction for taxpayers 65 and older is created	Beginning after December 31, 2024	Beginning before January 1, 2029
§70104	§24	The nonrefundable portion of the child tax credit is increased to a maximum of \$2,200, the credit is indexed for inflation, the credit for other dependents is made permanent	Beginning after December 31, 2024	Permanent
§70106	§2010(c)(3)	The base estate and gift tax exemption is increased to \$5 million	Beginning after December 31, 2025	Permanent
§70107	§55(d)(4)	The AMT exemption phase-out thresholds return to 2018 levels (indexed for inflation) and the AMT phase-out rate for excess AMTI is increased from 25% to 50%	Beginning after December 31, 2025	Permanent
§70108	§163(h)(3)(F)	The acquisition debt caps of mortgage loans for the mortgage interest deduction are made permanent, MIPs are deductible as mortgage interest	Beginning after December 31, 2025	Permanent
§70109	§165(h)(5)	Casualty loss deduction for federally declared disasters is made permanent, state declared disasters now also qualify	Beginning after December 31, 2025	Permanent
§70110	§67	Miscellaneous itemized deductions subject to the 2% AGI threshold are permanently suspended	Beginning after December 31, 2025	Permanent
§70110	§67(b)(13)	Educator expenses are not included as miscellaneous itemized deductions	Beginning after December 31, 2025	Permanent

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PROVISIONS OF THE OBBBA IMPACTING INDIVIDUALS *(continued)*

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OBBBA Section	IRC Reference	Description	Effective Beginning Date	Effective End Date
§70110	§67(g)	Educator expenses now include expenses paid by sports coaches and athletic administrators	Beginning after December 31, 2025	Permanent
§70111	§68	The Pease limitation is replaced with a 2/37 itemized deduction limitation for 37% tax bracket filers	Beginning after December 31, 2025	Permanent
§70112	§132(f)	Qualified bicycle commuting reimbursement is repealed	Beginning after December 31, 2025	Permanent
§70112	§274	Employer deductions for transportation fringe benefits are disallowed	Beginning after December 31, 2025	Permanent
§70114	§165	The deductible portion of wagering losses are limited to 90% of actual losses incurred	Beginning after December 31, 2025	Permanent
§70115	§529A(b)(2)(B)	Contribution limits to ABLE accounts introduced by the TCJA are made permanent	Beginning after December 31, 2025	Permanent
§70116	§25B(d)(1)	Taxpayers contributing to ABLE accounts may qualify for the federal saver's credit	Beginning before January 1, 2027	Permanent
§70117	§529A(c)(3)(C)(i)(III)	The ability to rollover funds from qualified tuition programs to ABLE accounts is made permanent	Beginning after December 31, 2025	Permanent
§70119	§108(f)(5)	Discharges of student loan debt are excluded from taxable income if the borrower dies or becomes disabled	Beginning after December 31, 2025	Permanent
§70120	§164(b)	The SALT limitation cap is increased (\$20,000 for MFS filers and \$40,000 for all other filers in 2025), indexed for inflation, and subject to limitations	Beginning after December 31, 2024	Beginning before January 1, 2030
§70201	§224 (new)	Employees and self-employed taxpayers may deduct up to \$25,000 for qualified tips, subject to limitations	Beginning after December 31, 2024	Beginning before January 1, 2029
§70202	§225 (new)	Taxpayers may deduct up to \$12,500 (\$25,000 for joint filers) of overtime compensation, subject to limitations	Beginning after December 31, 2024	Beginning before January 1, 2029
§70203	§163(h)	Taxpayers may deduct up to \$10,000 of qualified car loan interest per year, subject to limitations	Beginning after December 31, 2024	Beginning before January 1, 2029
§70204	§530A (new)	IRAs known as Trump accounts are created for individuals under the age of 18	Beginning after at least July 4, 2026	Permanent

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PROVISIONS OF THE OBBBA IMPACTING INDIVIDUALS *(continued)*

OBBBA Section	IRC Reference	Description	Effective Beginning Date	Effective End Date
§70204	§530A (new)	A one-time government-funded deposit into a Trump account will be made for qualifying children born	Beginning after December 31, 2024	Beginning before January 1, 2029
§70402	§23(a)	The adoption credit is enhanced, including a partial refundable portion, increased maximum credit, and carryforward for the non-refundable portion of the credit	Beginning after December 31, 2024	Permanent
§70403	§23(d)(3)	Indian tribal governments are recognized for purposes of determining eligibility of special needs children for the adoption credit	Beginning after December 31, 2024	Permanent
§70404	§129(a)(2)(A)	The annual contribution limits for the DCAP increase to \$7,500 per household (\$3,750 for MFS filers)	Beginning after December 31, 2025	Permanent
§70405	§21(a)	The maximum applicable percentage for the child and dependent care credit increases from 35% to 50%	Beginning after December 31, 2025	Permanent
§70411	§25F (new)	Taxpayers can receive a tax credit up to \$1,700 for contributions to scholarship granting organizations providing scholarships for qualified elementary and secondary education	Beginning after December 31, 2026	Permanent
§70411	§139K (new)	The receipt of a K-12 scholarship from a scholarship granting organization does not create taxable income for the recipient	Beginning after December 31, 2026	Permanent
§70412	§127	The exclusion from gross income for employer payments of student loans is made permanent and indexed for inflation	Beginning after December 31, 2025	Permanent
§70413	§529(c)(7)	Additional expenses are added as qualified expenses for §529 plan distributions for K-12	Beginning after December 31, 2025	Permanent
§70414	§529(f)	The expansion of postsecondary credentialing expenses is included as qualified higher education expenses for §529 plan distributions	Beginning after December 31, 2025	Permanent
§70424	§170(p)	Non-itemizers can deduct above-the-line charitable contributions up to \$2,000 (\$1,000 for MFS filers)	Beginning after December 31, 2025	Permanent
§70425	§170(b)	Itemized charitable deductions are limited to 0.5% of a taxpayer's AGI	Beginning after December 31, 2025	Permanent

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PROVISIONS OF THE OBBBA IMPACTING INDIVIDUALS *(continued)*

2

OBBBA Section	IRC Reference	Description	Effective Beginning Date	Effective End Date
§70501	§25E	The previously owned clean vehicle credit is terminated	Beginning after September 30, 2025	Permanent
§70502	§30D(h)	The clean vehicle credit is terminated	Beginning after September 30, 2025	Permanent
§70503	§45W(g)	The commercial clean vehicles credit is terminated	Beginning after September 30, 2025	Permanent
§70504	§30C(i)	The alternative fuel vehicle refueling property credit is terminated	Beginning after June 30, 2026	Permanent
§70505	§25C(h)	The energy efficient home improvement credit is terminated	Beginning after December 31, 2025	Permanent
§70506	§25D(h)	The residential clean energy credit is terminated	Beginning after December 31, 2025	Permanent
§70507	§179D	The energy efficient commercial buildings deduction is terminated	Beginning after June 30, 2026	Permanent
§70508	§45L(h)	The new energy efficient home credit is terminated	Beginning after June 30, 2026	Permanent
§70509	§168(e)(3)(B)(vi)	The cost recovery for energy property is terminated	Beginning after December 31, 2024	Permanent
§70511	§45V(c)(3)(C)	The clean hydrogen production credit is terminated	Beginning before January 1, 2028	Permanent
§70512	§45Y(d)	The clean electricity production credit for leased residential property is terminated	Beginning after July 4, 2026	Permanent
§70513	§48E(e)	The clean electricity investment credit is terminated	Beginning after July 4, 2026	Permanent
§70606	§25A(g)(1)	SSN is required for students who claim or are claimed for the AOTC and the lifetime learning credit	Beginning after December 31, 2025	Permanent
§71307	§223(c)(2)	Bronze-level and catastrophic health insurance plans qualify for HSAs	Beginning after December 31, 2025	Permanent

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PROVISIONS OF THE OBBBA IMPACTING BUSINESS ENTITIES

OBBBA Section	IRC Reference	Description	Effective Beginning Date	Effective End Date
§70105	§199A(b)(3)	The QBID is made permanent, the phase-ins for the deduction have been increased, and a new minimum deduction of \$400 is added	Beginning after December 31, 2025	Permanent
§70301	§168(k)(2)(A)	Bonus depreciation is set at 100%, and a transitional election for reduced expenses is created for the first taxable year	Beginning after January 19, 2025	Permanent
§70302	§174A (new)	Qualified R&E expenses may be fully deducted or elected to be capitalized over a period of at least 60 months	Beginning after December 31, 2024	Permanent
§70303	§163(j)	Trailers and campers qualify for floor plan financing interest, thereby receiving an exclusion from the business interest limitation	Beginning after December 31, 2024	Permanent
§70304	§45S	The paid family and medical leave credit is extended and employee eligibility is altered	Beginning after December 31, 2025	Permanent
§70305	§274	Deductible business meals now include meals included in employee compensation and meals provided on certain maritime vessels and remote fish processing facilities, but do not include meals provided in employer-operated cafeterias	Beginning after December 31, 2025	Permanent
§70306	§179(b)	The limit of property that can be expensed under §179 is permanently increased	Beginning after December 31, 2024	Permanent
§70308	§48D(a)	The advanced manufacturing investment credit is increased from 25% to 35%	Beginning after December 31, 2025	Permanent
§70341	§163(j)	Capitalized business interest qualifies for the business interest deduction	Beginning after December 31, 2025	Permanent
§70342	§163(j)	ATI excludes foreign income inclusions	Beginning after December 31, 2025	Permanent
§70401	§45F	The employer-provided childcare credit increases to 40% (50% for eligible small businesses) and the maximum credit increases to \$500,000 (\$600,000 for small businesses), indexed for inflation	Beginning after December 31, 2025	Permanent
§70421	§1400Z-1	The qualified opportunity zone program is made permanent and includes new provisions	Beginning after December 31, 2025	Permanent

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PROVISIONS OF THE OBBBA IMPACTING BUSINESS ENTITIES *(continued)*

2

OBBBA Section	IRC Reference	Description	Effective Beginning Date	Effective End Date
§70422	§42(h)	The 12% increase in state credit allocations to the LIHTC is permanent and projects qualify for the 4% credits with 25% financing from PABs	Beginning after December 31, 2025	Permanent
§70426	§170	The business charitable contribution deduction is subject to a 1% of taxable income floor for C corporations	Beginning after December 31, 2025	Permanent
§70432	§6050W	The thresholds for Form 1099-K reporting revert back to \$20,000 per payee and more than 200 transactions per calendar year	Beginning after December 31, 2024	Permanent
§70433	§6041	The thresholds for Forms 1099-MISC and 1099-NEC increase to \$2,000 and are indexed for inflation	Beginning after December 31, 2025	Permanent
§70435	§139L	Exclusion from gross income for 25% of interest that a qualified lender receives on qualified real estate loan	Beginning after July 4, 2025	Permanent
§70437	§1062	Net income tax from sale of farmland can be paid over four years	Beginning after July 4, 2025	Permanent
§70512	§45Y	The wind and solar facilities tax credit is terminated, the clean energy productions credit is disqualified for taxpayers receiving material assistance from prohibited foreign entities	Beginning after December 31, 2027	Permanent
§70601	§461(l)	The EBL limitation is permanent and the inflation adjustment base year is updated to 2025	Beginning after December 31, 2025	Permanent
§70602	§707(a)(2)	The IRS is allowed to enforce rules prohibiting the disguised sale of partnership interests	Beginning after July 4, 2025	Permanent

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Chapter 3: Rental Real Estate Activity Issues

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

About the Author

This chapter was originally provided by the Land Grant University Tax Education Foundation, with subsequent modification by the University of Illinois Tax School.

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

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Rental real estate activities are a cornerstone of many individual and business tax portfolios, offering opportunities and complexities in tax planning and compliance. This chapter explores the tax rules, limitations, and strategic considerations that govern rental real estate. It is designed to equip tax practitioners with an understanding of depreciation strategies,¹ self-employment (SE) rules,² qualified business income deduction (QBID),³ at-risk limitations,⁴ and passive activity loss (PAL) rules.⁵ Through detailed explanations, examples, and planning insights, this chapter lays the conceptual foundation necessary to navigate the nuanced tax treatment of rental properties.

In contrast, Chapter 4: Schedule E, shifts the focus from a conceptual analysis to practical application. It serves as a line-by-line guide to completing Schedule E (Form 1040), *Supplemental Income and Loss*, which is used to report income or loss from rental real estate, as well as royalties, partnerships, and other pass-through entities. That chapter emphasizes compliance, accuracy, and form mechanics. Practitioners are encouraged to use these chapters in tandem: begin with this chapter to build a strong conceptual framework, then consult the Schedule E chapter when preparing or reviewing tax returns. This dual approach ensures both compliance and strategic optimization in managing real estate rental activities.

RESIDENTIAL REAL ESTATE RENTALS

For individuals who own residential rental properties, it is necessary to report the income earned from rentals and to account for the associated deductible expenses. This section delves into the specifics of what qualifies as rental income and the types of expenses that can be deducted.

Note. Special rules apply to a taxpayer with a short-term rental, or a taxpayer who personally uses a rental property. For more information on the taxation of short-term rentals, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Unexpected Issues for Individual Taxpayers. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

RENTAL INCOME

In general, gross income includes rent received or accrued for the occupancy of real estate.⁶ Rental income includes direct payments of rent, advance rent, lease cancellation payments, and the expenses that a tenant pays for a landlord. Rental income may also include the fair market value (FMV) of property or services received as rent. However, in some cases, rental income may be sale proceeds, and not rent. This section explains when payments under a lease with an option to purchase are rental income, and when a tenant's payment of expenses and tenant improvements must be included in rental income.

Lease with Option to Purchase⁷

To the extent that the rental payments in a lease option do not exceed a fair rental price and are not an option premium, they are treated the same as rent paid under a lease that does not have an option to purchase.⁸ The landlord must include the rental payments in ordinary income. That income is offset by the landlord's rental expenses (discussed later).

^{1.} IRC §§167 and 168.

^{2.} IRC §1402(a)(1).

^{3.} IRC §199A.

^{4.} IRC §465.

^{5.} IRC §469.

^{6.} IRC §61(a)(5); IRS Pub. 527, *Residential Rental Property*.

^{7.} IRS Pub. 527, *Residential Rental Property*.

^{8.} *Osborne v. Comm'r*, TC 1987-553 (Sep. 4, 1986). The court's opinion in this case refers to comparable rents in the area as being one element governing fair rental value, citing the U.S. Senate's Explanation to *Black Lung Benefits Amendments of 1981*, PL 97-119.

A **fair rental price** is generally the amount of rent that an unrelated person would be willing to pay. Rent is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to property in the same area. An **option premium** is the amount that a prospective buyer pays for the opportunity, but not the obligation, to purchase a property at a specified price during a specified period.⁹ If the buyer chooses not to exercise the option to buy the property, they have forfeited the option premium, but have no further obligation to the selling property owner.

If the transaction is an installment sale rather than as a lease with an option to purchase, the initial option fee is considered a down payment, and the lease payments are allocated between principal and interest payments according to the unstated interest rules.¹⁰ The principal payments become part of the tax basis of the property.¹¹

The courts have ruled that the determination of whether an option lease is really an installment sale is based on the facts and circumstances, including the terms of the lease itself.¹² Although no single factor definitively characterizes a transaction as a lease with an option to purchase or a conditional sale, the intent of the contracting parties is particularly significant. The following other factors also indicate that the contract is a sale rather than a lease.¹³

1. The sum of the option premium and total rent payments is greater than or approximately equal to the property's FMV at the time of the purchase.
2. The rent is set at an above-market rate, and the option payment is below the market rate.
3. Regardless of whether rent is set at the fair rental price, the option payment(s) and rent payments are credited toward the purchase price of the property.
4. The tenant-buyer is required by the terms of the lease to make capital improvements to the property during the rental period.
5. The tenant-buyer is guaranteed title after making a certain number of required payments.
6. The contract stipulates that part of each rent payment is interest or a substitute for interest.

Tenant-Paid Expenses

Under Treas. Reg. §1.61-8(c), if a tenant pays any of their landlord's expenses, such payments are additional rental income to the landlord.

Example 1. Nora Lund owns a residential rental property. While Nora is away on vacation, the furnace in the rental property stops working. Nora's tenant pays for the necessary repairs and deducts the cost of the repair bill from their rent payment. Nora must include the repair cost the tenant paid as rental income. She can also deduct the repair payment as a rental expense.

Example 2. Use the same facts as **Example 1**. While Nora is away, her tenant pays the water and sewer bill for the rental property and deducts it from the normal rent payment. Under the terms of the lease, the tenant does not have to pay this bill. Nora must include the utility bill paid by the tenant as rental income. She can also deduct the utility bill as a rental expense.

⁹ *How to Make Money with Real Estate Options*. Seth, Shobhit. Jan. 16, 2025. Investopedia. [www.investopedia.com/articles/active-trading/021015/how-make-money-real-estate-options.asp] Accessed on Feb. 24, 2025.

¹⁰ Rev. Rul. 55-540, 1955-02 CB 39; *Lease Option or Installment Sale; What is the Economic Reality of Your Transaction?* Valachi, Donald. Oct. 15, 2015. CCIM Institute. [kjk.com/2015/10/12/lease-option-or-installment-sale-what-is-the-economic-reality-of-your-transaction] Accessed on Feb. 26, 2025.

¹¹ Ibid.

¹² *Benton v. Comm'r*, 197 F.2d 745 (5th Cir. 1952).

¹³ Rev. Rul. 55-540, 1955-02 CB 39.

Tenant-Provided Property or Services¹⁴

If the tenant pays the landlord with property or services, instead of money, as rent, the landlord must include the FMV of the property or services in rental income. If the services are provided at an agreed-upon or specified price, that price is the FMV, unless there is evidence to the contrary.

Example 3. Ross Litchfield's new tenant, Rena Cole, is a painter. Rena agrees to paint Ross's residential rental property instead of paying rent for two months. Ross must include in rental income the amount that Rena would have paid for two months of rent. He can deduct that same amount as a rental expense for painting the property.

Tenant Improvements

If tenant improvements on real estate constitute a substitute for rent, such improvements are rental income to the landlord. The transaction is the same as if the landlord paid directly for the improvements and the tenant directly paid the full agreed upon rent.¹⁵

Whether improvements made by a tenant result in rental income to the landlord depends on the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances.¹⁶ The landlord and the tenant must intend that some or all the tenant's capital expenditures are rent, and this intent must be plainly disclosed.

Example 4. Use the same facts as **Example 3**. Rena asks Ross's permission to build a small paint shop behind the rental. At the end of Rena's tenancy, the paint shop may be worthless or even detrimental to Ross. The improvement is not intended to compensate Ross and is not included in rental income.

RENTAL ACTIVITIES LACKING PROFIT MOTIVE¹⁷

Some taxpayers own real estate that they rent to others without intending to profit from the investment. A common example is when parents purchase a residence and allow their child to live in the home rent-free. Taxpayers who do not have a profit motive report the rental income on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*. Associated deductible expenses may be claimed on Schedule A, *Itemized Deductions*, and are subject to other limitations, as explained later.

Profit Motive

Profit motive is determined by the facts and circumstances of each situation.¹⁸ However, taxpayers are presumed to be renting the property for a profit if they make a profit in at least three years out of five consecutive years.

Even if the taxpayers do **not** profit from the rental activity, if they objectively **intend** to profit from the investment, that activity is not subject to the limitations on deductions. Taxpayers bear the burden of proof to substantiate that they are engaged in the activity with an objective of realizing a profit.¹⁹

¹⁴ IRS Pub. 527, *Residential Rental Property*.

¹⁵ *Your Health Club, Inc. v. Comm'r*, 4 TC 385 (1944).

¹⁶ Treas. Reg. §1.61-8(c).

¹⁷ IRS Pub. 527, *Residential Rental Property*.

¹⁸ See *Comm'r v. Robert P. Groetzinger*, 480 U.S. 23 (1987); IRC §183.

¹⁹ *Keanini v. Comm'r*, 94 TC 41 (1990).



Practitioner Planning Tip

Taxpayers should review the nine profit motive factors to determine if their behavior demonstrates their stated intent.²⁰ For an in-depth discussion of profit motive, including the nine factors, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Example 5. Louie and Carol won the lottery and receive \$500,000 per year for 20 years. They use the proceeds to buy residential properties where they allow their many children and grandchildren to live rent-free. In their wills, they leave each property to the beneficiary residing in the home. Louie and Carol never intended to profit from the investments.

Because Louie and Carol allowed family members to live in the properties rent-free and never intended to profit, the activity does not rise to the level of a rental real estate activity for tax purposes. The properties are considered personal-use properties, not income-producing assets. As a result, Louis and Carol do not report rental income or expenses on Schedule E. Additionally, any expenses related to the properties (such as mortgage interest or property taxes) may be deductible on Schedule A, subject to applicable limitations. Lastly, Louie and Carol cannot treat the FMV of the use of the homes as income.

Example 6. In 2019, PJ bought a new home and let her friends move into her old home. Her friends were supposed to pay rent, but they stopped paying regularly after the first three years. PJ has been losing money each year since then.

When preparing her 2023 income tax return in March 2024, PJ's tax advisor, Alex, notices that the property has lost money for two years in a row. He explains that after two years of losing money, PJ is no longer presumed to have a profit motive. Whether she does, in fact, have a profit motive can be demonstrated by facts and circumstances, such as how long she tolerates underpayment, if she evicts her friends, or how she justifies continuing to let them live there.

Alex asks PJ what she plans on doing about the situation in 2024 before she has another year of losses. PJ says that it costs too much to evict the tenants, the rent they do pay covers most of the cash outlays, she does not need the additional money, and she hopes the property will appreciate enough to cover her current losses. Alex recommends PJ document the potential costs of eviction and reasons for believing that the property will appreciate sufficiently. If PJ cannot demonstrate a genuine profit motive based on facts and circumstances, the activity may be reclassified as not engaged in for profit. In that case, PJ reports any income she receives on Schedule 1, not on Schedule E. Any deductions are limited, with most expenses disallowed except for mortgage interest and property tax (subject to Schedule A limitations, covered later.)

Taxpayers who do not meet the profit test for the first three years of a rental activity may choose to postpone the decision of whether the rental is for profit by filing Form 5213, *Election to Postpone Determination as To Whether the Presumption Applies That an Activity is Engaged in for Profit*. This form must be filed within three years after the due date (determined without extensions) of the return filed for the first year of the activity. Alternatively, if the IRS proposes to disallow deductions attributable to the activity in a written notice, the taxpayer has 60 days from receipt of the notice to file the form, even if the 3-year deadline has not passed.

²⁰ Treas. Reg. §1.183-2(b).

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Reporting Income

Income received from activities not engaged in for profit is reported on Schedule 1, line 8j. This line includes rental receipts and also income from hobbies.

Example 7. Use the same facts as **Example 6**, except in April 2024, PJ retroactively reduced her friends' rent from \$800 to \$200 per month, because that was all they could afford. When Alex prepares her 2024 return, PJ tells him that she cannot bring herself to evict her friends and does not care if she ever makes money on the house. The \$2,400 she received is reported as shown on the following Schedule 1.

SCHEDULE 1 (Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2024
Attachment
Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

P J Poorhouse

*****-**-5542**

For 2024, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss

Note: The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See www.irs.gov/1099k.

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1	
2a	Alimony received	2a	
b	Date of original divorce or separation agreement (see instructions): _____		
3	Business income or (loss). Attach Schedule C	3	
4	Other gains or (losses). Attach Form 4797	4	
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	
6	Farm income or (loss). Attach Schedule F	6	
7	Unemployment compensation	7	
8	Other income:		
a	Net operating loss	8a	()
b	Gambling	8b	
c	Cancellation of debt	8c	
d	Foreign earned income exclusion from Form 2555	8d	()
e	Income from Form 8853	8e	
f	Income from Form 8889	8f	
g	Alaska Permanent Fund dividends	8g	
h	Jury duty pay	8h	
i	Prizes and awards	8i	
j	Activity not engaged in for profit income	8j	2,400
k	Stock options	8k	
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8l	
m	Olympic and Paralympic medals and USOC prize money (see instructions)	8m	
n	Section 951(a) inclusion (see instructions)	8n	
o	Section 951A(a) inclusion (see instructions)	8o	
p	Section 461(l) excess business loss adjustment	8p	
q	Taxable distributions from an ABL account (see instructions)	8q	
r	Scholarship and fellowship grants not reported on Form W-2	8r	
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d	8s	()
t	Pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan	8t	
u	Wages earned while incarcerated	8u	
v	Digital assets received as ordinary income not reported elsewhere. See instructions	8v	
z	Other income. List type and amount: _____	8z	
9	Total other income. Add lines 8a through 8z	9	2,400
10	Combine lines 1 through 7 and 9. This is your additional income . Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8	10	2,400

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71479F

Schedule 1 (Form 1040) 2024

Reporting Expenses

Before the Tax Cuts and Jobs Act (TCJA), in addition to mortgage interest and real estate taxes, taxpayers could also deduct some of the other expenses related to activities not engaged in for profit on Schedule A as miscellaneous itemized deductions. These deductions were suspended for tax years 2018 through 2025 under TCJA. However, the One Big Beautiful Bill Act (OBBBA) permanently disallows these deductions beginning in 2026, eliminating their scheduled reinstatement.²¹ As a result, individuals will no longer be able to claim these miscellaneous itemized deductions under current law, even after the TCJA suspension period ends.

Note. For more information on the impact of the OBBBA on miscellaneous itemized deductions, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

Mortgage interest may be deductible if the home qualifies as a **second residence** and the mortgage satisfies the same requirements as those applicable to a primary residence.²² A taxpayer may only have one second home at a time, but the taxpayer does not need to meet any particular use tests to claim the related mortgage interest if the home is not rented out. Income reported on Schedule 1 is not rental income for purposes of this test.

Mortgage interest might also be deductible as investment interest expense subject to the related limitations.²³ Taxpayers calculate the current year's limitations on the amount claimed on Schedule A on Form 4952, *Investment Interest Expense Deduction*. Excess expenses may be carried forward.

Real estate taxes are generally deductible regardless of how many properties a taxpayer owns. However, the cost is included with other state and local taxes subject to the overall state and local tax (SALT) limitations.²⁴

Note. Other Schedule A deductions that could be applicable for property held without profit motive include casualty and theft losses and, in very rare circumstances, charitable contributions. These deductions should only be claimed by those well versed in the facts and law. For more details on casualty and theft losses, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 6: Individual Taxpayer Issues.

Example 8. Junior has a poor credit rating, but his dream home is on the market. His parents, Mom and Pop, obtain financing and purchase the property in their names alone. They escrow the insurance and real estate taxes, and Junior pays exactly enough each month to cover the mortgage payment. Mom and Pop intend to hold onto the property until they are both deceased, at which time Junior will inherit the real estate.

Because Mom and Pop do not have a profit motive, they should report the payments Junior makes on their Schedule 1 as income each year. They may include the real estate taxes and mortgage interest on their Schedule A.

Mom and Pop are both over 65, so their 2025 standard deduction is \$34,700 (not including the OBBBA senior deduction).²⁵ In 2025, they pay property taxes of \$5,000 on their primary home and \$2,500 on Junior's home. They also pay \$6,000 of mortgage interest on both homes combined. They have no other itemizable deductions. The standard deduction of \$34,700 is more than their total itemized deductions of \$13,500 (\$5,000 property tax + \$2,500 property tax + \$6,000 mortgage interest), so they use the standard deduction. Not only must they claim the income, but they receive no tax savings from the expenses.

²¹ *One Big Beautiful Bill Act*, PL 119-21, §70108.

²² IRS Pub. 936, *Home Mortgage Interest Deduction*.

²³ See IRC §163(d).

²⁴ IRC §164(a)(1); Instructions for Schedule A.

²⁵ Rev. Proc. 2024-40, 2024-45 IRB 1100; *One Big Beautiful Bill Act*, PL 119-21, §70103.



Practitioner Planning Tip

Mom and Pop should review their options to avoid the unpleasant tax results they are facing. They could charge Junior rent at the FMV for the property and thus would be required to report the activity as any other rental.

Alternatively, they might obtain better tax results by changing how the property is financed and the manner of holding title. They could also enter into a written agreement with Junior to treat the payments as reimbursements or contract for deed payments, depending upon the circumstances.

RENTAL EXPENSES

A landlord can deduct rental expenses, such as utilities, cleaning, insurance, mortgage interest, repairs, taxes, and depreciation. This section explains when a landlord can deduct mortgage interest and depreciation deductions for rental property. The deduction for certain improvements and repairs is discussed later in this chapter.

Mortgage Interest

A taxpayer can generally deduct mortgage interest that is used to buy or improve rental property.²⁶ A taxpayer who refinances the rental property for more than the previous outstanding balance cannot deduct the part of the interest allocable to loan proceeds that are unrelated to rental use.²⁷ If loan proceeds are deposited in an account with other funds, the taxpayer generally treats the loan proceeds as having been spent before other funds in the account.²⁸

Example 9. Daria Stevens owns a residential rental property that she purchased in 2015. The current mortgage balance is \$100,000, which is original acquisition debt, with a 4.5% interest rate. Daria has \$300,000 in student loans on which she is paying 7% interest. If Daria refinances the mortgage to include a payoff of the student loans, Daria must allocate the mortgage interest 25% to the rental property (\$100,000 mortgage ÷ \$400,000 total loans) and 75% to the student loan payoff (\$300,000 student loan ÷ \$400,000 total loans).

Depreciation²⁹

Generally, the landlord must capitalize expenses to acquire or improve rental property. The landlord then recovers the cost of those improvements through annual depreciation deductions. The amount of the depreciation deduction depends on the taxpayer's basis in the property, the recovery period, and the depreciation method.

²⁶ Temp. Treas. Reg. §1.163-8T.

²⁷ IRS Pub. 527, *Residential Rental Property*.

²⁸ Temp. Treas. Reg. §1.163-8T(c)(4)(ii).

²⁹ IRC §167.

Basis.³⁰ The basis of purchased property is typically its cost. Certain closing costs, fees, and other expenses paid when purchasing real property are included in the basis. Real estate taxes the buyer pays that were owed by the seller and not reimbursed by the seller are added to the property's basis. Any amounts the seller owes that the buyer agrees to pay (e.g., recording fees, mortgage fees, back taxes or interest, charges for improvements or repairs, and sales commissions) are added to the basis. Basis also includes the following costs.

- Abstract fees
- Charges for installing utility services
- Legal fees
- Recording fees
- Surveys
- Transfer taxes
- Title insurance

Certain settlement fees and closing costs are **not** included in the basis for the property. These include the following.

- Premiums for fire insurance
- Expenses to occupy the property prior to closing, such as rent
- Expenses to secure or refinance a loan (e.g., points, mortgage insurance premiums, loan assumption fees, costs of a credit report, and fees for a required appraisal)
- Escrowed taxes and insurance payments

When purchasing a property with an existing mortgage, the taxpayer's basis includes the purchase price and the remaining mortgage balance assumed.

A building's depreciable basis must exclude the land on which it is located. If the price of the real estate does not reasonably allocate costs between building and land, the purchaser must determine a reasonable allocation. Generally, each asset is allocated a part of the cost based on the ratio of the FMV of the asset to the FMV of the whole property at the time of purchase. If the FMV of the land or the buildings is not evident, the cost can be divided based on their assessed values for real estate tax purposes or another reasonable method to determine FMV.

Example 10. Hank is expanding his portfolio of commercial office buildings that he leases to businesses and buys two office buildings in 2025. He buys an office building and land on Main Street for \$750,000. He pays \$50,000 in cash and assumes a mortgage of \$700,000 on the property. His total basis is \$750,000. Based on an appraisal performed for the lender, the purchase price is allocated \$680,000 for the building and \$70,000 for the land.

Hank pays \$600,000 for land and an office building on First Street. The purchase contract does not itemize how much of the price is for the land and how much is for the building. The most recent real estate tax assessment for the First Street property was based on an assessed value of \$575,000, of which \$500,000 was for the building and \$75,000 was for the land. Hank can allocate 87% ($\$500,000 \div \$575,000$) of the purchase price to the building. Therefore, his basis in the building is \$522,000 ($\$600,000 \text{ cost} \times 87\%$). The remaining basis of \$78,000 is allocated to land and is not depreciable.

Hank calculates depreciation on the \$680,000 depreciable basis for the Main Street building and the \$522,000 depreciable basis for the First Street building on Form 4562, *Depreciation and Amortization*. The amounts carry to line 18 of Schedule E.

³⁰ IRC §1016; Treas. Reg. §1.1016-2; IRS Pub. 551, *Basis of Assets*.



Practitioner Planning Tip

Hank may benefit from a cost segregation study on both properties to determine if he can claim any accelerated depreciation because some of the bases can be allocated to the buildings' personal property. Cost segregation studies are discussed in the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Selected Real Estate Topics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Note. For more information about depreciation, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 7: Depreciation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Basis Other than Cost.³¹ Taxpayers cannot use cost to determine the basis for property they receive in one of the following ways.

- In return for services the taxpayer performed
- In exchange for other property
- As a gift from a spouse or former spouse as the result of a divorce
- As an inheritance

Note. For information on determining the basis for property received in each of the preceding manners, see IRS Pub. 551, *Basis of Assets*. For information on determining the adjusted basis to calculate an asset's depreciation, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Example 11. Ruby Coleman pays \$825,000 for a rental duplex. Her purchase documents do not allocate the purchase price between the land and the building. The county assessor assesses taxes based on a \$125,000 value for the land and a \$500,000 value for the building (\$625,000 total value).

Ruby must allocate the \$825,000 purchase price between the land and building in proportion to their assessed values. Ruby allocates 20% (\$125,000 assessed value of land ÷ \$625,000 total assessed value) or \$165,000 (20% × \$825,000 purchase price) to land and the remaining 80% or \$660,000 (80% × \$825,000 purchase price) to the building.

³¹ IRS Pub. 551, *Basis of Assets*.



Practitioner Planning Tip

There should be a proper allocation of the purchase price of real property among the various depreciable components, e.g., land, building, appliances, etc.³² The shorter lives of the personal property or land improvements will result in faster cost recovery, however they may result in depreciation recapture upon sale.³³ Cost segregation studies can prove helpful in an acquisition of a multiple family residential apartment complex or other complex property purchase.

Note. The owner of a condominium typically is considered to have acquired an undivided interest in the underlying land and a portion of such purchase price should be allocated to the land and not depreciated.³⁴

Recovery Period.³⁵ Most business and investment property placed in service after 1986 is depreciated using the modified accelerated cost recovery system (MACRS). Each item of property that can be depreciated under MACRS is assigned to a property class, determined by its class life. The recovery class determines the recovery period, which is the period over which the taxpayer recovers basis. Under the general depreciation system (GDS),³⁶ the recovery period of an asset is generally the same as its property class. The following table shows the property class and recovery periods for common residential rental property.

Asset	Recovery Period (Years)
Land	N/A
Appliances, carpeting, furniture	5
Roads, shrubbery, fences, driveways, patios	15
Residential rental building	27.5

Depreciation Method.³⁷ Residential rental property is depreciated using the straight-line method and the midmonth convention. Under the midmonth convention, the taxpayer treats all property placed in service or disposed of during a month as placed in service or disposed of at the midpoint of the month. This means that taxpayers can claim half a month of depreciation for the month when the property is placed in service and the month it is disposed of. Depreciation is only claimed for the months during which the property is in use.

Note. Residential rental property is any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. It does not include a unit in a hotel, motel, or other establishment where more than half the units are used on a transient basis. If a residential rental is a short-term rental, it may be nonresidential real property with a 39-year recovery period. Any change in use may require a correction in depreciation.³⁸

³² IRC §167(a).

³³ IRC §§1245 and 1250.

³⁴ IRS Notice 88-99, 1988-2 CB 422.

³⁵ IRC §§168(c), (d), and (e); IRS Pub. 946, *How to Depreciate Property*.

³⁶ IRC §168(a).

³⁷ IRC §168(b); IRS Pub. 946, *How to Depreciate Property*.

³⁸ IRC §168(e)(2); Treas. Reg. §1.168(i)-4.

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To help calculate the MACRS deduction, the IRS established percentage tables that incorporate the applicable convention and depreciation method. These percentage tables are in Appendix A in Publication 946, *How to Depreciate Property*. In general, the rates in the percentage tables are applied to the property's unadjusted basis.

Note. For an in-depth discussion on depreciation, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 7: Depreciation. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Example 12. Spring Cho purchases a single-family rental house for \$985,000 and places it in service on February 8, 2025. The sales contract shows that \$760,000 is allocated to the building and \$225,000 is allocated to the land. Spring's basis for depreciation is the \$760,000 original cost of the building.

Spring uses the GDS, which has a 27.5-year recovery period. Using the following table (found in IRS Pub. 946), she finds that the depreciation percentage for property placed in service in February of year 1 is 3.182%. Her 2025 depreciation deduction is \$24,183 ($\$760,000 \times 0.03182$).

Table A-6. **Residential Rental Property
Mid-Month Convention
Straight Line—27.5 Years**

Year	Month property placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2-9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
12	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
13	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
14	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
15	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
16	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
17	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
18	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
19	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
20	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
21	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
22	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
23	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
24	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
25	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
26	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
27	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
28	1.97	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29							0.152	0.455	0.758	1.061	1.364	1.667

TANGIBLE PROPERTY REGULATIONS³⁹

3

A taxpayer with rental property must determine whether an expenditure is a currently deductible repair or an improvement that must be capitalized. Several safe harbors exist, and the tax practitioner should determine whether a safe harbor applies before classifying the expenditure as a repair or an improvement. This issue discusses how the tangible property regulations and safe harbors apply to a taxpayer who owns rental property.

SAFE HARBORS

There are three safe harbors that may apply to taxpayers with rental property: a de minimis safe harbor, a routine maintenance safe harbor, and a safe harbor for small taxpayers.

De Minimis Safe Harbor⁴⁰

The de minimis safe harbor allows taxpayers to deduct small expenditures for the acquisition or production of new property, or for the improvement of existing property. The de minimis safe harbor election allows taxpayers without an applicable financial statement (AFS), defined later, to expense any item up to \$2,500 (per invoice or per item as substantiated by the invoice), and taxpayers with an AFS can expense any item up to \$5,000 (per invoice or per item as substantiated by the invoice).

An anti-abuse rule prohibits manipulating transactions to avoid the dollar limits. It applies if the taxpayer substantiates a single unit of tangible property with multiple invoices to stay within the dollar limit. The regulations give the example of a taxpayer who purchases a truck and obtains separate invoices for the cab, engine, trailer, and tires. Although each item is under the limit, taken together, they exceed the \$2,500/\$5,000 limit.



Practitioner Planning Tip

The tangible property regulations⁴¹ originally set the de minimis amount to \$500 for taxpayers without an AFS. The IRS raised the limit to \$2,500 for 2016 and subsequent tax years.⁴² The treasury regulations have not been updated to reflect the increase in the de minimis safe harbor for taxpayers without an AFS.

Although the landlord's or tenant's accounting procedures can set any dollar limit for expensing, the per-item tax deduction is limited to \$2,500 for landlords or tenants without an AFS and \$5,000 for landlords or tenants with an AFS. Therefore, if the accounting procedures state a threshold that exceeds \$2,500 (\$5,000 for landlords or tenants with an AFS), only the items that cost \$2,500 (\$5,000) or less qualify for the safe harbor.

³⁹ TD 9636, 2013-43 IRB 331; 79 Fed. Reg. 42,189 (Jul. 21, 2014).

⁴⁰ Treas. Reg. §1.263(a)-1(f).

⁴¹ Treas. Reg. §1.263(a)-1(f)(1).

⁴² IRS Notice 2015-82, 2015-50 IRB 859.

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In other words, an ordinary and necessary business expense must meet the following two requirements to qualify for the de minimis safe harbor.

1. It must be currently deductible under the landlord's or tenant's accounting procedure that was in place at the beginning of the tax year. That means it must be within one or both of two limits.
 - a. A de minimis amount (which can be greater than the \$2,500 or \$5,000 limit for the safe harbor)
 - b. A 12-month limit on the useful life of the item purchased (which may also have a limit)
2. The amount paid cannot exceed the \$2,500 or \$5,000 limit for the safe harbor.

When a taxpayer properly elects the de minimis safe harbor, the taxpayer does not treat the amount paid as a capital expenditure. Instead, the taxpayer deducts the amount under Treas. Reg. §1.162-1, provided it otherwise constitutes an **ordinary and necessary business expense**. The safe harbor allows the taxpayer to deduct the cost even if IRC §263(a) otherwise would require the taxpayer to capitalize it. The safe harbor also allows the taxpayer to take the deduction when the cost is paid or incurred, even if Treas. Reg. §1.162-3 would require the taxpayer to deduct the expense when the property was first used or consumed in the business.

However, de minimis amounts paid for tangible property may be subject to capitalization under IRC §263A if the amounts include the direct or allocable indirect costs of other property produced or acquired for resale. For example, the taxpayer must capitalize all the direct and allocable indirect costs of constructing a new building.



Practitioner Planning Tip

The taxpayer must have a purchase invoice to deduct an amount under the de minimis safe harbor.⁴³ For example, if a taxpayer purchases appliances together with the purchase of real property, and the price for each appliance is less than \$2,500, the taxpayer cannot deduct the cost of the appliances under the de minimis safe harbor unless the taxpayer has a separate invoice for the purchase of the appliances. While the regulations do not define the term **invoice**, at a minimum the invoice must state the total amount due and the price per item. The taxpayer does not have to include the additional costs of acquiring or producing such property (such as delivery and installation) if these costs are not included on the same invoice as the tangible property.

The de minimis safe harbor election is an annual election (discussed later). Taxpayers may not selectively choose items to expense under the de minimis safe harbor. If the taxpayer elects the safe harbor, the taxpayer must deduct expenditures for all units of property that meet the safe harbor requirements in the year the expenses are paid (by a cash-basis taxpayer) or incurred (by an accrual-basis taxpayer).

⁴³ Treas. Reg. §1.263(a)-1(f).

Any subsequent gain on disposition of the property expensed under the de minimis safe harbor is ordinary income.⁴⁴ It is not characterized as a sale or other disposition of a capital asset under IRC §1221 or as disposition of property used in a trade or business under IRC §1231. The sale is reported in part II of Form 4797, *Sales of Business Property*.

Note. The de minimis safe harbor does not limit a taxpayer's ability to deduct otherwise deductible repair or maintenance costs that exceed the specified dollar limit.⁴⁵ The de minimis safe harbor merely establishes a minimum threshold below which all qualifying amounts are considered currently deductible. Consistent with longstanding federal income tax rules, a taxpayer may continue to deduct all otherwise deductible repair or maintenance costs, regardless of the amount.

Accounting Procedures.⁴⁶ To qualify for the de minimis safe harbor election, a taxpayer must have accounting procedures in place at the beginning of the tax year that treat the cost of items as an expense for nontax purposes if the items either cost less than a specified amount or have an economic useful life of 12 months or less. The accounting procedures must be **written** only if the taxpayer has an AFS, as defined later.

Expensing Limit Policy. A taxpayer's nontax accounting procedures may set a per-item expensing limit that is lower or higher than the allowable tax deduction amount. If an accounting procedure sets a lower limit for financial accounting, that lower limit also applies for tax purposes. If the accounting procedure sets a higher limit, the tax deduction is limited to \$2,500 for taxpayers without an AFS or \$5,000 for taxpayers with an AFS. The expensing policy can set different limits for different types of property, and it can provide exclusions for specified types of property.

Economic Useful Life Policy. If the taxpayer's accounting procedures treat the cost of items that have a useful life of 12 months or less as a current deduction, the procedure can (but does not have to) also set a dollar limit on those items. However, even though the taxpayer's 12-months-or-less accounting procedure treats the cost of an item as a current deduction, the cost qualifies for the safe harbor only if the item costs \$2,500 for taxpayers without an AFS (\$5,000 for taxpayers with an AFS) or less.

The **economic useful life** of a unit of property is not necessarily its **inherent useful life**; instead, it is the period during which the property may reasonably be expected to be useful in the taxpayer's trade or business.⁴⁷ Taxpayers must consider the useful-life factors in Treas. Reg. §1.167(a)-1(b), which include the following.

1. Wear and tear and decay or decline from natural causes
2. Economic changes, inventions, and current developments in the industry and the taxpayer's trade or business
3. Climatic and other local conditions peculiar to the taxpayer's trade or business
4. The taxpayer's policy on repairs, renewals, and replacements

Applicable Financial Statement.⁴⁸ An AFS (in descending priority) is defined as one of the following.

1. A financial statement that the taxpayer must file with the Securities and Exchange Commission (SEC)
2. A certified, audited financial statement that is accompanied by the report of an independent CPA and that is used for credit purposes; reporting to shareholders, partners, or similar persons; or any other substantial nontax purpose
3. A financial statement (other than a tax return) that the taxpayer must provide to a federal or state government or an agency other than the SEC or the IRS

⁴⁴ Treas. Reg. §1.263(a)-1(f)(3)(iii).

⁴⁵ Treas. Reg. §1.263(a)-1.

⁴⁶ Treas. Reg. §§1.263(a)-1(f)(1)(i)(B) and (C).

⁴⁷ Treas. Reg. §1.162-3(c)(4).

⁴⁸ Treas. Reg. §1.263(a)-1(f)(4).

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If a taxpayer reports its financial results on a group AFS, the taxpayer can treat the group's AFS as the taxpayer's AFS and can treat the group's written accounting procedures as the taxpayer's written accounting procedures.⁴⁹

Annual Election. The de minimis safe harbor election is an annual election affecting only the election tax year. To make the election, an eligible taxpayer (anyone with an accounting procedure in place at the beginning of the year that requires expensing items that cost no more than a specified amount or that have a useful life of 12 months or less) must attach a statement to the taxpayer's timely filed (including extensions) original federal income tax return.⁵⁰

Once made, the taxpayer **cannot revoke** the election for that tax year. However, if the deadline for the return has not yet passed, the taxpayer may be able to file an amended return that does not make the election. The statement must be titled "Section 1.263(a)-1(f) De Minimis Safe Harbor Election." It must include the taxpayer's name, address, taxpayer identification number (TIN), and a statement that the taxpayer is making the de minimis safe harbor election under Treas. Reg. §1.263(a)-1(f).

For an S corporation or partnership, the entity must make the election, not the shareholders or partners. The following is an example of the required statement.

Section 1.263(a)-1(f) De Minimis Safe Harbor Election

Sam Smith Plumbing, Inc.
2014 Main Street
Schenectady, NY 12345
TIN: 12-3451231

For the year ending December 31, 2025

Taxpayer elects the de minimis safe harbor under Treas. Reg. §1.263(a)-1(f) for its tax year ending December 31, 2025.

Example 13. Tracy Sanders owns a 4-unit apartment building. Each unit has two large windows on the front side of the building. In 2025, Tracy replaces one of the windows at a cost of \$2,100. Usually, Tracy would have to capitalize and depreciate the cost of the window over 27.5 years. However, if Tracy elects the de minimis safe harbor, she can fully expense the cost of the window in the current tax year.

If the total cost of the window is \$4,200, Tracy could only expense it under the de minimis safe harbor election if she has an AFS because the amount exceeds \$2,500. (However, see the later discussion of the safe harbor for small taxpayers.)

Routine Maintenance Safe Harbor⁵¹

A taxpayer who owns rental property characterizes an expense for routine maintenance as a deductible repair and not an improvement that must be capitalized. Maintenance of a building or building system (defined later) is considered routine if it is expected to be performed more than once over a 10-year period.

The taxpayer does not actually have to perform maintenance more than once during the 10-year period. The taxpayer meets the routine maintenance safe harbor simply if they **expected** to perform the maintenance more than once during this period. For property other than buildings, the taxpayer must expect to perform the maintenance more than once during the alternative depreciation system (ADS) class life, even if the taxpayer does not depreciate the property under ADS.

⁴⁹ Treas. Reg. §1.263(a)-1(f)(3)(vi).

⁵⁰ Treas. Reg. §1.263(a)-1(f)(5).

⁵¹ Treas. Reg. §1.263(a)-3(i).

The expected need for routine maintenance must be attributable to the taxpayer's use of the property. Maintenance is not routine if it is performed to fix a defect that existed when the taxpayer purchased the property.



Practitioner Planning Tip

Tax practitioners should advise their clients with rental property to develop a written maintenance plan. The taxpayer can use the plan as evidence of the need for routine maintenance of the taxpayer's rental units.

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Example 14. Willie Wright owns a 4-unit apartment building with a \$500,000 unadjusted basis. As part of his ongoing maintenance plan, Willie replaces the handrails inside each condo unit stairway at a cost of \$11,000. He plans to replace the stair handrails every four years. Willie must expense the full cost of the handrail replacements as a repair because it is considered routine maintenance. The cost of the repair does not affect the applicability of the routine maintenance safe harbor.

Example 15. Use the same facts as **Example 14**. Willie has two coin-operated washers and two coin-operated dryers in the basement of the apartment building. When Willie purchased the appliances from Western Appliances, Inc. in 2024, he signed a maintenance contract. Under the contract, Western Appliances provides preventative maintenance once per year.

During the first maintenance call in 2025, Western Appliances identifies a major repair that costs \$2,800. Willie expenses the routine maintenance in 2025. Western Appliances goes out of business in late 2026, and Willie decides not to hire a new company to perform the routine maintenance. Willie does not perform any other maintenance in the following eight years.

Willie deducts the \$2,800 repair cost under the routine maintenance safe harbor. At the time that he incurred the repair cost, he expected to perform maintenance more than once in the 9-year ADS class life of the appliances, even though he only performed maintenance once in the 9-year period.

Safe Harbor for Small Taxpayers⁵²

Taxpayers with average annual gross receipts of \$10 million or less over the three preceding tax years may elect to expense amounts paid for repairs, maintenance, and improvements to buildings with an unadjusted basis of \$1 million or less, provided that the total annual expenditures for such costs do not exceed the **lesser of 2%** of the building's unadjusted basis **or \$10,000**.

The taxpayer makes this election each year by attaching a statement to a timely filed tax return, including extensions. The statement must reference the Treas. Reg. §1.263(a)-3(h) safe harbor for small taxpayers. Pursuant to Rev. Proc. 2015-13,⁵³ when the taxpayer makes this election or stops using the election, the taxpayer is not changing their accounting method, and Form 3115, *Application for Change in Accounting Method*, is not required.

Amounts expensed under the de minimis safe harbor and the routine maintenance safe harbor are included in the total cost of repairs, maintenance, and improvements for the purpose of determining whether the taxpayer can use the safe harbor for small taxpayers. The calculation is made separately for each building, and the basis of the building does not include the basis of the land.

⁵² Treas. Reg. §1.263(a)-3(h).

⁵³ Rev. Proc. 2015-13, 2015-5 IRB 419.

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Example 16. Larry Bonetti has \$140,000 average annual gross receipts.⁵⁴ He owns two residential rental properties (105 Pine Creek and 107 Pine Creek), and each building has a \$300,000 unadjusted basis. Larry pays \$5,000 for repairs and improvements to 105 Pine Creek. Because the amount does not exceed the lesser of \$10,000 or \$6,000 ($\$300,000 \times 2\%$), Larry may elect to apply the safe harbor and deduct the \$5,000 cost of the repairs and the improvements that might otherwise be capitalized.

Larry pays \$7,000 for repairs and improvements to 107 Pine Creek. Larry cannot elect the small taxpayer safe harbor for that building because \$7,000 exceeds the \$6,000 ($\$300,000 \times 2\%$) safe harbor amount. The safe harbor is applied building by building, so if Larry pays \$5,500 for repairs and improvements to 107 Pine Creek, Larry could deduct those amounts under the small taxpayer safe harbor.

Example 17. Matteo Arnold has \$185,000 average annual gross receipts. He owns a residential rental building with a \$750,000 unadjusted basis. In 2025, Matteo adds gutters on the front of the building. The materials and labor cost \$5,000. Matteo's other repairs and maintenance to the building for the year are \$6,000, for a total of \$11,000 ($\$5,000 + \$6,000$) in repair, maintenance, and improvement costs. Because the total costs exceed the lesser of \$10,000 or \$15,000 ($\$750,000 \times 2\%$), Matteo cannot elect the small taxpayer safe harbor for the repairs incurred in 2025.

REPAIRS OR IMPROVEMENTS TO RENTAL PROPERTY⁵⁵

If none of the safe harbors apply, the taxpayer must determine whether an expenditure on rental property is a repair or an improvement. The expenditure amount is not a factor. The taxpayer must separate the key components of the property and then determine if the expenditure is one of three types of improvements: a betterment, a restoration, or an adaptation.

The first step is to decide what key building system the expenditure belongs to. The building structure is a separate component, and the IRS has identified eight key systems within that building structure. Each key system is treated as its own unit of property. These key building systems include the following:

- Plumbing
- Electrical
- Heating, ventilation, and air conditioning (HVAC)
- Escalator
- Elevator
- Fire protection and alarm
- Gas distribution
- Security

The second step is to determine if the expenditure is a betterment, restoration, or an adaptation. If the expenditure falls into one of these three categories, it is categorized as an improvement, and the taxpayer capitalizes the expenditure (unless a safe harbor, discussed earlier, applies).

⁵⁴ This example is based on Treas. Reg. §1.263(a)-3(h)(10), Example 3.

⁵⁵ Treas. Reg. §1.263(a)-3.

Betterment

A betterment can fall into the following three main categories.

1. A fix for a material condition or defect that existed before the purchase of the unit of property.
2. A material addition to a unit of property, which is any material physical enlargement, expansion, extension, or addition of a major component or a material increase in capacity.
3. A material increase in productivity, efficiency, strength, quality, or output of the unit of property.

The treasury regulations do not define the term **material**. Some examples in the regulations use percentages, but there is no clear standard. The taxpayer must use common sense and reasonable judgment when deciding if an expenditure constitutes a betterment.

The following examples assume that none of the safe harbors apply.

Example 18. In 2025, Kathleen Hayes purchases a multi-unit apartment building. At the time that she purchases the building, it is in disrepair, and there are no tenants. Kathleen hires a contractor to make all the repairs necessary for the building to be habitable again. Kathleen must capitalize these costs because they are incurred to fix material defects in the property that existed before Kathleen purchased the property.

Example 19. Use the same facts as **Example 18**. Kathleen rents the apartments to tenants for several years. One of the walls of the building starts to lose its structural integrity. Kathleen's contractor puts in another wall and removes the existing wall. The new wall adds 20 square feet to a 900-square-foot apartment. Kathleen does not increase the rent. Even though the new wall adds square footage to the apartment, it is not considered a betterment because there was no material physical enlargement and no increased productivity. Kathleen must determine if the replacement is a restoration of a major structural component (discussed next).

Restoration

A restoration is an improvement that must be capitalized. Generally, an expenditure is considered a restoration if it meets one of the following tests.

1. It is replacing a component that has been sold or abandoned, and the appropriate gain or loss is recognized. This also includes replacement after a casualty loss where a basis adjustment was required.
2. The unit of property is in a state of disrepair, and the cost is incurred to bring the unit of property back to working order.
3. The expenditure results in the rebuilding of a unit of property to like-new condition at the end of its class life.
4. The expenditure is for replacement of a **major component** or a **substantial structural part** of a unit of property. A major component is defined as a part or combination of parts that performs a critical function in the operation of the unit of property. A substantial structural part is a part or parts that comprise a large portion of the unit of property.

For building-related expenditures, it is important to think about what key system the expenditure belongs to. If the expenditure applies to a major portion of the building or is critical to the operation of the building, it is an improvement.

Example 20. Use the same facts as **Example 19**. Kathleen continues to operate her apartment building. In 2029, a fire damages the electrical system and several interior walls in one of the units. Kathleen hires a contractor to replace the damaged wiring and rebuild the walls using materials similar to those originally used. These repairs restore the unit to its pre-fire condition.

Because the work restores a major component of the building (the electrical system and structural walls) to its ordinary, efficient operating condition after damage, the costs must be capitalized as a restoration.

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Example 21. Lana Nelson owns an apartment building.⁵⁶ The roof decking over Lana's building is covered with a waterproof rubber membrane. Over time, the rubber membrane begins to wear, and Lana experiences leaks in the upper apartments. However, the building is still functioning. To eliminate the problems, a contractor recommends that Lana replace the membrane on the roof with a new rubber membrane. Accordingly, Lana pays the contractor to strip the original membrane and replace it with a new rubber membrane. The new membrane is comparable to the original membrane but corrects the leakage problems.

The roof, including the membrane, is part of the building structure. Because the entire roof performs a discrete and critical function in the building structure, the roof comprises a major component of the building structure. Although the replacement membrane may aid in the function of the building structure, it does not, by itself, comprise a significant portion of the roof major component. In addition, the replacement membrane does not comprise a substantial structural part of Lana's building structure. Therefore, Lana is not required to capitalize the amount paid to replace the membrane as a restoration of the building.

Example 22. Sally Satterfield owns a duplex. The water line broke in the lower unit, and it remained unoccupied for two years. The unit is in such disrepair that Sally is unable to rent it. Sally makes some important renovations to make the unit habitable. These renovations are an improvement because they bring the unit back to working order. Sally must capitalize the cost of the renovations.

Adaptation

The third type of improvement is the adaptation of a property to a **new or different use**. The adaptation must not be consistent with the ordinary use of the unit of property at the time it was originally placed in service.

Example 23. Use the same facts as **Example 20**. Later that year, Kathleen decides to convert another unit in the building into a co-working space to attract a different type of tenant. She removes the kitchen, installs commercial-grade lighting and soundproofing, and reconfigures the layout to create open work areas.

These changes are considered an adaptation of the unit to a new or different use. The costs of the conversion must be capitalized because they adapt the property to a new use.

Example 24. Keith Robinson owns a 2-story rental house that he has always rented out to one family. He decides that he can greatly increase his rent if he turns the property into two separate units: a commercial rental downstairs and a residential rental upstairs. In addition to costs for permits, he must add one bathroom, create a separate entrance for the lower unit, and clear some trees to increase the parking area. Keith must capitalize these expenses because they are incurred to adapt the property to a new or different use.

Example 25. Use the same facts as **Example 24**. Several years later, Keith sells his rental property. In anticipation of selling the building, Keith pays contractors to repaint the interior walls and to refinish the hardwood floors. Preparing a building for sale does not constitute a new or different use for the building structure. Therefore, the amount that Keith pays to prepare the building structure for sale does not improve the building, and Keith does not have to capitalize the expenses. Instead, Keith expenses the amounts as repairs.

⁵⁶ This example is based on Treas. Reg. §1.263(a)-3(k)(7), Example 15.

SELF-EMPLOYMENT TAX ON RENTAL INCOME⁵⁷

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Payments for the use or occupancy of entire private residences or living quarters in duplexes or multiple housing units are generally real estate rentals. Except in the case of real estate dealers, such payments are excluded from SE net earnings.⁵⁸ Even if rental real estate activities rise to the level of an IRC §162 trade or business, those activities are generally reported on part 1 of Schedule E (Form 1040), because rental real estate is generally excluded from SE income. However, rental real estate may be subject SE tax if the landlord provides **substantial services** for the convenience of the occupants.

Note. Different rules may apply to the rental of personal property and farm property.

SUBSTANTIAL SERVICES⁵⁹

Taxpayers (including those in a qualified joint venture) use Schedule C (Form 1040), *Profit or Loss From Business*, when they provide **substantial services** in connection with the property. The IRS provides the following guidance to help identify substantial services.

*Services are substantial if the compensation for the services makes up a material part of the tenants' rental payments.*⁶⁰

Substantial services are services that are primarily for the tenant's convenience, such as regular cleaning, changing linen, or maid service. Substantial services do not include the furnishing of heat and light, the cleaning of public areas, trash collection, etc.

Example 26. Sharon lists her house on an online marketplace for vacation rentals. She rents it out to a couple for 20 days in July. Sharon provides the basic amenities such as water, electricity, air conditioning, and linens. No additional services are included in the rent other than the use of the property. The income and expenses from her rental are reported on Schedule E.

Example 27. Bradley lists his guest house on an online marketplace for vacation rentals. The guest house is on Bradley's property and is adjacent to his primary residence. He rents out the guest house to various occupants for a total of 27 days during the year. In addition to providing the necessary amenities, Bradley also prepares breakfast daily for the renters and has a maid service clean the guest house every other day. Because Bradley provides substantial services, he reports the income and expenses on Schedule C.

REAL ESTATE DEALERS

A real estate dealer is engaged in the business of selling real estate to customers to make a profit from those sales. If they receive incidental rents from real estate held for sale to customers, the real estate dealer reports that income on Schedule C.⁶¹ Generally, courts consider the following factors when determining whether a taxpayer is a dealer in real estate.⁶²

- The nature and purpose of buying the property
- The length of time the taxpayer owned the property
- The continuity of sales activity over a period of time

⁵⁷ Treas. Reg. §1.1402(a)-4.

⁵⁸ IRC §1402(a)(1).

⁵⁹ IRS Pub. 527, *Residential Rental Property*.

⁶⁰ IRS Pub. 334, *Tax Guide for Small Business*.

⁶¹ Ibid.

⁶² *McCullen v. Comm'r*; TC Memo 1997-280 (Jun. 19, 1997).

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- The number and frequency of sales
- The extent to which the taxpayer developed the property, solicited customers, and advertised
- The ratio of sales to other sources of income

Because income reported on a Schedule C is generally subject to SE tax, a taxpayer may try to avoid being labeled as a real estate dealer. The following tax issues apply to dealers.

- Depreciation is not an eligible expense on real estate property held as inventory in the ordinary course of business by a dealer.⁶³
- A dealer applies ordinary gain rates to the sale of real estate property held as inventory in the ordinary course of business. An investor in real estate applies capital gains rates to the sale of real estate property.⁶⁴
- A dealer cannot defer income tax under an installment sale.⁶⁵

Example 28. Taylor has two sources of income: flipping houses and renting out properties. Over the last six years, Taylor flipped seven houses; five made a profit, and two were losses. In 2025, she purchased two properties in foreclosure and spent \$750,000 to remodel them. In November, Taylor completes the flip on the house she bought in January 2025. She sells the house for \$600,000 and earns a profit of \$70,000. Taylor flips the other house in September for a \$3,500 profit. The sales are subject to the ordinary tax rate, and Taylor cannot claim depreciation on the buildings. The houses are kept as inventory, and Taylor is considered a real estate dealer. Her house-flipping activity is reported on Schedule C and is subject to SE tax.

Additionally, Taylor owns two properties that she rents out on annual leases and reports the income and expenses on Schedule E. During 2025, she remodels the kitchen and main bathroom in one of the rentals for a cost of \$100,000. After the remodel, Taylor sells the house for a \$25,000 profit. Her profit takes into account the accumulated depreciation she has claimed on the property since Taylor placed the building into service. Her profit is reported on Form 4797 and is subject to depreciation recapture rules under IRC §1250.



Practitioner Planning Tip

Because the determination of whether a taxpayer is a real estate dealer is made at the property level,⁶⁶ a taxpayer with multiple properties should maintain separate records. A taxpayer may benefit from classifying their real estate activity as Schedule E activity. It may be a good idea to place the rentals into separate legal entities apart from other real estate activities.

⁶³ See, e.g., *Wood v. Comm'r*; TC Memo 2004-200 (Aug. 31, 2004).

⁶⁴ See, e.g., *Murray v. Comm'r*; TC Memo 1965-148 (May 27, 1965); *Pool v. Comm'r*; TC Memo 2014-3 (Jan. 8, 2014).

⁶⁵ IRC §453(b)(2)(A).

⁶⁶ *Matthews v. Comm'r*; 315 F.2d 101 (6th Cir. 1963).

EXCLUSION FROM SE TAX

Generally, if the taxpayer provides only the dwelling and services primarily for the convenience of the tenant, then the taxpayer is a landlord and reports income and expenses on Schedule E (Form 1040). Insubstantial and routine services such as heat and light, cleaning stairways and lobbies, and collecting trash are services normally provided for the occupants' convenience.⁶⁷

QUALIFIED BUSINESS INCOME DEDUCTION

QBID, enacted under IRC §199A, allows eligible taxpayers to deduct up to 20% of qualified business income (QBI) from certain pass-through entities. While the deduction is widely applicable to sole proprietorships, partnerships, S corporations, and some trusts and estates, its application to rental real estate activities requires careful analysis.

RENTAL REAL ESTATE AS A TRADE OR BUSINESS

To qualify for the QBID, rental real estate must rise to the level of a trade or business under §162. This determination is inherently facts-and-circumstances-based, considering factors such as:

- Regularity and continuity of the rental activity
- The owner's or agent's level of involvement
- Intent to earn a profit

Passive ownership of a single property with minimal activity may not qualify, whereas managing multiple properties, handling tenant relations, and overseeing maintenance may support trade or business classification.

IRS SAFE HARBOR⁶⁸

To provide clarity, the IRS issued Rev. Proc. 2019-38, establishing a safe harbor under which a rental real estate enterprise may be treated as a trade or business for QBID purposes. Key requirements include:

- Separate books and records for each rental enterprise
- At least 250 hours of rental services performed annually (by the owner, employees, agents, or contractors)
- Contemporaneous documentation of services performed, including dates, hours, and descriptions

Note. Triple net leases and properties used by the taxpayer as a residence for any part of the year are excluded from the safe harbor.

Note. Self-rental is allowed for QBID, but may be subject to limitations.

⁶⁷ Treas. Reg. §1.1402(a)-4(c)(2).

⁶⁸ Rev. Proc. 2019-38, 2019-42 IRB 942.



Practitioner Planning Tip

The following are considerations for tax practitioners when analyzing a taxpayer's QBID situation for rental real estate.

- Documentation is critical. Encourage clients to maintain detailed records to support safe harbor eligibility.
- Multiple rental activities may be aggregated if they meet common ownership and operational criteria, potentially simplifying compliance.
- Consider whether holding rental properties in a pass-through entity enhances QBID eligibility or simplifies reporting.

AT-RISK RULES⁶⁹

Under the IRC §465 at-risk rules, deductions or losses from any activity are limited to the amount that the investor has at risk. Any losses that exceed the at-risk amount are suspended until the taxpayer increases the amount at risk. The taxpayer cannot carry back the suspended losses.

The at-risk limits apply to **active** trade or business losses and to investment and rental activities. Thus, for **passive activities**, the taxpayer must apply the at-risk rules and then the limits on PALs, discussed later.

TAXPAYERS SUBJECT TO THE RULES

The at-risk limits apply to individuals, estates, trusts, and certain closely held C corporations. The limits do not apply directly to partnerships, limited liability companies (LLCs), or S corporations. Instead, each individual partner, member, or shareholder must determine their amount at risk in the partnership or S corporation.

Closely held C corporations are subject to the §465 at-risk rules. A C corporation is closely held if five or fewer persons (with broad attribution rules) own more than 50% of the stock.⁷⁰ There are also special rules for closely held corporations that have an active equipment leasing business.⁷¹

AMOUNT AT RISK

The amount at risk includes money and the adjusted basis of property contributed to the activity and debts for which the taxpayer is personally liable. If the taxpayer has no personal liability but has pledged property that is **not** used in the activity as security for repayment of the debt, the amount at risk is the FMV of the pledged property less any superior liens. Pledged property that is used in the activity does not increase the taxpayer's amount at risk.

Note. In many cases, the taxpayer's amount at risk is the same as their adjusted basis. The principal differences arise when the taxpayer's basis is increased by nonrecourse debt or by an obligation to a co-owner in the activity.

⁶⁹ IRC §465.

⁷⁰ IRC §§465(a)(1)(B) and 542(a)(2).

⁷¹ IRC §465(c)(4).

A loan from a co-owner or person or entity related to a co-owner in the activity does not give the borrower any amount at risk, even if the borrower has an unconditional obligation to repay the loan.⁷² This rule does not apply to an interest as a creditor in the activity or an interest as a shareholder with respect to amounts borrowed by a corporation.



Practitioner Planning Tip

For purposes of determining whether a party is related to a co-owner, the IRC §§267(b) and 707(b)(1) rules apply, substituting 10% for 50%.⁷³ In addition, all members of a controlled group of corporations and any unincorporated businesses under common control are related persons.⁷⁴

Treas. Regs. §§1.465-8(a) and 1.465-20(a) provide that a person is not considered at risk with respect to any borrowed amounts if the loan was made by a person who has any interest in the activity other than that of a creditor.⁷⁵ Even if the borrower is personally and unconditionally liable for repayment but the lender holds an interest in the capital or profits of a partnership or stock in an S corporation, the borrowing partner or shareholder is not at risk.

In *Van Wyk v. Comm'r*,⁷⁶ a 50% shareholder in an S corporation borrowed money from the other 50% shareholder. The borrowing shareholder was not treated as being at risk with respect to the borrowed amounts.

Example 29. Tessa Dakota owns two apartment complexes.⁷⁷ She sells them to Northern Realty Partnership for \$3 million. Northern Realty pays Tessa \$1 million in cash and executes a promissory note to Tessa for the remaining \$2 million. Each of the three partners in Northern Realty assume personal liability for repayment under the note.

In addition, Northern Realty enters into an agreement with Tessa under which Tessa will continue to manage the apartment complexes in return for compensation equal to 6% of Northern Realty's net profits from the rental activity. Because Tessa has an interest in the net profits of Northern Realty's rental activity, Tessa is considered to have an interest in the activity other than that of a creditor. Accordingly, amounts payable to Tessa for use in that activity do not increase the partners' amount at risk even though the partners have personal liability for repayment.

AMOUNTS PROTECTED FROM LOSS

A person is not at risk with respect to contributed or borrowed amounts for which they are protected from loss.⁷⁸ Accordingly, a taxpayer is not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements, however there is an exception for qualified nonrecourse financing.

Treas. Reg. §1.465-27(b)(4) provides that for purposes of §465(b)(6), the personal liability of any partnership for repayment of a financing is disregarded. Thus, even if the partnership is liable for amounts paid by a guaranteeing partner, the guaranteeing partner may have amounts at risk.

⁷² IRC §465(b)(3)(A).

⁷³ IRC §465(b)(3)(C).

⁷⁴ IRC §465(b)(3)(C)(ii).

⁷⁵ Treas. Reg. §1.465-8(b)(1).

⁷⁶ *Van Wyk v. Comm'r*, 113 TC 440 (1999).

⁷⁷ Treas. Reg. §1.465-8(b)(4), Example 1.

⁷⁸ Prop. Treas. Reg. §1.465-6; IRC §456(b)(4).

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Qualified Nonrecourse Financing

For real estate placed in service after 1986, the at-risk rules apply, but with a significant modification. The taxpayer is not considered at risk for their share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity.

However, the taxpayer is considered at risk for qualified nonrecourse financing secured by real property used in an activity of holding real property. A nonrecourse loan gives the taxpayer an amount at risk if it is qualified nonrecourse financing.⁷⁹ Qualified nonrecourse financing is financing:

- That the taxpayer borrows with respect to the activity of holding real property;
- That the taxpayer borrows from a qualified person or represents a loan from any federal, state, or local government or instrumentality, or that is guaranteed by any federal, state, or local government;
- Except to the extent provided in the regulations, for which no person is personally liable for repayment; and
- That is not convertible debt.

The lender may be related to the borrower if the terms of the loan are commercially reasonable. However, the lender may not be the seller of the property, or any party related to the seller. The activity of holding real property includes holding personal property and providing services that are incidental to making real property available as living accommodations.

ADJUSTMENTS TO AMOUNTS AT RISK

The taxpayer's amount at risk is increased for additional contributions of cash or property and by the taxpayer's share of any income that the venture produces. In addition, a taxpayer can increase their amount at risk by changing a loan from nonrecourse to recourse. Finally, a taxpayer's at-risk amount increases for any gain recognized on the disposition of the taxpayer's interest in the activity.⁸⁰

Note. In *Miller v. U.S.*, a shareholder disposed of his S corporation stock.⁸¹ The shareholder had suspended losses in excess of basis at the time of disposition, and his basis and his at-risk amount were both zero. The gain from the disposition gave the shareholder an additional amount at risk but no increase to basis. Thus, without the basis adjustment there was no opportunity to deduct the prior years' suspended losses.

The amount at risk in any activity is reduced by any losses allowed in previous years under the at-risk rules. The at-risk amount is decreased by an investor's withdrawal of cash or property. It is also decreased by an investor's share of losses. If a recourse loan is refinanced with a nonrecourse loan, the borrower's amount at risk is decreased accordingly, but cannot be decreased below zero. If a decrease in the amount at risk reduces the at-risk amount to less than zero, the taxpayer must recapture losses deducted in earlier years to restore the amount at risk to zero.⁸²

⁷⁹ IRC §465(b)(6).

⁸⁰ Prop. Treas. Regs. §§1.465-12(a) and 1.465-66(a).

⁸¹ *Miller v. U.S.*, 39 F.Supp.2d 678 (N.D.W.Va. 1999).

⁸² IRC §465(e)(1).

PAL LIMITS

3

IRC §469 disallows many deductions and credits arising from passive activities. Rental activities are generally passive activities.⁸³ A special \$25,000 loss allowance applies to certain taxpayers who **actively participate** in a real estate rental activity.

GENERAL PAL RULES

Under the general PAL rules, a taxpayer's current-year deductible PALs are limited to passive activity income. Disallowed losses or credits are carried forward to the following tax year. When a fully taxable disposition of a passive activity is made to an unrelated party, any disallowed losses that remain outstanding generally become deductible in the year the disposition occurs. A different set of rules determines the treatment of remaining passive activity credits upon disposition of the passive activity.

Interest, dividends, annuities, and royalties that are not derived in the ordinary course of a trade or business are excluded from the PAL limitations despite their characterization as passive for other Code purposes.⁸⁴ The regulations characterize these items as portfolio income.⁸⁵

Note. Before determining the limitations on losses arising from passive activities, taxpayers must first consider the basis limitations and the at-risk limitation on losses. After the PAL rules are applied, noncorporate taxpayers must consider the IRC §461(l) limit on excess losses arising from a trade or business.

TAXPAYERS SUBJECT TO THE PAL RULES

The PAL rules apply to individuals, estates, trusts, closely held C corporations, and personal service corporations. The PAL rules do not apply to grantor trusts, S corporations, or partnerships at the entity level. However, they do apply to the deemed owner of a grantor trust, an S corporation shareholder, or to a partner in a partnership who is in one of the five categories previously listed.⁸⁶

Closely Held C Corporation

A closely held C corporation is defined as a C corporation that satisfies the stock ownership requirement under IRC §542(a). This means that, during the last half of the tax year, more than 50% of the corporation's outstanding stock, by value, is owned directly or indirectly by five or fewer individuals.⁸⁷ Closely held C corporations that are not personal service corporations can deduct passive losses (and use passive activity credits) to the extent of net active income. Net active income includes income and deductions from all activities except portfolio income.

Personal Service Corporation⁸⁸

A personal service corporation is a corporation whose principal activity is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. More than 50% of the corporation's compensation costs must come from the performance of personal services, and more than 20% of the corporation's compensation costs must be performed by employee-owners. To be a personal service corporation under the PAL limitations, employee-owners must own more than 10% of the FMV of the corporation's stock. Unlike closely held C corporations, personal service corporations may only deduct passive losses to the extent of passive income.

⁸³ IRC §469(c).

⁸⁴ IRC §469(e)(1)(a).

⁸⁵ Temp. Treas. Reg. §1.469-2T(c)(iii).

⁸⁶ IRC §469.

⁸⁷ IRC §469(j)(1).

⁸⁸ IRC §469(j)(2).

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RENTAL ACTIVITIES

Rent is the payment for the use of property. Rental activities are generally passive regardless of the level of participation. Passive rental losses are deductible only to the extent of passive income. The following are exceptions to this rule (discussed later).

- Taxpayers may deduct up to \$25,000 in rental real estate losses if the taxpayer actively participates in the rental activity. However, if the taxpayer's modified adjusted gross income (MAGI) exceeds a certain threshold, the allowance is phased out.⁸⁹
- A real estate professional may deduct rental real estate losses if they materially participate in the real estate activity.
- Taxpayers may deduct current and suspended passive losses on a qualifying disposition.⁹⁰

With some exceptions, an activity is a rental activity if tangible property (real or personal) is used by customers (or held for use by customers), and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

The following activities involving the use of tangible property are not rental activities.⁹¹

- The average period of customer use is seven days or less.
- The average period of customer use is 30 days or less, and the owner provides significant personal services.
- The owner provides extraordinary personal services in connection with making the property available for use by customers.
- The rental of the property is treated as incidental to a nonrental activity.
- The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers.
- The property is used in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

REAL ESTATE PROFESSIONALS

Persons who qualify as real estate professionals treat real estate rental activities as nonpassive activities if they materially participate in those activities.⁹² To qualify as a real estate professional, a taxpayer must meet both of the following two tests.

1. The taxpayer must perform more than half of the personal services in all trades or businesses during the tax year in real property trades or businesses in which the taxpayer materially participates.
2. The taxpayer must perform more than 750 hours of services during the tax year in real property trades or businesses in which they materially participate.

It is important to note that the Tax Court has held that the 750-hour requirement is not met by merely being on call.⁹³ The Code and underlying regulations require that the taxpayer actually perform services that count toward the 750-hour requirement.⁹⁴

⁸⁹ IRC §469(i).

⁹⁰ IRC §469(g).

⁹¹ Temp. Treas. Reg. §1.469-1T(e)(3)(ii).

⁹² IRC §469(c)(7).

⁹³ *James F. and Lynn M. Moss v. Comm'r*, 135 TC 18 (Sep. 20, 2010).

⁹⁴ IRC §469(c)(7)(B); Treas. Reg. §1.469-9(b)(4).

Real Property Trade or Business

Treas. Reg. §1.469-9(b)(1) defines a **trade or business** broadly to include any interest in rental real estate that gives rise to deductions under IRC §212. Under §212, a trade or business includes any activities directed toward the production of income, regardless of regularity.

A **real property trade or business** is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.⁹⁵ **Real property operation** is the day-to-day operations of a trade or business relating to the maintenance and occupancy of the real property. The principal purpose of such business operations should be to offer the use of real property or the physical space within it to customers. This should not involve providing significant or extraordinary personal services to customers alongside their incidental use of the property or space. Cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security are not significant personal services.

A real estate agent who brings together buyers and sellers of real property is engaged in a real property brokerage trade or business under §469(c)(7)(C). However, a mortgage broker who is a broker of financial instruments is not in a real property brokerage trade or business within the meaning of §469(c)(7)(C).⁹⁶

Observation. The §469 temporary regulations were promulgated in February 1988. Approximately 8 months later, IRC §7805(e)(2) was enacted that provides that any temporary regulation expires within three years after the date of issuance of such regulation. However, the new statute did not have retroactive application. Moreover, the Chief Counsel Regulation Handbook allows amendments to final regulations by reference to temporary regulations issued in the same Treasury Decision.⁹⁷ Accordingly, many of the §469 temporary regulations are still effective. See Treas. Reg. §1.469-11, as amended, for applicability dates.

Meeting the Tests

Spouses filing a joint return are qualifying taxpayers if at least one spouse separately meets both tests. However, the activities of both spouses are included for purposes of measuring material participation in the rental activities regardless of whether the spouses file a joint return.

Personal services rendered as an employee count toward the real estate professional tests only if the employee owns at least 5% of the employer's stock or other equity.⁹⁸ IRC §318 attribution rules apply to determine constructive ownership.

Note. A closely held C corporation, other than a personal service corporation, qualifies for the real estate professional exemption in any year if more than 50% of the gross receipts of such corporation for that tax year are derived from real property trades or businesses in which the corporation materially participates.

⁹⁵ IRC §469(c)(7)(C).

⁹⁶ CCA 201504010 (Jan. 23, 2015).

⁹⁷ IRM §32.1.1.2.4.1 (2018).

⁹⁸ Treas. Reg. §1.469-9(c)(5).

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Material Participation

If the taxpayer qualifies as a real estate professional, then profit or loss from a real estate rental activity is not passive if the taxpayer materially participates in the real estate rental activity.⁹⁹ For other nonrental business activities, if the taxpayer materially participates in the trade or business, the profit or loss is not passive. **Material participation is defined as involvement in the operation of the activity on a regular, continuous, and substantial basis.**¹⁰⁰

Material Participation Tests. Temp. Treas. Reg. §1.469-5T(a) adopts seven tests to determine material participation, and a taxpayer who meets any one of the tests materially participates in an activity.

1. **Participation exceeds 500 hours.** An individual materially participates in an activity if the individual participates in the activity for more than 500 hours in the tax year.
2. **Substantially all participation in the activity.** An individual materially participates in an activity if the individual's participation in the activity constitutes substantially all the participation in the activity for the tax year. For this test, the participation by individuals who are not owners are considered in determining whether the individual's participation was substantially all the participation.
3. **More than 100 hours and not less than anyone else.** An individual materially participates in an activity if the individual participates in the activity for more than 100 hours and at least as much as any other individual. Participation by non-owners counts in applying this test.
4. **Significant participation activities.** An individual materially participates in an activity if the activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. An activity is a significant participation activity if it is a trade or business activity in which the individual significantly participates (more than 100 hours) for the tax year, and the activity does not meet any of the other six tests for material participation. This test applies only to trades or businesses, and not to rentals.
5. **Material participation for five of last 10 years.** An individual who met one of the other material participation tests for five of the 10 tax years preceding the current tax year (whether or not consecutive) is a material participant for the current year.
6. **Material participation in personal service activity for three years.** An individual who materially participates in a personal service activity for at least three tax years (whether or not consecutive) preceding the current tax year is treated as a material participant for the rest of the individual's ownership in the activity. An activity is a personal service activity if it involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or in any other trade or business in which capital is not a material income-producing factor.¹⁰¹
7. **Facts and circumstances.** An individual may materially participate in an activity if, based on all the facts and circumstances, they participate on a regular, continuous, and substantial basis.

Note. Material participation is determined on an annual basis.

⁹⁹. IRC §469(c)(7).

¹⁰⁰. IRC §469(h)(1).

¹⁰¹. Temp. Treas. Reg. §1.469-5T(d).

Definition of Participation. Typically, any work done by an individual in relation to an activity in which they hold an interest at the time the work is performed is considered participation in that activity, regardless of the role in which the individual performs the work.¹⁰² However, work not customarily performed by owners does not count toward material participation if one of the principal purposes of the work is to avoid the application of the PAL rules.¹⁰³

Work performed by an individual in the individual's capacity as an **investor** is not participation unless the individual is directly involved in the activity's day-to-day management or operations.¹⁰⁴ Married taxpayers generally may combine their participation to determine whether they meet a material participation test, even if they do not file a joint tax return.¹⁰⁵ Special participation rules apply to activities of a limited partnership.

Note. A taxpayer who qualifies as a real estate professional may elect to treat all rental real estate activities as a single activity.¹⁰⁶ The election aggregates all rentals, whether owned individually or through a pass-through entity such as a partnership, S corporation, or trust. With a valid aggregation election, material participation is measured considering the entire rental portfolio and not for each individual property. The aggregation automatically includes newly acquired properties.

Example 30. Devon Warner purchases a condo in Florida. Devon and his relatives do not use the condo. The condo is available for rent on a monthly basis. Devon uses a management company to manage the property. The management company takes reservations, collects rent, and makes any necessary repairs. In 2025, 10 customers rent the condo for a total of 350 days (35 days average per customer). Because Devon does not materially participate in the activity, the condo rental is a passive activity that is subject to the PAL limitations.

If instead, Devon manages the property himself and he is the only one who provides services with regard to the property, Devon materially participates in the business. The rental is **still a passive activity** unless Devon or his spouse meets the real estate professional test.

Substantiating Participation. The extent of an individual's participation in an activity may be established by **any reasonable means**.¹⁰⁷ 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 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.

Example 31. Scott and Sharlyne are married and work full-time for an airline.¹⁰⁸ They own several properties in Illinois and Florida. Although Scott and Sharlyne rent out the properties they own, property expenses and depreciation are greater than the rents received. Accordingly, they claim rental real estate losses.

In response to an IRS audit, Scott and Sharlyne create logs showing the time spent on rental real estate activities. The logs are not prepared based on records, but on recollection. The logs do not list the hours spent on each activity. Their lack of contemporaneous verification and ballpark guestimate of time spent does not adequately establish that Scott is a real estate professional. As such, Scott and Sharlyne cannot deduct their real estate rental losses.

¹⁰². Temp. Treas. Reg. §1.469-5T(f)(1).

¹⁰³. Temp. Treas. Reg. §1.469-5T(f)(2)(i).

¹⁰⁴. Temp. Treas. Reg. §1.469-5T(f)(2)(ii).

¹⁰⁵. IRC §469(h)(5).

¹⁰⁶. Treas. Reg. §1.469-9(g)(1).

¹⁰⁷. Temp. Treas. Reg. §1.469-5T(f)(4).

¹⁰⁸. This example is based on *Iovine and Oliva v. Comm'r*, TC Summ. Op. 2012-32 (Apr. 10, 2012).

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SPECIAL ALLOWANCE FOR RENTAL REAL ESTATE LOSSES

Under §469(i), if an individual or a qualifying estate or revocable trust owns at least 10% of all interests in a rental real estate passive activity, the taxpayer can deduct up to \$25,000 of a related passive loss if the individual **actively** participated in the activity. However, if the taxpayer's MAGI exceeds a certain threshold, the allowance is phased out.

The \$25,000 maximum is applied to any aggregate passive loss associated with rental real estate remaining after all passive losses and gains have been netted. The allowance allows a passive loss to offset active income.

Active Participation¹⁰⁹

Active participation does not require regular, continuous, and substantial involvement in operations, but the taxpayer must participate in making management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions may include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions. A taxpayer cannot meet the active participation test if their interest (including a spouse's interest) in the real estate rental activity is less than 10% (by value) of all interests in the activity.

Phaseout of Allowance¹¹⁰

If a taxpayer's MAGI exceeds \$100,000, the \$25,000 maximum allowance is reduced by \$0.50 for each \$1 of excess income. The allowance is fully phased out at \$150,000 of MAGI. The following two special rules apply to **married taxpayers filing separate returns**.

1. If they live together at any time during the year, they are allowed no allowance.
2. If they do not live together at any time during the year, each spouse's maximum allowance is \$12,500, which is phased out by \$0.50 for each \$1 that MAGI exceeds \$50,000, and is fully phased out at \$75,000 MAGI.

An **estate's** allowance is reduced by the surviving spouse's allowance.

For purposes of the phaseout, MAGI is adjusted gross income (AGI) before any net loss from passive activities allowed for real estate professionals and excluding any taxable social security and tier 1 railroad retirement benefits. The calculation adds back the adjustments to gross income for retirement account contributions, student loan interest, and tuition and fees, any exclusion of employer-provided adoption assistance or interest from U.S. savings bonds used to pay higher-education expenses, and the deduction for foreign-derived intangible income and global intangible low-taxed income.

Note. Before deducting the allowance, the taxpayer must combine the income and losses from all the taxpayer's real estate rentals with active participation. If an activity has net income, that income is offset first by rental real estate activities that produce losses before the \$25,000 allowance is used.

Example 32. Jason and Carrie Clark file a joint return. In 2025, they have \$120,000 MAGI and a \$30,000 rental real estate passive loss. Carrie actively participates in the passive loss activity. Their maximum \$25,000 special allowance is phased-out by \$0.50 for every \$1.00 that MAGI exceeds \$100,000. Therefore, the \$25,000 allowance is phased out by \$10,000 $((\$120,000 \text{ MAGI} - \$100,000 \text{ threshold}) \times 0.50)$. Jason and Carrie can use \$15,000 (\$25,000 allowance – \$10,000 phase-out amount) of the loss to reduce other income.

Note. A disallowed deduction for a PAL is not taken into account in the taxpayer's taxable income.¹¹¹ Even if the disallowed loss is allocated to activities that are trades or businesses, the loss is excluded for the tax year in computing the taxpayer's net earnings from self-employment.

¹⁰⁹. IRC §469(i)(6)(A).

¹¹⁰. IRC §469; IRS Pub. 925, *Passive Activity and At-Risk Rules*.

¹¹¹. Temp. Treas. Reg. §1.469-1T(d)(3).

PASSIVE ACTIVITY CREDIT LIMITATIONS

Under §469(d)(2), a passive activity credit is the amount by which aggregate tax credits related to passive activities for a tax year exceed the taxpayer's aggregate regular tax liability allocable to passive activities. Generally, §469(a) disallows any passive activity credit. However, §469(b) allows taxpayers to carry forward any disallowed credits to the next tax year.

Passive income is taxable in the same manner as ordinary income. If the income tax on passive income equals or exceeds tax credits associated with passive activities, §469 does not limit those credits. Thus, there is no limit on use of tax credits associated with passive activities to offset passive activity income, but tax credits arising from passive activities cannot offset the income tax arising from active or portfolio income.

Exceptions and Allowances¹¹²

The rules for a closely held C corporation (other than a personal service corporation), discussed earlier, apply to a passive activity credit. The \$25,000 special allowance also applies to a passive activity credit. A qualifying taxpayer can offset credits from the activity against the tax on up to \$25,000 of nonpassive income after taking into account any losses allowed under the special allowance. The deduction equivalent of passive activity credits is the amount that, if allowed as a deduction, would reduce the regular tax liability by an amount equal to the credits.

Note. For a real estate professional, rental real estate activities in which the taxpayer materially participates are not passive activities.

Example 33. Theo and Tania Brown file a married filing jointly (MFJ) return. In 2024, their MAGI is \$135,000, which includes \$10,000 in passive income from a retail building rented to tenants operating a restaurant. Theo actively participates in the rental activity. Theo and Tania generate a \$7,000 IRC §48 energy credit for improvements to the building. The credit is reported on Form 3468, *Investment Credit*.

The \$7,000 energy tax credit associated with a passive activity is allowed to the extent of tax on passive activity income. Theo and Tania's taxable income is \$105,800 (\$135,000 MAGI – \$29,200 MFJ standard deduction). Using the 2024 MFJ tax rate schedules, Theo and Tania's tax with the passive activity income is \$13,382 $((\$105,800 - \$94,300) \times 22\%) + \$10,852$, and their tax without the passive activity income is \$11,182 $((\$95,800 - \$94,300) \times 22\%) + \$10,852$. The \$10,000 of passive activity income generated \$2,200 (\$13,382 tax – \$11,182 withholding) of tax liability. Thus, \$4,800 (\$7,000 – \$2,200) of the credit is not currently allowed.

Theo and Tania's special allowance is \$7,500 $((\$150,000 \text{ threshold} - \$135,000 \text{ MAGI}) \times 0.50)$. They calculate their allowed credit on the following Form 8582-CR, *Passive Activity Credit Limitations*. The special allowance reduces their taxable income to \$98,300 (\$105,800 – \$7,500). Theo and Tania's tax after the \$7,500 special allowance is \$11,732 $((\$98,300 - \$94,300) \times 22\%) + \$10,852$, reducing their tax liability by \$1,650 (\$13,382 – \$11,732). They carry forward a \$3,150 credit (\$7,000 – \$2,200 – \$1,650).

¹¹² IRS Pub. 925, *Passive Activity and At-Risk Rules*.

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For Example 33

Form 8582-CR (Rev. December 2024) Department of the Treasury Internal Revenue Service	Passive Activity Credit Limitations Attach to Form 1040, 1040-SR, or 1041. Go to www.irs.gov/Form8582CR for instructions and the latest information.	OMB No. 1545-1034 Attachment Sequence No. 89
Name(s) shown on return Theo and Tania Brown		Identifying number ***-**-1234
Part I Passive Activity Credits Caution: If you have credits from a publicly traded partnership, see <i>Publicly Traded Partnerships (PTPs)</i> in the instructions.		
Credits From Rental Real Estate Activities With Active Participation (Other Than Rehabilitation Credits and Low-Income Housing Credits) (See <i>Lines 1a through 1c</i> in the instructions.)		
1a Credits from Worksheet 1, column (a)	1a	7,000
1b Prior year unallowed credits from Worksheet 1, column (b)	1b	0
c Add lines 1a and 1b	1c	7,000
Rehabilitation Credits From Rental Real Estate Activities and Low-Income Housing Credits for Property Placed in Service Before 1990 (or From Pass-Through Interests Acquired Before 1990) (See <i>Lines 2a through 2c</i> in the instructions.)		
2a Credits from Worksheet 2, column (a)	2a	
2b Prior year unallowed credits from Worksheet 2, column (b)	2b	
c Add lines 2a and 2b	2c	0
Low-Income Housing Credits for Property Placed in Service After 1989 (See <i>Lines 3a through 3c</i> in the instructions.)		
3a Credits from Worksheet 3, column (a)	3a	
3b Prior year unallowed credits from Worksheet 3, column (b)	3b	
c Add lines 3a and 3b	3c	0
All Other Passive Activity Credits (See <i>Lines 4a through 4c</i> in the instructions.)		
4a Credits from Worksheet 4, column (a)	4a	
4b Prior year unallowed credits from Worksheet 4, column (b)	4b	
c Add lines 4a and 4b	4c	0
5 Add lines 1c, 2c, 3c, and 4c	5	7,000
6 Enter the tax attributable to net passive income (see instructions)	6	2,200
7 Subtract line 6 from line 5. If line 6 is more than or equal to line 5, enter -0- and see instructions	7	4,800
Note: If your filing status is married filing separately and you lived with your spouse at any time during the year, do not complete Part II, III, or IV. Instead, go to line 37.		
Part II Special Allowance for Rental Real Estate Activities With Active Participation Note: Complete this part only if you have an amount on line 1c. Otherwise, go to Part III.		
8 Enter the smaller of line 1c or line 7	8	4,800
9 Enter \$150,000. If married filing separately, see instructions	9	150,000
10 Enter modified adjusted gross income, but not less than zero (see instructions). If line 10 is equal to or more than line 9, skip lines 11 through 15 and enter -0- on line 16	10	135,000
11 Subtract line 10 from line 9	11	15,000
12 Multiply line 11 by 50% (0.50). Do not enter more than \$25,000. If married filing separately, see instructions	12	7,500
13 Enter the amount, if any, from line 9 of Form 8582	13	0
14 Subtract line 13 from line 12	14	7,500
15 Enter the tax attributable to the amount on line 14 (see instructions).	15	1,650
16 Enter the smaller of line 8 or line 15	16	1,650

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 64641R

Form **8582-CR** (Rev. 12-2024)

Special Allowance — Rehabilitation Tax Credit. IRC §469(i)(3)(B) allows a taxpayer, regardless of participation level, to increase the special allowance MAGI phase-out ceiling from \$150,000 to \$250,000 if the applicable tax credit is a **qualified real property rehabilitation credit** under IRC §47.

Note. The qualified real property rehabilitation credit (often referred to as the rehabilitation credit), is a federal tax incentive to encourage the preservation and rehabilitation of historic buildings. The credit is 20% of qualified rehabilitation expenses for certified historic structures that are listed in the National Register of Historic Places or located in a registered historic district and certified as being of historic significance. The credit is allocated ratably over a 5-year period. For more information, see **uofi.tax/25x4x1** [www.irs.gov/businesses/small-businesses-self-employed/rehabilitation-credit-historic-preservation-faqs].

The excess MAGI reduction begins at \$200,000. The tax credit deduction equivalent depends on the individual's regular tax rate. Thus, the maximum allowable tax credit (before phaseout) for an individual with a regular average tax rate of 20% would be \$40,000 ($\$200,000 \times 20\%$).

Special Allowance — Low-Income Housing Tax Credit. IRC §469(i)(3)(C) eliminates the tax credit ceiling and MAGI phaseout for individuals, regardless of participation level, when the applicable credit is the IRC §42 low-income housing tax credit (LIHTC). Accordingly, there is no §469 limitation on individuals using LIHTCs related to passive activities to offset active income.

Note. The LIHTC is a federal program designed to encourage the development and rehabilitation of affordable rental housing for low- and moderate-income households. The LIHTC provides a tax incentive to developers to construct or rehabilitate affordable rental housing. To qualify, a project must meet certain income and rent restrictions. For example, at least 20% of the units must be occupied by tenants with incomes at or below 50% of the area median income (AMI), or at least 40% of the units must be occupied by tenants with incomes at or below 60% of the AMI. Investors can claim the tax credits over a 10-year period once the housing project is placed in service. For more information on the LIHTC, see **uofi.tax/25x3x2** [taxpolicycenter.org/briefing-book/what-low-income-housing-tax-credit-and-how-does-it-work].

The OBBBA enhanced the LIHTC program effective for calendar years beginning after December 31, 2025. For more information, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

DISPOSITION¹¹³

For the year of the disposition, any current-year losses and all the suspended losses are released in full and are treated as losses that are not from a passive activity. Any loss recognized on disposition is also treated as not from a passive activity. However, any gain recognized on the disposition will reduce the disposition year loss deduction. The disposition must be of the entire activity in a completely taxable transaction and may not be made to a related party.

If there are disallowed passive activity credits remaining upon disposition of the related passive activity, the nature of the credits is unaffected. They continue to be characterized as passive activity related credits, that can be used to offset passive income. Taxpayers can instead elect to increase the basis of the affected credit property in an amount equal to the portion of the unused credit that previously reduced the basis of the credit property.

Note. IRC §469(b) allows taxpayers to carry forward passive activity credits. There is no specified maximum carryforward period. However, many of the tax credits arising from passive activities fall under the general business credit provisions of IRC §38. IRC §38 allows a business credit carryforward to each of the 20 tax years following the unused credit year. Presumably, when a business credit expires, the related passive activity credit also expires.

¹¹³ IRC §469; IRS Pub. 925, *Passive Activity and At-Risk Rules*.

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CASE STUDY: REPORTING RENTAL REAL ESTATE ACTIVITIES

Terrance and Mavis McLeod are married and file a joint tax return. Terrance is the foreman of a local manufacturing company, and Mavis is a second-grade teacher. They purchase a single-family residence and an apartment building for use as rental properties. They always use the MFJ filing status, and their 2024 MAGI is \$140,000.

SINGLE-FAMILY RESIDENCE

On January 1, 2024, Terrance and Mavis purchased a single-family residence near their principal residence. The purchase price was \$240,000. Their closing costs were an \$850 escrow fee, \$1,300 legal fees, and \$750 for a title insurance policy endorsement. Their \$242,900 basis (\$240,000 purchase price + \$850 escrow fee + \$1,300 legal fees + \$750 title insurance policy endorsement) was allocated \$30,000 to the land and \$212,900 to the building.

Terrance and Mavis borrowed \$192,000 to purchase the property. They have a 30-year fixed-rate loan. Mavis does all the accounting for the property, and Terrance makes all decisions regarding tenant selection and rent collection. Terrance also performs some minor repairs and maintenance and oversees major repairs and improvements.

Terrance and Mavis rented the property on January 11, 2024. The rent was \$2,400 per month and was not prorated. The tenant gave a \$2,400 security deposit and paid all utilities except water. Terrance and Mavis McLeod reported the following income and expenses for the residence in the 2024 tax year.

Rental income ($\$2,400 \times 12$ months)		\$28,800
Expenses:		
Insurance	\$ 1,763	
Property taxes	3,762	
Mortgage interest	12,584	
Cleaning	277	
Water	780	
Replacement garage door	2,630	
Labor to replace garage door (separately invoiced)	550	
Shingles to repair the roof	2,404	
Labor to repair roof (separately invoiced)	300	
Supplies used to maintain the property	450	
Depreciation ($\$212,900 \times 0.03485$)	7,420	
Total expenses	\$32,920	(32,920)
Net income (loss)		(\$ 4,120)

Note. Security deposits for rental real estate are generally not considered taxable income in the year received if they are intended to be returned to the tenant at the end of the lease. However, if any portion of the security deposit is used to cover unpaid rent or damages and is not returned to the tenant, that portion becomes taxable income in the year it is applied.¹¹⁴

¹¹⁴ IRS Pub. 527, *Residential Rental Property*.

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APARTMENT BUILDING

On June 1, 2024, Terrance and Mavis purchased and placed in service a 4-unit apartment building for \$400,000. Their total closing costs were \$2,100. Their \$402,100 basis (\$400,000 purchase price + \$2,100 closing cost) was allocated \$25,000 to the land and \$377,100 to the building. Terrance and Mavis borrowed \$375,000 to finance the purchase.

The building is located 40 miles from the McLeod's personal residence. Mavis does the accounting, and Terrance does minor maintenance and yard work on the property. Terrance kept records of travel miles for the apartment building. He also kept records of the hours he spent managing and maintaining the house and the apartment building. The tenants pay all the utilities costs. Terrance and Mavis's incurred the following income and expenses for the apartment building in the 2024 tax year.

Rental income (includes a \$1,000 nonrefundable pet fee)		\$27,600
Expenses:		
Insurance	\$ 3,775	
Property taxes	3,700	
Mortgage interest	11,398	
Terrance's mileage (3,000 miles $\times$ \$0.67 standard mileage rate)	2,010	
New windows	1,700	
Labor to replace windows (separately invoiced)	350	
New plumbing fixtures	500	
Labor to install plumbing fixtures (separately invoiced)	250	
Sidewalk and driveway repair	1,800	
Supplies used to maintain the property	475	
Depreciation ($\$377,100 \times 0.0197$)	7,429	
Total expenses	\$33,387	(33,387)
Net income (loss)		(\$ 5,787)

REPORTING

Terrance and Mavis elect to deduct the improvements (the new garage door for the residence and the new plumbing fixtures for the apartment building) as repairs under the safe harbor for small taxpayers as shown.

Treas. Reg. §1.263(a)-3(h) Safe Harbor Election for Small Taxpayers

The taxpayer hereby makes the safe harbor election for small taxpayers under Treas. Reg. §1.263(a)-3(h).

Description of eligible property:

- Residential property: 5556 SE Well Drive, Oklahoma City, OK, 73111
- Apartment building: 406 E Estate Lane, Norman, OK, 73019

Terrance L. McLeod

***-**-1232

Mavis R. McLeod

***-**-1233

1123 Walnut Wave St.

Oklahoma City, OK 73123

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The McLeod's report their \$4,120 loss on the single-family residence and a \$5,787 loss on the apartment building on line 21 of the following Schedule E (Form 1040).

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment
Sequence No. **13**

Name(s) shown on return

Terrance and Mavis McLeod

Your social security number

*****-**-1232**

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

- A** Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☒ **Yes** ☐ **No**
B If "Yes," did you or will you file required Form(s) 1099? ☒ **Yes** ☐ **No**

1a Physical address of each property (street, city, state, ZIP code)

A	5556 SE Well Drive, Oklahoma City, OK 73111
B	406 E Estate Lane, Norman, OK 73019
C	

1b	Type of Property (from list below)	2	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A	1			355	0	☐
B	2			214	0	☐
C						☐

Type of Property:

- 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe) _____

Income:		Properties:		
		A	B	C
3	Rents received	28,800	27,600	
4	Royalties received			
Expenses:				
5	Advertising			
6	Auto and travel (see instructions)		2,010	
7	Cleaning and maintenance	277		
8	Commissions			
9	Insurance	1,763	3,775	
10	Legal and other professional fees			
11	Management fees			
12	Mortgage interest paid to banks, etc. (see instructions)	12,584	11,398	
13	Other interest			
14	Repairs	5,884	4,600	
15	Supplies	450	475	
16	Taxes	3,762	3,700	
17	Utilities	780		
18	Depreciation expense or depletion	7,420	7,429	
19	Other (list) _____			
20	Total expenses. Add lines 5 through 19	32,920	33,387	
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	(4,120)	(5,787)	
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	(2,079)	(2,921)	
23a	Total of all amounts reported on line 3 for all rental properties	56,400		
b	Total of all amounts reported on line 4 for all royalty properties			
c	Total of all amounts reported on line 12 for all properties	23,982		
d	Total of all amounts reported on line 18 for all properties	14,849		
e	Total of all amounts reported on line 20 for all properties	66,307		
24	Income. Add positive amounts shown on line 21. Do not include any losses			
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here		(5,000)	
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2			(5,000)

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2024

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Terrance and Mavis have no passive income to offset the passive rental loss. They calculate their loss limitations on the following Form 8582, *Passive Activity Loss Limitations*. Terrance actively participated in the real estate rental activities. Their special allowance for real estate rental losses is \$5,000, which they enter on line 5 of Schedule 1. They have a \$4,907 (\$2,041 allocated to the residence + \$2,866 allocated to the apartment building) disallowed PAL, which they carry over to 2025.

Form 8582 Department of the Treasury Internal Revenue Service	Passive Activity Loss Limitations See separate instructions. Attach to Form 1040, 1040-SR, or 1041. Go to www.irs.gov/Form8582 for instructions and the latest information.	OMB No. 1545-1008 2024 Attachment Sequence No. 858
Name(s) shown on return Terrance and Mavis McLeod		Identifying number ***-**-1232

Part I 2024 Passive Activity Loss

Caution: Complete Parts IV and V before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation, see *Special Allowance for Rental Real Estate Activities* in the instructions.)

1a Activities with net income (enter the amount from Part IV, column (a))	1a	
1b Activities with net loss (enter the amount from Part IV, column (b))	1b	(9,907)
1c Prior years' unallowed losses (enter the amount from Part IV, column (c))	1c	()
1d Combine lines 1a, 1b, and 1c	1d	(9,907)

All Other Passive Activities

2a Activities with net income (enter the amount from Part V, column (a))	2a	
2b Activities with net loss (enter the amount from Part V, column (b))	2b	()
2c Prior years' unallowed losses (enter the amount from Part V, column (c))	2c	()
2d Combine lines 2a, 2b, and 2c	2d	

3 Combine lines 1d and 2d and subtract any prior year unallowed CRD. See instructions. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c or 2c. Report the losses on the forms and schedules normally used	3	(9,907)

- If line 3 is a loss and:
- Line 1d is a loss, go to Part II.
 - Line 2d is a loss (and line 1d is zero or more), skip Part II and go to line 10.

Caution: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II. Instead, go to line 10.

Part II Special Allowance for Rental Real Estate Activities With Active Participation

Note: Enter all numbers in Part II as positive amounts. See instructions for an example.

4 Enter the smaller of the loss on line 1d or the loss on line 3	4	9,907
5 Enter \$150,000. If married filing separately, see instructions	5	150,000
6 Enter modified adjusted gross income, but not less than zero. See instructions	6	140,000
Note: If line 6 is greater than or equal to line 5, skip lines 7 and 8 and enter -0- on line 9. Otherwise, go to line 7.		
7 Subtract line 6 from line 5	7	10,000
8 Multiply line 7 by 50% (0.50). Do not enter more than \$25,000. If married filing separately, see instructions	8	5,000
9 Enter the smaller of line 4 or line 8. If line 3 includes any CRD, see instructions	9	5,000

Part III Total Losses Allowed

10 Add the income, if any, on lines 1a and 2a and enter the total	10	
11 Total losses allowed from all passive activities for 2024. Add lines 9 and 10. See instructions to find out how to report the losses on your tax return	11	5,000

Part IV Complete This Part Before Part I, Lines 1a, 1b, and 1c. See instructions.

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Single-family residence rental		4,120			4,120
Apartment rental		5,787			5,787
Total. Enter on Part I, lines 1a, 1b, and 1c		9,907			

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 63704F

Form **8582** (2024)

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Form 8582 (2024)

Page **2**

Part V Complete This Part Before Part I, Lines 2a, 2b, and 2c. See instructions.

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 2a)	(b) Net loss (line 2b)	(c) Unallowed loss (line 2c)	(d) Gain	(e) Loss
Total. Enter on Part I, lines 2a, 2b, and 2c					

Part VI Use This Part if an Amount Is Shown on Part II, Line 9. See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a).
Single-family residence rental	Sch E In 22	4,120	0.415868	2,079	2,041
Apartment Building	Sch E In 22	5,787	0.584132	2,921	2,866
Total		9,907	1.00	5,000	4,907

Part VII Allocation of Unallowed Losses. See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
Single-family residence rental	Sch E In 22	2,041	0.415936	2,041
Apartment building	Sch E In 22	2,866	0.584064	2,866
Total		4,907	1.00	4,907

Part VIII Allowed Losses. See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Unallowed loss	(c) Allowed loss
Single-family residence rental	Sch E In 22	4,120	2,041	2,079
Apartment building	Sch E In 22	5,787	2,866	2,921
Total		9,907	4,907	5,000

Form **8582** (2024)

Note. If either Terrance or Mavis had been a real estate professional (such as foreman of a construction company), and satisfied one of the material participation tests, the losses would no longer be passive losses and therefore would be allowed in full in the current year.

Chapter 4: Schedule E

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

About the Author

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Taxpayers report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in real estate mortgage investment conduits on Schedule E, *Supplemental Income and Loss*. The income or losses from these activities flow from Schedule E to an individual's Form 1040, *U.S. Individual Income Tax Return*, or a fiduciary's Form 1041, *U.S. Income Tax Return for Estates and Trusts*. A taxpayer must only complete the relevant section(s) of Schedule E.¹

Note. Partnerships and S corporations with rental real estate activities report income and deductible expenses on Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation*.² C corporations do not report rental real estate activities on a separate form. Rather, gross rents are reported on line 6 of Form 1120, *U.S. Corporation Income Tax Return*. Related expenses for rental activities are not reported separately from other ordinary and necessary business expenses.

RENTAL REAL ESTATE AND ROYALTIES

Taxpayers report income and losses from rental real estate and royalties in part I on Schedule E.

Note. Rental real estate is covered extensively in the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

INCOME OR LOSS FROM RENTAL REAL ESTATE³

Income from rental real estate includes land rental, self-rental, and other real estate property rental. Rental income consists of any payment for the use or occupation of property and is not limited to normal rental payments. Other types of rental income include the following.

- Advance rent
- Amounts paid by a tenant to cancel a lease
- Expenses paid directly by a tenant (e.g., real estate taxes)
- Property or services in lieu of rent (valued at the fair market value (FMV) of the property or service)
- Security deposit retained because the tenant did not live up to the terms of the lease
- Payments from a lease with an option to purchase before the option is exercised

Caution. Taxpayers sometimes do not differentiate between pre-exercise payments and payments received after the option is exercised. Practitioners must be careful to report the rental income on Schedule E.

A taxpayer with a partial interest in rental real estate property reports only their part of the income and expenses on Schedule E. If the property is also used personally, the expenses related to personal use of rental real estate are not deductible on Schedule E and rental deductions may be limited.

¹. Instructions for Schedule E.

². Instructions for Form 8825.

³. Instructions for Schedule E; IRS Pub. 527, *Residential Rental Property*.

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When there is both personal and rental use, the property can be considered one of the following based on the amount of personal use and rental use. The following tax consequences apply.⁴

- **Personal-Use Property.**⁵ When a personal-use property is rented for less than 15 days, **and** the taxpayer uses it for more than 14 days, the rental income is not taxable. Real estate taxes and qualified mortgage interest are reported on Schedule A, *Itemized Deductions*. Other expenses related to the property are generally non-deductible.
- **Rental Property.** When rental property is utilized for personal use no more than 14 days or 10% of the days the property is rented (whichever is greater), the rental activity is reported on Schedule E with expenses allocated to rental and personal use.⁶ Only **real estate taxes** are deductible as either personal or rental expenses. The personal portion is deducted on Schedule A. The personal portion of **mortgage interest** is not deductible on Schedule A, because the property is not considered used as the taxpayer's home, but it may be deductible on Schedule A as investment interest. Rental activity is subject to passive-activity loss limits.
- **Mixed-Use Rental Property.** When the personal-use test for rental property is not met and the home is rented for more than 14 days, the rental activity is reported on Schedule E, with expenses allocated to rental and personal use. Rental expenses are limited to gross rental income. The personal-use portions of real estate taxes and mortgage interest are deductible on Schedule A, because the taxpayer is deemed to have used the property as a home or residence. Mortgage interest is deductible if the taxpayer elects to treat this property as a second home under mortgage interest rules.⁷
- **Rentals Lacking Profit Motive.** When the property owners do not intend for the property to be a profitable venture, rental receipts are reported as ordinary income and expenses are generally limited.⁸ The income is reported on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*. **If** the property is **also** used as a main or second home, mortgage interest and real estate taxes may be claimed on Schedule A.

Note. For more information on profit motive and deductible expenses, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

Personal-Use Days⁹

A taxpayer who personally uses a dwelling unit that they rent to others must divide expenses between rental and personal use. A **dwelling unit** has basic living accommodations such as a space for sleeping, toileting, and cooking (e.g., house, apartment, condominium, mobile home, boat, or vacation home). A single structure may contain more than one dwelling unit if each unit has basic living accommodations (e.g., a basement with basic living accommodations within a house is a separate dwelling unit). Dwelling units do not include property regularly available for occupancy by paying customers, such as hotels, and are not used as a home during the year by the owner.

As mentioned previously, a taxpayer is considered to use a dwelling unit as a residence if their personal use exceeds the greater of **14 days or 10% of the number of days during the year for which the unit is rented at fair rental**.

⁴. See Instructions for Schedule A.

⁵. IRC §280A(g).

⁶. IRC §280A(d)(1).

⁷. IRC §280A(c)(5).

⁸. IRS Pub. 527, *Residential Rental Property*.

⁹. Prop. Treas. Reg. §1.280A-1.

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A **day** is considered the 24-hour period for which a normal rental is calculated. Personal use of a dwelling unit is determined for any day if for any part of a day the unit is used:¹⁰

- For personal purposes by the taxpayer or other person with an interest in the unit or any member of their family (includes taxpayer's brother, sister, spouse, ancestor, or lineal descendant);
- By any individual using the unit under an arrangement that enables the taxpayer to use a different dwelling unit; or
- By any individual unless the unit is rented at a fair rental based on the facts and circumstances.

A day may count as a personal-use day even if the taxpayer does not spend the night in the dwelling.¹¹

Days spent primarily on repair or maintenance are not considered personal use.¹² If the taxpayer is not engaged in repair and maintenance on a substantially full-time basis, the facts and circumstances determine whether the primary purpose was to perform repairs and maintenance. Relevant facts include:¹³

- Amount of time dedicated to repair and maintenance,
- Frequency of the use for repair and maintenance during the year, and
- Presence and activities of companions.

Example 1. Colton owns a lakefront cottage that he rents out every summer.¹⁴ Colton and his wife, Winnie, arrive at the cottage Thursday night to get the cottage ready for renters. They eat dinner and go to bed. Colton spends the majority of Friday and Saturday fixing the deck, replacing a broken window, and updating some plumbing. Winnie spends several hours each day painting the kitchen but mostly relaxes by the lake. They complete all the necessary repairs by Saturday night. Sunday morning, the couple enjoys breakfast by the lake and leaves by noon. Because the principal purpose of using the unit from Thursday to Sunday is to perform repairs and maintenance, **none** of those days are considered personal use.

Expenses are allocated based on a ratio of the total number of days the unit was rented at a fair rental price to the total number of days during the year the dwelling unit is used.¹⁵ For allocating expenses, **any day that the property is available for rent but not actually rented is not a day of rental use.**¹⁶ A day of rental use is counted on any day the property is rented at a fair rental price, even if the landlord used it for personal purposes that day.¹⁷

¹⁰ IRC §280A(d)(2); Prop. Treas. Reg. §1.280A-1.

¹¹ *Chacon v. Comm'r*, TC Memo 1992-632 (Oct. 27, 1992).

¹² See *Cooke v. Comm'r*, TC Memo 2017-74 (May 1, 2017); Prop. Treas. Reg. §1.280A-1.

¹³ Prop. Treas. Reg. §1.280A-1(e)(6); IRC §280A(d)(2).

¹⁴ Adapted from Example 3 in Prop. Treas. Reg. §1.280A-1(e)(6).

¹⁵ IRC §280A(e)(1).

¹⁶ IRS Pub. 527, *Residential Rental Property*.

¹⁷ *Ibid*.

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Example 2. Frank and Sandy own a condo in Orlando, Florida. They use the property for their 4-week winter vacation in March each year. During the remainder of the time, they allow the condo association to rent it on a monthly basis. Frank and Sandy receive the rental income minus a 25% handling fee the condo association charges for managing the rental and preparing the condo for the next tenant.

In 2023, the association rented the condo for a total of 250 days. The net rental income was \$12,000 (\$62,500 gross rental income – \$50,500 gross rental expense).

Frank and Sandy used the property for personal purposes for 27 days. The following illustrates the allocation to Schedule E.

$$250 \text{ rental days} + 27 \text{ personal days} = 277 \text{ total use days}$$

$$\text{Rental portion} \quad 250 \text{ days} \div 277 \text{ days} = 90.25\%$$

$$\text{Residential portion} \quad 27 \text{ days} \div 277 \text{ days} = 9.75\%$$

Item	Total	Rental Portion	Residential Portion
Rental income	\$62,500	\$62,500	\$ 0
Expenses			
Utilities	\$ 3,000	\$ 2,708	\$ 292
Condo fees	1,000	903	97
Rental fee	15,625	14,102	1,523
Real estate tax	5,000	4,513	487
Mortgage interest	16,875	15,230	1,645
Depreciation	9,000	8,123	877
Total expenses	\$50,500 (50,500)	\$45,579 (45,579)	\$4,921 (4,921)
Net rental	\$12,000	\$16,921	\$ 0

The rental portion of the income and deductions are reported on the couple's Schedule E. If Sandy and Frank itemize their deductions, they can claim the residential portion of the mortgage interest and real estate tax on Schedule A, assuming they otherwise qualify.

Practitioner Planning Tip

The *Bolton*¹⁸ method (also known as the Tax Court method) allocates the mortgage interest and real estate tax expenses based on total days in the year instead of days in use. Operating expenses are still allocated based on the days of use. This approach may be helpful if there are high operating costs and the taxpayer can benefit from the itemized deductions. For more information on allocating personal use of rental real estate using the Tax Court method and a detailed example, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

¹⁸ *Bolton v. Comm'r*, 694 F.2d 556 (9th Cir. 1982), *aff'd* 77 TC 104 (1981).

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Limitation on Business Interest

Generally, for tax years beginning after December 31, 2017, taxpayers are allowed a deduction for business interest not to exceed the sum of the amount of business interest income for the year plus 30% of the adjusted taxable income (ATI) for the year, plus the floor plan financing interest for the year.¹⁹

Caution. The limitation on business interest **only applies to taxpayers with more than \$31 million** (for 2025) of average annual gross receipts for the prior three years.²⁰ The small business taxpayer exemption is explained in detail later in this section.

For these purposes, business interest expense is any interest paid or accrued on debt properly allocable to a trade or business of the taxpayer.²¹ Business interest expense does not include investment interest. Similarly, business interest income is the amount of the taxpayer's includable interest income properly allocable to a trade or business and does not include investment income.²² **Floor plan financing interest** is interest incurred to finance the acquisition of motor vehicles held for sale or lease and secured by the acquired inventory of them.²³ **ATI** is the taxable income of a taxpayer **without regard** to the following.²⁴

- Any item of income, gain, deduction, or loss not properly allocable to a trade or business
- Any business interest or business interest income
- Any net operating loss (NOL) deduction
- The qualified business income deduction (QBID) under IRC §199A
- Deductions for depreciation, amortization, or depletion for tax years beginning before January 1, 2022

Note. For more information on floor plan financing interest, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation and the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: New Legislation — Business Concerns. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Interest paid as part of rental real estate activities is **exempt** from the limitation on business interest **unless** the rental real estate activity is a trade or business.²⁵ A rental real estate activity that is considered a trade or business calculates the limit on its interest expense on Form 8990, *Limitation on Business Interest Expense Under Section 163(j)*, before completing lines 12 and 13 on Schedule E. Any interest the taxpayer cannot deduct in the current year is carried forward to the following year.²⁶

¹⁹ IRC §163(j)(1)(A); Prop. Treas. Reg. §1.163(j)-1.

²⁰ Rev. Proc. 2024-40, 2024-45 IRB 1100.

²¹ IRC §163(j)(5).

²² IRC §163(j)(6).

²³ IRC §163(j)(9).

²⁴ IRC §163(j)(8).

²⁵ Instructions for Schedule E; Prop. Treas. Reg. §1.163(j)-1(b)(44).

²⁶ Instructions for Schedule E.

Small business taxpayers without excess business interest expense from a partnership are not required to file Form 8990. A business that is not a tax shelter and has average annual gross receipts for the prior three tax years that do not exceed \$31 million (in 2025) is considered a **small business taxpayer**.²⁷ Additionally, if a taxpayer has interest expenses only from certain **excepted trades or businesses**, they are not required to file Form 8990.²⁸

- Trade or business of providing services as an employee
- Electing real property trade or business²⁹
- Electing farm business³⁰
- Certain utilities

A taxpayer with both excepted and non-excepted trades or businesses must allocate the interest income, expense, and other tax items based on the relative amounts of the taxpayer's adjusted basis in the assets. The adjusted basis is determined as of the close of each determination date during the year. The **determination date** is the last day of each quarter of the taxpayer's tax year. Those amounts are averaged to determine the relative basis in the assets for the excepted and non-excepted trades or businesses.³¹

There is a de minimis exception for taxpayers with 90% or more of their basis in a tax year allocable to either excepted or non-excepted trades or businesses. In this situation, all the taxpayer's interest income and expense for the year allocable to a trade or business is treated as allocable to either excepted or non-excepted trades or businesses, respectively.³²

The basis for an asset used in both an excepted and non-excepted trade or business is allocated to each trade or business using a permissible method that most reasonably reflects the use of the asset during the determination period. Once selected, a taxpayer must apply the same allocation method consistently. A taxpayer may change its method of allocation with the consent of the IRS. To obtain this consent, a taxpayer must submit a request for a letter ruling. Consent is granted only in extraordinary circumstances.³³

If a taxpayer uses an asset in two or more trades or businesses, they can allocate basis among the trades or businesses based on the following.³⁴

- Relative amounts of gross income the asset generates for the trades or businesses
- Relative amounts of physical space used by the trade or business (for land and permanent structures)
- Relative amounts of output if the trade or business generates the same unit of output

Note. A taxpayer making such an allocation must attach a statement to their timely filed federal income tax return for the tax year. Prop. Treas. Reg. §1.163(j)-10(c)(6)(iii) provides details on information the statement must contain.

²⁷ Rev. Proc. 2024-40, 2024-45 IRB 1100.

²⁸ IRC §163(j)(7)(A); Instructions for Form 8990.

²⁹ See IRC §163(j)(7)(B).

³⁰ See IRC §163(j)(7)(C).

³¹ Prop. Treas. Reg. §1.163(j)-10(c).

³² Prop. Treas. Reg. §1.163(j)-10(c)(1).

³³ Prop. Treas. Reg. §1.163(j)-10(c)(3).

³⁴ Ibid.

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Any carryforward of disallowed business interest expense that was treated as allocable to a non-excepted trade or business in a prior year continues to be treated as allocable to a non-excepted trade or business.³⁵

Note. For more information on the business interest limitation, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Agricultural Issues and Rural Investments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Basis for Depreciation³⁶

Basis as defined in IRS Pub. 551, *Basis of Assets*, is the amount of the taxpayer's investment in property for tax purposes. A taxpayer's basis in purchased property is usually its cost, which includes the amount paid in cash, debt obligations, and other property or services. For taxpayers constructing business, rental, or investment property, the basis computation is expanded to include construction period interest and taxes under IRC §263A.³⁷

Note. For a detailed discussion on property basis, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

IRC §481(a) Adjustment

A taxpayer can correct depreciation errors from a **single** prior year's return by **amending** it. However, if the taxpayer must correct depreciation errors from **multiple** prior years, a **§481(a) adjustment is required**. The adjustment is the aggregate amount of income or expense that would have been reported in prior tax years if the correct method had been used in those years. To calculate the §481(a) adjustment, the amounts on prior year returns (ignoring the statute of limitations) are compared with the correct amounts for those years.³⁸

The following rules apply to reporting the adjustment.

- For a **decrease** in income, the entire deduction is claimed in the year the error is discovered.³⁹
- For an **increase** in income, the §481(a) adjustment period is four years (add one-fourth of the adjustment to income each year). If the entire adjustment is less than \$50,000, the taxpayer can elect to include it in the year the error is discovered.⁴⁰
- For an applicant under IRS audit, the §481(a) adjustment period is two tax years for a positive adjustment, which is an increase in income.⁴¹
- If the taxpayer has discontinued the trade or business, the remaining balance of the §481(a) adjustment is taken into account in the tax year the business ceased or terminated.⁴²

The §481(a) adjustment is reported on Form 3115, *Application for Change in Accounting Method*, part IV, line 26, and the same form or schedule on which the original error was reported.

³⁵ Prop. Treas. Reg. §1.163(j)-10(c)(4).

³⁶ IRS Pub. 527, *Residential Rental Property*.

³⁷ IRC §263(A)(f)(1).

³⁸ Under §481, "if income escapes taxation because of a change in accounting method, the Commissioner may make an adjustment by including the omitted income in the year of the change." *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568, 570 (5th Cir. 1965).

³⁹ Rev. Proc. 97-27, 1997-21 IRB 10, as modified by Rev. Proc. 2002-19, 2002-13 IRB 696 and Rev. Proc. 2007-67, 2007-35 IRB 467.

⁴⁰ Rev. Proc. 2015-13, 2015-5 IRB 419.

⁴¹ *Ibid.*

⁴² *Ibid.*

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Example 3. Tony purchased a single-family building on June 15, 2021, for \$100,000, which he uses as residential rental real estate. He forgot to claim depreciation on his Schedule E for 2021, 2022, and 2023. As a result, Tony claims a §481(a) adjustment for missed depreciation on Form 3115 of \$9,242, which is calculated as follows.

	Depreciation
2021	\$1,970
2022	3,636
2023	<u>3,636</u>
Total	\$9,242

4

Tony reports the adjustment on his 2024 Schedule E, as shown on the following page.

Note. For more information on Form 3115 and examples of completed forms, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 7: Depreciation, and the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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For Example 3

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Name(s) shown on return

Tony T. Iger

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.

Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment
Sequence No. **13**

Your social security number

*****-**-9999**

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☒ **Yes** ☐ **No**

B If "Yes," did you or will you file required Form(s) 1099? ☒ **Yes** ☐ **No**

1a Physical address of each property (street, city, state, ZIP code)

A **888 Pine Road, Champaign, IL 61820**

B

C

1b Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A 1		A 366		☐
B		B		☐
C		C		☐

Type of Property:

1 Single Family Residence

3 Vacation/Short-Term Rental

5 Land

7 Self-Rental

2 Multi-Family Residence

4 Commercial

6 Royalties

8 Other (describe) _____

		Properties:		
		A	B	C
Income:				
3 Rents received	3	20,000		
4 Royalties received	4			
Expenses:				
5 Advertising	5			
6 Auto and travel (see instructions)	6			
7 Cleaning and maintenance	7			
8 Commissions	8			
9 Insurance	9			
10 Legal and other professional fees	10			
11 Management fees	11			
12 Mortgage interest paid to banks, etc. (see instructions)	12			
13 Other interest	13			
14 Repairs	14			
15 Supplies	15			
16 Taxes	16	122		
17 Utilities	17			
18 Depreciation expense or depletion	18	3,636		
19 Other (list Section 481(a) adjustment)	19	9,242		
20 Total expenses. Add lines 5 through 19	20	13,000		
21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	7,000		
22 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()	()
23a Total of all amounts reported on line 3 for all rental properties	23a	20,000		
b Total of all amounts reported on line 4 for all royalty properties	23b			
c Total of all amounts reported on line 12 for all properties	23c			
d Total of all amounts reported on line 18 for all properties	23d	3,636		
e Total of all amounts reported on line 20 for all properties	23e	13,000		
24 Income. Add positive amounts shown on line 21. Do not include any losses	24			7,000
25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()		
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26			7,000

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Cat. No. 11344L

Schedule E (Form 1040) 2024

ROYALTIES

Payments for the right to use intangible property (including trademarks, trade names, service marks, or copyrights) are classified as **royalties**.⁴³ Royalty income is generally associated with items that constitute passive income⁴⁴ and do not include payments for services.⁴⁵ Royalties are reported to the taxpayer on Form 1099-MISC, *Miscellaneous Income*, or similar statement.⁴⁶ The taxpayer reports royalty income on Schedule E unless they are in business as a self-employed writer, inventor, artist, etc.⁴⁷

Being engaged in a trade or business is not defined in the Code or regulations but is taken to mean that a taxpayer who regularly and continuously engages in the activity for the primary purpose of income or profit is likely considered engaged in a trade or business.⁴⁸ Any royalties resulting from a trade or business are considered self-employment (SE) income and reported on Schedule C, *Profit or Loss from Business*, as discussed later. Intellectual property owners classify royalty income as either business or nonbusiness income when the related intellectual property **is created**.⁴⁹

Example 4. Miranda is a high school chemistry teacher. In 1999, she wrote a manual on how to prepare for Y2K computer issues, which was unrelated to her duties as a teacher. At the time, she was not in the business of writing and never filed a Schedule C for this activity. In 2024, Miranda received royalties of \$800. Her royalties are reported on the following Schedule E and are not subject to SE tax.

⁴³ Rev. Rul. 81-178, 1981-2 CB 135; *Jones v. Comm'r*, TC Memo 1998-354 (Oct. 5, 1998).

⁴⁴ See *Disabled American Veterans v. U.S.*, 650 F.2d 1178 (Cl. Ct. 1981).

⁴⁵ *Jones v. Comm'r*, TC Memo 1998-354 (Oct. 5, 1998).

⁴⁶ See Instructions for Form 1099-MISC.

⁴⁷ Instructions for Schedule E.

⁴⁸ *Comm'r v. Groetzinger*, 480 U.S. 23 (1987); Rev. Rul. 58-112, 1958-1 CB 323.

⁴⁹ See Treas. Reg. §1.1402(a)-1(c); *Tax Issues for Individuals Who Create Intellectual Property*. Kelley, Claudia L. and Kowalczyk, Tamara. Nov. 30, 2013. The Tax Advisor. [www.thetaxadviser.com/issues/2013/dec/kelley-dec2013.html] Accessed on Nov. 20, 2024.

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For Example 4

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Name(s) shown on return

Miranda Doom

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.

Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment
Sequence No. **13**

Your social security number

***-**-1999

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☐ Yes ☒ No

B If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☐ No

1a Physical address of each property (street, city, state, ZIP code)

A	
B	
C	

1b Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A 6		A		☐
B		B		☐
C		C		☐

Type of Property:

1 Single Family Residence

2 Multi-Family Residence

3 Vacation/Short-Term Rental

4 Commercial

5 Land

6 Royalties

7 Self-Rental

8 Other (describe) _____

Income:

3 Rents received **3**

4 Royalties received **4** **800**

Expenses:

5 Advertising **5**

6 Auto and travel (see instructions) **6**

7 Cleaning and maintenance **7**

8 Commissions **8**

9 Insurance **9**

10 Legal and other professional fees **10**

11 Management fees **11**

12 Mortgage interest paid to banks, etc. (see instructions) **12**

13 Other interest **13**

14 Repairs **14**

15 Supplies **15**

16 Taxes **16**

17 Utilities **17**

18 Depreciation expense or depletion **18**

19 Other (list) _____ **19**

20 Total expenses. Add lines 5 through 19 **20**

21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If
result is a (loss), see instructions to find out if you must
file **Form 6198** **21** **800**

22 Deductible rental real estate loss after limitation, if any,
on **Form 8582** (see instructions) **22** () () ()

		Properties:		
		A	B	C
23a	Total of all amounts reported on line 3 for all rental properties	23a		
b	Total of all amounts reported on line 4 for all royalty properties	23b	800	
c	Total of all amounts reported on line 12 for all properties	23c		
d	Total of all amounts reported on line 18 for all properties	23d		
e	Total of all amounts reported on line 20 for all properties	23e	0	
24	Income. Add positive amounts shown on line 21. Do not include any losses	24	800	
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()	
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26	800	

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Cat. No. 11344L

Schedule E (Form 1040) 2024



Practitioner Planning Tip

In **Example 4**, if Miranda had been actively engaged in the business of writing in 1999, she would report the royalty income she receives in 2024 on Schedule C subject to SE tax. Accordingly, her tax advisor should have reviewed her 1999 filing to determine if she was actively engaged in this business at the time this book was created. If she had filed a Schedule C for 1999 to claim a loss on this writing venture, her characterization of the activity as a business would be binding in 2024.

Example 5. Dr. Harvey is a professor of chemistry at a respected university. During his summer break from lecturing, he authors a chemistry textbook for use in his class. Every four years, Dr. Harvey updates and revises the textbook. A publisher pays Dr. Harvey annual royalties based on the sales of the textbook. Because Dr. Harvey is considered regularly engaged in the business of writing, the royalties are included in his net earnings from self-employment and are reported on Schedule C.⁵⁰

Example 6. Use the same facts as **Example 5**. In 2024, Dr. Harvey retires from the university. The professor who replaces him continues to use Dr. Harvey's textbook. The royalties that Dr. Harvey earns in 2024 and future years are considered income from a trade or business even though Dr. Harvey is not currently engaged in the activity on a regular and continuous basis.



Practitioner Planning Tip

An advanced royalty must be included in income for the year in which a cash-method taxpayer received the payment.⁵¹ If paid as compensation for services performed by a writer, musician, vocalist, or producer, advanced royalties are reported in box 1 of Form 1099-NEC, *Nonemployee Compensation*, or on Form W-2, *Wage and Tax Statement*, depending on whether the person performing the services is an independent contractor or an employee.⁵² Tax practitioners must review the individual's employment contract because it governs whether the amount paid is compensation or royalty income.

⁵⁰ Ibid.

⁵¹ *Holbrook v. U.S.*, 194 F.Supp. 252 (D.Or. 1961); IRS Pub. 525, *Taxable and Nontaxable Income*.

⁵² Ltr. Rul. 9725037 (Mar. 25, 1997).

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A taxpayer who earns royalties of **\$10 or more** from a single payer during the year should receive a Form 1099-MISC or a similar statement, with the amount reported in box 2.⁵³ The amount in box 2 is reported on Schedule E, line 4. Each royalty property is reported in a separate column.⁵⁴

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.⁵⁵ Royalty income is also subject to the net investment income tax (NIIT).⁵⁶

Note. For information on the NIIT, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Unexpected Issues for Individual Taxpayers. This can be found at [uofi.tax/arc\[taxschool.illinois.edu/taxbookarchive\]](https://uofi.tax/arc[taxschool.illinois.edu/taxbookarchive]).

Oil, Gas, and Mineral Property

The amount received when natural resources are extracted from a taxpayer's property is royalty income from oil, gas, and mineral properties. The royalties are generally based on production or revenue (based on units such as barrels, tons, etc.) and are paid to the taxpayer by the person or company that leases the property from the taxpayer.⁵⁷

Oil and Gas Overview.⁵⁸ Landowners in the United States can own subsurface mineral rights, which they generally hold as a “fee interest.” Landowners may sell a share of subsurface mineral rights to another person, who becomes a mineral owner upon receipt of title to the subsurface minerals. The new mineral owner may or may not have **executive rights**, which entitle them to lease the minerals to another party.⁵⁹ The mineral owner may also sell a portion of their rights to the minerals produced to other persons, who are called **royalty owners**, because they possess the right to a fraction of the minerals produced, even though they do not have the right to execute leases for mineral production. With few exceptions, mineral and royalty owners are responsible only for the payment of severance taxes and property taxes but no operating expenses.

Note. As a practical matter, virtually all royalty interests are nonoperating because state law generally exempts them from the costs of production.⁶⁰

The mineral owner with executive rights generally leases the minerals to an oil and gas production company, which thereby acquires an **operating interest** in the mineral property. In a typical lease arrangement, the **working interest** owners pay royalties to the mineral and royalty interest owners. They share a royalty of one-eighth to one-quarter of the revenue generated. To finance the expenses of mineral production, the operating interest owner may seek investors who become **nonoperating working interest** owners.⁶¹ The operating and nonoperating working interest owners share the costs to produce the minerals.

⁵³ Instructions for Forms 1099-MISC and 1099-NEC.

⁵⁴ Instructions for Schedule E.

⁵⁵ IRS Pub. 525, *Taxable and Nontaxable Income*.

⁵⁶ IRC §1411(a)(1)(A).

⁵⁷ IRS Pub. 525, *Taxable and Nontaxable Income*; IRS Pub. 17, *Your Federal Income Tax*.

⁵⁸ IRS Pub. 5652, *Oil and Gas Audit Technique Guide*, p. 25–26 (2023).

⁵⁹ *TX Supreme Court Addresses Duty of Executive Rights Holder*. Dowell, Tiffany. Apr. 22, 2019. Texas A&M AgriLife Extension Service. [agrilife.org/texasaglaw/2019/04/22/tx-supreme-court-addresses-duty-of-executive-rights-holder] Accessed on Nov. 1, 2024.

⁶⁰ IRC §614(d); See, e.g., 31 Tex. Admin. Code §9.51(b)(1)(A) (2024).

⁶¹ *What is Working Interest in Oil and Gas and How to Calculate It*. Moore, Ryan. Oct. 17, 2024. Pheasant Energy. [www.pheasantenergy.com/working-interest] Accessed on Nov. 7, 2024.

There are other types of oil, gas, and mineral property payments that are reported on Schedule E, including the following.

- Bonus payments
- Delay rentals
- Landowner royalty
- Advance royalties
- Advance minimum royalties
- Shut-in royalties
- Overriding royalty interests (ORRIs), which have the responsibility to pay only taxes like other royalty interests, even though they are carved out of the working interest⁶²

Note. For more information on oil and gas taxpayers, including details on the various types of payments that are reported on Schedule E, see the 2015 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 6: Special Taxpayers. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Unless the taxpayer has a working interest in the extraction operation of the oil, gas, or minerals, the payments are reported on part I of Schedule E on line 4.⁶³ The gross royalty income is reported on line 4, even if state or local taxes are withheld from oil or gas payments received. Any taxes withheld by the producer are reported on line 16.⁶⁴ The payments are generally not subject to SE tax.

Payments that result from a working interest are reported on Schedule C and are generally subject to SE tax. A taxpayer who holds a working interest in an oil or gas well directly or through an entity that does not limit the taxpayer's liability (i.e., general partnership) **is not a passive activity**, even if the taxpayer did not materially participate. Royalty income that is not derived in the ordinary course of a trade or business reported on Schedule E is generally not considered income from a passive activity,⁶⁵ even though it is included in the definition of net investment income (NII).⁶⁶

Example 7. Rancher Cal owns 320 acres of undeveloped land in the Anadarko Basin and, in 2023, agreed to lease its subsurface minerals to Modern Energy, LLC, a disregarded entity owned by Boone. Cal retains a one-eighth royalty in any oil or natural gas produced. For a \$100,000 investment, Modern grants a one-sixteenth ORRI to Samantha, who is a passive investor.

In 2025, Modern generates \$160,000 of gross income from sales of natural gas produced from the property. Cal and Samantha each report their royalty income on Schedule E, but Boone reports income from produced hydrocarbons on Schedule C.

Observation. Because royalties from oil and gas production are generally free from expenses other than severance and property taxes, a royalty owner's Schedule E generally has few expenses.

⁶² IRS Pub. 5652, *Oil and Gas Audit Technique Guide*, p. 188 (2023).

⁶³ Ibid., p. 56.

⁶⁴ Instructions for Schedule E.

⁶⁵ Ibid.

⁶⁶ IRC §1411(c)(1)(A).

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Depletion. Owners of an economic interest in mineral deposits or oil and gas wells can recover their investment through a depletion allowance.⁶⁷ This deduction for depletion accounts for the reduction of the property's value or basis from extracting the natural resource by mining, drilling, quarrying stone, or cutting timber. An economic interest exists if:⁶⁸

- The taxpayer acquired any interest in mineral deposits or standing timber by investment, and
- The taxpayer has a legal right to income from the extraction of the mineral or cutting of the timber as a return on their capital investment.

The oil and gas depletion rate for royalty owners is generally 15% **of revenue**, not cost or tax basis, if they satisfy the requirements in IRC §613A to use **percentage depletion**.⁶⁹ Royalty owners generally satisfy these requirements if they produce less than 1,000 barrels of crude oil per day or 6 million cubic feet of natural gas.⁷⁰ The taxpayer's basis in the property is reduced (but not below zero) by the depletion allowed or allowable, whichever is greater.⁷¹ Although cost depletion generally reduces the adjusted tax basis, the taxpayer may continue to use the percentage depletion **even if the property's adjusted tax basis is zero**. If they cannot satisfy these requirements, they must use cost depletion, the discussion of which is beyond the scope of this section.

Depletion is reported on line 18 of Schedule E.⁷²

State Taxes. State laws may treat royalty interests as real estate interests subject to real estate taxes. States generally assess production taxes on the value of oil and gas produced, which are generally called **severance tax**.⁷³ These taxes are reported on line 16 of Schedule E, part I.

Example 8. In addition to his job, Raul has a royalty interest in 160 acres in the southwest corner of Andrews County, Texas, and Permian Unlimited, Inc. (PUI) is the operator for wells on the leased property. For 2024, he receives a Form 1099-MISC from PUI with \$5,600 of royalties reported in box 2. In addition to \$280 of severance tax withheld from payments, Raul is entitled to a depletion deduction of \$840 ($\$5,600 \times 15\%$).⁷⁴ He files the following Schedule E.

⁶⁷ IRS Pub. 17, *Your Federal Income Tax*.

⁶⁸ IRS Pub. 535, *Business Expenses*.

⁶⁹ IRC §§613(a) and 613A. IRC §613A limits percentage depletion for oil and gas wells, with exceptions for certain domestic gas wells and independent producers/royalty owners, subject to specific production caps.

⁷⁰ IRC §§613A(c)(3) and (4).

⁷¹ IRS Pub. 535, *Business Expenses*.

⁷² Instructions for Schedule E.

⁷³ Texas severance taxes are 4.6% of revenue, according to Texas Tax Code §202.052, although producers generally deduct 5% from royalty owners' checks to cover fees associated with the late filing of the associated tax; cf. *Texas Oil and Gas Severance Taxes: An Overview of Current Law and New Legislative Changes*, p. 1. McKee, Camie and Potts, Bradley. Jul. 26, 2023. Haynes Boone. [www.haynesboone.com/-/media/project/haynesboone/haynesboone/pdfs/alert-pdfs/2023/texas-oil-and-gas-severance-taxes-an-overview-of-current-law-and-new-legislative-changes.pdf] Accessed on Apr. 2, 2025. Although a study of severance payments is beyond the scope of this chapter, they are included in this example for accuracy.

⁷⁴ See IRC §613.

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For Example 8

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Name(s) shown on return

Raul Henson

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment
Sequence No. **13**

Your social security number

***-**-8888

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

- A** Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☐ Yes ☒ No
B If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☐ No

1a Physical address of each property (street, city, state, ZIP code)

A	B	C
1b	Type of Property (from list below)	2
A	6	For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.
B		
C		

Type of Property:

- 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe) _____

		Properties:		
		A	B	C
Income:				
3	Rents received	3		
4	Royalties received	4	5,600	
Expenses:				
5	Advertising	5		
6	Auto and travel (see instructions)	6		
7	Cleaning and maintenance	7		
8	Commissions	8		
9	Insurance	9		
10	Legal and other professional fees	10		
11	Management fees	11		
12	Mortgage interest paid to banks, etc. (see instructions)	12		
13	Other interest	13		
14	Repairs	14		
15	Supplies	15		
16	Taxes	16	280	
17	Utilities	17		
18	Depreciation expense or depletion	18	840	
19	Other (list) _____	19		
20	Total expenses. Add lines 5 through 19	20	1,120	
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	4,480	
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()
23a	Total of all amounts reported on line 3 for all rental properties	23a		
b	Total of all amounts reported on line 4 for all royalty properties	23b	5,600	
c	Total of all amounts reported on line 12 for all properties	23c		
d	Total of all amounts reported on line 18 for all properties	23d	840	
e	Total of all amounts reported on line 20 for all properties	23e	1,120	
24	Income. Add positive amounts shown on line 21. Do not include any losses	24		4,480
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()	
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26		4,480

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Cat. No. 11344L

Schedule E (Form 1040) 2024

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FARM RENTAL INCOME AND EXPENSES FOR ESTATES AND TRUSTS⁷⁵

For an estate or trust, farm rental income and expenses based on crops or livestock produced by a tenant is reported on part I of Schedule E. Estates and trusts do not use Form 4835, *Farm Rental Income and Expenses*, as an individual would, or Schedule F, *Profit or Loss From Farming*, for this purpose.

LOSS LIMITATIONS

A loss on Schedule E from rental real estate, royalties, partnerships, S corporations, or estates or trusts may be limited. Four different sets of rules may limit the amount of losses deductible by an investor in a pass-through entity. These limitations follow **in the order they are applied**.

1. The basis limitations (IRC §704(d) for partners and IRC §1366(d) for S corporation shareholders)
2. The at-risk rules under IRC §465
3. The passive activity loss rules under IRC §469
4. Excess business loss rules under IRC §461(l)

BASIS LIMITATION

An individual may not deduct losses in excess of their basis in the activity. Basis limitations for S corporations and partnerships are discussed later in the chapter.

Note. For more information on items that can increase or decrease basis, see IRS Pub. 551. For information pertaining to basis calculations for S corporation shareholders, see the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments. For information on variations of basis applicable to individual taxpayers, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis. These can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

AT-RISK RULES⁷⁶

The at-risk rules apply to any trade or business or income-producing activity. Under the at-risk rules, a taxpayer can only claim a loss up to the amount for which they are at risk. Taxpayers are at risk for the following.

1. The amount of money plus the adjusted basis of property contributed to the entity or activity
2. The amounts the individual borrowed for use in the entity's activity as long as the individual either:
 - a. Is personally liable for repayment, or
 - b. Has pledged property as security for the debt.

Note. For more information on the at-risk rules, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

⁷⁵ Instructions for Schedule E.

⁷⁶ IRC §465.

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Schedule E At-Risk Issues⁷⁷

The at-risk rules do not apply to losses from an activity of holding real property placed in service before 1987. They also do not apply to losses from any interest acquired before 1987 in a pass-through entity engaged in such activity. This exception does not apply to ownership of mineral property.

Example 9. On January 3, 2023, Jeff and Kelsey formed a limited liability partnership, Jay-Kay LLP, with the sole business purpose of distributing videos on farming techniques.⁷⁸ Under the partnership agreement, Jeff and Kelsey shared the entity's capital, allocations of debt, and all other allocations equally. On that day, both Jeff and Kelsey contributed \$10,000 cash to Jay-Kay.

On July 1 of that year, the partnership borrowed \$40,000 on a nonrecourse basis from the Central State Bank to purchase equipment. This equipment was the only collateral the bank required for the loan, and Jay-Kay purchased it on July 2. As of that date, Jeff's share of the debt is \$20,000 ($\$40,000 \times 50\%$).

On September 1, Jay-Kay repays \$4,000 of debt, which reduces each partner's share of the debt to \$18,000 ($(\$40,000 - \$4,000) \times 50\%$). On October 1, 2023, Jay-Kay distributes \$3,000 cash to each partner. For the year, Jay-Kay has no income or loss. Jeff's outside basis in the partnership is \$25,000 (\$10,000 initial capital contribution + \$18,000 share of borrowings – \$3,000 cash distributed). However, Jeff's amount at risk on October 1 is only \$7,000, as follows.

Initial investment at risk	\$10,000
Plus: items increasing basis other than §465(b)(3) or (4) items	0
Subtotal	\$10,000
Less: distribution	(3,000)
Jeff's amount at risk on October 1	\$ 7,000

Jeff's amount at risk limits his deduction for losses to \$7,000 before the passive activity loss rules are considered.

⁷⁷ Instructions for Schedule E.

⁷⁸ This example is based on Example 1 in Treas. Reg. §7.465-5.

2025 Workbook

PASSIVE ACTIVITY LOSS RULES⁷⁹

Passive activity rules generally provide that a credit or loss from a passive activity may be used only to the extent that the taxpayer has income from that activity or another passive activity. If passive activity losses (PALs) exceed a taxpayer's passive activity income, the losses are suspended until the taxpayer has sufficient income from the activity giving rise to the passive loss or from some other passive activity. Passive loss limitations are calculated on Form 8582, *Passive Activity Loss Limitations*.

Note. IRC §469 and the accompanying Treasury Regulations define a passive activity. Specifically, §469(c)(2) provides that the term passive activity includes any rental activity unless an exception is provided. The list of exceptions related to rental activities under §469 is included in the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

For activities that are not considered rental activities, the taxpayer must be able to satisfy one of the seven material participation tests before the activity is nonpassive. For the list of material participation tests, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

The losses also cease to be suspended when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction.⁸⁰

Note. With the complete disposition of the property, the activity becomes nonpassive for the entire tax year.⁸¹ Therefore, Form 8582 is not used for the activity in the year of its sale.⁸²

Example 10. Gregory has owned and managed an apartment building for many years. Neither Gregory nor his wife Linda qualifies as a real estate professional (discussed later). The couple has suspended passive losses of \$110,000 from prior years. In 2024, Gregory reports a \$10,000 loss in the real estate operation. On October 30, 2024, he sells the property in a fully taxable transaction for \$220,000. The suspended losses are released as fully deductible ordinary losses in 2024. For this reason, they do not use Form 8582 for their 2024 tax return.

⁷⁹ IRC §469.

⁸⁰ Instructions for Form 8582.

⁸¹ IRC §469(g)(1)(A).

⁸² Instructions for Form 8582, p. 9 (2023).

2025 Workbook

For Example 10

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Name(s) shown on return

Gregory and Linda Mantle

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment
Sequence No. **13**

Your social security number

***-**-5566

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

- A** Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☐ Yes ☒ No
B If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☐ No

1a Physical address of each property (street, city, state, ZIP code)

A **1951 Rook Lane, Urbana, IL 61801**

B

C

1b Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A 2		A 304	0	☐
B		B		☐
C		C		☐

Type of Property:

- 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe) _____

		Properties:		
		A	B	C
Income:				
3	Rents received	3 14,250		
4	Royalties received	4		
Expenses:				
5	Advertising	5 150		
6	Auto and travel (see instructions)	6		
7	Cleaning and maintenance	7 1,000		
8	Commissions	8		
9	Insurance	9 2,500		
10	Legal and other professional fees	10 2,500		
11	Management fees	11		
12	Mortgage interest paid to banks, etc. (see instructions)	12 5,600		
13	Other interest	13		
14	Repairs	14 3,000		
15	Supplies	15		
16	Taxes	16 1,000		
17	Utilities	17 4,000		
18	Depreciation expense or depletion	18 4,500		
19	Other (list) _____	19		
20	Total expenses. Add lines 5 through 19	20 24,250		
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21 (10,000)		
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22 (120,000)		
23a	Total of all amounts reported on line 3 for all rental properties	23a 14,250		
b	Total of all amounts reported on line 4 for all royalty properties	23b		
c	Total of all amounts reported on line 12 for all properties	23c 5,600		
d	Total of all amounts reported on line 18 for all properties	23d 4,500		
e	Total of all amounts reported on line 20 for all properties	23e 24,250		
24	Income. Add positive amounts shown on line 21. Do not include any losses	24		
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25 (120,000)		
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26 (120,000)		

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2024

2025 Workbook

Other Activities Exempted from PAL Rules

The following Schedule E activities have special PAL rules, as discussed previously.

- The rental of a dwelling unit the taxpayer uses as a home is not subject to the PAL rules.
- A working interest in an oil or gas well held directly or through an entity that did not limit the taxpayer's liability is not a passive activity, even if the taxpayer did not materially participate.⁸³
- Royalty income not derived in the ordinary course of a trade or business that is reported on Schedule E is generally not considered income from a passive activity.⁸⁴

Example 11. In 2023, Larry, Gretchen, and Dawn decide at Thanksgiving dinner that they want to invest in oil and gas ventures. Larry acquires a nonoperating working interest in a new oil well in their state, with drilling scheduled to start in January 2024. Larry's barber advises him to set up a limited liability corporation (LLC) to hold the interest, which Larry does in early December of 2023. Without discussing the investment with her counselors, Gretchen invests in a nonoperating working interest in the same property but does not set up an LLC to hold the interest. Instead, she owns it directly. Dawn acquires a royalty interest in a third property, which she holds as a casual investment that she owns directly.

With the costs of drilling, Larry's nonoperating working interest incurs a loss for 2024, as does Gretchen's interest. Because Larry owns his working interest through an entity that limits his liability, he does not benefit from the special rule that can exempt oil and gas working interests from the passive income. Consequently, he must treat the 2024 loss as a suspended loss.

In contrast, Gretchen can deduct the loss on her 2024 tax return because Temp. Treas. Reg. §1.469-1T(e)(4)(i) provides that her investment is **not** subject to the passive loss limitations. Her 2024 tax return reports a substantial loss that reduces her taxable income.

Dawn's investment in a royalty interest is not a passive activity because she does not hold the investment as a trade or a business. The royalty interest is profitable, but the passive activity loss rules would not apply to it even if it operated at a loss.

Real Estate Professional Exception

Real estate professionals have unique rules. Their rental activities are not automatically passive, thereby providing the possibility of offsetting ordinary income with losses from rental activities. Only if a real estate professional **materially** participates in the rental activities are the activities not considered passive.

Note. Material participation for real estate professionals is covered in detail in the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

Example 12. Each year, Tristan works 700 hours renting personal watercraft and spends 800 hours in his trade or business of renting real estate. During 2024, Tristan reports a loss of \$33,000 for his real estate rental activity. Because he is a real estate professional, Tristan's loss is not limited by the PAL rules. He files the following Schedule E.

⁸³. Temp. Treas. Reg. §1.469-1T(e)(4)(i).

⁸⁴. IRC §469(e)(1)(A)(i)(I).

2025 Workbook

For Example 12

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Name(s) shown on return

Tristan Tucker

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024

Attachment
Sequence No. **13**

Your social security number

*****-**-4444**

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☐ Yes ☒ No

B If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☐ No

1a Physical address of each property (street, city, state, ZIP code)

A **727 W Elm, Urbana, IL 61801**

B

C

1b Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A 4	A	366	0	☐
B	B			☐
C	C			☐

Type of Property:

1 Single Family Residence	3 Vacation/Short-Term Rental	5 Land	7 Self-Rental
2 Multi-Family Residence	4 Commercial	6 Royalties	8 Other (describe) _____

		Properties:		
		A	B	C
Income:				
3	Rents received	3 105,000		
4	Royalties received	4		
Expenses:				
5	Advertising	5 4,000		
6	Auto and travel (see instructions)	6		
7	Cleaning and maintenance	7 8,000		
8	Commissions	8 10,000		
9	Insurance	9		
10	Legal and other professional fees	10 3,000		
11	Management fees	11 15,000		
12	Mortgage interest paid to banks, etc. (see instructions)	12		
13	Other interest	13		
14	Repairs	14 7,000		
15	Supplies	15		
16	Taxes	16 35,000		
17	Utilities	17 6,000		
18	Depreciation expense or depletion	18 50,000		
19	Other (list) _____	19		
20	Total expenses. Add lines 5 through 19	20 138,000		
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21 (33,000)		
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22 (33,000)		
23a	Total of all amounts reported on line 3 for all rental properties	23a 105,000		
b	Total of all amounts reported on line 4 for all royalty properties	23b		
c	Total of all amounts reported on line 12 for all properties	23c		
d	Total of all amounts reported on line 18 for all properties	23d 50,000		
e	Total of all amounts reported on line 20 for all properties	23e 138,000		
24	Income. Add positive amounts shown on line 21. Do not include any losses	24		
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25 (33,000)		
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26 (33,000)		

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2024

2025 Workbook

Because Tristan is a real estate professional, his loss is also reported on page 2 of Schedule E on lines 41 and 43.

39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below		39
Part V Summary		
40 Net farm rental income or (loss) from Form 4835 . Also, complete line 42 below	40	
41 Total income or (loss) . Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5	41	(33,000)
42 Reconciliation of farming and fishing income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120-S), box 17, code AN; and Schedule K-1 (Form 1041), box 14, code F. See instructions	42	
43 Reconciliation for real estate professionals. If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	
		(33,000)

Schedule E (Form 1040) 2024

Land Rent⁸⁵

A recharacterization rule applies to bare land leases. Under this recharacterization rule, net income from a rental activity is considered **not** from a passive activity if less than 30% of the unadjusted basis of the property is depreciable. The rule converts both net rental income and any gain on disposition from passive income to nonpassive income. However, the recharacterization rule only applies if there is net income from the rental activity. If there is a loss, the loss remains passive.

Example 13. Dr. Miller owns interests in multiple limited partnerships that have suspended passive losses. In an attempt to use those losses, Dr. Miller bought farmland for \$400,000. Of this amount, \$100,000 was allocated to fences, tile lines, grain bins, and other depreciable property. Dr. Miller cash-leased the land to his cousin via a cash-rent lease to generate passive income that he could use to offset his suspended passive losses. However, because only 25% of the unadjusted basis of the farming investment is attributable to depreciable property, the cash-rent income is recharacterized (for passive loss rule purposes) as nonpassive income and cannot offset the suspended passive losses from the limited partnerships. If the cash rent produced a net loss after taxes, interest, and depreciation, it would be a passive loss. This is not the result that Dr. Miller was hoping to achieve.

Self-Rental

Immediately after the Tax Reform Act of 1986 was implemented, several new tax shelters arose. A common arrangement involved using self-rental arrangements to generate passive income to offset passive losses. The self-rental rule⁸⁶ was created to prevent taxpayers from shifting active income to passive income by renting property to a trade or business in which the taxpayer materially participates. Specifically, the self-rental rule recharacterizes a taxpayer's net rental activity income from an item of property as nonpassive if the property is rented for use in a trade or business activity in which the taxpayer materially participates.⁸⁷

Note. The self-rental rule has received renewed attention in the past several years because of the enactment of the NIIT and QBID. However, the final NIIT regulations⁸⁸ clarified that rental income recharacterized as nonpassive under the self-rental rule⁸⁹ is also treated as nonpassive for purposes of the NIIT.⁹⁰ Accordingly, self-rental income is not subject to the NIIT. Self-rental income qualifies for the QBID.

⁸⁵ Temp. Treas. Reg. §1.469-2T(f)(3) and see, e.g., *Wiseman v. Comm'r*; TC Memo 1995-203 (May 10, 1995).

⁸⁶ Treas. Reg. §1.469-2(f)(6).

⁸⁷ *Williams v. Comm'r*; TC Memo 2015-76 (Apr. 16, 2015).

⁸⁸ IRS Ann. 2014-18, 2014-17 IRB 983.

⁸⁹ Treas. Reg. §1.469-2(f)(6).

⁹⁰ Treas. Reg. §1.1411-5(b)(2)(i).

Applicability of Self-Rental Rule. Income may be subject to the self-rental rule if produced by property that is:⁹¹

- Rented for use in a trade or business activity⁹² in which the taxpayer materially participates, and
- Is not rented incidental to a development activity. (As described in Treas. Reg. §1.469-2(f)(5), this involves material or significant participation in an activity for the purposes of enhancing the value of the property if the property is rented during the year of its sale.)

Any work done by an individual in connection with an activity in which they own an interest at the time the work is performed is treated as participation by the individual in the activity. A taxpayer materially participates in an activity if any of the seven tests for material participation are met.⁹³

Example 14. Madge Juniper operates a construction business as a sole proprietor. Juniper, LLC (of which Madge is the sole member) owns an office building. Juniper, LLC, rents the office building to Madge's construction business at a fair rental price.

This arrangement is subject to the self-rental rule. The building owned by the LLC is rented by the construction company for use in a trade or business in which Madge materially participates.

Example 15. Harry Ruffcorn is a 1% shareholder in Imagine That, Inc., an S corporation that runs an advertising business. Harry does not materially participate in the business. Harry is also a 50% owner of a building that Imagine That, Inc., rents for its offices.

This arrangement is not subject to the self-rental rules because Harry does not materially participate in the business of Imagine That, Inc.

Self-Rental Income and Losses.⁹⁴ A taxpayer's rental income from an item of property rented for use in a trade or business activity in which the taxpayer materially participates is recharacterized as nonpassive. Conversely, the self-rental rule does not recharacterize a nonpassive loss incurred through such a rental as nonpassive. A loss from a self-rental arrangement retains its passive character.⁹⁵

Example 16. June and Leland are married taxpayers who own commercial property. They lease their property to FallsCo Inc., an S corporation in which they materially participate. During 2024, June and Leland report \$100,000 in rental income from FallsCo. Under the self-rental rule, the \$100,000 in rental income received from FallsCo is recharacterized as nonpassive income. June and Leland's Schedule E follows.

⁹¹ Treas. Reg. §1.469-2(f)(6).

⁹² This term is used within the meaning of Treas. Reg. §1.469-2(e)(2).

⁹³ Temp. Treas. Reg. §1.469-5T(a).

⁹⁴ Treas. Reg. §1.469-2(f)(6).

⁹⁵ IRC §469(a)(1)(A).

2025 Workbook

For Example 16

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

Attach to Form 1040, 1040-SR, 1040-NR, or 1041.

Go to www.irs.gov/ScheduleE for instructions and the latest information.

OMB No. 1545-0074

2024
Attachment
Sequence No. **13**

Name(s) shown on return

June and Leland Menshing

Your social security number

***-**-6543

Part I Income or Loss From Rental Real Estate and Royalties

Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions ☐ Yes ☒ No

B If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☐ No

1a Physical address of each property (street, city, state, ZIP code)

A 134 Maple Lane, Sycamore, IL 60178

B

C

1b Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A 7	A	366		☐
B	B			☐
C	C			☐

Type of Property:

1 Single Family Residence

2 Multi-Family Residence

3 Vacation/Short-Term Rental

4 Commercial

5 Land

6 Royalties

7 Self-Rental

8 Other (describe) _____

		Properties:		
		A	B	C
Income:				
3 Rents received	3	150,000		
4 Royalties received	4			
Expenses:				
5 Advertising	5			
6 Auto and travel (see instructions)	6			
7 Cleaning and maintenance	7	7,000		
8 Commissions	8	5,000		
9 Insurance	9	10,000		
10 Legal and other professional fees	10			
11 Management fees	11			
12 Mortgage interest paid to banks, etc. (see instructions)	12			
13 Other interest	13			
14 Repairs	14			
15 Supplies	15			
16 Taxes	16			
17 Utilities	17	15,000		
18 Depreciation expense or depletion	18	13,000		
19 Other (list) _____	19			
20 Total expenses. Add lines 5 through 19	20	50,000		
21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	100,000		
22 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()	()
23a Total of all amounts reported on line 3 for all rental properties	23a	150,000		
b Total of all amounts reported on line 4 for all royalty properties	23b			
c Total of all amounts reported on line 12 for all properties	23c			
d Total of all amounts reported on line 18 for all properties	23d	13,000		
e Total of all amounts reported on line 20 for all properties	23e	50,000		
24 Income. Add positive amounts shown on line 21. Do not include any losses	24			100,000
25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25			()
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26			100,000

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2024

2025 Workbook

Example 17. Use the same facts as **Example 16**, except June and Leland lost \$30,000 on the property they rented to FallsCo. The \$30,000 loss remains a passive loss.

June and Leland do not have passive income to offset the loss and have modified adjusted gross income (MAGI) of \$160,000. They file the following Schedule E and Form 8582, pages 1 and 2, to calculate their PAL limit.

SCHEDULE E (Form 1040)		Supplemental Income and Loss (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)		OMB No. 1545-0074 2024 Attachment Sequence No. 13	
Department of the Treasury Internal Revenue Service		Attach to Form 1040, 1040-SR, 1040-NR, or 1041. Go to www.irs.gov/ScheduleE for instructions and the latest information.			
Name(s) shown on return June and Leland Menshing				Your social security number ***-**-6543	
Part I Income or Loss From Rental Real Estate and Royalties Note: If you are in the business of renting personal property, use Schedule C. See instructions. If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.					
A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions. ☐ Yes ☒ No					
B If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☐ No					
1a Physical address of each property (street, city, state, ZIP code)					
A 134 Maple Lane, Sycamore, IL 60178					
B					
C					
1b Type of Property (from list below)		2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.		Fair Rental Days	Personal Use Days
A 7		A		366	☐
B		B			☐
C		C			☐
Type of Property: 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental 2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe) _____					
Income:		Properties:			
		A	B	C	
3 Rents received	3	20,000			
4 Royalties received	4				
Expenses:					
5 Advertising	5				
6 Auto and travel (see instructions)	6				
7 Cleaning and maintenance	7	7,000			
8 Commissions	8	5,000			
9 Insurance	9	10,000			
10 Legal and other professional fees	10				
11 Management fees	11				
12 Mortgage interest paid to banks, etc. (see instructions)	12				
13 Other interest	13				
14 Repairs	14				
15 Supplies	15				
16 Taxes	16				
17 Utilities	17	15,000			
18 Depreciation expense or depletion	18	13,000			
19 Other (list) _____	19				
20 Total expenses. Add lines 5 through 19	20	50,000			
21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	(30,000)			
22 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()	()	
23a Total of all amounts reported on line 3 for all rental properties	23a	20,000			
b Total of all amounts reported on line 4 for all royalty properties	23b				
c Total of all amounts reported on line 12 for all properties	23c				
d Total of all amounts reported on line 18 for all properties	23d	13,000			
e Total of all amounts reported on line 20 for all properties	23e	50,000			
24 Income. Add positive amounts shown on line 21. Do not include any losses	24				
25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()			
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2	26	0			

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11344L Schedule E (Form 1040) 2024

2025 Workbook

For Example 17

Form 8582	Passive Activity Loss Limitations See separate instructions. Attach to Form 1040, 1040-SR, or 1041. Go to www.irs.gov/Form8582 for instructions and the latest information.	OMB No. 1545-1008 2024 Attachment Sequence No. 858
Department of the Treasury Internal Revenue Service		
Name(s) shown on return June and Leland Menshing		Identifying number ***-**-6543

Part I 2024 Passive Activity Loss

Caution: Complete Parts IV and V before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation, see *Special Allowance for Rental Real Estate Activities* in the instructions.)

1a Activities with net income (enter the amount from Part IV, column (a))	1a		
b Activities with net loss (enter the amount from Part IV, column (b))	1b	(30,000)	
c Prior years' unallowed losses (enter the amount from Part IV, column (c))	1c	()	
d Combine lines 1a, 1b, and 1c	1d		(30,000)

All Other Passive Activities

2a Activities with net income (enter the amount from Part V, column (a))	2a		
b Activities with net loss (enter the amount from Part V, column (b))	2b	()	
c Prior years' unallowed losses (enter the amount from Part V, column (c))	2c	()	
d Combine lines 2a, 2b, and 2c	2d		

3 Combine lines 1d and 2d and subtract any prior year unallowed CRD. See instructions. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c or 2c. Report the losses on the forms and schedules normally used	3		(30,000)

- If line 3 is a loss and: • Line 1d is a loss, go to Part II.
• Line 2d is a loss (and line 1d is zero or more), skip Part II and go to line 10.

Caution: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II. Instead, go to line 10.

Part II Special Allowance for Rental Real Estate Activities With Active Participation

Note: Enter all numbers in Part II as positive amounts. See instructions for an example.

4 Enter the smaller of the loss on line 1d or the loss on line 3	4	(30,000)
5 Enter \$150,000. If married filing separately, see instructions	5	150,000
6 Enter modified adjusted gross income, but not less than zero. See instructions	6	160,000
Note: If line 6 is greater than or equal to line 5, skip lines 7 and 8 and enter -0- on line 9. Otherwise, go to line 7.		
7 Subtract line 6 from line 5	7	
8 Multiply line 7 by 50% (0.50). Do not enter more than \$25,000. If married filing separately, see instructions	8	
9 Enter the smaller of line 4 or line 8. If line 3 includes any CRD, see instructions	9	0

Part III Total Losses Allowed

10 Add the income, if any, on lines 1a and 2a and enter the total	10	
11 Total losses allowed from all passive activities for 2024. Add lines 9 and 10. See instructions to find out how to report the losses on your tax return	11	

Part IV Complete This Part Before Part I, Lines 1a, 1b, and 1c. See instructions.

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Office Building		30,000			30,000
Total. Enter on Part I, lines 1a, 1b, and 1c		30,000			

For Paperwork Reduction Act Notice, see instructions.

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For Example 17

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Part V Complete This Part Before Part I, Lines 2a, 2b, and 2c. See instructions.

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 2a)	(b) Net loss (line 2b)	(c) Unallowed loss (line 2c)	(d) Gain	(e) Loss
Total. Enter on Part I, lines 2a, 2b, and 2c					

Part VI Use This Part if an Amount Is Shown on Part II, Line 9. See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a).
Total			1.00		

Part VII Allocation of Unallowed Losses. See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
Office Building	Sch E Ln 22	30,000	1.000000	30,000
Total		30,000	1.00	30,000

Part VIII Allowed Losses. See instructions.

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Unallowed loss	(c) Allowed loss
Office Building	Sch E Ln 22	30,000	30,000	0
Total		30,000	30,000	0

Form **8582** (2024)

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The self-rental rule applies to an **item of property**, not an activity. This distinction remains even if the taxpayer has grouped activities as a single unit under the passive loss grouping rules, as discussed later.⁹⁶ Therefore, the taxpayer cannot aggregate self-rental activities to offset taxable income with losses.

Self-Rental Rule and SE Tax. Rentals from real estate and from personal property leased with real estate are excluded from the definition of SE income.⁹⁷ Consequently, income from self-rental real estate property does not trigger SE tax.

This exclusion does **not** apply to the rental of farmland when the owner materially participates in the farming operation.⁹⁸ Rentals involving the production of agricultural or horticultural commodities are subject to SE tax if the taxpayer materially participates in the production or the management of production on the land.

Grouping Rules

To determine whether the taxpayer materially participated in their rental real estate activities as a real estate professional, each interest in rental real estate is a separate activity unless the taxpayer elects to treat all their interests in rental real estate as one activity.⁹⁹

For taxpayers who are not real estate professionals, two or more activities may be grouped together and treated as one single activity.¹⁰⁰ However, any grouped activities must form an appropriate **economic unit**. Whether activities form an appropriate economic unit is based on all the facts and circumstances. A taxpayer can use any reasonable method to determine whether grouped activities form an appropriate economic unit. However, the factors that give the greatest weight to this determination are as follows.¹⁰¹ This list is not all-inclusive, and not all factors are considered in every grouping.

- Similarities and differences in types of trades or businesses
- Extent of any common control over the activities
- Extent of any common ownership of the activities
- Geographical location of the activities
- Degree of interdependency between the activities (including purchasing or selling goods, provision of products or services that are complimentary, existence of common customers or employees, and use of a single set of records for accounting)

If the taxpayer has two or more activities that form an appropriate economic unit and they elect to group them, all their grouped activities are treated as **a single activity** for material participation purposes. **Without grouping, the taxpayer would need to establish material participation separately for each individual activity.**

The regulations expressly prohibit certain groupings.¹⁰² Several examples follow.

- Rental activities cannot be grouped with other trade or business activities unless the activities constitute an appropriate economic unit.
- Real property rentals cannot be grouped with personal property rentals.
- Activities conducted as a limited partner or limited entrepreneur (for example, a shareholder in an S corporation that does not participate¹⁰³) cannot be grouped with other activities that are not the same type of business.

⁹⁶ Treas. Reg. §1.469-4(c)(1).

⁹⁷ IRC §1402(a)(1).

⁹⁸ Ibid.

⁹⁹ IRC §469(c)(7)(A); Instructions for Schedule E.

¹⁰⁰ Treas. Reg. §1.469-4(c)(1).

¹⁰¹ Treas. Reg. §1.469-4(c)(2).

¹⁰² Treas. Reg. §1.469-4(d).

¹⁰³ See IRC §461(k)(4).



Practitioner Planning Tip

Taxpayers may want to consider grouping the self-rental activity that produces a loss with their operating entity. They can do this if their activities together constitute an appropriate economic unit and the rental activity is insubstantial in relation to the business activity (or the business activity is insubstantial in relation to the rental activity).¹⁰⁴

To define “insubstantial,” the Treasury Department originally created an “80/20 test” for purposes of grouping rental and non-rental activities.¹⁰⁵ Under that test, rental and non-rental activities may be grouped “if more than 80% of the income of the [activity]... is attributable to one class of operations (i.e., rental or non-rental).” While this temporary regulation is no longer in place and the final regulations do not adopt a bright-line or safe harbor gross revenue test, the courts still view the 80/20 test as an appropriate representation of what constitutes “insubstantial.”¹⁰⁶

Benefits of Grouping. Grouping activities is a technique used to convert otherwise passive activities into nonpassive activities. Because grouping treats multiple activities as a single activity, participation hours are combined. This increases the likelihood that a taxpayer can attain the hours required for material participation. Moreover, the taxpayer must meet the material participation requirement only for the combined single activity instead of each separate activity. Treas. Reg. §1.469-4 provides general rules and limitations for grouping activities and identifies a facts-and-circumstances test to establish whether a particular grouping is appropriate. In general, under §469, activities can only be grouped if they constitute an appropriate economic unit for measuring gain or loss.

Grouping activities can provide significant tax advantages. An example of the benefits of the appropriate economic unit rule may be found in *Glick v. U.S.*¹⁰⁷ In this case, the Glicks (husband and wife) owned general partner and/or debt interests in 116 limited partnerships. Each limited partnership owned a specific low-income housing apartment project. One of their interests, the Gene B. Glick Company, Inc. (GBG), was an S corporation. The Glicks owned 93.57% of this business, whose sole purpose was to manage the apartment projects for a fee. It also provided all the required services either directly or by hiring third-party vendors to supply them.

The U.S. District Court for the Southern District of Indiana found that GBG and the limited partnerships worked as an interrelated and integrated single-business unit rather than as two distinct entities that happened to provide services to each other. The court found that this close operating relationship indicated that they were two parts of a single economic enterprise. The court analyzed the quantitative facts and found that “GBG clearly had no role beyond providing services to the partnerships. It was subservient to and totally dependent upon the partnerships for its revenue as well as its existence.” From this conclusion, the court ruled in favor of the taxpayer and allowed the passive losses generated from the Glicks’ limited partnership interests to offset the fee income generated by their S corporation.

¹⁰⁴ Treas. Reg. §1.469-4(d)(1)(i).

¹⁰⁵ Temp. Treas. Reg. §1.469-4T.

¹⁰⁶ See, e.g., *Candelaria v. U.S.*, 518 F.Supp.2d 852 (W.D.Tex. 2007).

¹⁰⁷ *Glick v. U.S.*, 96 F.Supp.2d 850 (2000).

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Other benefits of grouping include the following.

- Current losses that would otherwise be suspended are utilized.
- The 3.8% NIIT can be minimized.
- The burden of meeting the material participation rules for each activity is eliminated.

Drawbacks of Grouping. Some of the drawbacks of grouping include the following.

- Suspended passive losses cannot be utilized until there is a complete disposition of the grouped activity.
- Passive losses may not be currently deductible due to previous groupings that eliminated passive income.

When making an election to group activities, future capital gains from the activity's disposition will not be treated as passive income. For tax planning purposes, the practitioner should consider the benefits and drawbacks of the grouping, taking into account the current loss deduction versus the smaller future passive income amount available to be offset by future passive losses.

Regrouping. Beginning January 1, 2014, a taxpayer who becomes subject to the NIIT may, on a one-time-only basis, elect to regroup and disregard the prior grouping election, often called a fresh-start election.¹⁰⁸ However, this special grouping opportunity must be made in the first tax year in which the taxpayer owes NIIT. More information on the fresh-start election is provided later.

Note. Any regrouping of activities under this one-time regrouping election is still subject to the requirements for an appropriate economic unit and disclosure under §469, Treas. Reg. §1.469-4(e), and Rev. Proc. 2010-13.

Once activities are grouped together, the taxpayer may generally not regroup them in subsequent tax years.¹⁰⁹ However, regrouping is required when the taxpayer's original grouping is clearly inappropriate or if a material change in the taxpayer's circumstances makes a current grouping inappropriate.¹¹⁰ The IRS has the authority to regroup a taxpayer's activities if the grouped activities do not form an appropriate economic unit, and the principal purpose in using the grouping (or failing to group or regroup) is to circumvent the passive loss rules.¹¹¹

Disclosure Statement. The taxpayer is required to disclose activity groupings and regroupings in a written statement that is filed with the taxpayer's original return.¹¹² This statement must be filed at the following times.

1. The first year that two or more activities are grouped together by the taxpayer
2. In any tax year during which the taxpayer adds a new activity to an existing grouping
3. In a tax year during which the taxpayer regroups activities

^{108.} Treas. Reg. §1.469-11(b)(3)(iv).

^{109.} Treas. Reg. §1.469-4(e)(1).

^{110.} Treas. Reg. §1.469-4(e)(2).

^{111.} Treas. Reg. §1.469-4(f).

^{112.} Rev. Proc. 2010-13, 2010-4 IRB 329.

Disposition of Grouped Activities. Unless the taxpayer disposes of all activities in a group, the disposition is treated as a partial disposition. However, in the year in which the taxpayer disposes of substantially all of the group, the part disposed of may be treated as a separate activity if the taxpayer can establish both of the following with reasonable certainty.¹¹³

1. The amount of deductions and credits allocable to the part of the activity disposed of for purposes of the PAL suspension and carryforward rules
2. The amount of gross income, other deductions, and credits allocable to the disposed part of the activity

Grouping Elections. More favorable tax treatment sometimes results when taxpayers apply various elections to group their passive activities. Toward this end, Treas. Reg. §1.469-4, Rev. Proc. 2010-13, and Chief Counsel Memorandum 201427016¹¹⁴ provide guidance regarding grouping and regrouping activities.

General Grouping Election.¹¹⁵ A taxpayer uses guidance provided in Rev. Proc. 2010-13 when making the election to group two or more trade or business activities or rental activities as a single activity. The taxpayer files a written statement with their original income tax return for the first tax year of the grouping. This statement must identify the names, addresses, and federal employer identification number, if applicable, for the grouped trade or business activities or rental activities. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469.

Adding New Activities to Existing Groupings.¹¹⁶ If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping, a written statement is required to be filed with the taxpayer's original income tax return for that tax year. The same information is required in the new grouping election as provided in the original grouping election.

Regrouping Activities. Under Treas. Reg. §1.469-4(e)(2), if the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances occurred to make the original grouping inappropriate, the taxpayer must regroup the activities. If such a determination and regrouping is made, a written statement must be filed with the taxpayer's original income tax return for that tax year. The same information is required in the regrouping election as provided in the first election.

The statement reporting a regrouping must also contain 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.

Failure to Report.¹¹⁷ The Code treats activities as separate for the PAL and credit limitation rules of §469 unless a taxpayer groups them as a single activity. However, if a taxpayer discovers that a grouping of activities should have been made and discloses the omission on the tax return for the first year it was discovered, the taxpayer is deemed to have made the disclosure on a timely basis. If, instead, the IRS discovers the grouping's omission, the taxpayer must have reasonable cause for not making the required disclosures and qualify for an exception to the substantial understatement penalty.¹¹⁸ The relief available for extensions of time to make elections under Treas. Reg. §301.9100 is not available if grouping disclosures are not made.

¹¹³. Treas. Reg. §1.469-4(g).

¹¹⁴. Ltr. Rul. 201427016 (Apr. 28, 2014).

¹¹⁵. Rev. Proc. 2010-13, 2010-4 IRB 329.

¹¹⁶. Ibid.

¹¹⁷. Ibid.

¹¹⁸. Treas. Reg. §1.6662-2; IRM 20.1.5.8.1 (2012).

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Although the default rule established by Rev. Proc. 2010-13 generally results in unreported activities being treated as separate activities, the IRS retains the authority to regroup a taxpayer's activities to prevent tax avoidance under Treas. Reg. §1.469-4(f).

Fresh-Start Regrouping. As mentioned previously, beginning January 1, 2014, a taxpayer who becomes subject to the NIIT may, on a one-time-only basis, elect to regroup and disregard the prior grouping election.¹¹⁹ However, this special grouping opportunity must be made in the first tax year in which the taxpayer is liable for the NIIT.

When amending a return, a taxpayer may discover that they are liable for the NIIT for the first time. This situation makes them eligible for the regrouping election under the “fresh-start” provisions of Treas. Reg. §1.469-11(b)(3)(iv).

If a taxpayer has already used the one-time regrouping rule and decides to amend a return for a year in which the regrouping election was in effect, the amended return must reflect the regrouped activities. If the amended return does not reflect the activities as regrouped, the regrouping is deemed invalid. The regrouping is valid, though, if the taxpayer can show that there was a significant change in facts and circumstances, as discussed previously. The general grouping rules of §469 must support the regrouping in the year it occurred.

If the taxpayer discovers that they were not eligible to regroup because the amended return shows that the taxpayer is not subject to the NIIT for that year, the regrouping is deemed to have no effect for that year or subsequent years. Appropriate amended returns should be filed to reflect these changes for the affected years.

Special Election for Real Estate Professionals.¹²⁰ As discussed previously, there is a special election available to taxpayers who qualify as real estate professionals (qualifying taxpayers). The election is relevant only after determining whether the real estate professional is a qualifying taxpayer. Real estate professionals are not affected by the grouping election under Treas. Reg. §1.469-9(g).

Once the real estate professional is classified as a qualifying taxpayer, it must be determined whether they materially participated in the rental real estate activity. If the taxpayer did **not** make an election to group the properties, they are treated as separate rental properties, and the nonelecting real estate professional must separately meet the tests for material participation for each property.

A qualifying taxpayer may elect to treat **all interests in rental real estate as a single real estate activity** by filing a statement with the taxpayer's original income tax return for the year. The election must be made in a year in which the taxpayer is a qualifying taxpayer. The election is effective for the tax year in which it was made and all future years in which the taxpayer is a qualifying taxpayer, even if there are intervening tax years in which the taxpayer is not a qualifying taxpayer. In such intervening years in which the taxpayer does not qualify, the election has no effect.

Although the election may be revoked, it may only be revoked in the year in which a material change to facts and circumstances occurs or in any subsequent year in which the material change in facts and circumstances continues to prevail. The fact that an election is not as advantageous to the taxpayer does not constitute a material change. In addition, loss of status as a qualifying taxpayer does not constitute a material change.

A statement is required to either make or revoke this election. Further guidance may be found in Chief Counsel Memorandum 201427016 and Treas. Reg. §1.469-9(g)(3).¹²¹

Late Election. To obtain relief from an otherwise late election, the taxpayer must have reasonable cause for not making a timely election. The taxpayer must attach a statement to an amended return for the most recent tax year, along with the reason for the failure to file a timely election and identify the year for which they are making a late election. Once the IRS approves the relief application, the taxpayer may treat all interests in rental real estate as a single activity for the year for which the election was made.

¹¹⁹ Treas. Reg. §1.469-11(b)(3)(iv).

¹²⁰ IRC §469(c)(7)(A).

¹²¹ Ltr. Rul. 201427016 (Apr. 28, 2014).

Grouping and Regrouping Examples. The following examples illustrate the concept of grouping and regrouping rental real estate activities.

Example 18. George is involved in two partnerships. In the George's Family Restaurant partnership, he is a general partner working 50 hours per **year** as a kitchen consultant for this restaurant activity. KitKatConsult Partners is a consulting business that advises restaurant owners. It is also organized as a partnership. George is a partner in this activity as well. He works 50 hours per **week** as a consultant for the consulting business. George is unmarried and uses the single filing status on his income tax returns.

In 2024, George's restaurant activity had a loss. His 2024 Schedule K-1 (Form 1065), *Partner's Share of Income, Deduction, Credits, etc.*, for George's Family Restaurant reports \$100,000 as his share of the loss. His 2024 Schedule K-1 for the consulting business reports a \$130,000 profit.

Tax filing season arrives, and George takes his tax information to his tax preparer, Ginger. She reviews his returns from prior years and his 2024 tax information, including both Schedules K-1. She discovers that George never made an election to group the two partnerships' activities.

Ginger notes that because George does not materially participate in the restaurant activity, the \$100,000 loss is considered passive. She also notes that George has no passive income that this passive loss can offset. Because the restaurant loss is passive, it cannot offset any of the KitKatConsult Partner's nonpassive income.

After researching the grouping election rules, Ginger recommends that George elect to group the two activities. She concludes that both activities represent an appropriate economic unit. If a grouping election is made, George's partnership interests are treated as one activity. The benefits of making a grouping election are as follows.

1. George can offset the income from the consulting activity with the restaurant activity loss.
2. For 2024, George meets the material participation requirement for both activities because the election treats both activities as a single activity.

There are a few disadvantages to a grouping election for George.

1. The grouping decision is irrevocable without the IRS's consent. However, if George has a subsequent tax year that triggers the NIIT, he may regroup using the "fresh-start" one-time regrouping rule as long as he has never triggered the NIIT.
2. The election treats future income from the consulting activity with George's Family Restaurant as nonpassive.

George agrees to the election and authorizes Ginger to file the required statement with his 2024 tax return. This statement follows.

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Statement Filed in Accordance with Rev. Proc. 2010-13 and Election to Group Activities Under Treas. Reg. §1.469-4(c)

Taxpayer Name: **George Jones**

Tax Yearend: **2024**

Taxpayer ID #: *****-**-9876**

New Groupings

The following activities were grouped as a single activity for the first time during the current tax year.

Activity	Address	EIN	Type of Activity
George's Family Restaurant	123 Island Dr., Oceanside, MD	39-5555555	Restaurant
KitKatConsult Partners	125 Island Dr., Oceanside, MD	39-5456555	Consulting

Adding Activities to Existing Grouping

The following activities were added to an existing group during the current tax year.

Activity	Address	EIN	Type of Activity
N/A			

Regrouping Activities

The following activities were regrouped either due to an error or change in facts and circumstances during the current tax year.

Activity	Address	EIN	Type of Activity
N/A			

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George files the following Schedule E, which shows the two activities grouped together.

Schedule E (Form 1040) 2024

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

George Jones

Your social security number

***-**-**9876**

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☐ **Yes** ☐ **No**

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	George's Family Restaurant	P	☐	39-5555555	☐	☐
B	KitKatConsult Partners	P	☐	39-5456555	☐	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss

Nonpassive Income and Loss

	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A			100,000		
B					130,000
C					
D					
29a Totals					130,000
b Totals			100,000		
30	Add columns (h) and (k) of line 29a				30 130,000
31	Add columns (g), (i), and (j) of line 29b				31 (100,000)
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31				32 30,000

Part III Income or Loss From Estates and Trusts

4

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Example 19. Use the same facts as **Example 18**. In addition to his 2024 partnership interests in the restaurant and consulting business, George also solely owned both a catering business and a food truck business, which are part of the following election. He employs full-time operations managers for each of these activities.

George spends 80 hours during 2025 in the catering business, much less than the managers, so it is a passive activity for him. Nevertheless, the catering business generates \$10,000 in income for George. The food truck business does not do as well and reports a \$72,000 loss for the year. George spends 50 hours in 2025 on this business, which is also a passive activity for him.

Statement Filed in Accordance with Rev. Proc. 2010-13 and Election to Group Activities Under Treas. Reg. §1.469-4(c)

Taxpayer Name: **George Jones**

Tax Yearend: **2024**

Taxpayer ID #: *****-**-9876**

New Groupings

The following activities were grouped as a single activity for the first time during the current tax year.

Activity	Address	EIN	Type of Activity
George's Family Restaurant	123 Island Dr., Oceanside, MD	39-5555555	Restaurant
KitKatConsult Partners	125 Island Dr., Oceanside, MD	39-5456555	Consulting
George's Catering	125 Island Dr., Oceanside, MD	39-6555555	Catering
George's Food Truck	125 Island Dr., Oceanside, MD	39-5555557	Food Truck

Adding Activities to Existing Grouping

The following activities were added to an existing group during the current tax year.

Activity	Address	EIN	Type of Activity
N/A			

Regrouping Activities

The following activities were regrouped either due to an error or change in facts and circumstances during the current tax year.

Activity	Address	EIN	Type of Activity
N/A			

2025 Workbook

In 2025, George decides to invest in a kitchen supply business as a partner. George's wealthy aunt died early in the year, and he inherited her vast holdings. From this inheritance, George purchases a rental property mid-year. He reports the rental real estate on Schedule E. In 2025, George's tax information is as follows.

		Income/Loss	Participation Hours (2025)
Wages		\$230,000	
Interest income		11,000	
Ordinary dividends from estate		29,000	
Group 1: George's Family Restaurant	(\$100,000)		50
KitKatConsult	130,000		2,600
Catering	10,000		80
Food truck	(72,000)		50
Group 1 total	(\$32,000)	(32,000)	2,780 ^a
Kitchen supply company (passive activity)		(25,000)	80
Real estate rental loss		(9,500)	

^a George devoted more than 500 hours to the group 1 activity. Therefore, the group 1 activity is considered nonpassive, and the \$32,000 loss is allowable in computing George's 2025 adjusted gross income.

Ginger provides George with the following tax information.

Wages	\$230,000	
Interest income	11,000	\$11,000
Ordinary dividends from estate	29,000	29,000
Passive loss from rental (\$9,500)	0 ^a	
Kitchen supply business loss (\$25,000)	0 ^a	
Group 1 nonpassive loss	(32,000)	
MAGI	\$238,000	
Less: net investment income (NII) threshold ^b	(200,000)	
A: Excess of MAGI over NII threshold	\$ 38,000	
B: Total passive income		\$40,000
Lesser of A or B	\$ 38,000	
	× 3.8%	
NIIT	\$ 1,444	

^a Passive loss limitation.

^b See instructions for Form 8960, *Net Investment Income Tax*, and IRC §1411(b).

Ginger explains that because 2025 is the first year George is subject to the NIIT, he is allowed to regroup his previous Group 1 activities under the fresh-start provisions.

George elects to regroup his activities for 2025. He removes the catering business from Group 1 and adds the kitchen supply business to it. George has offset the \$10,000 of passive income from the catering business with the \$9,500 passive real estate rental loss. By adding the kitchen supply business to Group 1, he can increase his Group 1 activity loss by the \$25,000 kitchen supply loss.

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After regrouping using the fresh-start election, George's relevant tax information is as follows.

Wages		\$230,000	
Interest income		11,000	\$11,000
Ordinary dividends from estate		29,000	29,000
Group 1: George's Family Restaurant	(\$100,000)		
KitKatConsult	130,000		
Kitchen supply	(25,000)		
Food truck	(72,000)		
Group 1 total	(\$67,000)	(67,000)	
George's Family Restaurant (passive activity)		10,000	10,000
Real estate rental (passive activity)		(9,500)	(9,500)
MAGI		\$203,500	
Less: NII threshold		(200,000)	
A: Excess of MAGI over NII threshold		\$ 3,500	
B: Total passive income			\$40,500
Lesser of A or B	\$ 3,500		
	× 3.8%		
NIIT	\$ 133		

By regrouping using the fresh-start election, George saves \$1,311 (\$1,444 – \$133) in NIIT.

Caution. Unless there is material change in George's facts and circumstances, he must continue with this grouping.

Observation. Although the grouping discussion has been focused on PAL and strategies associated with avoiding NIIT, there are different aggregation rules and strategies associated with qualified business income (QBI).

QBID and Previously Disallowed Losses¹²²

As a general rule, carryforwards of tax losses reduce taxpayers' taxable income and, therefore, their income tax. However, they also reduce QBI under §199A, reducing a taxpayer's QBID, possibly causing the taxpayer to carry amounts forward.¹²³

Taxpayers with carried-forward losses should apply the losses from previous years on a first-in, first-out (FIFO) basis.¹²⁴ Unless the losses result from a publicly traded partnership, they are treated as though arising from a separate business. In computing QBI, taxpayers can ignore years that ended before January 1, 2018.

¹²². Treas. Reg. §1.199A-3(b)(1)(iv).

¹²³. IRC §199A(c)(2).

¹²⁴. TD 9899, 2020-29 IRB 62.

The QBI loss carryforwards may have been caused by a variety of factors. The governing regulation offers the following four categories for suspended QBI losses, which are similar to the general loss limitations for relevant pass-through entities.¹²⁵

1. Excess business losses (§461(l))
2. At-risk suspended losses (§465)
3. Passive activity losses (§469)
4. Losses from partnerships (§704(d)) or S corporations (§1366(d)) that are suspended because the taxpayer has insufficient basis in the entity to absorb the loss

When a taxpayer has a loss suspended for one of the reasons listed above, it is carried forward with other years' losses of the **same type**. The loss may still be deductible from taxable income for other reasons, it is just not taken into account for the current year's QBI; it is retained to reduce subsequent years' QBI.

Taxpayers can use Form 8995, *Qualified Business Income Deduction Simplified Computation*, to compute their QBID if their taxable income before the QBID deduction does not exceed the QBI threshold in §199A(e)(2) for the year. For 2025, this threshold is:¹²⁶

- \$394,600 for taxpayers using the married filing jointly (MFJ) filing status, and
- \$197,300 for all other filing statuses.

Taxpayers with taxable incomes exceeding these amounts or who patronize agricultural cooperatives must use Form 8995-A, *Qualified Business Income Deduction*, to compute their QBID.

Note. The One Big Beautiful Bill Act (OBBBA) makes the QBID permanent beginning in 2026.¹²⁷ For more information on the changes the OBBBA makes to QBID, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

QUALIFIED JOINT VENTURE¹²⁸

Generally, an unincorporated business owned by a married couple is classified as a partnership for federal income tax purposes. However, a married couple who are the only participants of a jointly owned and operated rental real estate business can elect treatment as a **qualified joint venture (QJV)**.¹²⁹ A QJV is a joint venture that conducts a trade or business meeting all the following requirements.¹³⁰

1. The only members of the joint venture are a married couple who file a joint return.
2. Both spouses materially participate in the trade or business (as discussed previously).
3. Both spouses elect not to be treated as a partnership.

Caution. The spouses must be conducting a trade or business. Merely owning property together is not sufficient to qualify for the election.¹³¹

¹²⁵ Treas. Reg. §1.199A-3(b)(1)(iv)(A).

¹²⁶ Rev. Proc. 2024-40, 2024-45 IRB 1100.

¹²⁷ *One Big Beautiful Bill Act*, PL 119-21, §70105.

¹²⁸ *Election for married couples unincorporated businesses*. Aug. 26, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses] Accessed on Nov. 20, 2024; Instructions for Schedule E.

¹²⁹ CCA 200816030 (Apr. 18, 2008).

¹³⁰ IRC §761(f)(2).

¹³¹ Instructions for Schedule E.

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The business **must be owned and operated by the spouses as co-owners**, not as an entity formed under state law such as a limited partnership or limited liability company, unless the taxpayer lives in a community property state.¹³² The spouses must divide all items of income, gain, loss, deduction, and credit according to their respective interests in the venture. Additionally, each spouse must consider their spouse's respective share of such items as if they were attributable to a sole proprietorship conducted by their spouse.¹³³

ELECTION

A married couple makes the election for their rental real estate business by checking the “QJV” box on line 2 of the Schedule E for each property that is part of the QJV. Each spouse reports their interests as **separate properties** on line 1 of the Schedule E. They do not file separate Schedules E, as they might for Schedule C if their joint venture requires using that form. For each separate property interest, the spouses enter their share of the applicable income, deduction, or loss on lines 3 through 22.¹³⁴

The QJV election can only be revoked with the IRS's consent. However, the election is only valid if the spouses continue to meet the requirements for a QJV. A new election is required for any future year after a year in which the spouses fail to meet the requirements of a QJV.

The election eliminates the requirement for the spouses to file a Form 1065, *U.S. Return of Partnership Income*, for any year the election is in effect. If the spouses filed a Form 1065 for the year before the election, the partnership terminates at the end of the immediately preceding tax year before the election takes effect. It is unnecessary to amend a previously filed Form 1065 solely to mark it final.¹³⁵

The chief benefit for a married couple to make a QJV election is that they would avoid the complexities of partnership accounting and tax reporting. Instead of filing Form 1065, they would report their interests on the same Schedule E.

SCHEDULE E VERSUS SCHEDULE C

At times it can be difficult to distinguish which income gets reported on Schedule E and which should be reported on Schedule C. As a general rule, a taxpayer uses Schedule C to report income or loss from a business or profession they operate as a sole proprietor. An activity qualifies as a business if the taxpayer's primary purpose for engaging in the activity is for income or profit and they are involved in the activity on a regular and continuous basis.¹³⁶

RENTAL

Taxpayers report the rental of **real estate** on Schedule E. If the taxpayer is in the business of renting personal property, any income and expenses from the rental of **personal property** is reported on Schedule C. If the taxpayer is not in the business of renting personal property (e.g., cars or equipment), rental income and expenses are reported on Schedule 1.¹³⁷ The determination of where to report rental activity is based on substantial services and whether the taxpayer is a real estate dealer.

Note. For a detailed discussion on substantial services and real estate dealers, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 3: Rental Real Estate Activity Issues.

¹³². Rev. Proc. 2002-69, 2002-2 CB 831.

¹³³. IRC §761(f)(1).

¹³⁴. Instructions for Schedule E.

¹³⁵. Instructions for Form 1065.

¹³⁶. Instructions for Schedule C.

¹³⁷. *Topic No. 414, Rental Income and Expenses*. Nov. 15, 2024. IRS. [www.irs.gov/taxtopics/tc414/] Accessed on Nov. 20, 2024.

OIL AND GAS INTERESTS¹³⁸

When a taxpayer's income results from land ownership, they generally report the information on Schedule E. This is also the case with various types of royalty interests that are carved out of working interests, such as ORRI and net profits royalty interests, as discussed previously.¹³⁹ However, a dealer in royalty interests may have an obligation to report income on Schedule C.¹⁴⁰ Because they routinely buy and sell royalty interests, they have an active business in the properties, much as a real estate dealer in houses, apartments, or other buildings.

Taxpayers with a **working interest** in oil and gas operations report their income and expenses on Schedule C. A working interest is an investment in an oil and gas drilling operation, regardless of whether it is an operating working interest or a nonoperating working interest. The investor is directly liable for a percentage of the expenses related to exploring, drilling, and production in exchange for profits from successful wells.¹⁴¹

Note. Detailed information about oil and gas operations is beyond the scope of this chapter. More information can be found in the following resources.

- Treas. Reg. §1.614-2(b)
- IRS Pub. 5652, *Oil and Gas Audit Technique Guide*
- IRM 4.41.1.3.1.2 (2005)

ROYALTY INCOME OTHER THAN OIL AND GAS¹⁴²

Self-employed writers, inventors, artists, etc., report their royalty income and expenses on Schedule C, rather than Schedule E. Any ordinary and necessary expenses associated with royalty income are deductible under §162 on Schedule C. As mentioned previously, royalty income that is not considered a trade or business is reported on Schedule E.

INCOME OR LOSS FROM PARTNERSHIPS AND S CORPORATIONS

Partners and shareholders are required to report income and loss items from their Schedules K-1 on Schedule E, even if the income has not been received.¹⁴³ The instructions for Schedule K-1 (Form 1065) and Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, Credits, etc.*, provide requirements that must be followed.

Caution. If a taxpayer treats items on their tax return differently from the way the partnership or S corporation reported them on its return, they may have to file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*.

¹³⁸. Instructions for Schedule E.

¹³⁹. Rev. Rul. 73-541, 1973-2 CB 206; IRS Pub. 5652, *Oil & Gas Audit Technique Guide*, p. 50 (2023).

¹⁴⁰. IRS Pub. 5652, *Oil & Gas Audit Technique Guide*, p. 231 (2023).

¹⁴¹. *Working Interest: Meaning, Overview, Advantages and Disadvantages*. Chen, James. Jun. 6, 2022. Investopedia. [www.investopedia.com/terms/w/working-interests.asp] Accessed on Nov. 20, 2024.

¹⁴². Instructions for Schedule E.

¹⁴³. Ibid.

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Losses reported from a partnership or S corporation are subject to the same loss limitations discussed earlier. Any partnership loss that exceeds the partner's adjusted basis at the end of the partnership's tax year cannot be claimed. The loss is carried forward indefinitely and deducted in a future year, subject to basis limitations in that year. Similarly, a loss from an S corporation is limited to the taxpayer's basis in their stock (determined with regard to distributions received during the tax year) and any loans from the shareholder to the S corporation. Any loss is carried forward indefinitely and deducted in a future year subject to basis limitations in that year.¹⁴⁴

A partner or shareholder who is subject to the at-risk basis limitations must check the box on part II, column (f) of Schedule E, and calculate the amount of any deductible loss on Form 6198, *At-Risk Limitations*. If the activity is nonpassive, any deductible loss from Form 6198 is reported in part II, column (i) of Schedule E.¹⁴⁵ An example of Schedule E, Part II follows.

Schedule E (Form 1040) 2024

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

- 27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☐ **Yes** ☐ **No**

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss

Nonpassive Income and Loss

	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					
B					
C					
D					

29a	Totals				
b	Totals				

30	Add columns (h) and (k) of line 29a	30	

31	Add columns (g), (i), and (j) of line 29b	31	()

32	Total partnership and S corporation income or (loss). Combine lines 30 and 31	32	

Part III Income or Loss From Estates and Trusts

A taxpayer with a PAL generally must first complete Form 8582 to determine the amount of the loss to report on Schedule E, part II, column (g). General partners or S corporation shareholders reporting a loss from a rental real estate activity and who meet all the requirements listed earlier under "Real Estate Exceptions" do not need to complete Form 8582. Instead, their loss is entered directly in part II, column (g) of Schedule E. Any **passive income** is reported in part II, column (h) of Schedule E. Any **nonpassive income** or losses are reported in part II, columns (i) through (k) of Schedule E.¹⁴⁶

¹⁴⁴. Ibid.

¹⁴⁵. Ibid.

¹⁴⁶. Ibid.

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BASIS ATTACHMENT REQUIREMENT

Starting with the 2018 version of Schedule E, the IRS added the following language in part II above line 27.¹⁴⁷

If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you must check the box in column (e) on line 28 and attach the required basis computation.

Schedule E (Form 1040) 2024

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☐ Yes ☐ No

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss			Nonpassive Income and Loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					
B					
C					
D					
29a	Totals				
b	Totals				
30	Add columns (h) and (k) of line 29a				30
31	Add columns (g), (i), and (j) of line 29b				31 ()
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31				32

Part III Income or Loss From Estates and Trusts

The expansion of the rules to **anyone who receives a distribution** encompasses more taxpayers with S corporation activity.

Shareholders calculate their stock and debt basis on IRS Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*.¹⁴⁸ Form 7203 fulfills the requirement for the attached requirement basis computation. S corporation shareholders must file this form if any one of the following events occurs.

- They report a loss from an S corporation, even if basis limitations prevented them from reporting a loss in the previous year.
- They received a distribution from the S corporation that was not a dividend from some previous year's earnings and profits.
- They disposed of their S corporation's stock regardless of whether they reported a gain.
- They received a repayment of a loan they previously made to the S corporation.

The basis of a partner's interest in the partnership can be calculated using the worksheet shown on the following page, found in the partner's instructions for Schedule K-1 (Form 1065).¹⁴⁹

¹⁴⁷. See Schedule E.

¹⁴⁸. Instructions for Form 7203.

¹⁴⁹. Partner's Instructions for Schedule K-1 (Form 1065).

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Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership

Keep for Your Records



Part I—Partner Basis	
1. Adjusted basis at the beginning of the tax year. Don't enter less than zero	1.
Section A—Increases	
2. Acquisitions of partnership interests and contributions of money and property	2.
3a. Partner's share of liabilities at the end of the year	3a.
3b. Partner's share of liabilities at the beginning of the year	3b.
3c. Increase (decrease) in partnership liabilities (subtract line 3b from line 3a)	3c.
3d. Partnership liabilities assumed during the tax year	3d.
3e. Increase in liabilities (add lines 3c and 3d) (If amount is negative, enter on line 9a below.)	3e.
4a. Ordinary business income	4a.
4b. Net rental real estate income	4b.
4c. Other net rental income	4c.
4d. Interest income	4d.
4e. Ordinary dividends	4e.
4f. Dividend equivalents	4f.
4g. Royalties	4g.
4h. Net short-term capital gain	4h.
4i. Net long-term capital gain	4i.
4j. Net section 1231 gain	4j.
4k. Other income	4k.
4l. Tax-exempt income	4l.
4m. Other increases to basis	4m.
4n. BIE (enter as a positive) (see instructions)	4n.
4o. Total increases (add lines 4a through 4n)	4o.
5. Gain recognized on contributions of property during the year	5.
6. Excess depletion adjustment	6.
7. Total basis before decreases (add lines 1, 2, 3e, 4o, 5, and 6)	7.
Section B—Decreases (Enter as a negative.)	
8. Withdrawals, distributions of money, and the adjusted basis of distributed property	
8a. Cash and marketable securities distributed	8a.
8b. Distribution subject to section 737	8b.
8c. Other property distributed	8c.
8d. Total distributions (add lines 8a through 8c)	8d.
9a. Decrease in partner's share of liabilities (see instructions)	9a.
9b. Partner's liabilities assumed by the partnership during the tax year	9b.
9c. Decrease in liabilities (sum of lines 9a and 9b)	9c.
10. Total distributions and decrease in liabilities (add lines 8d and 9c)	10.
11a. Basis after distributions (add lines 7 and 10) (If the result is negative, enter -0- on line 11a and enter the amount as a positive on line 11b.)	11a.
11b. Gain on distributions in excess of basis	11b.

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Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership (continued)

Keep for Your Records



Part II—Allowable Loss and Deduction Items (Enter as a negative.)					
	Column A	Column B	Column C	Column D	Column E
	Current year distributive share	Prior year carryforward amount	Total of columns A and B	Amount reducing basis (see instructions)	Suspended carryforward
12. Nondeductible expenses					
13. Depletion for oil and gas					
14. Basis after nondeductible expenses and depletion (reduce line 11a by the amounts on lines 12 and 13, column D)					
	Column A	Column B	Column C	Column D	Column E
	Current year distributive share	Prior year carryforward amount	Total of columns A and B	Allowable loss and deductions (see instructions)	Disallowed loss carryforward
15a. Ordinary business loss					
15b. Net rental real estate loss (excluding BIE)					
15c. Other net rental loss (excluding BIE)					
15d. Foreign taxes paid or accrued					
15e. Net short-term capital loss					
15f. Net long-term capital loss					
15g. Net section 1231 loss					
15h. Other losses					
15i. Section 179 deduction					
Other Deductions					
15j. Charitable contributions					
15k. Investment interest expense					
15l. Deductions (royalty income)					
15m. Section 59(e)(2)					
15n. EBIE					
15o. Deductions—portfolio (other)					
15p. All other					
15q. BIE					
15r. Other decreases to basis					
15s. Subtotal (add lines 15a through 15r)					
15t. Total deductions and losses (add lines 15a through 15r, column C)					
16. Allowable deductions and losses					
17. Unutilized EBIE on sale of partnership interest					
18. Adjusted basis at the end of the tax year (Enter the sum of lines 14, 16, and 17.)					

Caution. Starting with 2024 returns, taxpayers receiving **property** distributions from partnerships must report them using Form 7217, *Partner's Report of Property Distributed by a Partnership*. Although the information on this form is not explicitly reported on Schedule E, it may influence the portion of a loss that is deductible.

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Note. It is the responsibility of the taxpayer to maintain basis records.¹⁵⁰ However, it is complicated to calculate the change in basis annually, so many taxpayers expect their tax professional to perform the task. In the future, it may be the responsibility of the entity to maintain basis schedules for its shareholders, just as partnerships must currently maintain basis schedules for each partner.¹⁵¹ For more information on Form 7203, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 10: Small Business Issues. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

Note. Often, new clients do not have basis schedules. In the absence of historical records, tax preparers can make a reasonable estimate of basis from the S corporation returns.¹⁵²

PRIOR YEAR ADJUSTMENTS¹⁵³

Taxpayers who report any loss not allowed in a prior year due to at-risk limitations, a prior year unallowed loss from a passive activity not reported on Form 8582, or unreimbursed partnership expenses must follow additional instructions. The IRS may send a notice of additional tax due if the amounts reported on Schedule K-1 do not match the amounts claimed on Schedule E. Therefore, the taxpayer may be required to disclose additional information in addition to checking “yes” in part II, line 27.

Limited by Basis or At-Risk Rules

Any prior year unallowed losses due to basis or at-risk rules that are deductible in the current year must be entered in column (i) of line 28. The losses should not be combined with or netted against any current year amounts from the partnership or S corporation. The abbreviation for prior year adjustment, “PYA,” should be entered in column (a) to indicate the adjustment.

¹⁵⁰. Treas. Reg. §1.6001-1(a).

¹⁵¹. See Partner’s Instructions for Schedule K-1 (Form 1065); IRS Notice 2019-66, 2019-52 IRB 1509.

¹⁵². *S corporation shareholder recomputation of basis*. Fairbanks, Greg. Feb. 1, 2022. The Tax Adviser. [www.thetaxadviser.com/issues/2022/feb/s-corporation-shareholder-recomputation-basis.html] Accessed on Nov. 19, 2024.

¹⁵³. Instructions for Schedule E.

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Example 20. Francine and Frank Stix file their tax return jointly, and he owns 75% of the stock of Lollipops 4U, Inc., which he purchased when it was organized as an S corporation. They are not actively involved with the business, and Lollipops is a passive activity for him. Lollipops reported \$50,000 of ordinary income on Frank's 2024 Schedule K-1 (Form 1120-S), and he received a distribution of \$6,000. In 2023, he could not claim a \$10,000 ordinary loss due to insufficient basis. At the beginning of 2024, Frank Stix had a stock basis of \$0 and had loaned no funds to Lollipops.

The Stixes are required to file Form 7203 with their Schedule E, as follows.

Schedule E (Form 1040) 2024

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Frank and Francine Stix

***-**-6789

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☒ **Yes** ☐ **No**

	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Lollipops 4U, Inc.	S	☐	11-2222227	☒	☐
B	PYA: Basis Carryover	S	☐	11-2222227	☒	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss

Nonpassive Income and Loss

	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A		50,000			
B	10,000				
C					
D					
29a Totals		50,000			
b Totals	10,000				
30	Add columns (h) and (k) of line 29a				30 50,000
31	Add columns (g), (i), and (j) of line 29b				31 (10,000)
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31				32 40,000

Part III Income or Loss From Estates and Trusts

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Parts I and III of Frank's Form 7203 appear next. Part II is not relevant because the Stixes have not extended loans to Lollipops 4 U, Inc.

Form 7203 (Rev. December 2022) Department of the Treasury Internal Revenue Service		S Corporation Shareholder Stock and Debt Basis Limitations Attach to your tax return. Go to www.irs.gov/Form7203 for instructions and the latest information.		OMB No. 1545-2302 Attachment Sequence No. 203
Name of shareholder Frank Stix			Identifying number ***-**-6789	
A Name of S corporation Lollipops 4U, Inc.			B Employer identification number 11-2222227	
C Stock block (see instructions): 1				
D Check applicable box(es) to indicate how stock was acquired: (1) ☒ Original shareholder (2) ☐ Purchased (3) ☐ Inherited (4) ☐ Gift (5) ☐ Other: _____				
E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation ☐				
Part I Shareholder Stock Basis				
1 Stock basis at the beginning of the corporation's tax year			1	0
2 Basis from any capital contributions made or additional stock acquired during the tax year			2	
3a	Ordinary business income (enter losses in Part III)	3a	50,000	
b	Net rental real estate income (enter losses in Part III)	3b		
c	Other net rental income (enter losses in Part III)	3c		
d	Interest income	3d		
e	Ordinary dividends	3e		
f	Royalties	3f		
g	Net capital gains (enter losses in Part III)	3g		
h	Net section 1231 gain (enter losses in Part III)	3h		
i	Other income (enter losses in Part III)	3i		
j	Excess depletion adjustment	3j		
k	Tax-exempt income	3k		
l	Recapture of business credits	3l		
m	Other items that increase stock basis	3m		
4	Add lines 3a through 3m	4	50,000	
5	Stock basis before distributions. Add lines 1, 2, and 4	5	50,000	
6	Distributions (excluding dividend distributions)	6	6,000	
Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15	7	44,000	
8a	Nondeductible expenses	8a		
b	Depletion for oil and gas	8b		
c	Business credits (sections 50(c)(1) and (5))	8c		
9	Add lines 8a through 8c	9	0	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15	10	44,000	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	10,000	
12	Debt basis restoration (see net increase in instructions for line 23)	12		
13	Other items that decrease stock basis	13		
14	Add lines 11, 12, and 13	14	10,000	
15	Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	15	34,000	
Part II Shareholder Debt Basis				

2025 Workbook

For Example 20

33						
34	Reportable gain. Subtract line 33 from line 32 . . .					
Part III Shareholder Allowable Loss and Deduction Items						
	Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35	Ordinary business loss		10,000	10,000		
36	Net rental real estate loss					
37	Other net rental loss					
38	Net capital loss					
39	Net section 1231 loss					
40	Other loss					
41	Section 179 deductions					
42	Charitable contributions					
43	Investment interest expense					
44	Section 59(e)(2) expenditures					
45	Other deductions					
46	Foreign taxes paid or accrued					
47	Total loss. Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	0	10,000	10,000	0	0

Form **7203** (Rev. 12-2022)

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Example 21. Use the same facts as **Example 20**, except Lollipops 4U is organized as a partnership and Francine Stix is a 75% partner. She received ordinary passive income from Lollipops 4U of \$50,000 during 2024.

In 2023, Francine had an ordinary loss of \$10,000, as her basis at the start of the year was \$0. Thus, she did not have enough **basis** to claim the loss during the year. In 2024, when her basis was sufficient to claim the carryforward loss, the Stixes filed the following Schedule E.

Schedule E (Form 1040) 2024		Attachment Sequence No. 13		Page 2		
Name(s) shown on return. Do not enter name and social security number if shown on other side.				Your social security number		
Frank and Francine Stix				***-**- 6789		
Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.						
Part II Income or Loss From Partnerships and S Corporations						
Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you must check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (f) on line 28 and attach Form 6198 . See instructions.						
27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☒ Yes ☐ No						
28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Lollipops 4U	P	☐	11-2222227	☐	☐
B	PYA: Basis Carryover	P	☐	11-2222227	☐	☐
C			☐		☐	☐
D			☐		☐	☐
Passive Income and Loss			Nonpassive Income and Loss			
(g) Passive loss allowed (attach Form 8582 if required)		(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
A		50,000				
B	10,000					
C						
D						
29a	Totals	50,000				
b	Totals	10,000				
30	Add columns (h) and (k) of line 29a			30	50,000	
31	Add columns (g), (i), and (j) of line 29b			31	(10,000)	
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31			32	40,000	
Part III Income or Loss From Estates and Trusts						

Limited by Passive Activity Not Reported on Form 8582¹⁵⁴

Passive losses that are not reported on Form 8582 are entered on a separate line in column (g) of line 28. These include losses that were not allowed in a prior year and are deductible in the current year because:

- The taxpayer does not have an overall loss from passive activities, or
- The taxpayer disposed of the entire interest in a passive activity in a fully taxable transaction.

The losses should not be combined with or netted against any current year amounts from the partnership or S corporation. "PYA" should be entered in column (a) of line 28 to indicate the amount is a prior year adjustment.

¹⁵⁴. Ibid.

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Example 22. Use the same facts as **Example 21**, except the ordinary loss carryforward from 2023 was \$50,100, which the Stixes incurred because they did not have enough **passive income** in 2023 to offset the passive loss. Francine received a final Schedule K-1 reporting \$50,000 of 2024 passive income. The Stixes file the following Schedule E reporting their income from the partnership.

Schedule E (Form 1040) 2024

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Frank and Francine Stix

***-**-6789

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☒ **Yes** ☐ **No**

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Lollipops 4U	P	☐	11-2222227	☐	☐
B	PYA: Passive Carryover	P	☐	11-2222227	☐	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss			Nonpassive Income and Loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A		50,000			
B	50,100				
C					
D					
29a	Totals	50,000			
b	Totals	50,100			
30	Add columns (h) and (k) of line 29a				30 50,000
31	Add columns (g), (i), and (j) of line 29b				31 (50,100)
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31				32 (100)

Part III Income or Loss From Estates and Trusts

Limited by Unreimbursed Partnership Expenses¹⁵⁵

Unreimbursed ordinary and necessary partnership expenses that a taxpayer pays on behalf of a partnership are deductible on Schedule E if the partner was required to pay the expenses according to the partnership agreement. Only trade or business expenses under §162 are deductible.

Unreimbursed partnership expenses (UPE) are **not reported separately** if the expenses are from a passive activity **and** the taxpayer is required to file Form 8582. Otherwise, the UPE from nonpassive activities are entered on a separate line in column (i) of line 28. These expenses are not combined or netted against any other amounts from the partnership.

A taxpayer with expenses from a passive activity who is not required to file Form 8582 enters the expenses on a separate line in column (g) of line 28. These expenses cannot be combined with or netted against any other amounts from the partnership. The expenses are labeled with "UPE" in column (a) of line 28.

¹⁵⁵. Ibid.

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Example 23. Use the same facts as **Example 21**. In 2024, Francine pays UPE of \$1,000, as required by the Lollipops 4U partnership agreement. She reports the income and expenses from Lollipops 4U on the following Schedule E.

Schedule E (Form 1040) 2024

Attachment Sequence No. **13**

Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Frank and Francine Stix

*****-**-6789**

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

- 27** Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section ☒ **Yes** ☐ **No**

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Lollipops 4U	P	☐	11-2222227	☐	☐
B	PYA: Basis Carryover	P	☐	11-2222227	☐	☐
C	UPE	P	☐	11-2222227	☐	☐
D			☐		☐	☐

Passive Income and Loss

Nonpassive Income and Loss

	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A		50,000			
B	10,000				
C	1,000				
D					

29a	Totals	50,000			
b	Totals	11,000			

30 Add columns (h) and (k) of line 29a **30** **50,000**

31 Add columns (g), (i), and (j) of line 29b **31** (**11,000**)

32 **Total partnership and S corporation income or (loss).** Combine lines 30 and 31 **32** **39,000**

Part III Income or Loss From Estates and Trusts

Chapter 5: S Corporation Formation and Basics

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

About the Author

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

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From its inception, the IRC of 1954 (now IRC of 1986) has recognized only two entities, the partnership¹ and the corporation.² The partnership has no sub-classifications in the tax law. The general form for the corporation is the C corporation;³ however, many closely held corporations elect to be S corporations.

There is no statutory classification for an organization that does not fit exactly into the partnership or corporation category. Thus, an entity such as a limited liability company (LLC) must shoehorn into the corporation, the partnership, or remain a disregarded entity for federal income tax purposes.

This chapter covers the basics and creation of S corporations. This includes relevant elections and basis calculations. An analysis of various advantages and disadvantages of S corporations is included in chart form at the end of the chapter.

Note. The following chapter focuses on important topics at the beginning of an S corporation's existence. Although some operational topics are included, they are generally beyond the scope of this chapter.

BACKGROUND OF S CORPORATIONS

Within the corporate form there are two separate federal income tax regimes. C corporations are taxed separately from their owners and cannot deduct dividend payments from their taxable income.⁴ Shareholders must include dividend distributions in gross income,⁵ although for several years, qualified dividends have been subject to lower rates of tax than ordinary income. Many corporations can avoid this double taxation by electing to be S corporations.

S corporation shareholders must take reasonable compensation for services provided as wage or salary income, which is subject to Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and income tax withholding.⁶ Moreover, they are not subject to self-employment (SE) tax on their profits from the company.⁷ Taking distributions in lieu of wages may result in significant penalties on both the corporations and, in some cases, tax preparers.⁸



Practitioner Planning Tip

Congress is aware that the temptation exists for S corporation shareholders who are employed and perform services for their own S corporation to underreport their compensation to reduce their payroll tax exposure. A prudent practitioner should stress to their clients that this is not an acceptable practice and Congress could take action to curtail this if deemed abused.

¹. IRC §7701(a)(2).

². IRC §7701(a)(3).

³. IRC §1361(a)(2).

⁴. IRC §§11 and 246.

⁵. IRC §301.

⁶. *IRS Fact Sheet FS-2008-25*. Aug. 2008. IRS. [www.irs.gov/pub/irs-news/fs-08-25.pdf] Accessed on Feb. 5, 2025.

⁷. IRC §1402(a)(2).

⁸. IRC §§6652, 6662, and 6672. See *Blossom Day Care Centers, Inc. v. Comm'r*; TC Memo 2021-86 (Jul. 13, 2021).

POPULARITY

While S corporations represent only one form of corporate structure, they account for over two-thirds of all corporations filing federal tax returns. Moreover, the number of S corporation returns exceeds the number of partnership returns.

The 2023 IRS Data Book yields the following information about the business tax returns filed in the federal government's fiscal year 2023.⁹

Entity	Number of Returns	Percent of Total
C corporation	2,464,836	18.31%
S corporation	5,882,030	43.68%
Partnership	5,117,987	38.01%
Total	13,464,853	100.00%

Therefore, an understanding of the S corporation rules is essential to the business tax professional, especially where privately held business entities are concerned.

GENERAL EXEMPTION FROM INCOME TAX¹⁰

The S corporation generally is not subject to corporate federal income tax. The income, deductions, gains, losses, and credits of the S corporation flow through to its shareholders. An S corporation, however, may be subject to some entity level taxes, such as the tax on excessive passive income or on built-in gains. However, these taxes are limited to corporations that were formerly C corporations. These taxes are beyond the scope of this chapter.

NONTAX CONSIDERATIONS

In addition to the previously mentioned tax considerations, there are some nontax considerations that may impact the decision on whether to elect S corporation status.

- **Limited liability protection.** S corporations generally provide limited liability protection to their shareholders. This means that shareholders are generally not personally responsible for the debts and liabilities of the business.¹¹
- **Continuity of ownership.** S corporations have perpetual existence in many states (e.g., Illinois¹²), meaning the business can continue even if ownership changes. Transfers of ownership must comply with S corporation eligibility rules to avoid terminating the S election.¹³
- **Compliance and administrative requirements.** Shareholders must adhere to specific compliance and administrative requirements to maintain their S corporation status. This includes holding regular shareholder meetings and maintaining detailed records.¹⁴

⁹ IRS Pub. 55-B, *Data Book, 2023*, Table 2, p. 4.

¹⁰ IRC §§1363(a) and 1366.

¹¹ *Choose a business structure*. Mar. 7, 2025. U.S. Small Business Administration. [www.sba.gov/business-guide/launch-your-business/choose-business-structure] Accessed on Jul. 29, 2025.

¹² See 805 ILCS 5/3.05.

¹³ See Treas. Reg. 1.1361-1(b).

¹⁴ See 805 ILCS 5, §§7.05, 7.10, and 8.40.

CORPORATION REQUIREMENTS

Each new separate legal business entity must take certain actions, such as the following.

1. Reserving and obtaining a business name.
2. Engaging legal counsel to draw up state charter applications, appoint a board of directors or managers, draft operating agreements (geared to the desired tax status), borrowing resolutions, etc.
3. Applying for a charter from the state, district, territory, or possession, unless operating as a sole proprietorship or common law partnership (not typically recommended).
4. Filing Form SS-4, *Application for Employer Identification Number*, to obtain a federal employer identification number.
5. Determining the need (if any) for a local business license.
6. Evaluating the need for sales tax registration in jurisdictions where the business will deliver products or services.
7. Arranging for business liability insurance.
8. Consulting with human resource specialists on employee matters, such as federal and state payroll tax withholding and reporting, wage and hour laws, unemployment insurance, worker's compensation, retirement plans, and other fringe benefit rules.
9. If necessary, requesting approval from regulatory or licensing authorities to operate the business or profession.

Before committing the business to S corporation status, there may be some important **nontax** considerations. First, if the business already has a state corporate charter, the owner or owners should meet with competent legal counsel to ensure that the corporation meets the S corporation criteria discussed later. For example, the business might have some owners who are ineligible to hold shares in S corporations. If there is no equitable means of eliminating their ownership, it might be advisable to remain a C corporation and manage income through compensation, rents, interest, commissions, or other payments to the shareholders, as circumstances may dictate.

However, if it fits with the business plan, eligible persons may acquire the interests of ineligible persons or entities. Alternatively, the corporation could redeem their shares. Each of these strategies would require an outlay of cash or other assets and would likely be taxable.

An existing corporation should also examine its stock records. Before electing S corporation status, it may need to eliminate any preferred shares. This can often be accomplished by a **recapitalization**, whereby the preferred shareholders surrender their stock and receive common stock in exchange. This is often accomplished without any immediate imposition of tax.¹⁵

¹⁵ IRC §§354 and 368(a)(1)(E).

If the entity is not already in existence as a corporation, there are additional considerations. A proprietor cannot file an S election until there is an entity organized under state law.¹⁶ Thus, a proprietor must obtain a charter, either as a corporation or as an LLC, before electing S corporation status. LLCs, as well as partnerships, (including limited partnerships and limited liability partnerships), may become corporations, using one of these methods.¹⁷

1. A partnership may become an LLC by obtaining the proper charter from the appropriate state office.
2. The LLC may then convert to corporate status, in most states. This step is best achieved by competent legal counsel. This process is termed a “statutory,” or “formless” conversion.¹⁸
3. The parties may form a new corporation and merge the LLC into the new company.

Either the formless conversion or the merger avoids the actual transfer of assets, contracts, debts, etc. The prior members become shareholders, the creditors retain their relationships, and the entity retains title to all its properties.

Entities that are not traditional state law corporations may also meet the domestic corporation requirement. The term “corporation” includes any domestic entity classified as an association under the “check-the-box” rules of Treas. Reg. §301.7701-3. The unincorporated entity retains its status under state law but becomes a corporation for federal income tax purposes. If the unincorporated entity intends to be a C corporation it files Form 8832, *Entity Classification Election*. If it intends to be an S corporation, it files Form 2553, *Election by a Small Business Corporation*.

Note. The simplicity of the check-the-box election is often misleading for an entity electing S corporation status. There are some legal fictions that may not be evident to the inexperienced business owner or tax advisor. For example, although the entity does not issue corporate stock, it must treat its owners as shareholders. Furthermore, it must examine the owners’ relative rights in the event of liquidation. If the rights are based on capital accounts, it will not comply with the single-class-of-stock rule, covered later. For these and other reasons, a formless conversion or a merger into a corporation may be preferable.

S CORPORATION QUALIFICATIONS

An entity must meet certain prerequisites to qualify as a **small business corporation** (S corporation).¹⁹ If all the prerequisites are met, the corporation can obtain subchapter S tax treatment by making the appropriate election. The following are prerequisites to qualify for the S election.²⁰

- The corporation must be a **domestic corporation**.
- There can be **no more than 100 shareholders**.
- The corporation **cannot have more than one class of stock**.
- All shareholders must be **qualified shareholders**.

¹⁶ This falls under the domestic corporation requirement covered later in this section that a corporation must be created or organized in the United States or under federal or **state** law. A state or federal corporate charter meets this requirement. See Treas. Reg. §301.7701-5(a).

¹⁷ All states have specific statutes for issuance of charters for LLCs and corporations.

¹⁸ Illinois is one of the few states that does not permit a conversion. However, an Illinois LLC may convert to a corporation with another state’s charter, such as Delaware. See 8 DE Code § 265 (2024).

¹⁹ IRC §1361(a)(1).

²⁰ IRC §1361(b)(1).

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These prerequisites must be satisfied at the time the corporation files its S election. In addition, once S status is obtained, these prerequisites must be **continually maintained** or the corporation risks losing its S status.²¹ The tax election and the maintenance of these prerequisites are discussed later in this chapter.

No other tax entity has any parallel to these exacting requirements. Undoubtedly, with over 5 million S corporations filing returns each year, closely held businesses have found ways to coexist with potential problems. However, two rules cause consistent problems. Accordingly, tax professionals must be on the alert for:

- The single class of stock rule; and,
- The ownership rule, especially if a trust is involved.

Fortunately, there are remedies available to entities desiring S corporation status that inadvertently violate one or more of these requirements. The remedies may be inexpensive or quite costly, depending on the time elapsed since the timing of the violation and the cure, the presence of more than one disqualifier, or disagreements among the shareholders. These will be covered later in the chapter.

Note. The IRS examines a low percentage of S corporation returns. However, an auditor is likely to ask for documentation for the election and compliance with the requirements. However, an even more likely examination of compliance occurs when the current owners of S corporation stock are attempting to sell the entity. A savvy buyer will engage a due diligence review over several aspects of the corporation, such as payroll and sales tax liabilities, as well as other potential claims. When the acquisition target is an S corporation, the due diligence team examines agreements, ownership records, and other documentation to evaluate compliance with the subchapter S requirements. Failure of the corporation to conform to these rules may turn a potential buyer away, or require a reduction in the sales price. A due diligence study is at least as likely to uncover faults with the tax status as is an IRS examination.

DOMESTIC CORPORATION

Generally, an S corporation must meet the **domestic corporation** requirement of IRC §1361(b). A domestic corporation is a corporation created or organized in the United States or under federal or state law.²² A state or federal corporate charter meets this requirement.

As mentioned previously, entities that are not traditional state law corporations may also meet the domestic corporation requirement. The check-the-box rules provide that any unincorporated entity may elect to be an **association**, which qualifies it for corporate tax treatment. If the association meets all the prerequisites for an S corporation, it may elect subchapter S status.

The Code specifically prohibits some types of corporations from becoming S corporations.²³ **Ineligible** corporations include the following.

- A bank or other financial institution that uses the reserve method of accounting for bad debts, as described in IRC §585
- An insurance corporation subject to tax under subchapter L
- A domestic international sales corporation (DISC) or former DISC²⁴

An LLC is an example of a domestic entity that is not a traditional state law corporation but is nevertheless eligible for S status.²⁵

²¹ IRC §§1361 and 1362.

²² Treas. Reg. §301.7701-5(a).

²³ IRC §1361(b)(2).

²⁴ Treas. Reg. §1.992-1.

²⁵ *Limited Liability Company (LLC)*. Oct. 8, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc] Accessed on Feb. 6, 2025.

100 SHAREHOLDER LIMIT

An S corporation cannot have more than 100 shareholders at any time during the tax year.²⁶ For S corporation purposes, the determination of shareholder status is a question of federal law rather than state law. Ordinarily, a person who is entitled to distributions is considered a shareholder of the S corporation. As a matter of federal law, **beneficial ownership** in the corporation is determinative of shareholder status as opposed to being listed as a shareholder of record or having shareholder rights under applicable state law. Beneficial ownership exists when an individual or entity enjoys the rights of share ownership, such as the receipt of distributions or the ability to exercise control over the S corporation, without actual share ownership.²⁷

Family and Spousal Attribution

Under §1361, there are special rules relating to spousal share ownership and family share ownership.

Spouses who own shares count as one shareholder.²⁸ If one or both spouses die, this share attribution extends to their estates. However, the spouses and their estates are now considered as one shareholder under the family ownership rules. Hence, the spousal attribution is redundant for purposes of the shareholder count.

Observation. Spousal attribution is automatically considered when determining the number of shareholders. However, this attribution does not apply to the consents required for electing S status and remedying violations. These consents must be signed by each person who is deemed to own shares due to community property laws and similar regulations, as well as any joint owners. Shareholder consents are covered later in the chapter.

All family shareholders are treated as one shareholder. The term **family shareholders** is defined broadly to include:²⁹

- Individuals with a common ancestor,
- The lineal descendants of the common ancestor, and
- The spouses (or former spouses) of the lineal descendants or common ancestor.

Family share ownership attribution only applies with a common ancestor that is not more than six generations removed from the youngest generation of shareholders as of the **earliest** of the following dates.¹⁴

- The effective date of the subchapter S election;
- The earliest date that a family member became a shareholder in the S corporation; or,
- October 22, 2004.

²⁶ IRC §1361(b)(1)(A).

²⁷ *Kean v. Comm’r*, 51 TC 337 (1968), *aff’d* 469 F.2d 1183 (9th Cir. 1972); *Cabintaxi Corporation v. Comm’r*, 68 TC 49 (1994), TC Memo 1994-316 (Jul. 11, 1994).

²⁸ IRC §1361(c)(1)(A)(i).

²⁹ IRC §1361(c)(1)(B).

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Under the family ownership rule, spouses are considered in the same generation. Each person owning the S corporation stock jointly or by tenancy in common is counted as a shareholder. However, special rules apply to married couples.³⁰ Married couples are considered one shareholder until dissolution of the marriage for any reason other than death.³¹ Therefore, after a divorce, each spouse is considered a separate shareholder.

Moreover, the estate or trust of a family shareholder may also be considered a family shareholder in connection with the application of these rules.³²

Observation. The IRS occasionally releases information about characteristics of S corporations. As of this writing, the most recent information about numbers of shareholders is for 2021. Statistics indicate that over 99.999% of the S corporations had between one and 30 shareholders.³³ Therefore the family attribution rules are useful for a miniscule percentage of S corporations.

ONE CLASS OF STOCK

To qualify as an S corporation, the corporation cannot have more than one class of stock.³⁴ As a general rule, an S corporation is considered to have only a single class of stock if all outstanding shares provide shareholders with identical distribution and liquidation rights and no other instruments, obligations, or arrangements that may be treated as a second class of stock have been entered into by the corporation.³⁵ In contrast, the law permits any variation of voting rights.

Distribution Rights

To comply with the one-class-of-stock rule, the corporation's governing documents must ensure that all shareholders receive distributions and liquidation proceeds proportionally. **Governing provisions** such as the corporate charter or articles, bylaws, applicable state laws, and any binding agreements comprise the principal sources of information that determine whether all outstanding shares meet the one-class-of-stock requirement.³⁶

Identical Governing Provisions. When governing documents indicate that identical distribution and liquidation rights exist for all outstanding shares (identical governing provisions), the IRS states that the corporation has a single class of stock.³⁷ When a corporation has identical governing provisions, varying distributions among the shareholders do not create a violation. Unfortunately, the lack of formality in many closely held businesses results all too frequently in such divergence from rules and practices, which could result in potential violations of subchapter S, as well as shareholder disputes. The regulations require that when disproportionate distributions do not create a second class of stock, the distributions must be given appropriate tax effect.³⁸

³⁰ Treas. Reg. §1.1361-1(e)(2), (3).

³¹ IRC §1361(c)(1); Treas. Reg. §1.1361-1(e)(2).

³² IRC §1361(c)(1)(B)(ii); Treas. Reg. §1.1361-1(e)(3)(i).

³³ *SOI Tax Stats — Corporation Income Tax Returns Complete Report (Publication 16)*, Table 9. Sep. 24, 2024. IRS. [www.irs.gov/statistics/soi-tax-stats-corporation-income-tax-returns-complete-report-publication-16] Accessed on Feb. 6, 2025.

³⁴ IRC §1361(b)(1)(D).

³⁵ Treas. Reg. §1.1361-1(l)(1).

³⁶ Treas. Reg. §1.1361-1(l)(2)(i).

³⁷ Treas. Reg. §1.1361-1(l).

³⁸ Treas. Reg. §1.1361-1(l)(2)(i).

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Example 1. Loosey Corporation has four shareholders, each of whom owns 25% of the shares. In 2024, the corporation distributed cash in the following amounts.

Shareholder	Amount	Percent of Total Distribution
Abigail	\$ 40,000	40
Bryce	0	0
Evelyn	29,000	29
James	31,000	31
Total	\$100,000	100

Loosey’s corporate charter permits the corporation to have one class of stock. The bylaws require all distributions to be equal per share. Given the rules in the corporate charter, the IRS will not treat Loosey as having more than one class of stock. However, an IRS examination of the year could result in some unpleasant reallocations.

To preempt any such adjustments, Loosey should ensure that the year’s activities are given the appropriate tax effect. First, the corporation should determine the total amount for distributions in 2024. Assuming the parties agree that \$100,000 is the appropriate amount of total distributions and each shareholder should report \$25,000 on their Schedule K-1 (Form 1120-S), *Shareholder’s Share of Income, Deductions, Credits, etc.* The following is one example of applying the appropriate tax effect.

Shareholder	Original Amount	Correct Amount Reported on Schedule K-1	Over/(Under) Distributed	Tax Effect
Abigail	\$ 40,000	\$ 25,000	\$15,000	Create \$15,000 note from Abigail to Loosey corporation. Charge interest from the date of the distribution.
Bryce	0	25,000	(25,000)	Create \$25,000 note from Loosey Corporation to Bryce. Charge interest from the date of the distributions to the other shareholders.
Evelyn	29,000	25,000	4,000	Create \$4,000 note from Evelyn to Loosey Corporation to shareholder. Charge interest from the date of the distribution.
James	31,000	25,000	6,000	Create note from James to Loosey Corporation. Charge interest from the date of the distribution.
Total	\$100,000	\$100,000	\$ 0	

Another possibility is to treat the largest distribution as the appropriate amount per shareholder. The corporation could then make “true-up” distributions to the other shareholders, as shown in the next example.

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Example 2. Use the same facts as **Example 1**. Abigail owns 25% of the shares and receives \$40,000. Therefore, Loosey decides that the total distributions for the year should be \$160,000 ($\$40,000 \div 25\%$). Because Abigail received the correct amount, she is not entitled to any additional distribution for the year. However, the other shareholders should receive the difference between their proper distribution of \$40,000 and their actual distribution received. Moreover, each of the three who received less than the proper amount should be compensated for the time value of money. The result will be a corrective, or true-up distribution.

Loosey chooses a valid interest rate of 6%, compounded semiannually. The corporation distributed the cash in July 2024. The corrective distribution in January 2025 uses 3% as the appropriate interest factor for half of the year. The corrective distribution is calculated as follows.

Shareholder	Original Amount Reported on 2024 Schedule K-1	Correct Amount Using Abigail's Distribution as the Base	Under-distributed Amount Reported on 2025 Schedule K-1	Interest (3%)	Distribution Plus Interest
Abigail	\$ 40,000	\$ 40,000	\$ 0	\$ 0	\$ 0
Bryce	0	40,000	40,000	1,200	41,200
Evelyn	29,000	40,000	11,000	330	11,330
James	31,000	40,000	9,000	270	9,270
Total	\$100,000	\$160,000	\$60,000	\$1,800	\$61,800

Note. These are just two feasible solutions to correct disproportionate distributions. Others could include classifying excess distributions as gifts from the other shareholders or compensation from the corporation, reducing distributions to make them proportionate and treating the difference as compensation to the shareholders who received excess distributions.

Nonidentical Governing Provisions. When there is some binding rule that provides for unequal distributions per share, the situation becomes more complicated. If left uncorrected, the corporation (or unincorporated entity that elected S corporation status) may have more than one class of stock.

Observation. The most likely culprit for nonidentical governing provisions is an LLC that elects S corporation status. If the drafter of the operating agreement does not anticipate S corporation status for the entity, the distribution and liquidation provisions in the agreement may be based on members' capital account balances. This type of agreement is essential for operation as a partnership, but is incompatible with the single-class-of-stock rule governing S corporations. When a tax professional encounters an LLC with an S election in place or intended, a review of the company's operating agreement is essential. If there is a nonidentical governing provision, the ideal time to correct it is before the entity files the S corporation election. If the election is already in effect, correction before the company makes any disproportionate distributions can avoid costly remediation.

Rev. Proc. 2022-19 allows the corporation to **retroactively** remedy a nonidentical governing provision if it meets three conditions.³⁹

1. Since the corporation adopted the provision (or elected S status if the provision was already in effect), the corporation has made no disproportionate distributions;
2. The corporation has consistently filed Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and has not been more than six months delinquent for any taxable year; and
3. The IRS has not yet discovered the nonidentical provision.

Observation. A purported S corporation with a nonidentical governing provision which does not meet the retroactive remedy provisions of Rev. Proc. 2022-19 must forego S corporation status or file a request for inadvertent ineffective election or inadvertent termination relief.

5

If the corporation meets all the requirements for retroactive relief under Rev. Proc. 2022-19, it prepares certain statements. These statements, prepared and signed by the corporation and each owner, along with the operating agreement and owners' agreements, demonstrate the company's compliance with the single-class-of-stock rule. Copies of these statements do not need to be filed with the IRS. However, corporations should retain these statements in its permanent file in case the IRS (or a person performing due diligence), should request them in the future.

Other Class of Stock Issues

Commercial contracts, such as leases, employment agreements, and loan agreements, are not considered governing provisions unless a principal purpose is to deliberately create a second class of stock, thereby disqualifying the corporation from meeting this requirement.⁴⁰

Differences in **voting rights** are disregarded in determining whether a corporation has more than one class of stock.⁴¹ Distribution or liquidation rights on stock that is not outstanding, such as treasury stock or other unissued stock, are irrelevant.

Example 3. Somerset Corporation has Class A voting shares and Class B nonvoting shares. All outstanding Class A and Class B shares have the same liquidation and distribution rights. Somerset meets the one-class-of-stock requirement and may qualify as an S corporation if it meets all the other prerequisites.

Restricted Stock

Restricted stock is unsecured, unfunded promises to pay cash or stock in the future and considered nonqualified deferred compensation.⁴² Restricted stock issued to employees as compensation does not constitute outstanding stock unless the employee elects to include the stock in gross income in the year it is received under IRC §83(b). If the employee elects §83(b), the stock is considered outstanding stock, and the employee is considered a shareholder.⁴³

³⁹ Rev. Proc. 2022-19, 2022-41 IRB 282.

⁴⁰ Treas. Reg. §1.1361-1(l)(2)(i).

⁴¹ IRC §1361(c)(4).

⁴² IRS Pub. 5992, *Equity (Stock) — Based Compensation Audit Technique Guide*.

⁴³ Treas. Reg. §1.1361-1(b)(3).

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Deferred Compensation Arrangements⁴⁴

A deferred compensation plan arrangement does not constitute outstanding stock if it:

- Does not give voting rights,
- Constitutes a promise to pay in the future that is unfunded and unsecured,
- Is provided to a worker in connection with the performance of services to the corporation, and
- The worker is not currently taxed on the income.

Other Instruments, Obligations, or Arrangements⁴⁵

Instruments, obligations, or arrangements of the corporation, such as corporate debt, **are** treated as a second class of stock if they:

- Constitute equity **or** the holder is treated as a shareholder, and
- Have a principal purpose of circumventing distribution or liquidation rights **or** circumventing the 100-shareholder limit.

Debt Safe Harbors. A debt safe harbor stipulates that short-term, unwritten advances are not considered a second class of stock if the following conditions are met.⁴⁶

- The shareholder's advances are collectively less than \$10,000 at all times during the corporation's tax year.
- The parties involved in the transaction treat the advances as debt.
- It is expected that the debts will be repaid in a reasonable time.

Similarly, **straight debt** is not considered a second class of stock. Straight debt is an unconditional obligation to pay on demand or at a future due date that:⁴⁷

- Does not use interest rates or payment dates that are based on the borrower's discretion, on profits, or dividend distributions on stock or similar aspects;
- Is not convertible into any equity of the S corporation; and
- Is held by an individual, estate, or trust (if eligible to be an S corporation shareholder) or a commercial lender. Even though a tax-exempt charity or pension trust is eligible to hold S corporation shares, it is not eligible to hold safe harbor debt.

Another safe harbor applies to certain debt instruments, which are not regarded as a second class of stock if the debt is owned exclusively by the corporation's owners and held in the same proportion as their ownership of the corporation's stock.⁴⁸

⁴⁴. Treas. Reg. §1.1361-1(b)(4).

⁴⁵. Treas. Reg. §1.1361-1(l)(4)(ii).

⁴⁶. Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1).

⁴⁷. IRC §1361(c)(5)(B).

⁴⁸. Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2).

Call Options and Similar Arrangements⁴⁹

A **call option** grants the holder the right to purchase a specified number of shares from the option writer at a predetermined price, at any time before a specified future date.⁵⁰ A call option or similar arrangement constitutes a second class of stock if, under all the facts and circumstances, it is substantially certain that it will be exercised, and:

- The exercise price is substantially below the fair market value (FMV) of the corporation's stock at the time the option is issued,
- It is transferred by an eligible S corporation shareholder to someone who is ineligible, or
- The option has been materially modified.

When an option and loan arrangement are issued together, an option time extension consistent with an extension on the loan does not result in a material modification.

QUALIFIED SHAREHOLDERS

Under subchapter S, only certain types of individuals and entities are permitted to hold shares in the S corporation. Among qualified shareholders are individuals, estates, and trusts. Additionally, certain qualified retirement plans and nonprofit organizations may be qualified shareholders in a S corporation.

Individuals

Shareholders who are **individuals** must be U.S. citizens or U.S. residents. A corporation with a nonresident alien shareholder does not qualify as an S corporation.⁵¹ However, a U.S. citizen with a nonresident alien spouse can make a joint spousal tax election to have the nonresident spouse treated as a resident alien for tax purposes.⁵² This subjects the nonresident alien spouse to the same worldwide income reporting requirement as the U.S. citizen spouse. If this tax election is made, the nonresident alien spouse is eligible to hold shares in an S corporation.⁵³

Estates⁵⁴

Estates are considered qualified shareholders of S corporations, allowing them to hold S corporation stock for a period necessary to administer the estate. This eligibility ensures that the S corporation can maintain its tax-advantaged status while the estate's affairs are being settled, providing continuity and stability for the business. However, it is important to manage this transition carefully to comply with the specific time limits and requirements set forth by the IRS.

Decedents' Estates. A decedent's estate can indefinitely hold S corporation shares without jeopardizing the S election status.⁵⁵ The transfer of shares to a decedent's estate does not terminate the S election even if a beneficiary of the estate is ineligible to hold S corporation shares. However, the corporation and surviving shareholders need to be aware of the dispositions by the estate. Often, a transfer to a trust may create eligibility problems. Moreover, if an estate's administration extends beyond the time necessary to settle the decedent's affairs, the IRS may treat the estate as a trust.⁵⁶

⁴⁹ Treas. Reg. §1.1361-1(l)(4)(iii).

⁵⁰ IRS Pub. 550, *Investment Income and Expenses*.

⁵¹ IRC §1361(b)(1)(C).

⁵² IRC §6013(g); Treas. Reg. §1.6013-6.

⁵³ Treas. Reg. §1.1361-1(g)(1)(i), Example 2.

⁵⁴ IRC §1361.

⁵⁵ IRC §1361(b)(1)(B).

⁵⁶ *Old Virginia Brick Company, Inc. v. Comm'r*, 367 F.2d 276 (4th Cir. 1966). (The shareholder was an ineligible shareholder because part of his shares were held by an estate that was a testamentary trust at the time of election; the estate was administered for approximately 23 years).

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Bankruptcy Estates. When an individual declares Chapter 11 bankruptcy, the individual's property is placed in a bankruptcy estate, which ultimately may distribute some or all the property to creditors.⁵⁷ A bankruptcy estate is an eligible S corporation shareholder.⁵⁸ When the S corporation shares are held by the bankruptcy estate, the corporation's S status remains intact. However, if any of the shares are ultimately transferred to a creditor who is not an eligible shareholder, the corporation's S status terminates.

Trusts

In general, a trust **does not qualify** as an S corporation shareholder. There are a few specific exceptions. These trusts, **and only these trusts**, are eligible.

- Grantor trusts
- Deemed grantor trusts (beneficiary-controlled trusts)
- Grantor and deemed grantor trusts after death of the grantor or beneficiary
- Testamentary trusts
- Qualified subchapter S trusts (QSSTs)
- Electing small business trusts (ESBTs)
- Voting trusts

Caution. QSSTs and ESBTs are frequent causes of confusion and remediation. QSSTs can only have one income beneficiary, and all income must be distributed annually to that beneficiary, which can complicate estate planning and tax reporting.⁵⁹ On the other hand, ESBTs can have multiple beneficiaries and do not require annual income distribution, but they are taxed at the highest trust tax rate on S corporation income. These differences can lead to misunderstandings and potential compliance issues. While a discussion of these topics is beyond the scope of this chapter, it is essential to thoroughly understand the specific requirements and implications of each trust type to avoid unintended violations of subchapter S and ensure proper compliance.

To add to the general confusion over which trusts are eligible shareholders, some of the eligible trusts (QSSTs and ESBTs) require trust-level elections and the others do not. Grantor post-death and testamentary trusts are limited to two years of eligibility, but other trusts are not. The QSST has strict distribution requirements and the others do not. Moreover, a death or other change in beneficiary can cause a trust to convert from one category to another, usually a grantor trust to a post-death grantor trust. Two years later, many trusts become ineligible, due to the failure of the proper parties to file a QSST or ESBT election.

Observation. Ownership of S corporation stock by trusts has likely caused more confusion than any other subchapter S rule. There are numerous letter rulings issued each year granting inadvertent termination or inadvertent ineffective election relief. These rulings are expensive and time-consuming. Even more noteworthy is the liberal policy of granting relief without a ruling, which indicates a serious lack of awareness on the part of the tax professional community.

However, attention to the rules discussed in this chapter will prepare the tax professional to ask the right questions and advise the client to take timely actions. Paying attention to a few simple rules may prevent many of the costly problems that occur when an S corporation has one or more trusts as a shareholders and does not have proper communication with an informed tax advisor.

⁵⁷ IRC §1398.

⁵⁸ IRC §1361(c)(3).

⁵⁹ IRC §§678 and 1361; See, *Trusts for holding S corporation interests: QSSTs vs. ESBTs*. Blase, James G. May 1, 2022. AICPA. [www.thetaxadviser.com/issues/2022/may/trusts-holding-s-corporation-interests-qsst-vs-esbts.html] Accessed on Feb. 19, 2025.

No foreign trust is eligible to be an S corporation shareholder, even though it might otherwise appear to qualify.⁶⁰ A domestic trust must meet two requirements.⁶¹

1. The trust must be within the jurisdiction of a U.S. court.
2. U.S. persons must control all substantial decisions.

Grantor Trusts. A **grantor trust** is generally a trust created by an individual who transfers property into the trust and who subsequently retains a large degree of control over the trust arrangement. The grantor is considered the owner of the trust property for federal tax purposes.⁶² Powers held by the grantor include the following.

- A reversionary interest in trust property⁶³
- Power of the grantor or subordinate party to control beneficial enjoyment of trust property⁶⁴
- General powers of administration over trust property, including power to vote stock⁶⁵
- Power to revoke the trust⁶⁶
- Power to receive distributions of money or property from the trust⁶⁷
- Power to acquire trust property by substituting property of equal value⁶⁸

Note. Transferring property to a grantor trust does not have an income tax impact. However, the trust may serve estate planning objectives well. A properly created trust directs property from the grantor to desired beneficiaries.

For more information on grantor trusts, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 9: Various Specialized Trusts.

Deemed Grantor Trusts. A beneficiary may have sufficient control over a trust such that the beneficiary is considered the owner of the trust property. This type of beneficiary-controlled trust is a **deemed grantor trust**.⁶⁹

Note. A grantor or deemed grantor trust is also referred to as a **subpart E trust**. Within the Code, subchapter J outlines the various tax rules associated with certain trusts that have beneficial owners who are treated as owners of their respective portions of the trust upon which they are taxed.⁷⁰ For tax purposes a subpart E trust is a disregarded entity.

⁶⁰ Treas. Reg. §1.1361-1(h)(2).

⁶¹ IRC §7701(a)(30).

⁶² IRC §671.

⁶³ IRC §673(a).

⁶⁴ IRC §674(a).

⁶⁵ IRC §675.

⁶⁶ IRC §676.

⁶⁷ IRC §677.

⁶⁸ IRC §675(4).

⁶⁹ IRC §678.

⁷⁰ IRC §§671–679.

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A donor may transfer certain powers to children or other beneficiaries, even though the intent is to hold the property in the trust for the long term. Among other advantages of this arrangement is qualification of the gift for the annual gift tax exclusion, currently \$19,000 per donee.⁷¹ This exclusion requires the donee to have a **present interest**, rather than a future interest in the property transferred from the donor.⁷²

Observation. In *Crummey v. Comm'r*, a donor transferred property to a trust for the benefit of his children. He gave each child the right to withdraw the property, but only for 30 days. Thereafter, the property would remain with the trust. The IRS challenged this technique, but the Ninth Circuit ruled in favor of the taxpayer.⁷³ Thus, a temporary power to withdraw trust property is often termed a **Crummey power**.

When a beneficiary has a right to withdraw property but does not do so, the tax law treats the beneficiary as if they had withdrawn the property and then transferred the property back to the trust for their own benefit.⁷⁴

In the case of grantor and deemed grantor trusts, the trust is eligible to hold S corporation shares if the grantor or controlling beneficiary is a U.S. citizen or U.S. resident.⁷⁵ No special election is required by the grantor or deemed grantor trust for S corporation shareholder eligibility.

Grantor Trusts and Deemed Grantor Trusts After Death. After the death of the grantor or controlling beneficiary, the trust can generally continue to hold the S corporation shares for the 2-year period that begins on the date of death.⁷⁶ Before the expiration of the 2-year post-death period, the stock must either be transferred to a qualified shareholder or there must be an election to convert the trust to a QSST or ESBT status. If the trust cannot meet the QSST or ESBT qualifications, it must transfer the shares or undergo judicial reformation.

Testamentary Trusts. A testamentary trust, created by a decedent's will and established at death, may hold S corporation shares for a period of two years commencing with the date the trust receives the shares from the estate.⁷⁷

QSST.⁷⁸ A QSST is a type of trust that can hold S corporation stock. While it is treated as a grantor trust for tax purposes, it qualifies as an S corporation shareholder subject to specific qualifications and a required election.

Note. QSST elections seem to cause a great deal of confusion among tax professionals. Each month there are several rulings granting inadvertent termination or inadvertent ineffective election relief to S corporations when the only violation was failure of a beneficiary to file a timely QSST election. This recurring issue highlights the importance of understanding and adhering to the specific requirements for QSST elections to avoid costly mistakes and ensure compliance with S corporation regulations. Tax professionals must stay vigilant and informed to navigate these complexities effectively.

⁷¹ Rev. Proc. 2024-40, 2024-45 IRB 1100.

⁷² IRC §2503(b)(1).

⁷³ *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968). See also Rev. Rul. 73-405, 1973-2 CB 321.

⁷⁴ IRC §2514; Treas. Reg. §25.2514-3.

⁷⁵ IRC §1361(c)(2)(A)(i).

⁷⁶ IRC §1361(c)(2)(A)(ii).

⁷⁷ IRC §1361(c)(2)(A)(iii).

⁷⁸ IRC §1361(d).

The trust instrument of a QSST must contain these provisions.

- There can be only one current income beneficiary, who must be a U.S. citizen or resident.
- All distributions of trust property may be made only to the income beneficiary.
- The income beneficiary's interest in the trust cannot terminate during their lifetime.
- The trust instrument must provide that all trust property must be distributed to the income beneficiary if the trust terminates during their lifetime.

One trust instrument may serve more than one current income beneficiary. However, the rights of each beneficiary must be segregated as to certain properties, such as the S corporation stock. A trust with this arrangement has separate shares.⁷⁹ For tax purposes, each separate share is treated as a separate trust.

Moreover, the trust must distribute all its accounting income annually. This may be via express terms of the trust agreement or by action of the trustee.⁸⁰ Finally, the beneficiary must file an election to treat the trust as a QSST.⁸¹ The following election deadlines are in effect.

- If the trust owns stock on the date the corporation files its S election, the beneficiary (not the trustee) must file the QSST election within two months and 16 days of the date the corporation files Form 2553 (but not before the corporation files the form).⁸² In this case, the beneficiary (not the trustee) must also sign the shareholder consent for the shares owned by the trust.⁸³
- If the corporation has already filed the S election when the trust acquires the stock, the beneficiary must file the QSST election within two months and 16 days after the trust acquires the stock.

ESBT. The ESBT allows considerably more flexibility than the grantor trust, including the following.⁸⁴

- There can be more than one beneficiary.
- The trustee has flexibility in distributions to each beneficiary.
- The trustee does not need to distribute income, but can accumulate it in the trust.
- The trust may have a nonresident alien as a beneficiary.
- The trust's eligibility is not limited to the life of the grantor or the life of any beneficiary.

However, there are certain tradeoffs.

- The trust is subject to the top individual income tax rates.
- The trust is treated as two (or three) different tax reporting entities.
 - The "S portion," which includes only the stock of one or more S corporations;
 - The "grantor portion," if one or more persons has grantor type powers over any trust property, including the S corporation stock; and
 - The "non-S portion," which holds all trust property not in the other two portions.⁸⁵

⁷⁹ IRC §663(c).

⁸⁰ IRC §1361(d)(3).

⁸¹ IRC §1361(d)(2).

⁸² IRC §1361(d)(2)(D); Treas. Reg. §1.1361-1(j)(6)(iii)(A). Inexplicably, this is one day longer than the period in which a corporation needs to file an S election to take effect at the beginning of the year.

⁸³ There are rulings granting inadvertent ineffective election relief when the trustee, rather than the beneficiary, signs the trust election and the S election.

⁸⁴ IRC §1361(e)(1)(A) states the general rules for ESBTs. It contains none of the restrictions in the list, in contrast to QSSTs.

⁸⁵ Treas. Reg. §1.641(c)-1(a).

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There are other complications with the ESBT. Its deductions are limited to the passthrough deductions from the S corporation plus:⁸⁶

- Gain or loss from the disposition of S corporation stock;
- State and local taxes and administrative expenses of the trust, as provided in regulations; and
- Interest on purchase money debt.

Note. There is no statutory authorization for the qualified business income (QBI) deduction of IRC §199A to the S portion. However, Treas. Reg. §1.199A-6(d)(3)(iv) authorizes the deduction to the S portion of the trust.

The S portion (consisting only of the stock of one or more S corporations) has some unusual attributes. Any distributions attributable to this portion are not deductible by the trust. These distributions are tax-free to the beneficiaries.⁸⁷ However, distributions from the non-S portion are subject to the normal tax rules for computation of distributable net income (DNI) and deductions for distributions.⁸⁸

Voting Trust.⁸⁹ A voting trust holds title to stock, based on certain contractual arrangements, such as might happen during periods of change in control. These trusts hold no power other than to elect directors, and the power must be limited in time. Each beneficial owner holds a certificate, and the certificate owners are entitled to all distributions from the corporation, and must report the S corporation income and other items on their returns.

Other Entities

Other entities that qualify as S corporation shareholders are as follows.⁹⁰

- Qualified retirement plans meeting the criteria of IRC §401(a).
- Nonprofit organizations described in IRC §501(c)(3).

In most cases, these exempt entities must treat all income from the S corporation as unrelated business taxable income. This treatment even extends to interest and dividends, which are not normally unrelated business taxable income to exempt organizations.⁹¹ Therefore, S corporation stock is not a popular form of investment for these entities.

ESOPs. In 1997, employee stock ownership plans (ESOPs) were first allowed to hold shares in S corporations.⁹² Unlike other tax-exempt entities, these owners are not subject to unrelated business income tax.⁹³ An ESOP is a defined contribution qualified retirement plan.⁹⁴ The securities are held in a trust for the benefit of the employees of the sponsoring corporation.⁹⁵

^{86.} IRC §641(c)(2)(C).

^{87.} IRC §641(c)(2).

^{88.} IRC §641(c)(3).

^{89.} Treas. Reg. §1.1361-1(h)(1)(v).

^{90.} IRC §1361(c)(6).

^{91.} IRC §512(e).

^{92.} *Small Business Job Protection Act*, PL 104-188, §1316(a)(2).

^{93.} IRC §512(e)(3).

^{94.} IRC §4975(e)(7).

^{95.} IRC §401(a).

ESOPs are rather expensive to administer and are generally suited to corporations with many employees. ESOPs have a unique tax advantage as S corporation shareholders. Both the S corporation and the shareholder are generally exempt from income tax on the undistributed income of the ESOP.⁹⁶ The only tax is payable by employees when they retire. If this tax deferral is worth the administrative cost, it can be a useful tax structure for a business.

Ineligible Shareholders

The following individuals and entities are not included in §1361(b)(1)(B). Therefore, they are **not eligible** to hold S corporation shares.

- Nonresident aliens
- Foreign trusts
- Individual retirement arrangements (IRAs)
- C corporations
- Partnerships, including limited partnerships and limited liability partnerships
- LLCs other than a single-member LLC (SMLLC) owned by a U.S. citizen or resident, and has not elected to be a corporation for tax purposes

S CORPORATION ELECTIONS

When forming an S corporation, there are several critical elections that must be made to ensure compliance with federal tax regulations and optimize tax benefits. These elections include obtaining S corporation status, making changes in tax classification, securing shareholder consents, and selecting a tax year. Each of these decisions plays a vital role in the corporation's tax treatment and overall financial strategy, requiring careful consideration and timely action.

S CORPORATION STATUS

If all requirements mentioned earlier are met, any domestic corporation or other entity eligible to be taxed as a corporation may make an S election. This election is made by filing Form 2553.

The corporation should file the election no later than two months and 15 days after the beginning of the tax year in which the election is to take effect, or it can be made at any time during the tax year preceding the tax year that the election is to take effect.⁹⁷ However, the corporation must be in existence before the S corporation election can be filed.⁹⁸ If the corporation has not previously existed, the timeline for electing S corporation status starts when the Secretary of State for the relevant state has chartered the organization.⁹⁹ Thereafter, the corporation's starting date is the earliest of the dates that the corporation:¹⁰⁰

- Has shareholders to whom it has issued shares,
- Acquires property, or
- Begins to conduct business.

⁹⁶ IRC §§501(a) and 401(a).

⁹⁷ IRC §1362(b)(1).

⁹⁸ Treas. Reg. §1.1362-6(a)(2).

⁹⁹ *Frentz v. Comm'r*, 44 TC 485 (1965).

¹⁰⁰ Treas. Reg. §1.1362-6(a)(2)(ii)(C).

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Example 4. Jack and Brenda decided to start a publishing corporation in 2024. The corporation issued shares on December 13, 2024, in exchange for \$20,000. On January 15, 2025, the corporation opened a bank account and deposited the \$20,000. On February 1, 2025, the corporation started operations.

The corporation is considered to have started business on December 13, 2024 (the earliest of the dates that it issued shares, acquired property, or commenced business). Consequently, the election is due on or before February 27, 2025, to be treated as timely filed. If the start date was May 1, the election is due on or before July 15. In all these examples, the third month and the start of the 15-day count begins on the same numerical day as the year began (i.e., February 13, July 1 plus 14 days yields the critical date).

Corporations file Form 2553 with the IRS center in either Kansas City, Missouri or Ogden, Utah, depending on the state in which the electing corporation files its annual return. Corporations that e-file should select the location of where it would file a paper return if it did not e-file.¹⁰¹

Note. As of the date this workbook went to press, taxpayers are not permitted to e-file Form 2553. However, each service center has a fax number on which it will accept Form 2553. The fax numbers for the IRS Centers are 855-887-7734 (Kansas City, Missouri) and 855-214-7520 (Ogden, Utah).

If the corporation (entity) files the election by fax, the entity should keep the original Form 2553 with their permanent records.

CHANGE IN TAX CLASSIFICATION ELECTION

Entities use Form 8832 to elect a federal income tax classification different from their default tax classification.¹⁰² For example, an SMLLC is taxed as a sole proprietorship by default.¹⁰³ A multiple-member LLC's default status is partnership.¹⁰⁴ To change this classification, the entity must:

- File Form 8832 to elect to be taxed as a **C corporation**.¹⁰⁵ The entity must also attach a copy of this form to its Form 1120, *U.S. Corporation Income Tax Return*, for the first effective year of the election.¹⁰⁶
- File Form 2553 to elect to be an **S corporation**.¹⁰⁷ This form does not indicate whether the filing entity is incorporated or an unincorporated entity electing S corporation status, unless the company files after the deadline.

The IRS normally sends CP261 Notice, *Notice of Acceptance as an S Corporation*, after an S corporation files Form 2553 to confirm that it has accepted a business's election to be treated as an S corporation.¹⁰⁸ The CP261 Notice serves as an official approval letter and outlines the responsibilities of the S corporation. Internal Revenue Manual (IRM) §21.2.1.64(8) states that a business taxpayer can view and download CP261.

¹⁰¹. Treas. Reg. §1.1362-6. Instructions to Form 2553 indicate the appropriate Service Center.

¹⁰². Instructions for Form 8832.

¹⁰³. Treas. Reg. §301.7701-3.

¹⁰⁴. Ibid.

¹⁰⁵. Treas. Reg. §301.7701-3(c)(1)(i).

¹⁰⁶. Treas. Reg. §301.7701-3(c)(1)(ii).

¹⁰⁷. Treas. Reg. §301.7701-3(c)(1)(v)(C).

¹⁰⁸. *Understanding your CP261 notice*. Dec. 16, 2024. IRS. [www.irs.gov/individuals/understanding-your-cp261-notice] Accessed on Feb. 25, 2025.



Practitioner Planning Tip

Tax practitioners should keep a copy of the CP261 Notice in a taxpayer's permanent file. The best way to access copies of a CP261 Notice is through the taxpayer's business tax account. For more information on the business tax account, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

The IRS will send a CP264 Notice if it **denies** the S corporation election. The CP264 Notice informs the taxpayer why the election was denied and when it can reapply.¹⁰⁹

Note. When a filing date is critical, as is the case with many documents including Form 2553, the taxpayer may need evidence of when the IRS actually receives the return or other statement. In this case, a registered or certified mail receipt is prima facie evidence that the form was properly addressed and timely mailed, as is a receipt from a designated private delivery service.¹¹⁰ However, taxpayers are permitted to fax Form 2553, which should provide evidence of when the taxpayer filed the document.

The IRS can, at any time in the future, disallow an S election if there is no conclusive evidence that the corporation ever filed the form.¹¹¹ It can even disallow the S election after an audit of a prior year in which it had tacitly accepted the S election.¹¹²

However, Rev. Proc. 2013-30, discussed later, can provide some relief, even if the corporation has been claiming S corporation status for many years without proof of the election.¹¹³

SHAREHOLDER CONSENTS

All existing shareholders must consent to the election to obtain status as an S corporation.¹¹⁴ Not only all shareholders holding stock (voting and nonvoting) at the time of election, but also former shareholders who have held stock during the earlier portion of that taxable year must consent. If one or more persons who held stock in the corporation during the year prior to the election do not consent to the election, the election is treated as made for the following tax year.¹¹⁵

Example 5. At the beginning of 2025, David, Ellen, and Fred own the stock of GHI Corporation, which uses the calendar year. On February 15, 2025, Fred sells all his shares in GHI to Clyde. On March 1, 2025, the three current shareholders file an S corporation election. For the election to be effective for 2025, all shareholders on the date of election (Clyde, David, and Ellen), as well as Fred, must consent. Failure to obtain Fred's consent would cause the election to become effective for 2026.

^{109.} *Understanding Your CP264 Notice*. May 6, 2024. IRS. [www.irs.gov/individuals/understanding-your-cp264-notice] Accessed on Feb. 25, 2025.

^{110.} IRC §7502(c).

^{111.} *Mora v. Comm'r*, TC Memo 1972-123 (May 30, 1972); *Hooper v. Comm'r*, TC Memo 1974-176 (Jun. 27, 1974).

^{112.} *Campbell v. Comm'r*, TC Memo 1975-149 (May 19, 1975); *Combs v. Comm'r*, TC Memo 1989-206 (May 1, 1989); *Garrett & Garrett, PC v. Comm'r*, TC Memo 1993-453 (Sep. 28, 1993); *Barber v. Comm'r*, TC Memo 1999-260 (Aug. 4, 1999).

^{113.} Rev. Proc. 2013-30, 2013-36 IRB 173.

^{114.} IRC §1362(a)(2).

^{115.} IRC §1362(b)(2).

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Persons Required to Consent

Any other person who is treated as a part owner or co-owner must also sign their consent. These persons include spouses if the shares are held in joint tenancy, tenancy in common, or community property.¹¹⁶

Example 6. Barry and Renee (who are married, but not to each other) are equal shareholders in the BR Corporation. The corporation is located in Illinois, a separate property state. Barry is a resident of Illinois. Renee is a resident of Washington, a community property state. The corporation files a Form 2553 making an S election. The shares are issued to Barry and Renee as individual holders. Barry and Renee must consent to the election. Barry's wife has no immediate rights of ownership in Barry's shares and does not need to sign a consent. Renee's husband must consent because he has a community property interest in Renee's shares.

The following table identifies circumstances in which a person is required to sign on behalf of a shareholder.¹¹⁷

Shares Held By	Person Who Must Sign	Authority
Community property, tenants in common, joint tenants, tenants by the entirety	Each person holding an interest	Treas. Reg. §1.1362-6(b)(2)(i)
Minor	Self, parent, or legal representative	Treas. Reg. §1.1362-6(b)(2)(ii)
Estate	Executor or administrator	IRC §1361(c)(2)(B)(ii), Treas. Reg. §1.1362-6(b)(2)(iii)
Grantor trust	Deemed owner	Treas. Reg. §1.1362-6(b)(2)(iv)
QSST	Beneficiary	Treas. Reg. §1.1362-6(b)(2)(iv)
Decedent	Executor or administrator	Rev. Rul. 92-82, 1992-39 IRB 10
ESBT: S portion	Fiduciary	Treas. Reg. §1.1361-1(m)(2)
ESBT: grantor portion	Deemed grantor	Treas. Reg. §1.1362-6(b)(2)(iv)

Note. There is no specific guidance as to the proper signatory when a charity, pension fund, or ESOP owns the shares. Presumably, the usual principles of business law would treat an officer, fiduciary, or other person with signatory authority for the organization as the appropriate "shareholder" for purposes of subchapter S. Ltr. Rul. 201017038 waived an inadvertent defective election when the wrong person signed on behalf of an ESOP. However, the ruling did not specify the position of the person who had originally signed, or the person who signed correctly.¹¹⁸

¹¹⁶ Treas. Reg. §1.1362-6(b)(2)(i); *Clemens v. Comm'r*, TC Memo 1969-235 (Nov. 4, 1969).

¹¹⁷ See Treas. Reg. §1.1362-6(b)(2).

¹¹⁸ Ltr. Rul. 201017038 (Jan. 22, 2010).

Relief for Late Consents

Although the Code has fairly stringent requirements regarding the S corporation election, it is strangely silent regarding the consents. It does not specify the time or manner of submitting the required consents. However, the IRS has developed its own rules for late consents. In general, the IRS will accept a late consent if such consent is filed within a “reasonable” period of time, provided there was reasonable cause for the delay and that the interests of the government would not be jeopardized by granting the consent.¹¹⁹

The corporation must file the consents with the IRS and must include the consents of all persons who have been shareholders since the date the corporation filed Form 2553, if they have not already consented to the corporation’s S election.¹²⁰

In cases where the only issue is the failure to include a spouse who is treated as a shareholder due to a community property interest, the relief is even more streamlined.¹²¹ The corporation files a statement with the appropriate Service Center. The statement includes representations signed by both community spouses. If they have included all income and other subchapter S items on their tax returns for the period, the IRS accepts the consent.

TAX YEAR ELECTION

An S corporation must select a tax year. Moreover, it must use a **permitted** tax year.¹²² A permitted tax year is one of the following.¹²³

1. The calendar year
2. A 52–53-week year that ends with reference to the required year
3. A year elected under IRC §444
4. Any other year, if the S corporation demonstrates to the IRS that there is a **business purpose** for using a fiscal year

A newly electing S corporation does not require IRS approval for using a permitted year, and any of the first three options may be adopted.¹²⁴ An electing S corporation that wants to adopt any other tax year (option 4) must obtain IRS approval under IRC §442.

An automatic business purpose yearend refers to a fiscal year that the IRS automatically approves without requiring a detailed business purpose justification. To qualify for this, the S corporation must meet one of two requirements.¹²⁵

1. There must be a peak 2-month contiguous period in which the corporation (or predecessor entity) realizes more than 25% of its gross receipts for the 12-month period then ended. The entity must have a 3-year period of this pattern; or,
2. The holders of a majority of the shares must have the same noncalendar year.

If an S corporation has other reasons for a business yearend, such as seasonality, it must apply for permission to use a fiscal year.¹²⁶

¹¹⁹ Treas. Reg. §1.1362-6(b)(3)(iii)(A).

¹²⁰ Treas. Reg. §1.1362-6(b)(3)(iii)(B).

¹²¹ Rev. Proc. 2004-35, 2004-23 IRB 1029.

¹²² IRC §1378(a).

¹²³ IRC §1378(b); Treas. Reg. §1.1378-1(a).

¹²⁴ Treas. Reg. §1.1378-1(b).

¹²⁵ Rev. Proc. 2006-46, 2006-45 IRB 851.

¹²⁶ Rev. Proc. 2002-39, 2002-22 IRB 1046.



Practitioner Planning Tip

Selecting a fiscal year allows shareholders more flexibility in tax planning at the end of their individual (i.e., calendar) year. For example, a taxpayer could offset unexpectedly high S corporation flowthrough income through additional charitable contributions, contributions to selected retirement plans, etc.

C Corporation to S Corporation Considerations

If a C corporation converts to S corporation status, it may retain its tax year if the year ends in (or with respect to):¹²⁷

- December;
- September, October, or November (may require payment of annual deposit to compensate the government for deferral); or
- A natural business yearend.

If an electing C corporation wishes to retain one of these years, it must indicate its new taxable year on part II, page 3 of Form 2553. If an electing C corporation does not have one of these years, or wishes to change to one of these years, it must indicate its new taxable year on page 3 of Form 2553.

The treatment of the election depends on the type of year selected.¹²⁸

- A change to the **calendar year** is granted automatically and does not require IRS approval.
- A change to a **natural business year** or **ownership tax year** may qualify for automatic approval, but the corporation must meet specific criteria and provide supporting documentation.

If the requested year does not fall within the permitted categories, the corporation must file Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, demonstrate a business purpose, and pay a user fee to request IRS approval.¹²⁹

LATE AND DEFECTIVE ELECTIONS

The Code establishes the deadline to make an S election as two months and 15 days after the beginning of the tax year in which the S election is to be effective.¹³⁰ However, it also gives the IRS the authority to treat a late election as timely when the taxpayer had reasonable cause for missing the deadline.¹³¹ Late S elections are so common that nearly 20% of the instructions for Form 2553 are dedicated to late S elections. The only statutory requirement is that there must be **reasonable cause** for the delinquency.

Observation. Reasonable cause is not intended to be a difficult standard to meet. A statement such as “[corporation] was unaware of the need to file Form 2553 by [date]. When advised of the need to file, [corporation] took prompt action to complete the form, secure the necessary signatures and consents and file the form with the Internal Revenue Service Center” should suffice to demonstrate reasonable cause and ensure compliance.

¹²⁷ Rev. Proc. 2006-46, 2006-45 IRB 851.

¹²⁸ Ibid.

¹²⁹ See instructions to Form 1128.

¹³⁰ IRC §1362(b).

¹³¹ IRC §1362(b)(5).

Closely related to late election relief is inadvertent ineffective election relief. This can happen when an entity intending to be an S corporation files Form 2553, but one (or both) of these problems exists.

- The corporation does not complete the form properly.
- The corporation does not meet the S corporation eligibility requirements when it files Form 2553.

IRC §1362(f) instructs the IRS to accept the inadvertent ineffective election if the defect is inadvertent, and the corporation takes prompt corrective action. This provision also applies when a corporation has had a valid S election in effect and subsequently committed a violation, such as the addition of an ineligible shareholder.

Observation. The legislative history indicates that **inadvertence** is a higher standard than **reasonable cause**. The corporation and all shareholders (from the date of the initial filing to the date of the filing of the relief request) must sign under penalties of perjury that there was no tax avoidance motive to the offense.

SIMPLIFIED RELIEF¹³²

Rev. Proc. 2013-30 provides simplified methods for taxpayers to request relief for a late S election. This procedure also contains provisions for taxpayers to make late elections for classification as an ESBT, QSST, qualified subchapter S subsidiary (QSub), or entity classification along with the S election.

To qualify for relief, the corporation must meet all the following requirements.

1. The requesting entity intended to be classified as an S corporation as of the effective date.
2. The requesting entity requests relief within **three years and 75 days** after the effective date.
3. The failure to qualify as an S corporation, ESBT, QSST, or QSub as of the effective date was solely because the appropriate election was not timely filed by the due date of the election under subchapter S.
4. The requesting entity has **reasonable cause** for its failure to make a timely S corporation or QSub election, or the failure to file a QSST or ESBT election was inadvertent.
5. The parties acted **diligently** to correct the mistake upon its discovery.
6. The Form 2553 states “FILED PURSUANT TO REV. PROC. 2013-30” at the top.
7. The completed Form 2553 includes signatures from all shareholders that indicates that, during the period between the date the S election was to have become effective and the date the completed form is filed, they have reported their income on all affected returns consistent with the S election for the year the election should have been filed and for all subsequent years.

Note. Most tax software should have a feature available to automatically generate this statement.

¹³² Rev. Proc. 2013-30, 2013-36 IRB 173.

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The completed Form 2553 must be signed by all the following persons.

- A corporate officer with the authority to sign the corporation's tax returns.
- All persons who were shareholders at any time during the period that began on the first day of the tax year for which the election is to be effective and ends on the day the corporation files the completed Form 2553.

Observation. Relief under Rev. Proc. 2013-30 is preferable to filing a ruling request. However, there are several rulings each month where a corporation has missed the three year plus 75-day window period for expedited relief. Moreover, any recalcitrant shareholder can delay or prevent this relief, because each person treated as a shareholder must sign Form 2553.

If applicable, the beneficiary of each QSST shareholder must submit the proper election and attest to the inadvertence of the failure to file timely. Also, the trustee of each ESBT shareholder that has not filed a timely election must attach the election and representation of inadvertence.

Corporation Has Not Filed Form 1120-S

If the corporation has not yet filed Form 1120-S for the first intended S corporation year or any subsequent year, there must be **no inconsistent** reporting by any of the shareholders. This means that no shareholder has omitted income or loss from the S corporation on a Form 1040, *U.S. Individual Income Tax Return*, or Form 1041, *U.S. Income Tax Return for Estates and Trusts*, filed for the year that includes the end of the first S year. If any of the shareholders has filed a tax return that has omitted any S corporation item, it appears that this condition has been violated.

For a corporation that has not filed Form 1120-S, the corporation may file Form 2553 on paper or by fax. Alternatively, the corporation may attach Form 2553 to the Form 1120-S for the intended effective year. In addition, the corporation must file any delinquent Forms 1120-S at the same time as Form 2553.

Corporation Has Already Filed Form 1120-S

If the corporation has already filed Form 1120-S for the intended S year, all parties must have filed returns in a manner consistent with the S election being in effect. Thus, if any shareholder has omitted S corporation items, or has not filed a return at the time of the relief request, the corporation is in violation of this condition.



Practitioner Planning Tip

Practitioners should advise any nonfiling shareholders to file their returns for the year before or at the time of the relief requests.

No Notification from the IRS Within 6 Months of Filing Form 1120-S

Occasionally, the IRS informs a corporation that it does not have a valid S election in effect, even when the corporation has filed as an S corporation for several years. Under Rev. Proc. 2013-30, the relief is automatic. The corporation does not need to file a ruling request and does not need to wait for further communications from the IRS acknowledging the validity of the S election. The corporation need not state reasonable cause.

The corporation and its shareholders are now assured that the election will be accepted as timely for the first year for which the corporation was intended to be an S corporation.

There are some rather simple and straightforward procedural rules.

- The corporation is not seeking late entity classification relief. In other words, it is already treated as a corporation for purposes of federal income tax laws.
- The corporation fails to qualify as an S corporation solely because Form 2553 was not timely filed. Thus, there cannot be any defect in the election, such as the lack of a timely QSST or ESBT election.
- The corporation and all its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year (if any).
- At least six months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation.
- Neither the corporation nor any of its shareholders were notified by the IRS of any problem regarding the S corporation status within six months of the date on which the Form 1120-S for the first year was timely filed.
- The completed election form includes statements from all persons who have been shareholders since the intended effective date of the election.

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In short, for the corporation to qualify for this relief provision everyone involved — **including the corporation, its tax advisors, and the IRS** — must have overlooked the filing requirements for Form 2553, and the first Form 1120-S must have been filed at least six months ago. The corporation sends Form 2553 to the Service Center, regardless of the amount of time that has elapsed since the intended effective date of the S election.

RELIEF PROCEDURES

For both late¹³³ and inadvertent ineffective election¹³⁴ relief, the corporation must apply to the IRS for relief.¹³⁵ The IRS, under its administrative powers, then decides how the offending corporation must submit an application.¹³⁶

Unless the IRS explicitly through a Rev. Proc., regulation, or other announcement specifies an alternative course of action, the parties involved must submit a ruling request to the IRS National Office. The first Rev. Proc. of each year gives instructions on application procedures. For 2025, the authority is Rev. Proc. 2025-1.¹³⁷ This Rev. Proc. is approximately 100 pages long. It contains a checklist with 55 questions that must accompany each ruling, as well as the user fees that must accompany the request. For requests submitted after February 1, 2025, the base user fee is **\$43,700**.¹³⁸ If there is more than one offense, the corporation must request relief for each. However, the user fee for additional requests involving the same issue is \$4,370. For S corporations applying for relief with less than \$400,000 in gross receipts, the fee is \$3,450. If the gross receipts exceed \$400,000 but are less than \$10 million, the fee is \$9,775.¹³⁹

¹³³. IRC §1362(b)(5).

¹³⁴. IRC §1362(f).

¹³⁵. Treas. Reg. §1.1362-4(c).

¹³⁶. For 2025, the IRS guidance for special relief for late S corporation and related elections in lieu of letter ruling process can be found in Rev. Proc. 2025-1, 2025-1 IRB 1. This guidance is updated annually in the first Rev. Proc. issued in any year.

¹³⁷. Rev. Proc. 2025-1, 2025-1 IRB 1.

¹³⁸. Ibid.

¹³⁹. Ibid.

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Total Income¹⁴⁰

To calculate whether a corporation is eligible for a reduced fee, Rev. Proc. 2025-1 uses the term gross income, but then defines the term as “total income” plus cost of goods sold. On Form 1120-S page 1, line 6 is the total of all the non-separately reported gross income. However, to comply with the Rev. Proc. definition, an S corporation must use the amount from line 6 and add cost of goods sold. Then it must add amounts reported on Schedule K (Form 1120-S), *Shareholders’ Pro Rata Share Items*, at lines 3a, 4, 5a, 6, 7, 8a, 9, and 10.

If the S corporation has not filed a full 12-month return, it must submit shareholder information as a proxy. If any person owns 50% or more of the stock, the corporation must add the shareholder’s gross income to the total. The shareholder’s computation must include “total income,” shown on Form 1040, page 1, line 9, plus cost of goods sold and any tax-exempt interest.

Example 7. Hangloose Corp. commenced business on March 29, 2024. It filed Form 1120-S for the short-year ended December 31, 2024. Hangloose did not file a timely Form 2553. Hangloose has 10 shareholders, one of whom is a Canadian citizen and resident.

Hangloose committed two offenses.

- The corporation did not file a timely Form 2553.
- The corporation has an ineligible shareholder.

Hangloose cannot use the simplified relief provision because of its ineligible shareholder. Instead, Hangloose must apply via a ruling request to the IRS National Office. Assuming Hangloose does not qualify for the reduced user fee, its fee to the IRS National Office is \$48,070, calculated as follows.

Offense #1	\$43,700
Offense #2	<u>4,370</u>
Total	\$48,070

Note. Unless Hangloose has a controller or treasurer with a license to practice before the IRS, (attorney, CPA, or EA) and experience in requesting rulings, the corporation must engage the services of an outside professional.¹⁴¹ The professional fees are likely to be at least as high as the IRS user fee.

As part of the ruling request, the corporation needs to indicate how the parties will pay the tax on any income allocated to the nonresident alien and specify how it corrected the ownership problem. Each shareholder must consent to the request and state that they have complied, and will comply, with the return reporting requirements for an S corporation shareholder.¹⁴²

Once the person preparing the request has compiled all the shareholder statements, and complied with the format and checklist, the preparer can file the document with the IRS National Office.¹⁴³

Along with the ruling request, there must be statements from all persons treated as shareholders for the entire period in question. This includes all persons treated as shareholders under community property or other joint ownership laws.

Example 8. Use the same facts as **Example 7**. On March 29, 2024, Larry, a California resident, becomes a shareholder. Larry and his wife, Maria, are going through a bitter divorce when Hangloose discovers its compliance problems. Maria must sign her affidavit as part of the request. This gives her considerable bargaining power with her husband and the other shareholders.

¹⁴⁰. Ibid.

¹⁴¹. See Circular 230, §10.3.

¹⁴². IRC §1362(f)(4).

¹⁴³. Rev. Proc. 2025-1, 2025-1 IRB 1.

LATE QSST AND ESBT ELECTIONS

Late QSST and ESBT elections are also subject to the same three year and 75 day period governing a late Form 2553. However, there are frequent letter rulings granting relief for trusts that miss this period.

Letter Ruling 202431011 addresses a situation where four trusts owned stock in two S corporations.¹⁴⁴ Later, the same trusts acquired stock in another corporation which elected S status. Still later, two more trusts acquired stock in the third corporation.

Subsequently, another trust acquired stock in one of the first corporations mentioned in the ruling. Thereafter, two of the trusts acquired stock in a fourth S corporation. Next, an individual who owned shares in the six corporations died. Some of the ownership of the decedent was through two grantor trusts. Shortly after death, the estate transferred stock in the various corporations to two more trusts. There were subsequent transfers of the stock of several of the corporations to and from the various trusts. The IRS ruled that the terminations were inadvertent. However, to receive the relief, each of the trusts needed to file elections. Eight were ESBT elections and two were QSST elections.

In 2024, there were at least 18 rulings where grantor trusts had held stock for more than two years after the grantor's death.¹⁴⁵ Considering the 2-year automatic qualification, and the three year and 75-day period during which a Service Center can grant relief, the implication is that the corporation applied for relief more than five years after the death of the former shareholder.

REMEDY CLASS OF STOCK VIOLATIONS¹⁴⁶

Rev. Proc. 2022-19 allows certain entities electing S status to remedy nonidentical governing provisions governing distributions. If the corporation has not yet made a nonconforming distribution, it may amend its operating agreement or bylaws without notifying the IRS. To qualify for this expedited relief, the corporation must meet the following qualifications.

- The corporation has consistently filed Form 1120-S and has not been more than six months delinquent for any taxable year.
- The IRS has not yet discovered the nonidentical provision.

Additionally, the nonidentical governing provision must be the sole cause of disqualification. In other words, there is no “double fault” relief.

Example 9. Whynot, LLC elects S corporation status starting on January 1, 2024. Whynot has only one owner, but it has a nonidentical governing provision requiring liquidating distributions to be in proportion to capital accounts. Whynot takes its books and records for 2024 to Gina Kelly, CPA. Gina asks for evidence of Form 2553, but Whynot has never filed the form.

Because Whynot did not file a timely Form 2553, the nonidentical governing provision is not the sole reason for disqualification. Therefore, Whynot is ineligible for relief under **Rev. Proc. 2022-19**.

Because the corporation does not comply with the single-class-of-stock rule, failure to file a timely Form 2553 is not the sole cause for disqualification. For this reason, Whynot does not meet the requirements of **Rev. Proc. 2013-30**.

Therefore, Whynot is not eligible for any automatic relief and can only apply for relief via a letter ruling.

¹⁴⁴. Ltr. Rul. 202431011 (Aug. 2, 2024).

¹⁴⁵. Ltr. Ruls. 202411001 (Mar. 15, 2024), 202412004 (Mar. 22, 2024), 202413006 (Mar. 29, 2024), 202416004 (Apr. 19, 2024), 202418008 (May 3, 2024), 202426010 (Jun. 28, 2024), 202429006 (Jul. 19, 2024), 202438003 (Sep. 20, 2024), 202438007 (Sep. 20, 2024), 202438008 (Sep. 20, 2024), 202438009 (Sep. 20, 2024), 202438010 (Sep. 20, 2024), 202438011 (Sep. 20, 2024), 202438012 (Sep. 20, 2024), 202444001 (Nov. 1, 2024), 202447011 (Nov. 22, 2024), 202448001 (Nov. 29, 2024), 202450002 (Dec. 13, 2024).

¹⁴⁶. Rev. Proc. 2022-19, 2022-41 IRB 282.

OWNERSHIP OF SUBSIDIARIES

Although a business entity cannot own shares in an S corporation,¹⁴⁷ an S corporation may own complete or fractional interests in other business entities (except for other S corporations). For example, several major professional franchises are limited partnerships that have an S corporation as the general partner. S corporations may also own stock in corporations.

If an S corporation owns less than 100% of a subsidiary corporation, the subsidiary must be a C corporation. However, a special rule allows an S corporation that owns 100% of the stock of a domestic corporation to treat the subsidiary as a special type of disregarded entity, known as a QSub.¹⁴⁸ For most tax purposes, a QSub is equivalent to an SMLLC, which is also a disregarded entity.

A parent S corporation with one or more QSub corporations provides a way to preserve separate entity status for nontax purposes, and yet be a single entity for purposes of income tax.

Example 10. Ace Corporation is a bank holding company. Under banking laws, a bank holding company cannot conduct any banking business and a bank cannot own any stock in another bank.¹⁴⁹ None of the banks uses the reserve method of accounting. Thus, they would be eligible to be S corporations if they were stand-alone entities.

Ace would like to treat the entire group as a single S corporation for tax purposes. It may accomplish this goal by electing S corporation status for itself and filing a QSub election for each of its wholly owned banks.

The deadline for the QSub election is two months and 15 days after the parent corporation wants the status to start. If the corporation owns 100% of the stock before it intends QSub status, it may file the election up to one year early.¹⁵⁰

CONTRIBUTION OF PROPERTY TO A CORPORATION

When property is contributed to a corporation in exchange for stock, it is considered an exchange. Generally, such exchanges are taxable events. Taxpayers must determine the FMV of the property received and the adjusted basis of the property given up. The difference is gain or loss realized on the exchange.¹⁵¹ Unless an exception applies to a particular transaction, the gain or loss realized is also recognized and must be reported on the tax return of each party to the exchange.¹⁵² Understanding the tax implications is crucial when establishing an S corporation, as it affects the initial financial structure and tax obligations of the business. However, an S corporation does not recognize any gain when dealing in its own stock.¹⁵³ Therefore, the potential tax burden of an exchange of property for stock falls solely on the shareholder.

¹⁴⁷. Partnerships and C corporations are not eligible shareholders, because they are not included in the list of eligible shareholders listed in IRC §1361(b)(1)(B).

¹⁴⁸. IRC §1361(b)(3).

¹⁴⁹. 12 USC §1843.

¹⁵⁰. Treas. Reg. §1.1361-3(a)(4).

¹⁵¹. IRC §1001(a) and Treas. Reg. §1.1001-1(a).

¹⁵². IRC §1001(c).

¹⁵³. IRC §1032.

TAX DEFERRAL BY REASON OF IRC §351

IRC §351 provides an exception to the immediate taxation of a shareholder when exchanging property for stock in a corporation. The general tax policy behind this exception is that there is a change in form, rather than substance, of the shareholder's contribution. Therefore, the gain or loss realized (difference between the FMV of the stock received and the adjusted basis of the property contributed) is not generally subject to immediate taxation. The general rule for transfer of property to a corporation is found in §351. These rules apply equally to C corporations and S corporations.¹⁵⁴

The tax deferral, as opposed to permanent exclusions, results from two companion provisions governing basis.

1. The shareholder's basis in the stock received is generally the same as was the basis in the contributed property.¹⁵⁵
2. The corporation's basis in the property received is generally the basis of the contributing shareholder.¹⁵⁶

Example 11. Jeanne Engel forms a corporation for her new business venture, Pals, Inc. Pals is a neighborhood restaurant and bar. Jeanne contributes appreciated art and other décor items to the corporation. The value of the art and décor is \$300,000 and the basis is \$100,000. She has never claimed depreciation on the décor. All the excess FMV is attributable to appreciation in the art and collectibles marketplace. Sam Taylor will be an equal shareholder and is contributing \$300,000 in cash.

Jeanne **realizes** \$200,000 of gain (\$300,000 FMV – \$100,000 basis). However, under §351, Jeanne **recognizes** no gain. The corporation recognizes no gain or loss on the transfer. The corporation's tax basis in the property is the same as Jeanne's tax basis prior to the transfer.

Asset	Jeanne Basis	Jeanne FMV	Sam Basis	Sam FMV	Pals, Inc. Basis	Pals, Inc. FMV
Property	\$100,000	\$300,000			\$100,000	\$300,000
Cash			\$300,000	\$300,000	300,000	300,000
Total	\$100,000	\$300,000	\$300,000	\$300,000	\$400,000	\$600,000

CONTROL IMMEDIATELY AFTER THE EXCHANGE

For nonrecognition treatment after the transfer of property under §351, the transferor shareholder(s) must own:¹⁵⁷

- Stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote, and
- At least 80% of the total number of shares of all other classes of stock.

Both components of the previous test are generally referred to as “the 80% control test.” To meet the second part of this control test, the transferor must own at least 80% of the total number of shares of **each** class.¹⁵⁸

The length of time the shareholders must retain control after the transaction is not specified. It seems that if the shareholders are reasonably diligent in executing an integrated plan with continuity of interest in the overall transaction and the transaction represents a mere change in form, only a minimal time frame (perhaps only a moment) suffices.¹⁵⁹

¹⁵⁴. IRC §1371(a).

¹⁵⁵. IRC §351(a)(1).

¹⁵⁶. IRC §362(a).

¹⁵⁷. IRC §368(c).

¹⁵⁸. Rev. Rul. 59-259, 1959-2 CB 115.

¹⁵⁹. Two early cases involving issues about the length of time of control are *American Bantam Car Co. v. Comm'r*, 11 TC 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S., 920 (1950), and *Intermountain Lumber Co. v. Comm'r*, 65 TC 1025 (1976).

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Example 12. In 2024, Tom and Richard formed a taxable corporation, each contributing business property valued at \$20,000. Under §351, neither recognized any gain or loss on the transfer, regardless of their individual basis.

A year later, in 2025, Harold contributes \$20,000 of business property in exchange for a one-third voting/ownership interest. Harold does not qualify for the nonrecognition rules of §351 because he does not own at least 80% of the voting power immediately after the exchange.

EFFECTS OF BOOT

Most §351 exchanges are not straightforward. They often involve some other transfers, including liabilities. In general, when a contributor receives property other than stock, the cash or other property is termed “boot received.”

Any gain realized by a transferor, in an otherwise qualified §351 exchange, must be recognized to the extent of boot received. The gain is characterized by reference to the character of the assets transferred, taking into account the impact of the depreciation recapture provisions. No loss may be recognized.¹⁶⁰

IRC §358(a) determines the basis of the stock received by the transferor. It states that the basis of the property received is:

- Basis of the property transferred,
- Decreased by the FMV of any other property and the amount of money received by the transferor (shareholder), and
- Increased by the gain recognized by the transferor.

Example 13. Use the same facts as **Example 11**, except Jeanne receives stock with an FMV of \$250,000 and cash of \$50,000 in exchange for her contribution of the art and décor. Sam contributes \$250,000. Pals uses \$50,000 of Sam’s contribution to transfer the cash to Jeanne. The contribution of the asset still qualifies under §351, but Jeanne must recognize gain to the extent of the boot received, or \$50,000.

Asset	Jeanne Basis	Jeanne FMV	Sam Basis	Sam FMV	Pals, Inc. Basis	Pals, Inc. FMV
Property	\$100,000	\$300,000			\$100,000	\$300,000
Cash contributed			\$250,000	\$250,000	250,000	250,000
Cash received		(50,000)				(50,000)
Total	\$100,000	\$250,000	\$250,000	\$250,000	\$350,000	\$500,000

¹⁶⁰. IRC §351(b).

Character of the Gain¹⁶¹

The gain recognized by the shareholder depends on the nature of the assets being transferred to the corporation and any boot received. For example, if the shareholder transfers a capital asset to the corporation in exchange for stock and boot, any gain recognized must be capital gain. Depreciated personal property is subject to depreciation recapture, and will result in ordinary income to the transferor. IRC §1231 gain, as well as any gain on intangible assets warrants special scrutiny.

- If the transferring shareholder does not own more than 50% of the corporation at the time of the transfer, the character of the gain is not subject to any special rules.
- However, if the shareholder owns more than 50% of the outstanding shares, IRC §1239 characterizes all gain as **ordinary income**, if the transferee (receiving corporation) is able to depreciate the property. Intangibles may create a special trap, because the amortization allowable by IRC §179 is treated as depreciation. For this relationship, the shareholder must consider all stock treated as indirectly owned via the operation of IRC §267. An individual is treated as owner of stock held by family members and entities such as trusts, partnerships, and corporations.

Note. Although the material primarily addresses gains recognized by shareholders during asset transfers to a corporation, the rules regarding boot still apply. Boot received in such exchanges is taxable and must be considered when determining the character of the gain.

Example 14. Use the same facts as **Example 13**. Pals, Inc. treats the items that Jeanne transfers as depreciable capital assets. Because she receives \$50,000 cash in the exchange and does not own more than 50% of Pals's outstanding shares, Jeanne recognizes \$50,000 capital gain.

Example 15. Use the same facts as **Example 14**, except that Jeanne and Sam are sister and brother. Because the assets are depreciable to Pals, Jeanne recognizes ordinary income of \$50,000.

Timing of the Gain¹⁶²

When the boot is in the form of cash or most other assets, the transferor recognizes gain immediately upon receipt of the boot.¹⁶³ However, if the boot is in the form of a corporate note, the transfer may qualify for the installment method.

The note will **not** qualify for the installment method if:¹⁶⁴

1. The note is tradeable on an established market or payable on demand.
2. The property transferred by the shareholder was held by the shareholder for sale in the ordinary course of a trade or business, such as inventory or other dealer sales.¹⁶⁵
3. The property transferred by the shareholder is depreciable to the corporation and the shareholder owns more than 50% of the stock of the corporation.
4. The note is attributable to depreciation recapture.
5. The property transferred is marketable stock or securities.

Otherwise, if the agreement provides that any of the principal payments are due after the year of sale, there is an installment sale.¹⁶⁶

¹⁶¹ Treas. Reg. §1.351-1(a)(1).

¹⁶² Treas. Reg. §1.453-11(a)(1).

¹⁶³ IRC §351(b).

¹⁶⁴ IRC §453.

¹⁶⁵ With limited exceptions for farm property, timeshares, and residential lots.

¹⁶⁶ IRC §453(b)(1).

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ASSUMPTION OF LIABILITIES

Many corporate formations involve the transfer of encumbered property or the assumption of liabilities by the transferee corporation. Normally, when a taxpayer is relieved of indebtedness related to the disposition of property, the debt relief amount is realized income for the taxpayer, even if it is nonrecourse debt. However, a different rule applies in the context of a corporate formation.

Liabilities Not Treated as Boot

Under IRC §357(a), the assumption of a liability by a transferee corporation in a tax-free §351 exchange does not constitute boot and does not prevent the exchange from qualifying under §351. Instead, what otherwise would be recognized gain attributable to the transferred liabilities is postponed under §358(d). Under that provision, the basis of stock received in the exchange is reduced by treating the relieved liabilities as money received by the transferor for purposes of determining the shareholder's basis.

Example 16. Floyd Bates incorporates his auto repair business as Floyd the Fixer, Inc. He contributes inventory worth \$60,000, equipment worth \$400,000, and cash of \$40,000 for a total value of \$500,000. The equipment is subject to liabilities of \$80,000. Assume that all the debts being transferred were originally taken out to finance the purchase of the equipment and inventory. His basis in the inventory is \$55,000 and his basis in the equipment is \$75,000. Under the general rule of §357(a), he calculates the following tax consequences of the transfer.

Asset	Floyd Basis	Floyd FMV	Floyd the Fixer, Inc. Basis	Floyd the Fixer, Inc. FMV
Cash	\$ 40,000	\$ 40,000	\$ 40,000	\$ 40,000
Inventory	55,000	60,000	55,000	60,000
Equipment	75,000	400,000	75,000	400,000
Total property contributed	\$170,000	\$500,000	\$170,000	\$500,000
Less: liabilities assumed by corporation	(80,000)	(80,000)	(80,000)	(80,000)
Total	\$ 90,000	\$420,000	\$ 90,000	\$420,000

Liabilities Treated as Boot

If a transferor exchanges several assets in exchange for stock and boot, the boot must be allocated among the transferred assets, in relationship to the relative FMV. Similarly, allocations are required to determine the basis of the assets in the hands of the corporation. The gain attributable to a specific asset and the basis adjustment for the corporation are:¹⁶⁷

$$\text{Basis adjustment to each asset} = \frac{\text{FMV of specific asset}}{\text{FMV of all assets transferred}} \times \text{Gain recognized}$$

There are two exceptions to §357(a).

1. IRC §357(b) sets forth a tax avoidance exception.
2. IRC §357(c) provides that any excess transferred liabilities over the aggregate basis of property contributed is treated as boot.

¹⁶⁷ Rev. Rul. 68-55, 1968-1 CB 140.

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IRC §357(b). The assumption of a liability is treated as boot if the taxpayer's principal purpose in transferring the liability was the avoidance of federal taxes or was not for a bona fide business purpose. If any portion of the transferred liability is disqualified under §357(b), then all the liabilities from that shareholder are treated as boot.

Example 17. Use the same facts as **Example 16**, except that Floyd incurred \$3,000 of the liabilities for personal purposes. Transferring the \$3,000 along with the business liabilities causes all the transferred liabilities to be treated as boot.

The consequences are shown in the following table.

Asset	Floyd Basis	Floyd FMV	Floyd the Fixer, Inc. Basis	Floyd the Fixer, Inc. FMV
Cash	\$ 40,000	\$ 40,000	\$ 40,000	\$ 40,000
Inventory	55,000	60,000	55,000	60,000
Adjustment for gain ^a			10,435	
Equipment	75,000	400,000	75,000	400,000
Adjustment for gain ^b			69,565	
Total property contributed	\$170,000	\$500,000	\$250,000	\$500,000
Less: liabilities assumed by corporation	(80,000)	(80,000)	(80,000)	(80,000)
Gain (boot) recognized	80,000	80,000		
Total	\$170,000	\$500,000	\$170,000	\$420,000

^aBasis adjustment to inventory, following the formula prescribed in Rev. Rul. 68-55.

$$\begin{aligned}
 \text{Basis adjustment} &= \frac{\text{FMV Inventory}}{\text{FMV (Inventory + Equipment)}} \times \text{Gain recognized} \\
 &= \frac{\$60,000}{(\$60,000 + \$400,000)} \times \$80,000 \\
 &= \$10,435
 \end{aligned}$$

^bBasis adjustment to equipment, following the formula prescribed in Rev. Rul. 68-55.

$$\begin{aligned}
 \text{Basis adjustment} &= \frac{\text{FMV Equipment}}{\text{FMV (Inventory + Equipment)}} \times \text{Gain recognized} \\
 &= \frac{\$400,000}{(\$60,000 + \$400,000)} \times \$80,000 \\
 &= \$69,565
 \end{aligned}$$

IRC §357(c). IRC §357(c) provides that if the sum of the liabilities assumed by the corporation exceed the aggregate adjusted bases of the properties transferred by a particular transferor, the excess is treated as gain from the sale or exchange of the property.

For this purpose, assumed liabilities do not include any obligation that would give rise to a deduction if paid for by the transferor.¹⁶⁸ In most instances, this is an important exception. This exception allows cash method taxpayers to incorporate without immediate recognition of cash method receivables.

¹⁶⁸ IRC §357(c)(3).

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Example 18. Lisa transfers the following assets to Elemeno Pea, Inc., a newly formed corporation, in exchange for 1,000 shares of stock.

Asset	FMV	Adjusted Basis	Liabilities	Gain Recognized (\$357(c))
Equipment	\$300,000	\$100,000	\$150,000	\$50,000
Inventory	100,000	40,000	50,000	10,000
Total	\$400,000	\$140,000	\$200,000	\$60,000

Because the liabilities assumed by Elemeno (\$200,000) exceed the adjusted basis of the property transferred (\$140,000), Lisa recognizes \$60,000 as gain.

SHAREHOLDER BASIS

Accounting for shareholder stock and debt basis is crucial. Shareholder basis represents the amount of a shareholder's investment in the corporation for tax purposes. Basis is an important and often misunderstood factor for deduction of losses, receipt of tax-free distributions, and measurement of gains or losses on the sale of their stock. Proper record keeping is essential to substantiate basis, which aids shareholders in appropriately reporting their basis on their tax returns.

Initial stock basis is computed based on how the shareholder acquired their stock. Shareholders must also compute any debt basis and basis adjustments. A shareholder who disposes of their investment is responsible for the proper reporting of any associated gain or loss.

RECORDKEEPING

A shareholder is required to maintain adequate books and records to substantiate their basis.¹⁶⁹ The burden of proof is on the shareholder to demonstrate adequate basis for claiming losses.¹⁷⁰ The IRS has succeeded in imposing penalties for failure to maintain books and records.¹⁷¹

Instances in which a shareholder needs to use their basis include the following.

- When determining whether a current year and/or prior year loss is deductible to the shareholder when preparing their individual return.¹⁷²
- When determining the tax implications of a distribution to the shareholder.¹⁷³
- When determining any gain or loss to the shareholder when all or part of their interest in the S corporation is disposed of in a sale or gift.¹⁷⁴

¹⁶⁹. Treas. Reg. §1.6001-1(a).

¹⁷⁰. *Welch v. Comm'r*, TC Memo 2012-179 (Jun. 28, 2012).

¹⁷¹. See *Riggins v. Comm'r*, TC Summ. Op. 2010-99 (Jul. 26, 2010), for a negligence penalty imposed due to a failure to keep books and records.

¹⁷². IRC §1366(d).

¹⁷³. IRC §§1368(b)(1) and 1368(c)(1).

¹⁷⁴. IRC §§1001(a) and 1015.

A tax practitioner cannot solely rely on a Schedule K-1 (Form 1120-S) from the S corporation for all the necessary information to compute basis for a shareholder-client. The Schedule K-1 includes only income and loss incurred by the corporation and allocated to the shareholder. It does not include:

- Initial basis for a new shareholder or new block of stock;
- Carryforwards of suspended losses from prior years (found on previous year's Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*);
- Contributions to capital; and
- Certain externally generated basis adjustments, such as related party stock redemptions, reductions of basis caused by excluded cancellation of debt income of the shareholder, etc.

Note. There are different rules for computing basis for alternative minimum tax (AMT) purposes which are not discussed in this chapter. In addition, state law may require additional computations.

BASIS REPORTING ON SHAREHOLDER TAX RETURN

The IRS instructs S corporation shareholders to submit basis calculations with their tax returns in certain situations. Beginning with the 2018 tax returns, there is a separate box to check on Schedule E (Form 1040), *Supplemental Income and Loss*, if basis reporting is required.¹⁷⁵ This computation is necessary whenever a taxpayer who owns an interest in an S corporation reports a loss, receives a distribution, disposes of stock, or receives a loan repayment from the S corporation.¹⁷⁶

In 2021, the IRS released Form 7203. This form is required for S corporation shareholders beginning with the 2021 tax returns. Shareholders use Form 7203 to determine any potential limitations on their share of the S corporation's deductions, credits, and other items that can be deducted on their tax return. S corporation shareholders must file Form 7203 if they are claiming a deduction for their share of an aggregate loss from an S corporation (including any aggregate loss not allowed last year due to basis limitations), received a nondividend distribution from an S corporation, disposed of stock in an S corporation (regardless of whether a gain is recognized), or received a loan repayment from an S corporation. Shareholders should consider completing Form 7203 even in years when it is not required to be filed, as this helps ensure their bases are consistently maintained over time.

INITIAL STOCK BASIS

Except for stock received from a decedent, subchapter S contains no special rules for the determination of initial basis. Moreover, except for contributions to a corporation under §351 and related statutes, a shareholder's initial basis has no resemblance to any of the corporation's balance sheet accounts such as common stock, accumulated adjustments account (AAA), or other equity accounts. This section explores the establishment of stock basis through several methods of exchange.

Formation

The beginning stock basis consists of the basis of property contributed to the corporation, plus any gain recognized by the contributor, minus any boot received.¹⁷⁷ The shareholder reduces basis for any debt assumed or taken by the corporation.

¹⁷⁵. Schedule E, line 28, box e (2024).

¹⁷⁶. Schedule E, part II, first paragraph.

¹⁷⁷. IRC §358.

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Contributions to Capital

A shareholder's contribution of money or property to a corporation is not income to the corporation.¹⁷⁸ Additional contributions to capital after the shareholder owns stock increase the shareholder's stock basis.¹⁷⁹ However, if a shareholder makes a disproportionately large contribution to capital, it may be a gift to the other shareholders.¹⁸⁰

Example 19. Phil owns one-third of the stock of Harco, Inc., an S corporation. Phil holds a note from Harco with a face amount and tax basis of \$300,000. Phil's children, Seth and Rachel, own the remaining shares in equal portions. Phil contributes the note to Harco. This is an indirect gift of \$100,000 to each of his children. Thus, Phil increases his basis in Harco stock by \$100,000. Seth and Rachel each realize an equivalent basis increase.

There have been cases where certain persons or entities other than shareholders have contributed to the capital of a business entity. For example, in *Saline Sewer Co. v. Comm'r*, a corporation received fees from future customers to enable construction of a sewer system.¹⁸¹ Before December 22, 2017, some of these fees were excludable from the gross income of the recipient.¹⁸² After 2017, a contribution by a nonshareholder is gross income to the corporation.¹⁸³ Thus, property or cash offered by a municipality or business league to a business for the purpose of locating operations and creating jobs must be gross income to the recipient.

Purchased Stock

If stock is purchased from a shareholder, the beginning basis is the price paid for the shares.¹⁸⁴ If the shareholder acquires blocks in different transactions, they must track basis for each block of stock separately.¹⁸⁵

Stock Acquired by Gift

The beginning basis of stock received from a donor is the basis of the stock in the hands of the donor.¹⁸⁶ The basis is increased by the amount of any gift tax paid by the donor on the excess (if any) of the FMV of the stock over the donor's basis.¹⁸⁷ However, a gift of property with a FMV less than the donor's basis is subject to the following **dual basis rule**.

- If the stock's FMV is greater than the donor's original cost basis, the donee's basis is the same as the donor's basis.
- If the stock's FMV is less than the donor's original cost, the donee's basis is the FMV on the date of the gift.¹⁸⁸ This reduced basis also applies to limit deduction of losses passing through from the corporation to the shareholder.¹⁸⁹

¹⁷⁸. IRC §118(a).

¹⁷⁹. Treas. Reg. §1.118-1.

¹⁸⁰. Treas. Reg. §25.2511-1(h)(1).

¹⁸¹. *Saline Sewer Co. v. Comm'r*, TC Memo 1992-236 (Apr. 21, 1992).

¹⁸². IRC §118(b), before amendment by the *Tax Cuts and Jobs Act of 2017*.

¹⁸³. IRC §118(b).

¹⁸⁴. IRC §1012.

¹⁸⁵. Treas. Regs. §§1.1367-1(b)(2), 1.1367-1(c)(3), and 1.1367-1(h).

¹⁸⁶. IRC §1015(a).

¹⁸⁷. IRC §1015(d)(6). For gifts made before 1977, the gift tax increase is the amount attributable to the FMV of the gift.

¹⁸⁸. IRC §1015(a).

¹⁸⁹. Treas. Reg. §1.1366-2(a)(7).

Stock Acquired from a Spouse or Former Spouse

There is no gain or loss recognized on the transfer of property between spouses.¹⁹⁰ The same rule applies to transfers between former spouses, but only if the transfer is incident to a divorce.¹⁹¹ Any property transferred between spouses, or between former spouses, retains its basis.¹⁹²

Example 20. Joseph and Sally were divorced in 2020. As part of the settlement, the court awarded Sally stock in Picco, Inc., an S corporation. Joseph and Sally lived in a separate property state, and Joseph was the shareholder of record. The stock was worth \$100,000, but Joseph's basis was zero. Sally's basis in the Picco stock is Joseph's basis of zero.

Stock Acquired by Inheritance

The beneficiary's beginning basis is generally the FMV of the stock in the deceased shareholder's estate.¹⁹³ However, if the corporation uses the cash method of accounting, or has any unrecognized gain from installment sales, a special rule applies. Cash method receivables (net of cash method payables) and unreported installment gains would be income in respect of a decedent (IRD).¹⁹⁴ IRD items have zero basis. Subchapter S provides that a shareholder must reduce basis of stock by the allocable portion of the corporation's items that would be IRD if the individual shareholder held them directly.¹⁹⁵

Note. In 2010, there was a rule that allowed estates to elect out of the estate tax. Any property transferred via one of these electing estates was subject to a carryover basis rule.¹⁹⁶ If the estate did not elect out of the estate tax, the basis to the successor was the prior, and current, FMV rule, with the exception for IRD. If a current shareholder received stock from a decedent in 2010, it may be necessary to examine records of the decedent's estate to determine the current owner's basis.

Unlike a partnership where the underlying property can receive a step up in basis,¹⁹⁷ in the S corporation, only the stock receives a step up in basis.

Receipt of Stock in a Tax-Free Reorganization

In a tax-free reorganization, the basis of stock received generally carries over from the stock exchanged. The shareholder's basis in the new stock is generally the same as their basis in the old stock.¹⁹⁸ Generally, shareholders do not recognize any gain or loss if the stock is exchanged in a tax-free reorganization. There are limitations for excess principal amounts, accrued interest, and nonqualified preferred stock.¹⁹⁹

Example 21. Teresa was a shareholder in Dakota Corporation, an S corporation. Dakota merged into Alaska Corporation, also an S corporation, in a tax-free reorganization.²⁰⁰ At the time of the merger, Teresa's basis in her Dakota stock (including any adjustments to basis for the portion of the year up to the date of the exchange) was \$650,000. She receives stock in Alaska worth \$3 million. She recognizes no gain on the exchange. Her initial basis in her Alaska stock is \$650,000.

¹⁹⁰. IRC §1041(a)(1).

¹⁹¹. IRC §1041(a)(2).

¹⁹². IRC §1041(b).

¹⁹³. IRC §1014(a).

¹⁹⁴. IRC §691(a).

¹⁹⁵. IRC §1367(b)(4).

¹⁹⁶. IRC §1022 (repealed, but in effect for property initially subject to its rules).

¹⁹⁷. IRC §754.

¹⁹⁸. IRC §358(a).

¹⁹⁹. IRC §354.

²⁰⁰. IRC §368(a)(1)(A).

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Transfer of Shareholder Attributes: Suspended Losses

When a shareholder's portion of an S corporation's losses for a year exceeds their basis in stock or debt, the shareholder must carry forward the excess portion of each category of loss.²⁰¹ Generally, if a shareholder transfers less than all of their shares, the entire suspended loss remains with the shareholder.²⁰² In contrast, if a shareholder transfers their entire stock holdings in the S corporation, the general rule is that the new owner does not acquire any losses that the prior shareholder had been unable to deduct.²⁰³ Because there is no opportunity for the former shareholder to increase basis, the prior losses in excess of basis will yield no tax benefits.

However, there are two exceptions.²⁰⁴

1. If the transfer is to a spouse or incident to a divorce, then the new owner receives all the suspended losses from the spouse or former spouse.
2. If the shareholder receives stock in a tax-free reorganization, any suspended losses from the relinquished stock survive as attributes of the stock received.

DEBT BASIS

In addition to stock basis, a shareholder may also have **debt basis**. Debt basis reflects the portion of the shareholder's investment in the form of loans made to the S corporation. Debt basis does not include any bank or third-party debt.²⁰⁵

Generally, only bona fide direct debt constituting an actual economic outlay by the shareholder provides debt basis to the shareholder.²⁰⁶ Indirect debt (guarantees, sureties, or acting as a cosigner), **does not provide debt basis**.²⁰⁷ However, if the shareholder is called upon to pay some or all the debt²⁰⁸ or issue a note²⁰⁹ to the lender, the amount actually paid increases the shareholder's basis in the corporation.²¹⁰ In this situation, basis becomes available in the year in which the payment, note, or other satisfaction of the guarantee or surety is made. It does not "relate back" to the year the guaranty or surety was created.²¹¹

Note. Debt basis calculations are more critical when there is an increased likelihood of losses caused by claiming large expenses such as bonus depreciation. In some cases, the shareholders may be better served if the corporation forgoes the early deduction.

Unlike a partnership in which a partner's basis for loss deductions includes their share of the partnership loans,²¹² a shareholder in an S corporation can only include debt basis for loans personally made to the corporation. The Code uses the phrase, "basis of indebtedness from the corporation to the shareholder."²¹³

²⁰¹ IRC §1366(d)(2)(A).

²⁰² Treas. Reg. §1.1361-2(a)(6)(i).

²⁰³ Ibid.

²⁰⁴ Treas. Reg. §1.1366-2.

²⁰⁵ Treas. Reg. §1.1366-2(a)(2).

²⁰⁶ Treas. Reg. §1.1366-2(a)(2)(i), *D.L. Russell et al. v. Comm'r*; TC Memo 2008-46 (Oct. 30, 2008).

²⁰⁷ *William H. Perry v. Comm'r*; 47 TC 159 (1966), *aff'd* 392 F2d 458 (1968).

²⁰⁸ Treas. Reg. §1.1366-2(a)(2)(ii), Rev. Rul. 70-50, 1970-1 CB 178.

²⁰⁹ Rev. Rul. 75-144, 1975-1 CB 277, amplifying Rev. Rul. 70-50, 1970-1 CB 178.

²¹⁰ Treas. Reg. §1.1366-2(a)(2)(iii), Example 4.

²¹¹ Rev. Rul. 71-288, 1971-2 CB 319, clarifying Rev. Rul. 70-50.

²¹² IRC §752(a).

²¹³ IRC §1366(d)(1)(B).

Failure to understand the differences between S corporations and partnerships has led to significant litigation regarding subchapter S issues. The IRS has prevailed in the majority of the cases, although there have been a few shareholder victories. Several notable cases illustrate the complexities and challenges faced by shareholders and the IRS in these disputes, particularly involving debts to shareholders, guarantees of corporate obligations by shareholders, and payments on those guarantees, substitution of a borrower, and initial debt basis.

Debt to the Shareholder

According to the IRS, guarantee of an S corporation's debt does not create shareholder debt basis. The often-cited case of *Raynor v. Comm'r*, states: "No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay all or a part of the obligation."²¹⁴

Current regulations provide a 2-part test to determine the validity of a shareholder's debt basis in an S corporation.²¹⁵

1. **Bona fide indebtedness.** There must be a genuine debt between the corporation and the shareholder.
2. **Basis in the loan.** The shareholder must have basis in the loan, meaning they must have invested money or assets into the corporation through the loan.

Note. The first criterion, that the debt must run directly to the shareholder, prohibits the shareholder from claiming any basis in a loan made by another person, such as a family member, or another entity owned by the same shareholder.

Example 22. George owns 100% of the stock of Craneco, Inc., an S corporation. George's father, Scott, loans \$50,000 to Craneco. The loan from Scott does not create basis for George. Scott has basis in the loan, but he is not a shareholder. Therefore, neither Scott nor George can use this loan to deduct any losses passing through from Craneco.

However, if the lender is a disregarded entity owned by the S corporation shareholder, the shareholder may claim debt basis.²¹⁶

Example 23. Caroline is a shareholder in Kajico, Inc., an S corporation. She is also the sole owner of CAS, LLC, a disregarded entity. On December 4, 2024, CAS loans \$100,000 in cash to Kajico. Because the loan was made in cash, CAS has \$100,000 basis in the loan. There is a clear preponderance of evidence that the loan is bona fide indebtedness. Because CAS is a disregarded entity, the loan is treated as if it were made directly by Caroline. Accordingly, she has \$100,000 debt basis in Kajico as a result of this loan.

Moreover, debt basis does not include any loan made by the shareholder to another entity, unless there is a formal assumption by the S corporation so that the S corporation has a legal obligation running directly to the shareholder.²¹⁷

Example 24. Chester is a majority shareholder in Artco Corp., and Bioco Corp., both of which are S corporations. The corporations are in similar business lines and deal with each other frequently. In 2023, Chester loaned \$100,000 to Artco. The loan was evidenced by a note and was valid under local law. In 2024, Bioco acquired property from Artco. As part of the consideration, Bioco agreed to pay all the outstanding principal and interest on the \$100,000 loan from Chester. At the end of 2024, Bioco had not entered into a formal assumption agreement with Chester. The current arrangement does not give Chester debt basis in Bioco.

²¹⁴ *Raynor v. Comm'r*, 50 TC 762 (1968).

²¹⁵ Treas. Reg. §1.1366-2(a)(2)(i).

²¹⁶ Treas. Reg. §1.1366-2(a)(2)(iii), Example 1.

²¹⁷ *Hitchins v. Comm'r*, 103 TC 711, 719-720 (1994).

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Guarantees of Corporate Obligations

The guarantee of a loan does not create basis to the shareholder.²¹⁸ History is replete with cases in which the shareholder attempted to claim basis for guarantees, and the IRS disallowed loss deductions.²¹⁹ Almost invariably the Tax Court, District Courts, and Appellate Courts have sided with the IRS.

Note. There is one outlier. In *Selfe v. U.S.*, the Eleventh Circuit Court of Appeals allowed a shareholder to claim basis for a debt that was taken by a corporation in a §351 transfer.²²⁰ Other circuits have come to the opposite conclusion.

Payment on a Guarantee

Treas. Reg. §1.1366-2(a)(2)(ii) explains the treatment of guarantees and payments thereon. Specifically, it states that a shareholder does not obtain basis in the S corporation's indebtedness merely by **guaranteeing** a loan or acting as a surety, accommodation party, or in any similar capacity. However, when a shareholder makes a **payment** on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, the shareholder may increase their basis of indebtedness to the extent of that payment.

This regulation ensures that shareholders can only increase their basis in the corporation's debt when they actually make payments on the guaranteed debt, rather than simply by providing a guarantee. This distinction is crucial for determining the allowable deductions for losses and other passthrough items from the S corporation.

Example 25. Allen is the sole shareholder of Bocco, Inc., an S corporation. In 2024, Allen guarantees a \$100,000 loan made by a bank to Bocco. In 2025, Bocco is unable to make payments, and Allen pays \$20,000 on Bocco's behalf from his personal funds. Allen does not receive basis when he guarantees the loan, but he does receive \$20,000 basis in Bocco for the 2025 payment on Bocco's obligation.

Substitution of Borrower

For 50 years, the IRS has provided a remedy for a shareholder who guarantees a loan to the corporation and wants to create debt basis. Rev. Rul. 75-144 honors the substance of a transaction when a shareholder guarantees the loan and substitutes himself as the debtor. The Rev. Rul. states that when the parties take this action, the doctrine of **subrogation** treats the former guarantor as the creditor.²²¹ However, the state law doctrine of subrogation may vary by jurisdiction. The Tax Court has held that the substitution is sufficient regardless of state law.²²²

Debt Basis Before Adjustments

Often the initial basis is the amount loaned by the corporation to the shareholder. However, there are some exceptions.

- The holder may have received the debt via purchase, gift, spousal transfer, inheritance, or in a tax-free reorganization;²²³ and
- If the loan has no substance, the IRS and courts may disallow the basis.

²¹⁸ Treas. Reg. §1.1366-2(a)(2).

²¹⁹ *Hargis v. Comm'r*, TC Memo 2016-232 (Dec. 21, 2016).

²²⁰ *Selfe v. U.S.*, 778 F.2d 769 (11th Cir. 1985).

²²¹ Rev. Rul. 75-144, 1975-1 CB 277.

²²² *Gilday v. Comm'r*, TC Memo 1982-242 (May 3, 1982).

²²³ IRC §354(a)(1).

For example, the case of *Oren v. Comm'r* involved Mr. Oren who owned all the stock in several S corporations. One of the corporations was profitable, and Mr. Oren had ample stock basis. Two of the others were not profitable, and Mr. Oren lacked sufficient basis to deduct losses. He and his corporations engaged in several transactions, all of which had the same fact pattern.²²⁴

- Mr. Oren wrote a note to the profitable corporation.
- On the same day, the unprofitable corporation wrote a note to Mr. Oren for the same amount of his note to the profitable corporation.
- On the same day, the profitable corporation wrote a note to the unprofitable corporation for the same amount of the note to Mr. Oren.

The IRS termed this series of actions a **circular transaction**. The Tax Court and Eighth Circuit agreed that the entire paper shuffling exercise lacked substance. Therefore Mr. Oren had no debt basis.

Note. The *Oren* case illustrates the second principal of the IRS regulation governing debt basis. Even though there may have been a bona fide debt running directly from the unprofitable corporation to the shareholder, the shareholder lacked **basis**, under general tax principles, for the purported loan.

ADVANTAGES AND DISADVANTAGES OF S CORPORATIONS

The table on the following pages provides a framework for analysis of the advantages and disadvantages of S corporations compared to other entity options.

Note. This extensive table appeared in the 2023 edition of “S Corporations,” Chapter 12 of James W. Pratt and William N. Kulsrud, *Corporate, Partnership, Estate and Gift Taxation*, (Cincinnati, OH, Van-Griner Publishing). It is reprinted with permission.

²²⁴. *Oren v. Comm'r*, TC Memo 2002-172 (Jul. 19, 2002), *aff’d* *Oren v. Comm'r*, 357 F.3d 854 (8th Cir. 2004).

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Items for Comparison	Proprietorship/Proprietor	Partnership/Partner	S Corporation/Shareholder	C Corporation/Shareholder
1. What are the restrictions on the number of owners or who may be an owner?	One owner who must be an individual	None, except there must be at least two owners	No more than 100 shareholders who must be individuals, estates, certain trusts, charities, pensions, and ESOPs	None
2. Are owners liable for business debts that they have not personally guaranteed?	Yes, except if single-member LLC	Yes, for general partners but no for limited partners or partners in an LLP, LLC members	No	No
3. What are the appropriate tax forms and schedules and who files them?	Schedules C, SE, and all supporting schedules and forms	Form 1065 and Schedules K-1 are prepared by partnership; partners report on Schedules E, SE, and other supporting schedules	Form 1120S and its Schedules K-1 are prepared by corporation; shareholders report on Schedule E and other supporting schedules	Form 1120 and all supporting schedules are filed for the C corporation; shareholders report dividend income on Schedule B
4. Who is the taxpayer?	Proprietor	Partners	Shareholders except tax on built-in gains, excess passive investment income, and LIFO recapture	C corporation: its shareholders are also taxed on dividend income when corporate earnings are distributed
5. Do owners have self-employment (SE) income from the business?	Yes, the net income from Schedule C	Yes, each <i>general</i> partner's share of net (SE) income plus guaranteed payments; for <i>limited</i> partners, only guaranteed payments from services	No	No
6. Must the business's taxable year be the same as that of the majority owners?	Yes	Generally, but a different year may be used if the partnership has natural business year or pays a tax on deferred income	Same as partnership	No, any period may be used except for personal service corporation
7. Are contributions of assets for an ownership interest taxable transactions?	No	No, same as proprietorship	No, <i>if</i> parties to the exchange own more than 80% of the corporation after the contribution, but otherwise, a taxable exchange with no carryover of tax attributes	Same as S corporation
8. Are distributions of cash includible income to owners?	No	No, except a distribution in excess of the partner's basis in the partnership is treated as a partial sale of the ownership interest	No, unless distribution exceeds shareholder's stock basis or is from accumulated E&P	Yes, if from the C corporation's earnings and profits
9. Do property distributions result in taxable income to the business or the owners?	No, basis is preserved in distributed property	No, with several exceptions	Yes, S corporation must recognize realized gain—but not loss—if a nonliquidating distribution; shareholders have dividend income if the FMV of the property exceeds AAA and the S corporation has AE&P	Yes, corporation recognizes gain, but not loss; shareholders have dividend income to extent of property's value or E&P
10. May an owner enter into taxable transactions (sales, loans, etc.) with the business	No	Yes, when acting in a nonpartner capacity, but subject to related-party restrictions	Yes, subject to related-party restrictions	Same as S corporation

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Items for Comparison	Proprietorship/Proprietor	Partnership/Partner	S Corporation/Shareholder	C Corporation/Shareholder
11. May an accrual basis business deduct accrued expenses to cash basis owners?	No, not applicable	No, deductible only when paid (except see 12 below)	Not deductible until shareholder includes in income. Applies to any shareholder	Not deductible until shareholder includes in income. Applies to >50% shareholder
12. Are accrued expenses of the business includible income to cash basis owners? If yes, when?	No, not applicable	Yes, when received, except guaranteed salary and interest on capital are includible when accrued	Yes, when received	When accrued to minority shareholders, when received by majority shareholders
13. Can owners be employees of the business and be paid salaries subject to employment taxes and withholding?	No	No. Guaranteed payments are not reported on Form W-2. Thus, they do not add to the limit for the QBI deduction.	Yes. Since these salaries are reported on Form W-2, they may increase the limit for the QBI deduction	Yes
14. Are fringe benefits for owner/employees deductible expenses?	No	Yes, but partner must include in gross income	Yes, but a more than 2% shareholder must include in gross income	Yes, subject to nondiscrimination rules
15. May the business use the cash method?	Yes, depending on income and type of business unless it qualifies as a tax shelter	Yes, depending on income and type of business unless it qualifies as a tax shelter or has a C corporation as a partner	Yes, depending on income and type of business unless it qualifies as a tax shelter	No, unless gross receipts do not exceed \$25 million or it qualifies under "type of business" exception
16. Is the business a conduit with the original character of the items flowing through to its owners as of the last day of the business's taxable year?	Yes	Yes	Yes	No, the business is an entity and the flow-through concept is not applicable
17. How are capital gains and losses of the business treated?	As though received by the proprietor	Flow through to each partner	Same as partnership	Net capital gain includible in corporate taxable income and taxed at regular rates; net capital losses carried back three and forward five years, with no deduction against ordinary income
18. How is dividend income received by the business treated?	Includible income as though received by the proprietor (may be subject to reduced rate)	Flows through to each partner as dividend income (may be subject to reduced rate)	Same as partnership	Includible income with a dividend-received deduction
19. How are charitable contributions treated?	An itemized deduction as though contributed by the proprietor. Subject to the AGI limitations.	Flow through to each partner as an itemized deduction. Subject to the AGI limitations.	Same as partnership. Subject to the AGI limitations	Deductions may not exceed 10% of taxable income before certain deductions. Some special rules applicable only to corporations
20. Who pays state and local income taxes on the business net income and how are they treated?	Proprietor; an itemized deduction, limited after 2017 as though paid by the proprietor	Each partner; an itemized deduction, limited after 2017	Same as partnership, except some state and local income taxes are assessed on the S corporation	Deductible expense

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Items for Comparison	Proprietorship/Proprietor	Partnership/Partner	S Corporation/Shareholder	C Corporation/Shareholder
21. How are tax credits treated?	Offsets proprietor's tax	Qualifying credits flow through to each partner subject to any limitations applicable at the partner level	Same as partnership	Computed at the corporate level and reduces corporate tax liability
22. How is net ordinary income treated?	Includible with proprietor's AGI	Flows through to each partner	Same as partnership	Included in corporate taxable income
23. How is net ordinary loss treated?	Reduction of proprietor's AGI	Flows through to each partner, potentially deductible up to that partner's basis in the partnership; any excess is carried forward	Same as partnership except that basis rules differ	Different NOL rules for years prior to 2018, for years 2018 through 2020 and years after 2020.
24. How are AMT adjustments and preferences treated?	Included on proprietor's return	Flow through to partners	Same as partnership	AMT repealed after 2017
25. Is § 291(a)(1) applicable?	No	No	Yes, if C corporation for any of three prior tax years	Yes
26. How are items allocated among the owners?	Not applicable	According to profit and loss ratio or may be specially allocated	According to stock ownership ratio; special rules for years of termination or dispositions	Not applicable
27. Is the basis of business assets adjusted when an ownership interest is sold?	Yes, since the assets of the business are actually or constructively sold	Yes, if partnership has elected the optional adjustment to basis	No, unless § 338(h)(10) or § 336(e) election is in effect	No, unless § 338 or § 336(e) election is in effect
28. Is basis in entity affected by business liabilities?	Not applicable	Yes, a partner's basis includes his or her share of partnership liabilities	No, except for loans directly from shareholders	No
29. Is basis in entity affected by business income, gains, deductions, and losses?	Not applicable	Yes, all income and gains increase basis and all expenses and losses (that flow through) decrease basis	Yes, same as partnership	No
30. What is the character of gains and losses on the sale of a business interest?	Each asset is treated as sold individually and the character of the gain or loss is dependent on that asset	Capital gain or loss except ordinary income to the extent of partner's share of unrealized receivables, depreciation recapture, or inventory. Some gain may be taxed at 25 or 28 percent.	Capital gains and losses, except losses may qualify as § 1244 ordinary losses if the corporation meets certain requirements. Some gain may be taxed at 28% (but not at 25%).	Same as S corporation, except no 28% portion. Special rules apply if stock is § 1202 stock.
31. Must a reasonable salary be allocated to family members performing services for the business?	No	Yes	Yes	No

The following example provides some of the uses of multiple entities for conduct and ownership of a business.

Example 26. Andrew and Ruth are the sole and equal owners of AR, an accounting firm set up as a partnership. They are planning to incorporate the practice as an S corporation, so that they can limit exposure to SE income. They do not have any covenants not to compete with the company, thus avoiding corporate ownership of goodwill. However, the practice currently owns an office building of which AR is the sole occupant.

1. Their tax advisor suggests that they keep the office building in a separate partnership, to be structured as an LLC under local law. Andrew and Ruth will be the two equal partners. The firm will rent the property from the partnership. This structure provides the following advantages over the corporation owning the property. Rent of the property creates a deductible expense to the practice. However, real estate rent is not SE income.²²⁵ Therefore, this arrangement provides for a return on the shareholders' capital investment without treating it as taxable FICA wage. Moreover, the corporation will not be liable for payroll tax on the rent paid.
2. Either partner can assign partial interests in the rental partnership to family members or others who will not participate in the accounting practice. Nor will any other partner be required to meet professional licensing requirements, or even be eligible to hold shares in an S corporation.
3. If Andrew or Ruth sell the practice or merge with another firm, the new owner may not want the real estate. If the real estate is in a separate entity, Andrew and Ruth will not need to have the S corporation divest of the property, which would likely have adverse tax consequences. Ruth and Andrew would be free to seek new tenants.
4. Upon the death of either Ruth or Andrew, or the sale of an interest to a new partner, the partnership would be able to adjust the basis of the property for the new member with an IRC §743(b) election. This adjustment requires that the entity make, or have in effect, an election under IRC §754, which is available to partnerships, but not to C or S corporations.

Note. For more information on elections under §§743 and 754, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

²²⁵ IRC §§162 and 1402(a)(1).

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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SCHEDULE A ITEMS

Schedule A (Form 1040), *Itemized Deductions*, allows taxpayers to itemize their deductions instead of taking the standard deduction. By itemizing, individuals can potentially reduce their taxable income by reporting specific expenses such as medical and dental costs, state and local taxes (SALT), home mortgage interest, charitable contributions, casualty and theft losses, and certain miscellaneous itemized deductions.¹ Many of these deductions specifically benefit **higher-income taxpayers**. This section will delve into these itemized deductions, providing insights into how each deduction works and the requirements for claiming them. Understanding these deductions can help taxpayers make informed decisions and maximize their tax benefits.

Fewer taxpayers have been itemizing deductions due to the increased standard deduction under the Tax Cuts and Jobs Act (TCJA).² The percentage of taxpayers itemizing deductions was 9% in 2022 compared to 31% in 2017, the last year before the TCJA became effective.³ However, this trend may reverse due to the passage of the One Big Beautiful Bill Act (OBBBA).⁴

Note. For more information about the OBBBA, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

Several provisions and structural rules related to itemized deductions tend to benefit higher-income taxpayers, including the following.

- The OBBBA eliminates the Pease limitation, which previously reduced itemized deductions by the lesser of 3% of adjusted gross income (AGI) above a threshold or 80% of allowable deductions. Its suspension allows high-income taxpayers to retain the full value of their itemized deductions.⁵
- Expanded charitable contribution limits, allowing cash contributions to qualified organizations to be deducted up to 60% of the taxpayer's contribution base (previously 50%), subject to a 0.5% AGI floor under the OBBBA.⁶
- Certain deductions unaffected by the alternative minimum tax (AMT),⁷ such as mortgage interest and charitable contributions, which retain their full value even when AMT applies.

Note. For more information on calculating the AMT, see the 2018 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Individual Taxpayer Issues. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

For more information on the impact of the OBBBA on the Pease limitation, the charitable floor, and AMT, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

¹. Instructions for Schedule A.

². *Tax Cuts and Jobs Act*, PL 115-97, §§11021, 11023, 11042, 11043, and 11046.

³. *Selected Issues in Tax Reform: Itemized Deductions*. Buffie, Nicholas E. Mar. 4, 2025. Congressional Research Service. [www.congress.gov/crs-product/IN12517] Accessed on Mar. 23, 2025.

⁴. *One Big Beautiful Bill Act*, PL 119-21.

⁵. IRC §68(a).

⁶. *One Big Beautiful Bill Act*, PL 119-21, §70111.

⁷. IRC §56.

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The OBBBA limits **deductions** affecting higher-income taxpayers, including the following provisions.

- Adding an income phaseout to the enhanced SALT deduction, the SALT deduction is limited to \$10,000 (\$5,000 for married filing separately (MFS)), reduced from its previous unlimited status.⁸
- The acquisition indebtedness deduction (including mortgage interest) was reduced from \$1 million (\$500,000 if MFS) to interest on the first \$750,000 (\$375,000 if MFS) of mortgage balances.⁹
- Taxpayers are no longer able to deduct interest payments on home equity loans unless the payments qualify as acquisition indebtedness.

Beginning in 2026, the OBBBA replaces the Pease limitation with a new formula under revised IRC §68. Taxpayers in the 37% tax bracket reduce their itemized deduction by $\frac{2}{37}$ of the lesser of:

- The taxpayer's total itemized deductions, or
- The amount by which their taxable income exceeds the 37% bracket threshold for their filing status.

MEDICAL EXPENSES — NURSING HOMES

If conditions are met, nursing home expenses qualify as a medical deduction, subject to the 7.5% AGI limitation per IRC §213. Nursing home care is covered in detail later in this chapter, including how to save and pay for care.

The criteria for deducting nursing home care differ from those for long-term care. Requirements for deductibility of nursing home care include the following.

- **Meals and lodging** qualify if it is for medical care; for example, the person requires continuous medical supervision rather than for convenience.¹⁰
- A taxpayer may deduct nursing home expenses for a parent or child who **qualifies as a dependent**. A taxpayer can include medical expenses paid for an individual who otherwise would have been a dependent of the taxpayer, except they do not need to meet the following requirements.¹¹
 - ♦ The person does not meet the gross income test (\$5,200 in 2025).¹²
 - ♦ The person filed a joint return for the tax year.
 - ♦ The taxpayer or taxpayer's spouse, if filing jointly, could be claimed as a dependent on someone else's return for the tax year.
 - ♦ A chronically ill individual, if qualified (discussed later in the chapter).

If the stay is not primarily medical, the expenses **must be allocated** between medical and non-medical.¹³

Example 1. Jacob lives alone and broke his arm. Jacob could have remained at home during his recovery, but he chooses to stay at a nursing home facility as he feels he can benefit from the assistance they provide with dressing, preparing meals, and other tasks. Because his stay is for convenience and not medically necessary, Jacob asks the nursing home to itemize his receipt so that his tax preparer can properly deduct only the medical-related costs.

⁸. IRC §164(b)(6); *One Big Beautiful Bill Act*, PL 119-21, §70120.

⁹. IRC §163(h).

¹⁰. Treas. Reg. §1.213-1(e)(1)(v).

¹¹. IRS Pub. 502, *Medical and Dental Expenses*.

¹². Rev. Proc. 2024-40, 2024-45 IRB 1100.

¹³. *Ibid*.

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STATE AND LOCAL TAXES¹⁴

The TCJA imposed a \$10,000 deduction limit (\$5,000 for MFS) for the combined amount of various state and local income, sales, and property taxes. The OBBBA temporarily increases this limit to \$40,000, subject to limitations.¹⁵ There are a few exceptions to the SALT limitation.

Note. For more information about SALT, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

- Taxes paid or accrued in carrying on a trade or business or an income-producing activity (e.g., Schedule C (Form 1040), *Profit or Loss From Business*, Schedule E (Form 1040), *Supplemental Income and Loss*, or Schedule F (Form 1040), *Profit or Loss From Farming*).
- Foreign income taxes are reported on Schedule A, line 6. Foreign real property taxes are no longer deductible.

Note. Taxpayers should consider whether the amount paid for foreign taxes is more beneficial as a federal tax credit.

- Property taxes on unimproved land is considered an investment and is deductible on Schedule A, regardless of the SALT limitation.¹⁶



Practitioner Planning Tip

A taxpayer can make an annual election to capitalize real property taxes and carrying charges, including mortgage interest, on **unimproved** and **unproductive** land.¹⁷ This option may be advantageous when the taxpayer does not receive a benefit, i.e., when they do not itemize deductions. This election is made by attaching a statement to the return. The statement must include specific details, including the description, amount, and date the expense was incurred. The election must be attached to the original return by the due date, including extensions.

While this election may not benefit the taxpayer until the disposition of the land, it is preferred to having no tax benefit.

¹⁴ IRC §164.

¹⁵ *One Big Beautiful Bill Act*, PL 119-21, §70120.

¹⁶ See IRC §212.

¹⁷ Treas. Reg. §1.266-1(b)(1).



Practitioner Planning Tip

In certain states, property taxes are due in installments, with the first installment typically due in January. However, the taxpayer receives the bill in December so that they can pay before the end of the calendar year. The taxpayer may ultimately benefit from using a bunching strategy, where they pay extra taxes in one year to itemize and then use the standard deduction the next year.

Example 2. Charles lives in a town where property taxes are due January 31 and July 31. Charles has already paid more than \$40,000 in SALT in 2025. Paying property taxes on his residence by December 31, 2025, provides no federal tax benefit. After consulting with his tax preparer, Charles decides to wait until January 2026 to pay the final installment.

Pass-Through Entity Tax

Many states have created pass-through entity (PTE) tax laws. These generally permit a flow-through entity, such as an S corporation or partnership, to elect to pay the PTE tax at the entity level rather than at the shareholder, partner, or member level. These permit a federal tax deduction for the state income tax incurred by the owners, based on business taxable income, at the entity level. PTE tax provides a federal deduction for an expense that may otherwise have no benefit at the individual level due to the SALT limitation. The owners receive a pro-rata credit of the taxes paid for their personal state income tax return, communicated to the taxpayer on the state copy of the Schedule K-1 equivalent.¹⁸

Observation. One disadvantage of the PTE tax may be if the owner is not a resident of the state where the business operates, and the resident state does not permit a credit for this tax. Another disadvantage would be if the state's tax is graduated and the PTE tax is at the highest rate, yet the individual's marginal tax rate is lower than the PTE tax. The taxpayer should consider both scenarios' net benefit or cost of electing the PTE tax.

For more information on planning and pitfalls of PTE, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 10: Small Business Issues. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

HOME MORTGAGE INTEREST DEDUCTION¹⁹

The deduction for home mortgage interest is limited based on the date the taxpayer acquired the debt. The maximum amount of **acquisition indebtedness** was reduced from \$1 million to \$750,000 (\$375,000 for MFS) for new debt acquired on or after December 15, 2017. The OBBBA makes this provision permanent and beginning in 2026, the interest can include mortgage insurance premiums (commonly referred to as PMI, private mortgage insurance).²⁰

Note. There is an exception for taxpayers with a written binding contract before December 15, 2017, who were scheduled to close on or before January 1, 2018, and who purchased that residence by April 1, 2018.

¹⁸ IRS Notice 2020-75, 2020-49 IRB 1453.

¹⁹ IRC §163(h)(3).

²⁰ *One Big Beautiful Bill Act*, PL 119-21, §70108.

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Acquisition indebtedness refers to debt incurred to acquire, construct, or substantially improve the taxpayer's primary or second residence. If the taxpayer has more than two residences, they can decide which is their second home. A **home** includes a house, condominium, cooperative, mobile home, house trailer, and boat, or similar property that has sleeping, cooking, and toilet facilities.²¹ The home(s) must also secure the debt. Interest related to home equity indebtedness is no longer deductible unless it qualifies as acquisition indebtedness.

Example 3. Joe and Sue are married and file jointly. They purchased a home in May 2016 with a mortgage of \$950,000. Because this was under the \$1 million limit, their mortgage interest deduction was not subject to limitation.

In 2021, their mortgage balance was \$850,000. To take advantage of historically low interest rates, they refinanced the \$850,000 at 2.7%. All related mortgage interest remains deductible because the original acquisition date of the mortgage is May 2016. In 2025, they pay \$20,920 of interest on the loan, all of which is deductible.

Example 4. Use the same facts as **Example 3**, except that because the value of their home has increased, Joe and Sue take out \$300,000 in cash to substantially improve their kitchen and bathrooms. The average mortgage balance is now recalculated annually based on pre- and post-December 16, 2017, original acquisition date. In 2025 they pay \$28,304 of mortgage interest. Of that amount, \$20,920 of the mortgage interest is deductible, and \$7,384 is not deductible.

Example 5. Use the same facts as **Example 4**, except Joe and Sue take out \$200,000 in cash to substantially improve their kitchen and bathrooms and \$100,000 for equipment used in Joe's business, which he reports on Schedule C. For 2025, they pay \$28,304 of interest on the home loan. They allocate \$2,462 of interest related to the \$100,000 to Schedule C. The Schedule A mortgage indebtedness limit is calculated in the same manner as **Example 4**, and \$20,920 of the remaining mortgage interest is deductible.

Note. In these three examples, the Schedule A deductible mortgage interest remains the same; however, this may not always be the case.



Practitioner Planning Tip

If the property is mixed-use (e.g., part long-term rental, part short-term rental, or used for business purposes), the debt should be allocated to each non-personal use first before applying the mortgage indebtedness limit. The limitations do not apply to Schedule C, E, or F interest expense.

The limitation is at the taxpayer, not at the property level. Therefore, for two unmarried taxpayers who own a home, each is subject to the \$750,000 or \$1 million limitation.²²

²¹ IRM 4.19.15.20.3.4.2 (2019).

²² *Voss v. Comm'r*, U.S. Court of Appeals, 9th Circuit; Nos.12-73257, 12-73261 (Aug. 7, 2015).



Practitioner Planning Tip

It may be helpful to ask clients on the annual questionnaire about any additional proceeds from mortgages or home equity lines of credit to ensure proper allocation and deductibility.

IRS Correspondence Audits Related to Mortgage Issues

A taxpayer may receive a correspondence audit letter with Form 886-A, *Explanation of Items*, requesting specific information about the taxpayer's mortgage interest deduction.²³ The request could be due to several factors, some of which follow.

- The seller financed and failed to issue a Form 1098, *Mortgage Interest Statement*, and/or report interest income with the taxpayer's name and social security number.
- A Form 1098 has an improper origination date.
- The taxpayer claimed a high mortgage interest deduction compared to taxable income.
- The taxpayer was issued Forms 1098 for more than two properties but does not have any Schedule E rentals.
- The taxpayer used the exact method, rather than the average method, to calculate deductible mortgage interest.

Note. The exact method is when the taxpayer determines the limit on each qualifying mortgage separately, starting with the oldest outstanding mortgage.²⁴ Conversely, the average method totals the average balances of all the qualified mortgages and then determine the percentage of the total mortgage interest which is deductible.

Depending on the information the IRS requests and the circumstances, the taxpayer may need to provide a worksheet for the deductible home mortgage interest limitation, proof of mortgage payments, and other relevant documentation. The entire mortgage interest deduction will be denied if the taxpayer fails to respond to the notice.²⁵

Note. For more information on mortgage interest deductions, including home equity loans, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

²³ IRM 4.19.15.20.3.4.2 (2019).

²⁴ Ibid.

²⁵ Ibid.

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CHARITABLE CONTRIBUTIONS

Taxpayers may deduct cash contributions of up to 60% of their contribution base. For contributions after December 31, 2025, this is subject to a 0.5% floor. Additionally, any disallowed deduction can be carried forward for up to five years.²⁶

Note. The OBBBA created an additional charitable deduction for nonitemizers starting after December 31, 2025. For more information, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

Two ways for taxpayers, especially higher income taxpayers, to maximize their charitable contributions are through donor-advised funds (DAF) and qualified charitable distribution (QCD).

Donor-Advised Funds²⁷

A DAF is an account that allows a taxpayer to donate assets, which can be distributed to various charities over time. Managed by a third-party organization, a DAF is maintained by an IRC §501(c)(3) organization, in which the donor recommends preferred charities to distribute funds. A DAF offers several of the following advantages.

- Earnings grow tax-free. Thus, there could be more to distribute to the charities.
- The distributions from a DAF to a charitable organization can be anonymous, if desired.
- No distributions are required, as with a private foundation or charitable trusts.
- They may be able to contribute various asset types beyond cash, such as stocks, mutual funds, cryptocurrency, and non-publicly traded assets.
- It permits taxpayers to make a tax-deductible contribution in one year and the ultimate distribution in future years.
- The taxpayer may potentially escape capital gains tax by transferring highly appreciated assets. See non-cash assets described later.

Note. A charitable-minded donor with unusually high taxable income in one year would benefit from the contribution in one year with the distribution in a future year. They could make a significant contribution to a DAF that year and then take the time to decide which charities they would like to donate to in future years. Matching the donation year with the high-income year would provide the donor with the best way to lower income taxes.

Similarly, if a taxpayer typically uses the standard deduction and does not itemize, contributing to a DAF in one year to bundle several years' worth of charitable donations, can provide a tax benefit greater than the standard deduction.

²⁶ IRC §170(b)(1)(G); *One Big Beautiful Bill Act*, PL 119-21, §§70424–70425.

²⁷ Treas. Reg. §53.4966-3; IRC §4966(d); *Donor-Advised Funds Guide Sheet Explanation*. Jul. 31, 2008. IRS. [www.irs.gov/pub/irs-tege/donor_advised_explanation_073108.pdf] Accessed on May 2, 2025.

Example 6. Nora normally contributes \$5,000 per year to her favorite charities and takes the standard deduction due to insufficient itemized deductions. In 2025, Nora receives a \$25,000 bonus from her employer. After consulting with her tax preparer when she received the bonus, she establishes a DAF and contributes \$25,000 to it in 2025. Nora has \$8,000 in other itemized deductions for a total of \$33,000. She intends to permit the funds to grow some in the account and will request a distribution of one-fifth of the amount each year to her charities. Nora intends to take the standard deduction for the next four years.

While a **DAF** has many attractive features, it also has **some disadvantages**.

- The sponsoring organization likely charges fees to administer the account. These annual fees are often a percentage of the taxpayer's assets. Often, the brokers take out the fees without communicating the amount to the taxpayer.²⁸ Additionally, some brokers require a minimum initial contribution, which may be in the tens of thousands.²⁹
- The custodian's minimum distribution amounts may be higher than what the taxpayer wants to contribute to each individual charity.
- The donor may not be able to control the investments in the account.
- The donor makes recommendations for the distributions, but the sponsoring organization must approve them.
- A donor may contribute appreciated stock to a DAF, and the fund continues to hold the stock so that it (or the proceeds from the sale) is not distributed to a charity for several years. In that case, the donor loses the additional deduction due to the increased value appreciation while the stock is held inside the DAF.
- A donor cannot use a QCD to contribute to a DAF, as such contributions are explicitly prohibited under IRC §408(d)(8).
- The taxpayer receives an immediate tax deduction; however, the charity, which is the ultimate recipient, may not recognize the contribution for many years.
- Establishing and funding the account to qualify for the desired tax deduction for the current year will take longer than writing a check on December 31 or initiating a payment via credit card. Some planning may be needed to fund the account by the end of the tax year.
- Under OBBBA provisions beginning after December 31, 2025, nonitemizers cannot use DAF for the nonitemized charitable deduction.³⁰

Non-Cash Assets. Appreciated stock has always been an attractive vehicle for charitable contributions. The donor receives a tax deduction for the stock's value on the donation date, and this event triggers no capital gains tax.³¹

While some charitable organizations can receive non-cash assets (usually publicly traded securities), a DAF can often accept a broader range of non-cash assets, such as grain, vehicles, or real estate.

²⁸ *Have a Donor-Advised Fund? Here's Why You're Probably Paying Too Much.* Oct. 21, 2023. Daffy. [www.daffy.org/resources/donor-advised-funds-costs-compare] Accessed on May 5, 2025.

²⁹ *Pros and Cons of Donor-Advised Funds.* Arnott, Amy C. Nov. 29, 2021. Morningstar. [www.morningstar.com/personal-finance/pros-cons-donor-advised-funds] Accessed on May 5, 2025.

³⁰ *One Big Beautiful Bill Act*, PL 119-21, §70424.

³¹ See IRS Pub. 526, *Charitable Contributions*.



Practitioner Planning Tip

While not specific to retirement savings, by donating appreciated assets held for more than one year to a DAF, taxpayers can recognize an itemized deduction for the fair market value (FMV) of the donated asset up to 30% of their AGI (any excess is carried forward for up to five years) and avoid paying capital gain tax on the sale.³² Donating an appreciated asset directly to a fund also allows taxpayers to donate more to charity than if they had sold the asset and only contributed the after-tax funds from the sale.

Note. When property other than money is donated to a DAF or another §501(c)(3) organization, the charity sells the property and distributes the proceeds to charities. For example, a grain farmer saves on self-employment and income taxes, because the sale is not recognized as income. The farmer may still be able to deduct the cost of producing the grain but does not report a charitable contribution because their basis is zero.³³

Stock Equity Awards with an IRC §83(b) Election.³⁴ Another way to potentially increase the value of a donation while minimizing tax is to donate vested stock after making a §83(b) election on restricted stock. Typically, restricted stock is taxed as ordinary income on the difference between the taxpayer's basis on the grant date and the stock's FMV on the vesting date.

A §83(b) election permits an employee to pay ordinary income taxes on the FMV of the stock at the time of the grant, rather than when vested. Any subsequent appreciation in the stock value is taxed at capital gains rate instead of ordinary income. By donating the appreciated shares, the taxpayer can deduct the FMV of the shares at the time of donation and avoid paying capital gains tax on the appreciation.

Some disadvantages of a §83(b) election include the following situations.

- The employee pays income tax before they have rights to stock ownership. If the employee leaves before a specified date, they would have paid income tax on an asset they never owned.
- The stock value decreases between the §83(b) election date and the option's exercise date. The employee would have paid more income tax if the §83(b) election had not been made.

Note. Due to these potential downsides, the §83(b) election is generally more attractive to owner-employees or key employees of start-up companies with high potential for future growth and/or private companies expected to offer an initial public offering.

³² Ibid.

³³ Treas. Reg. §1.170A-1(c)(4).

³⁴ Treas. Reg. §1.83-2.

The following are filing requirements to complete a §83(b) election.³⁵

- File the §83(b) election with the IRS within 30 days of transferring the restricted property.
- Provide a copy of this election to the service recipient (usually the employer).

QUALIFIED CHARITABLE DISTRIBUTION³⁶

A QCD allows taxpayers who are at least **70½ years** old to direct the custodians of their individual retirement arrangement (IRA) to donate directly to a specified public charity. The trustee or custodian of a taxpayer's IRA can make the QCDs directly to an organization listed in IRC §170(b)(1)(A), which includes churches, educational organizations, governmental units, public charities, and other organizations that can receive tax-deductible contributions. A taxpayer cannot make a legal QCD to a DAF or a supporting organization supporting other charities, as described in IRC §509(a)(3).³⁷

Taxpayers must observe the following rules with QCDs.³⁸

- QCDs cannot exceed the annual per-individual limits, which are indexed for inflation (\$105,000 in 2024; \$108,000 in 2025).³⁹
- Contributions must be deductible under §170.
- Taxpayers may **not** also claim an itemized charitable deduction for the QCD.
- The charity must provide a receipt that meets the requirements of §170(f)(8).
- If the taxpayer is making IRA contributions after reaching the required minimum distribution (RMD) age as permitted under the SECURE Act,⁴⁰ these post-RMD contributions are not eligible for QCDs.⁴¹

Note. Taxpayers facing RMDs may consider QCDs as an option to comply with RMD rules while being provided with a financial motivation to donate to churches, veterans organizations, and §501(c)(3) organizations. In doing so, the taxpayer decreases both their total income and AGI. A lower AGI can increase itemized medical deductions, and possibly even reduce AMT and taxable portion of social security.

The rules regarding RMDs are beyond the scope of this chapter. For information on the RMD rules, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 8: Retirement Plan Issues for Individuals. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Caution. Because a charity may still issue a contribution statement, it is essential to accurately report the QCD as a reduction of the IRA distribution rather than as a Schedule A charitable contribution.

³⁵. See Form 15620, *Section 83(b) Election*.

³⁶. IRC §408(d)(8).

³⁷. IRS Notice 2007-7, 2007-5 IRB 395.

³⁸. IRC §408(d).

³⁹. IRC §408(d)(8)(G).

⁴⁰. *SECURE Act of 2019*, PL 116-94, §107(a).

⁴¹. *Ibid.*, §107(b).

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Starting in 2025, there is a new code “Y” for box 7 on Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, to identify a QCD.⁴² Previously, QCDs were reported using general distribution codes, and taxpayers had to manually adjust their taxable income on their tax returns. With the new code “Y,” it will be clearer and more straightforward to identify and report these charitable distributions.

Note. For detailed coverage of QCDs, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Elder Issues, and the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Individual Taxpayer Issues. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

CASUALTY AND THEFT LOSSES

For tax years 2018 through 2025, individuals may only deduct casualty or theft losses of personal-use property if the loss is attributable to a federally declared disaster.⁴³ The OBBBA makes this provision permanent and extends the relief to certain state disasters declared after December 31, 2025.⁴⁴ Taxpayers use Form 4684, *Casualties and Thefts*, to report those on Schedule A. Other personal property casualty and theft losses are no longer deductible. Taxpayers may also use Form 4684 to report theft of investment income-producing property due to a Ponzi-type investment schemes.

Note. Business or income-producing property gains and losses are also reported on Form 4684. Depending upon the nature of the property, it may or may not be reported on Schedule A but instead on the appropriate Form 4797, *Sales of Business Property*, related to the activity. This section does not address these losses.

Non-deductible losses include:⁴⁵

- Money or property that was misplaced or lost.
- Breakage of china, glassware, furniture or similar items under normal conditions.
- Progressive damage to property (buildings, clothing, trees, etc.) caused by termites, mold, moths, other insects, or disease.
- A decline in market value of stock, caused by disclosure of accounting or other illegal misconduct by the officers or directors of the corporation that issues the stock, that was acquired on the open market for investment. It may be deducted as a capital loss on Schedule D (Form 1040), *Capital Gains and Losses*, if the stock is sold or exchanged or becomes completely worthless. Ponzi-type investment schemes are deductible on Form 4684 and discussed later in this section.

⁴² Instructions for Forms 1099-R and 5498 (2025).

⁴³ *Tax Cuts and Jobs Act*, PL 115-97, §70109.

⁴⁴ *One Big Beautiful Bill Act*, PL 119-21, §11044.

⁴⁵ Instructions for Form 4684.

Due to the recent fires, hurricanes, and storms, many taxpayers may be eligible to claim deductions for uninsured or underinsured claims. Only losses in excess of insurance reimbursements can be deductible and if a taxpayer's property is uninsured or underinsured, the deductible loss could be substantial. The rules differ depending on whether the loss is a federally declared disaster loss, a qualified disaster loss, or a state-declared disaster loss (beginning in 2026).⁴⁶

- **Federally declared disaster loss** is a casualty loss resulting from a disaster declared by the President under the **Stafford Act**. These are the only personal-use losses eligible for deduction under current law.⁴⁷
- **Qualified disaster loss** is a **subset** of federally declared disaster losses that meet additional criteria. These losses receive **enhanced tax relief**, such as a higher per-loss deduction limit and exemption from the 10% AGI threshold (covered later).
- **State-declared disaster loss** is a casualty loss resulting from a disaster declared by the governor (or mayor, in the case of the District of Columbia). A state-declared disaster is “any natural catastrophe (including any hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, or drought), or, regardless of cause, any fire, flood, or explosion, ... which ... causes damage of sufficient severity and magnitude to warrant allowance of a deduction.”⁴⁸

Federally Declared Disaster Losses. The estimated damage from the recent California wildfires ranges from \$76 billion to \$131 billion, with insured losses accounting for approximately \$45 billion.⁴⁹ One estimate is that one in 10 homes in California are uninsured.⁵⁰ While mortgagors generally require homeowner's insurance, those without a mortgage may choose not to carry insurance because it may be unaffordable or specific policies are more challenging to underwrite.

In Florida's 2024 hurricane season, some areas experienced more damage due to flooding than to wind.⁵¹ The Midwest experienced extensive flooding in 2019, presenting significant challenges to farmers, including the loss of stored crops.⁵² The 2024 storms and tornadoes had a severe impact on North Carolina farmers. Farmers' crops may only be 75% insured, and disaster aid may only cover 20% of the uninsured portion of the losses.⁵³

⁴⁶ *One Big Beautiful Bill Act*, PL 119-21, §70109.

⁴⁷ IRS Pub. 547, *Casualties, Disasters, and Thefts*.

⁴⁸ IRC §165(h)(5)(C)(i); *One Big Beautiful Bill Act*, PL 119-21, §70109.

⁴⁹ *Economic Impact of the Los Angeles Wildfires*. Li, Zhiyun and Yu, William. Mar. 3, 2025. UCLA Anderson School of Management. [anderson.ucla.edu/about/centers/ucla-anderson-forecast/economic-impact-los-angeles-wildfires] Accessed on Mar. 23, 2025.

⁵⁰ *1 in 10 Los Angeles homes do not have insurance, says one estimate*. Lansner, Jonathan. Jan. 27, 2025. Los Angeles Daily News. [dailynews.com/2025/01/11/1-in-10-los-angeles-homes-dont-have-insurance-says-one-estimate] Accessed on Feb. 17, 2025.

⁵¹ *What is the Cost of the 2024 Hurricane Season?* Yanes, Nadeen. Dec. 2, 2024. ABC Action News Tampa Bay. [www.abcactionnews.com/news/region-pinellas/what-is-the-cost-of-the-2024-hurricane-season] Accessed on Feb. 17, 2025.

⁵² *U.S. disaster aid won't cover crops drowned by Midwest floods*. Polansek, Tom. Apr. 2, 2019. Reuters. [reuters.com/article/us-usa-weather-iowa-idUSKCN1RE0BU] Accessed on Feb. 17, 2025.

⁵³ *Storms and drought cost NC farmers billions in 2024. Lawmakers want to pay them back*. Doran, Will. Feb. 26, 2025. WRAL News. [wral.com/story/storms-and-drought-cost-nc-farmers-billions-in-2024-lawmakers-want-to-pay-them-back/21881734] Accessed on Mar. 23, 2025.

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The following are general rules for reporting personal use property losses on Form 4684, Section A, *Personal Use Property*.⁵⁴

- Report the disaster (DR) or emergency (EM) declaration number assigned by the Federal Emergency Management Agency (FEMA). These can be found at FEMA.gov/Disaster.
- Each uninsured loss is subject to a \$100 deduction.
- All combined losses for the tax year are deductible only if the total net loss exceeds 10% of the taxpayer's AGI.
- The net loss is generally reported on Schedule A, line 15.
- The loss is reported in the tax year it was discovered. As these are limited to those in a federally declared disaster area, the tax year is generally the year it occurred. However, IRC §165(i) permits a taxpayer to deduct the loss in the tax year immediately preceding the event, which may accelerate a refund to assist the taxpayer.

Deducting Disaster Losses in Previous Tax Year. If a taxpayer deducts the loss on the previous tax year's return, it can be claimed on either an original or amended tax return. This election must be made within six months after the due date of the taxpayer's federal income tax return for the disaster year without regard to any extension of time to file.⁵⁵

The taxpayer must include an election statement with the return, stating that they are making a §165(i) election, and must include the following information either on a separate attachment to the return or on Form 4684, line 1.⁵⁶ This election and potential revocation can also be reported on Form 4684, Section D, *Election To Deduct Federally Declared Disaster Loss in Preceding Tax Year*.

- The name or description of the disaster and date(s) of the disaster which gave rise to the loss.
- The address, including the city, town, county, parish, state, and zip code, where the damaged or destroyed property was located at the time of the disaster.

The taxpayer must consider the facts that exist when the election is made. If the taxpayer later receives reimbursement above the reported loss, the taxpayer reports it as income in the year it was received (or accrued).⁵⁷

A revocation of the §165(i) election can be made if done within 90 days of the election.⁵⁸ This revocation could be made if losses are much more significant than initially estimated or if it is determined there is a greater tax benefit in the year the loss occurred. The amended return revoking the election must be filed within 90 days of the election's due date and on or before the date the taxpayer files any return or amended return for the year that includes the disaster loss. The amended return should refigure the tax liability due to revoking the election.⁵⁹ The taxpayer must pay or arrange to pay any tax and interest due to the revocation.

⁵⁴ Instructions for Form 4684.

⁵⁵ Rev. Proc. 2016-53, 2016-44 IRB 530.

⁵⁶ Ibid.

⁵⁷ Treas. Reg. §1.165-1(d)(2)(iii).

⁵⁸ Rev. Proc. 2016-53, 2016-44 IRB 530.

⁵⁹ Treas. Reg. §1.165-11(d).

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Qualified Disaster Losses. Not all federally declared disaster losses are qualified disaster losses. A qualified disaster loss is an individual's casualty loss of personal-use property resulting from a significant disaster declared by the President under the Stafford Act.⁶⁰ Such losses are subject to a \$500 per casualty limitation (instead of \$100 for a federally declared disaster loss) and are exempt from the 10% AGI limitation.⁶¹ Individuals who suffered a qualified disaster loss are eligible to claim a casualty loss deduction, elect to claim the loss in the preceding tax year, and deduct the loss without itemizing other deductions on Schedule A.

Note. For the current list of qualified disasters, see the current year's instructions for Form 4684 or Pub. 547, *Casualties, Disasters, and Thefts*.

Increased Standard Deduction. Taxpayers with a net qualified disaster loss who are not itemizing can claim an increased standard deduction by completing the following steps.⁶²

- List the amount from Form 4684, line 15, on the dotted line next to line 16 as "Net Qualified Disaster Loss," and attach Form 4684.
- List the standard deduction amount on the dotted line next to line 16 as "Standard Deduction Claimed With Qualified Disaster Loss."
- Combine the two amounts on line 16 and enter on Form 1040, *U.S. Individual Income Tax Return*, or 1040-SR, *U.S. Income Tax Return for Seniors*, line 12.

Caution. Taxpayers may not report amounts on any other lines for Schedule A.

Example 7. Bob and Sarah's home was damaged, but not destroyed, by a qualified disaster in 2024. They incurred an uninsured loss of \$10,500, will file as married filing jointly (MFJ), and otherwise would take the standard deduction for 2024. The net qualified loss is \$10,000 after a \$500 limitation, and their standard deduction is \$29,200. They report the total loss of \$39,200 on the following Schedule A.

Other Itemized Deductions		16	Other—from list in instructions. List type and amount: Net Qualified Disaster Loss 10,000 Standard Deduction Claimed with Net Qualified Disaster Loss 29,200	15	
Total Itemized Deductions		17	Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 12	16	39,200
		18	If you elect to itemize deductions even though they are less than your standard deduction, check this box ☐	17	

For Paperwork Reduction Act Notice, see the Instructions for Form 1040.

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Schedule A (Form 1040) 2024

State-Declared Disaster Losses. State-declared disasters follow the provisions of federally declared disaster losses.

The Filing Relief for Natural Disasters Act,⁶³ passed on July 24, 2025, includes additional state provisions and extensions of federal tax deadlines. This bill authorizes the IRS to postpone federal tax deadlines for taxpayers affected by a qualified state-declared disaster, upon written request by the state governor. The bill also increases the automatic extension of federal tax deadlines for certain taxpayers.

⁶⁰ IRC §165(i).

⁶¹ IRC §165(h).

⁶² Instructions for Schedule A (Form 1040).

⁶³ *Filing Relief for Natural Disasters Act*, PL 119-29.

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Under current law, the IRS may postpone federal tax deadlines for taxpayers affected by a federally declared disaster, including (but not limited to) deadlines for the following.

1. Filing federal tax returns
2. Paying federal taxes
3. Making retirement plan contributions
4. Tax assessments and collections

The Act authorizes the IRS to postpone such federal tax deadlines for taxpayers affected by a qualified state-declared disaster upon written request by the state's governor (or the District of Columbia mayor). Under the Act, a state includes the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands.

The Act defines a qualified state-declared disaster as any natural catastrophe, fire, flood, or explosion that causes damage of sufficient severity and magnitude to warrant a request to postpone such federal tax deadlines.

Additionally, under current law, an automatic 60-day extension of such federal tax deadlines applies to certain relief workers, individuals killed or injured as a result of a federally declared disaster, and taxpayers whose principal residence, business, or tax records are located in a federally declared disaster area.

The Act increases to 120 days the automatic extension of federal tax deadlines for these taxpayers.

Tax Relief for Scammed Individuals

Certain scammed individuals can deduct their losses on Form 4684 rather than as an investment loss that has an annual \$3,000 deduction limitation (unless offset by other capital gains). Even if there were other capital gains, the capital gain rate is lower than the ordinary income tax rate, making it less effective. These specific losses are covered later in this chapter.

Qualified investors can report a qualified loss on Form 4684, Section C, *Theft Loss Deduction for Ponzi-Type Investment Scheme Using the Procedures in Revenue Procedure 2009-20*. The net investment before recovery is subject to either a 95% or 75% limitation⁶⁴ but, otherwise, is not subject to either the \$100 or the 10% AGI limitation.⁶⁵

MISCELLANEOUS ITEMIZED DEDUCTIONS⁶⁶

The OBBBA permanently terminated most miscellaneous itemized deductions. There are some deductions that are still permitted because they are not subject to the 2% of AGI limitation. These include, but are not limited to, the following.

- Educators' and coaches' unreimbursed educator expenses
- Gambling losses subject to limitations
- Federal estate tax on income in respect of a decedent
- Employees with impairment-related work expenses

Note. There are exceptions for Armed Forces reservists, performing artists, and certain fee-based government officials. Those taxpayers should refer to the instructions for Form 2106, *Employee Business Expenses*, to report qualifying deductible expenses on Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, line 12.

⁶⁴ Ibid.

⁶⁵ Rev. Rul. 2009-9, 2009-14 IRB 735.

⁶⁶ IRC §67; *One Big Beautiful Bill Act*, PL 119-21, §§70111–70112.

OTHER FORM 1040 DEDUCTIONS

While this section focuses on itemized deductions reported on Schedule A, there are a few other places where taxpayers can deduct personal costs (those not related to business, rental, or farming activities). Examples of these are noted next.

Final Year of Trust or Estate Income Tax Return

Form 1040, Schedule 1, part II, *Adjustments to Income*, includes several familiar deductions, such as certain alimony and student loan interest, as well as a newer line item, line 24k, *Excess deductions of Section 67(e) expenses from Schedule K-1 (Form 1041)*. With an aging population, it is increasingly essential for practitioners to familiarize themselves with proper reporting procedures for Schedules K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, that are issued to beneficiaries of trust and/or estate income.

Note. For more information, see the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Select Trust Topics. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Investment-Related Expenses

Taxpayers receive potentially other reportable information on consolidated brokerage tax reporting statements, such as:

- Form 1099-DIV, *Dividends and Distributions*
- Form 1099-INT, *Interest Income*
- Form 1099-MISC, *Miscellaneous Income*
- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*
- Form 1099-OID, *Original Issue Discount*
- Supplemental Information Not Reported to the IRS

The table on the following page shows where to report each expense item.

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2024 Form	Box Description	2024 Form or Schedule	Line	Notes
1099-DIV/INT/MISC/OID	Federal Income Tax Withheld	1040	25b	Usually only if taxpayer is subject to back-up withholding or is an unidentifiable taxpayer.
1099-DIV	Section 199A Dividends	8995	6	Made permanent by OBBBA.
1099-DIV/INT/OID	Investment Expenses	A		If tax-exempt investment income at brokerage, may be able to allocate a portion at state level, if deductible.
1099-DIV -INT	Foreign Tax Paid	3	1	Report on Form 1116, if required; could also report on Schedule A, line 6, but the credit may be preferred.
1099-DIV/INT/MISC/OID	State Tax Withheld	A	5a	Also ensure credit is on respective state return, if required to file.
1099-INT/OID	Early Withdrawal Penalty	1	18	
1099-INT/OID	Bond Premium/Bond Premium on Treasury obligations			Default is that premium is part of bond cost basis; alternate is initial election to amortize over life of bond which reduces interest income each year.
1099-INT	Bond Premium on Tax-Exempt Bonds	B	I, 1	Must reduce tax-exempt interest income.
1099-OID	Acquisition Premium	B	I, 1	Reduces taxable interest income.
Supplemental	Margin Interest Paid	4952	1	Flows to Schedule A, limited to investment income, disallowed carries forward on Form 4952.
Supplemental	Tax-Exempt Investment Expense	n/a		May be deductible at state level.
Supplemental				Review the nature of any other expenses.

TAX IMPLICATIONS OF LONG-TERM CARE

With the median annual cost of a private nursing home room nearing \$117,000 in 2023,⁶⁷ long-term care (LTC) planning has become a critical component of financial and tax strategy. Individuals who prepare early in life, by setting aside funds or securing insurance, rarely regret doing so. In contrast, those who delay often face difficult choices and diminished options.

This section equips tax practitioners with the knowledge to guide clients through the tax implications of saving for and paying for skilled nursing care, whether through health savings accounts (HSAs), LTC insurance, retirement assets, or Medicaid-related benefits. It also addresses the unique needs of chronically ill individuals and the tax treatment of in-home care, nursing home expenses, and difficulty of care payments.

SAVING FOR LTC

Planning for LTC should begin decades prior to retirement. For younger taxpayers, especially those in their twenties and thirties, the opportunity to accumulate and grow tax-advantaged savings over time can make a significant difference in their ability to afford skilled nursing care later in life.

Fortunately, the Code offers several tools to help individuals prepare for these future expenses. From HSAs to LTC insurance, taxpayers can leverage these options to build financial resilience and ensure access to quality care when it is needed most.

Health Savings Accounts⁶⁸

A taxpayer can use an HSA to fund LTC expenses or to pay LTC insurance premiums, among other eligible medical expenses. The taxpayer's employer may sponsor the plans or taxpayers may purchase the plans individually. Many LTC expenses are eligible for reimbursement through HSA distributions.

Taxpayers can contribute to HSAs only if they maintain a high-deductible health insurance plan (HDHP). Taxpayers are not required to use all funds in their HSAs annually, and they can carry balances over to the following year. If taxpayers cease to maintain an HDHP, they can no longer **contribute** to their HSA. However, they can keep their HSA even if they stop participating in an HDHP. They can either continue to use funds in the HSA for qualified expenses or maintain the balance in the account. This feature makes HSAs a valid means to save for future healthcare expenses.

A taxpayer may contribute to their own HSA, although in many cases, employers make contributions, too. Individuals can treat their contributions as adjustments to income, lowering their AGI. Taxpayers use Form 8889, *Health Savings Accounts (HSAs)*, to report contributions to their HSAs, calculate deductions, report distributions, and calculate additional tax for their failure to participate in an eligible HDHP.

⁶⁷. *Genworth Releases Cost of Care Survey Results for 2023: Twenty Years of Tracking Long-Term Care Costs*. Mar. 12, 2024. Genworth. [investor.genworth.com/news-events/press-releases/detail/972/genworth-releases-cost-of-care-survey-results-for-2023] Accessed on May 30, 2025.

⁶⁸. IRC §223.

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When an employer contributes to an employee's HSA, the contribution is excluded from federal income tax and employment taxes, with one exception. The exception applies to stockholders of more than 2% of an S corporation's stock or partners with HDHPs, who must include the contribution in their taxable income.⁶⁹ They can subsequently deduct the contribution from their gross income using the self-employed health insurance deduction. By maintaining the HSA over their careers yet withdrawing little to fund current medical expenses, taxpayers can eventually grow large balances to fund nursing home or skilled nursing expenses in their golden years.

Caution. HSA contributions are limited in the year the taxpayer enrolls in Medicare. For more information, see the 2004 *University of Illinois Federal Tax Workbook*, Chapter 14: New Legislation. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

To accelerate this process, taxpayers can make a once-in-a-lifetime distribution from an IRA to fund an HSA.⁷⁰ This opportunity comes with the following limitations and requirements.

- The distribution is limited to the HSA limit that is in effect on the first day of the month the contribution is made.⁷¹
- The distribution is based on the taxpayer's age at the end of the year.
- Contributions to HSAs cannot be made after a taxpayer is entitled to Medicare benefits.⁷²

An individual who makes a one-time funding distribution from a traditional IRA to an HSA must remain an eligible individual for 12 months following the month of the transfer.⁷³ As a practical matter, the individual must continue to have an HDHP for 12 months and not be eligible for health benefits under another plan. If the individual becomes ineligible during this 12-month testing period, the distribution becomes a taxable event subject to a 10% penalty.⁷⁴ This distribution must be made by a trustee-to-trustee transfer directly from the traditional IRA, moving IRA assets directly to the HSA. The amount transferred counts towards the taxpayer's annual HSA contribution limit and reduces the amount they can contribute by other means in that year.



Practitioner Planning Tip

If they are approaching Medicare eligibility, clients considering a one-time IRA-to-HSA transfer should time the transfer carefully. To avoid triggering tax and penalties, practitioners should ensure the client will maintain HDHP coverage and HSA eligibility for the full 12-month testing period. This strategy can be especially effective for clients with large IRA balances who want to fund future medical expenses tax-free.

⁶⁹ IRS Notice 2005-8, 2005-4 IRB 368.

⁷⁰ IRC §408(d)(9)(C)(ii)(I).

⁷¹ IRC §408(d)(9)(C)(i).

⁷² IRC §223(b)(7).

⁷³ IRC §408(d)(9)(A), which uses the definition of an eligible individual found in IRC §223(c).

⁷⁴ IRC §408.

For 2025, the total amount a taxpayer under age 55 can contribute to an HSA, including both contributions made directly and a one-time funding distribution from a traditional IRA, cannot exceed \$4,300 for a self-only plan and \$8,550 for a family plan.⁷⁵ The amounts are increased by \$1,000 for each taxpayer age 55 or over.⁷⁶ Consequently, an individual over age 55 can contribute \$5,300 to an HSA account, while a married couple age 55 or older with family coverage can contribute \$9,550 during 2025.

Neither a simplified employee pension (SEP) nor a savings incentive match plan for employees (SIMPLE) plan can be used to make a qualified HSA funding distribution.⁷⁷ This funding distribution must be a direct rollover from the IRA trustee to the HSA trustee.⁷⁸

Example 8. Ron is single and 62 years old. He has worked for many years at a local manufacturing firm that sponsors an HSA-qualified HDHP. This plan enables Ron to fund his HSA regularly. Ron also has a traditional IRA with a \$300,000 balance.

Ron reaches age 65 in November 2027 and plans to start Medicare on the first day of the following month. He is considering making a one-time HSA funding distribution, but his tax practitioner has advised him to do so by October 2026. Ron decides to make this one-time funding distribution in January 2025. By making the transfer more than a year before the potential termination, he satisfies the 12-month requirement.

Acting on this plan, Ron requests a transfer of \$5,300 on January 4, 2025, because the HSA contribution limit for 2025 is \$5,300 (\$4,300 + \$1,000 catch-up contribution). Because he has made the maximum contribution early in the year, he cannot make any additional HSA contributions during 2025. Ron plans to reserve this money for LTC. He has effectively transferred \$5,300 from his traditional IRA to his HSA, making it available for qualified medical expenses, including LTC or LTC insurance premiums.

Example 9. Maria is a 58-year-old CPA who owns 25% of a small S corporation, where she works full-time. The company offers an HDHP that qualifies for HSA contributions. In 2025, the S corporation contributes \$5,300 to Maria's HSA because she has self-only coverage and qualifies for the \$1,000 catch-up contribution.

Because Maria owns more than 2% of the S corporation, the \$5,300 employer contribution is included in wages on her Form W-2, *Wage and Tax Statement*. However, as long as Maria has sufficient Medicare wages, she can deduct the \$5,300 on her Form 1040, *U.S. Individual Income Tax Return*, as an adjustment to income, effectively neutralizing the income inclusion for federal tax purposes.

Maria has consistently contributed to her HSA over the past 15 years but has rarely withdrawn funds, choosing instead to pay out-of-pocket for minor medical expenses. As a result, her HSA has grown to over \$60,000, and she has invested in a diversified portfolio within the account. She plans to use these funds in retirement to pay for LTC insurance premiums and skilled nursing care, which are qualified medical expenses under §213(d).

⁷⁵ IRS Notice 2008-51, 2008-25 IRB 1163; Rev. Proc. 2024-25, 2024-21 IRB 1214.

⁷⁶ IRC §223(b)(3).

⁷⁷ IRC §408(d)(9)(B).

⁷⁸ Ibid.

LTC Insurance

Insurers originally positioned LTC insurance as a nursing home insurance product to complement the other health insurance products provided by insurance companies.⁷⁹ It allows taxpayers to accumulate assets to fund medical needs, such as extended stays in skilled nursing facilities.

The market for LTC insurance policies has tightened in recent years as many insurance companies have left the market. Insurance costs have increased significantly as medical costs have increased considerably for doctors, hospitals, and nursing homes. However, purchasing LTC insurance when an individual is younger is generally less expensive. For example, taxpayers may find paying for a policy from ages 50 to 75 cheaper than purchasing one from the same insurer at age 65 and maintaining it for just 10 years.⁸⁰

Taxpayers can deduct premiums paid for LTC insurance as a medical expense up to a limit. The Code specifies a limit on the deductible amount based on the insured taxpayer's age. Consequently, a taxpayer up to age 40 can deduct only \$480 for LTC in 2025.⁸¹ In contrast, a taxpayer of at least 71 years can deduct up to \$6,020 of premiums in 2025.⁸² If an employer provides LTC insurance, it is a tax-free benefit.⁸³ Self-employed individuals, partners, and 2% S corporation shareholders can treat it as self-employed health insurance. However, an employer may not offer LTC insurance through an IRC §125 cafeteria plan.

Life Insurance Options for LTC

Life insurance policies generally fall into three categories: **term life**, **whole life**, and **universal life**.⁸⁴

- **Term life insurance** provides coverage for a specific period (e.g., 10, 20, or 30 years). It is typically the most affordable option, but it does not build cash value. Term policies are generally not eligible for LTC riders but may offer accelerated death benefits.
- **Whole life insurance** is a type of permanent insurance that offers lifelong coverage and includes a cash value component that grows over time. These policies are more expensive but are often used as the foundation for **hybrid LTC policies**, which allow policyholders to access benefits while still living if they become chronically or terminally ill.
- **Universal life insurance** is a flexible form of permanent insurance that offers lifelong coverage and a cash value component that earns interest. Unlike whole life insurance, it allows policyholders to adjust their premiums and death benefits over time. These policies are often used in hybrid LTC planning. However, their performance depends on sufficient funding and interest crediting to cover the rising cost of insurance as the insured ages. If the policy's cash value does not earn enough interest or is underfunded, it may eventually lapse, potentially resulting in loss of coverage and adverse tax consequences.

⁷⁹ *Long-Term Care Insurance Research Brief*. May 31, 2012. U.S. Department of Health and Human Services. [aspe.hhs.gov/reports/long-term-care-insurance-research-brief-0] Accessed on Dec. 10, 2024.

⁸⁰ See, *2025 Long-Term Care Insurance Facts - Prices - Data - Statistics - 2025 Reports*. American Association for Long-Term Care Insurance. [www.aaltci.org/long-term-care-insurance/learning-center/lcfacts-2025.php] Accessed on Jun. 2, 2025; *With the Challenges and Problems Facing the LTC Insurance Industry, Is "Self-Insuring" a Better Option?* Zurndorfer, Ed. May 23, 2025. Serving Those Who Serve. [stwserv.com/with-the-challenges-and-problems-facing-the-ltc-insurance-industry-is-self-insuring-a-better-option] Accessed on Jun. 7, 2025.

⁸¹ Rev. Proc. 2024-40, 2024-45 IRB 1100.

⁸² Ibid.

⁸³ IRC §7702B(a)(3).

⁸⁴ *Term Life Vs. Whole Life Insurance*. Danise, Amy. Feb. 20, 2025. Forbes. [www.forbes.com/advisor/life-insurance/term-life-vs-whole-life-insurance] Accessed on Jun. 2, 2025.

While traditional LTC insurance provides dedicated coverage for extended care needs, many individuals now turn to life insurance policies that offer LTC benefits through specialized riders. These riders allow policyholders to access a portion of their life insurance benefits while still living—either in the form of an **accelerated death benefit** or an **LTC rider**. Though both options can help cover the cost of care, they differ in structure, eligibility, and impact on the policy's death benefit.

Conventional policies usually have a provision that allows the insurance company to increase premiums, often because the costs of care increase. Companies selling life insurance with LTC riders cannot raise premiums once they issue the policy. The market sometimes refers to these policies as asset-based LTC policies.⁸⁵ Regardless of the policy type, insured persons should expect an elimination period during which they cannot perform some of the activities of daily living, but they are not yet eligible for insurance benefits. This elimination period functions like an insurance deductible. Furthermore, some policies use counterintuitive means of defining an elimination period.⁸⁶

Accelerated Death Benefit Rider.⁸⁷ Some life insurance policies have a provision for accelerated death benefits that give the policyholder access to a part of the death benefit if they become chronically ill, terminally ill, or require LTC. Because this is an early death benefit payment, it reduces the death benefit that the insurance company eventually pays the beneficiaries.

The accelerated death benefit rider is typically activated when a policyholder is diagnosed with a terminal illness with an expected duration of one to two years. A chronic illness or a need for LTC can also activate the accelerated death benefit rider. Depending on the policy, the accelerated death benefit may be a small percentage of the stated or entire death benefit.

LTC Rider.⁸⁸ In contrast, insurance policies with LTC riders are more focused on the LTC function of the policy. They are typically activated when a policyholder can no longer independently perform some of the following activities of daily living. The activities of daily living for which assistance is needed to determine loss of functional capacity follow the statutory requirements for LTC.⁸⁹

- Eating
- Toileting
- Transferring
- Bathing
- Dressing
- Continence

These activities of daily living are also used to determine that an individual is chronically ill, as discussed later.

⁸⁵ *How Hybrid Life Insurance Pays for Long-Term Care*. Huddleston, Cameron. Oct. 27, 2023. Forbes. [www.forbes.com/advisor/life-insurance/long-term-care-hybrid] Accessed on Dec. 10, 2024.

⁸⁶ *A Shopper's Guide to Long-Term Care Insurance*, p.15. 2019. National Association of Insurance Commissioners. [content.naic.org/sites/default/files/publication-ltc-lp-shoppers-guide-long-term.pdf] Accessed on Jun. 12, 2025.

⁸⁷ *How Hybrid Life Insurance Pays for Long-Term Care*. Huddleston, Cameron. Oct. 27, 2023. Forbes. [www.forbes.com/advisor/life-insurance/long-term-care-hybrid] Accessed on Dec. 10, 2024.

⁸⁸ Ibid.

⁸⁹ IRC §7702B(c)(2)(B).

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Critical Illness Rider.⁹⁰ A third type of rider provides a lump-sum benefit if the insured is diagnosed with an illness covered explicitly in the policy document. Unlike a life insurance policy with an LTC rider which is triggered when the insured cannot perform some of the activities of daily living, the critical illness rider will only provide benefits if the insured person is diagnosed with a specific covered condition, such as heart attacks, cancer, strokes, or other serious illnesses. In this sense, the critical illness rider is similar to an accelerated death benefit rider, as both allow early access to life insurance proceeds. However, the critical illness rider is more narrowly focused on specific medical diagnoses.

Tax Treatment of LTC Policies and Life Insurance with LTC Riders

IRC §7702B establishes the tax-deductibility of qualified LTC insurance. A qualified LTC insurance contract has the following attributes.

- The only insurance protection it provides is coverage of qualified LTC services.
- The insurance contract does not reimburse or pay expenses reimbursable under Medicare.
- The insurance policy is guaranteed to be renewable.
- The insurance policy does not have a cash surrender value that can be borrowed or used as collateral for a loan.
- If the refund or a dividend is payable under the insurance contract, the contract must stipulate that the refund or dividend either pays future premiums or increases future benefits.
- The insurance contract must meet consumer protection provisions of §7702B(g).

In contrast, a hybrid policy likely has no tax-deductible portion. Any payment charged against the cash surrender value of a life insurance contract disallows the deduction.

Life insurance is not generally a deductible expense, and an LTC rider does not make it deductible.

Caution. IRAs cannot invest in life insurance contracts.⁹¹ An individual should not invest the proceeds of an IRA in a life insurance contract with a long-term rider, as this is a prohibited transaction that subjects the IRA to lose its exempt status on the first day of the year.⁹²

Example 10. John wants LTC insurance and is open to a life insurance policy with an LTC rider. The LTC rider contains the following clause.

In the event of the claim under section 14.5 of this policy, the surrender value of this policy shall be reduced by the value of the claim once the claim is paid.

Because his policy clearly provides for reducing the surrender value by the amount of any claims paid, the premium paid for the policy is not a deductible itemized expense, nor would it be deductible as a self-employed owner's health insurance.

⁹⁰ What is a life insurance critical or chronic illness rider? Progressive Casualty Insurance Company. [www.progressive.com/answers/critical-chronic-illness-rider] Accessed on Jun. 9, 2025.

⁹¹ IRC §408(a)(3).

⁹² IRC §408(e)(2)(A).

Reporting LTC Insurance and Archer MSAs⁹³

Taxpayers report contributions to and distributions from Archer medical savings accounts (MSAs), as well as benefits received under qualified LTC insurance contracts on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*. The form also reports distributions from Medicare Advantage MSAs and handles the special reporting when taxpayers receive accelerated death benefits.

Taxpayers use Form 8853, **part I** to:

- Report contributions made to an Archer MSA,
- Calculate the allowable deduction for those contributions, and
- Report employer contributions, even though they are not deductible by the employee.

Contributions are deductible only if the taxpayer is eligible (self-employed or employed by a small employer with an HDHP). They are limited to 65% of the minimum annual deductible for HDHPs providing self-only coverage and 75% for those providing family coverage, as discussed previously. Excess contributions are subject to a 6% excise tax unless withdrawn in a timely manner.

Taxpayers use Form 8853, **part II** to report:

- Distributions from Archer MSAs,
- Whether the distributions were used for unreimbursed qualified medical expenses, and
- The additional 20% tax on taxable Archer MSA distributions.

While qualified medical expenses are tax-free, non-qualified expenses are subject to income tax **and** a 20% addition to tax (unless an exception applies). The addition to tax does not apply if the account holder turns 65, becomes disabled, or dies.

Taxpayers use Form 8853, **part II, Section B**, to report distributions from **Medicare Advantage MSAs**. As previously discussed, eligible taxpayers are enrolled in Medicare and are covered by an HDHP meeting Medicare requirements. Using this section, taxpayers report:

- Distributions from Medicare Advantage MSAs,
- Total distributions from Medicare MSAs that pay the taxpayer's qualified medical expenses, and
- The additional 50% tax arising from distributions that were not used for qualified medical expenses.

Taxpayers use Form 8853, **part II, Section C**, to report the following information from **LTC insurance contracts**.

- Per diem or reimbursement-based benefits received under a qualified LTC insurance contract
- The extent to which the LTC insurance benefits are taxable

If the insured is **terminally** ill, amounts they receive as accelerated death benefits are tax-free, even if they exceed the per diem limit.⁹⁴ If the insured is **chronically** ill, rendering them unable to perform two of the activities of daily living for at least 90 days, any per diem insurance benefits paid are tax-free up to a limit established by §7702B(d)(4). For 2025, the per diem limit is \$420 per day, up from \$410 in 2024.⁹⁵ Benefits exceeding this amount may be taxable unless actual expenses justify the higher amount.

⁹³ Instructions for Form 8853.

⁹⁴ IRC §7702B(d)(1).

⁹⁵ Rev. Proc. 2024-40, 2024-45 IRB 1100; Rev. Proc. 2023-34, 2023-48 IRB 1287.

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Taxpayers generally obtain this information on Forms 1099-LTC, *Long-Term Care and Accelerated Death Benefits*, which payers of LTC benefits use to report total amounts paid as long-term care benefits. This form is generated by the LTC insurance company or the payer organization that paid the claim. The payer can also indicate any amounts received as accelerated death benefits and whether the amounts were paid as a per diem amount or whether they were paid to reimburse actual expenses incurred. A copy of this form follows.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Gross long-term care benefits paid \$	OMB No. 1545-1519 Form 1099-LTC (Rev. April 2025)	Long-Term Care and Accelerated Death Benefits
PAYER'S TIN		2 Accelerated death benefits paid \$	For calendar year _____	
POLICYHOLDER'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code		3 ☐ Per diem ☐ Reimbursed amount INSURED'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code		Copy B For Policyholder This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
Account number (see instructions)		4 Qualified contract (optional) ☐		
		5 (optional) ☐ Chronically ill ☐ Terminally ill Date certified		

Form **1099-LTC** (Rev. 4-2025) (keep for your records) www.irs.gov/Form1099LTC Department of the Treasury - Internal Revenue Service

Example 11. In late November 2023, Jackson loses the ability to perform two of the six activities of daily living.⁹⁶ His doctor certifies him as a chronically ill person on December 2, 2023, but he is not terminally ill. Two weeks later, Jackson moves into a nursing home that is operated by his church's denomination.

Jackson's LTC insurance policy has a 30-day elimination period before it starts paying a \$2,000 per month benefit. Consequently, his LTC insurance benefit starts on January 1, 2024. The LTC policy also reimburses Jackson for 50% of his LTC expenses. He incurs costs of LTC of \$150 per day or \$54,900 for all of 2024 (\$150 per day × 366 days). Thus, he receives a reimbursement of these expenses of \$75 per day (\$150 per day × 50% reimbursement rate).

For all 2024, Jackson receives insurance benefits with the following two components.

- Gross LTC payments received on a period basis (line 17) of \$24,000 (\$2,000 per month × 12 months).
- Reimbursements for qualified LTC services (line 24) of \$27,450.

Jackson's 2024 Form 8853 reports no taxable income from his LTC insurance benefits, as shown on the following Form 8853, page 2.

⁹⁶ This example is based on Example 1 in Instructions for Form 8853.

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For Example 11

Form 8853 (2024)

Attachment Sequence No. **39**

Page **2**

Name of policyholder (as shown on return)

Jackson Buck

Social security number
of policyholder

*****-**-4622**

Section C. Long-Term Care (LTC) Insurance Contracts. See **Filing Requirements for Section C** in the instructions before completing this section.

If more than one Section C is attached, check here ☐

14a Name of insured **Jackson Buck** **b** Social security number of insured *****-**-4622**

15 In 2024, did anyone other than you receive payments on a per diem or other periodic basis under a qualified LTC insurance contract covering the insured or receive accelerated death benefits under a life insurance policy covering the insured? ☐ Yes ☒ No

16 Was the insured a terminally ill individual? ☐ Yes ☒ No

Note: If "Yes" and the **only** payments you received in 2024 were accelerated death benefits that were paid to you because the insured was terminally ill, skip lines 17 through 25 and enter -0- on line 26.

17 Gross LTC payments received on a per diem or other periodic basis. Enter the total of the amounts from box 1 of all Forms 1099-LTC you received with respect to the insured on which the "Per diem" box in box 3 is checked **17** **24,000**

Caution: Don't use lines 18 through 26 to figure the taxable amount of benefits paid under an LTC insurance contract that isn't a **qualified** LTC insurance contract. Instead, if the benefits aren't excludable from your income (for example, if the benefits aren't paid for personal injuries or sickness through accident or health insurance), report the amount not excludable as income on Schedule 1 (Form 1040), line 8e, or, for taxpayers filing Form 1040-NR, on Schedule NEC (Form 1040-NR), line 12.

18 Enter the part of the amount on line 17 that is from **qualified** LTC insurance contracts **18** **24,000**

19 Accelerated death benefits received on a per diem or other periodic basis. Don't include any amounts you received because the insured was terminally ill. See instructions **19**

20 Add lines 18 and 19 **20** **24,000**

Note: If you checked "Yes" on line 15 above, see **Multiple Payees** in the instructions before completing lines 21 through 25.

21 Multiply \$410 by the number of days in the LTC period **21** **150,060**

22 Costs incurred for qualified LTC services provided for the insured during the LTC period (see instructions) **22** **54,900**

23 Enter the **larger** of line 21 or line 22 **23** **150,060**

24 Reimbursements for qualified LTC services provided for the insured during the LTC period **24** **27,450**

Caution: If you received any reimbursements from LTC contracts issued before August 1, 1996, see instructions.

25 Per diem limitation. Subtract line 24 from line 23 **25** **122,610**

26 **Taxable payments.** Subtract line 25 from line 20. If zero or less, enter -0-. Also include this amount in the total on Schedule 1 (Form 1040), line 8e, or, for taxpayers filing Form 1040-NR, on Form 1040-NR, Schedule NEC, line 12. For taxpayers filing Form 1040-NR, on Schedule NEC (Form 1040-NR), line 12, enter "LTC" and the amount **26** **0**

Form **8853** (2024)



Practitioner Planning Tip

Practitioners should ensure clients receiving LTC insurance benefits track their actual medical expenses to justify exclusions, understand the per diem limits and how they affect taxable income, and retain documentation for all LTC-related expenses and insurance payments.

Personal Savings⁹⁷

Taxpayers may accumulate savings to fund LTC during their earning years. The funds could accumulate in a bank account or an investment account. Paying for LTC from accumulated assets receives no special tax treatment. However, if the taxpayer eventually spends them on LTC needs, future expenditures can result in itemized medical deductions under §213(a).

PAYING LTC EXPENSES

Individuals can make tax-free withdrawals from their HSAs and Archer MSAs when the funds are used to pay for qualified medical expenses. These accounts are designed to help cover a wide range of health-related costs, both routine and unexpected. These accounts can provide important financial support if the expenses meet the criteria set by the IRS.

HSA Distributions⁹⁸

Individuals can pay for qualified medical expenses for themselves or a beneficiary without paying tax on their withdrawal from an HSA.⁹⁹ Taxpayers who use money from an HSA to pay for medical or dental expenses cannot also claim those **same** expenses as a deduction on Schedule A.

With some exceptions, expenses that qualify for a medical expense deduction on Schedule A are also considered qualified medical expenses for HSA distributions.¹⁰⁰

One of the exceptions holds that withdrawals from HSAs to fund health care insurance are not qualified medical expenses.¹⁰¹ However, if a taxpayer makes payments on an LTC insurance contract that satisfies the requirements of §7702B(b), the payments constitute qualified medical expenses.¹⁰²

Amounts distributed from an HSA are generally tax-free when used to pay for qualified medical expenses. Since the beginning of 2019, taxpayers can use HSA funds to pay for over-the-counter medicine, even if a doctor did not prescribe it.¹⁰³

Disability Insurance Recoveries¹⁰⁴

If a taxpayer has disability insurance, a recovery under this plan may provide funding for skilled nursing. Generally, both short-term and long-term disability insurance are designed to replace lost wages, not pay medical bills.

Short-term disability insurance covers the taxpayer's lost wages when they cannot work, generally covering a period lasting from three to 12 months. Long-term disability insurance typically has a benefit period lasting from two to 10 years. Typically, these policies have an elimination period, during which the policyholder is ineligible for benefits under the policy. The elimination period for a short-term policy is shorter than that for a long-term policy, perhaps lasting 14 calendar days. In contrast, the elimination period for a long-term policy may be 20 to 100 calendar days.¹⁰⁵

⁹⁷. *Planning for Retirement? Include Long-Term Care Needs*. Ali Khawar. Nov. 16, 2021. U.S. Department of Labor. [blog.dol.gov/2021/11/16/planning-for-retirement-include-long-term-care-needs] Accessed on Dec. 10, 2024; *How can I pay for nursing home care?* Centers for Medicare and Medicaid. [www.medicare.gov/what-medicare-covers/what-part-a-covers/how-can-i-pay-for-nursing-home-care] Accessed on Dec. 10, 2024.

⁹⁸. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

⁹⁹. IRC §223(f)(1).

¹⁰⁰. IRC §223(d)(2)(A).

¹⁰¹. IRC §223(d)(2)(B).

¹⁰². IRC §223(d)(2)(C)(ii).

¹⁰³. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*, p. 9 (2023).

¹⁰⁴. *What is the Difference Between Short-Term and Long-Term Disability Insurance*. Feb. 27, 2024. Paychex, Inc. [www.paychex.com/articles/employee-benefits/short-vs-long-term-disability-insurance] Accessed on Dec. 19, 2024.

¹⁰⁵. *A Shopper's Guide to Long-Term Care Insurance*, p.15. 2019. National Association of Insurance Commissioners. [content.naic.org/sites/default/files/publication-ltc-lp-shoppers-guide-long-term.pdf] Accessed on Jun. 12, 2025.

Rev. Rul. 2004-55 addresses the income tax treatment of long-term and short-term disability benefits under IRC §104(a)(3) and 105(a).¹⁰⁶

The taxation of amounts paid from long-term and short-term disability plans depends on who contributed to the plan and whether the policyholder's taxable wages included the premiums. Thus, their Form W-2, box 1, wages include the disability insurance premiums.¹⁰⁷

- When a plan's premiums are funded solely by an employer, proceeds are includable in the policyholder's gross income to the extent that such amounts are attributable to employer contributions not includable in the employee's gross income.¹⁰⁸
- When both the employer and the employee contribute to a plan, proceeds are **includable** in the employee's gross income to the extent that such amounts are attributable to employer contributions **not includable** in the employee's gross income.¹⁰⁹
- When an individual has purchased a plan with their own funds, their gross income excludes any proceeds received for personal injuries or sickness under §104(a)(3).¹¹⁰

Tax Treatment of Insurance Claims on LTC Insurance

When a taxpayer has a need for skilled nursing care, they generally have a claim to benefits under the policy they have purchased. The tax treatment of claims on an LTC policy depends on the insurance policy's wording. Taxpayers may exclude from taxable income benefits received from a policy in the following three situations.

1. Benefits based on actual expenses paid¹¹¹
2. Benefits paid on behalf of a terminally ill person¹¹²
3. Per-diem amount based on limits set annually

Note. The Secretary of the Treasury sets the per-diem amount each year in coordination with the Secretary of Health and Human Services. For 2025, the limit is \$420 per day.¹¹³

Taxpayers may receive LTC insurance benefits that are **not fully exempt from federal income tax** when the per diem payments exceed the IRS daily limit. If the total daily benefits from all policies exceed this threshold and actual care expenses are lower, the excess may be taxable.¹¹⁴

In contrast, when LTC benefits are paid through a **life insurance policy with an accelerated death benefit rider**, the payments are **generally tax-free**, provided the insured is certified as chronically or terminally ill. These benefits are excluded from income under **IRC §101(g)**, and the premiums for such policies are typically **not tax-deductible**, which helps preserve the tax-exempt status of the benefits.

¹⁰⁶. Rev. Rul. 2004-55, 2004-26 IRB 1081.

¹⁰⁷. Treas. Reg. §104-1(d).

¹⁰⁸. IRC §105(a).

¹⁰⁹. Treas. Reg. §1.105-1(a).

¹¹⁰. Treas. Reg. §1.104-1(d).

¹¹¹. IRC §7702B(a)(2).

¹¹². IRC §7702B(d)(1).

¹¹³. IRC §§7702B(d)(4) and (5), as updated by Rev. Proc. 2024-40, 2024-45 IRB 1100.

¹¹⁴. IRC §7702B(d)(4).



Practitioner Planning Tip

Taxpayers who pay extensive medical and nursing home costs with after-tax funds should consider distributions from pre-tax retirement funds (such as regular IRAs or §401(k) accounts) to create taxable income to maximize allowable itemized deductions on Schedule A. This will allow beneficiaries to inherit more after-tax funds rather than pre-tax retirement funds.

Qualified LTC Services.¹¹⁵ Under §7702B(c), qualified LTC services include necessary diagnostic, preventive, therapeutic, and rehabilitative care, as well as maintenance or personal care services, provided to a **chronically ill** individual under a plan of care prescribed by a licensed health care practitioner. A chronically ill individual is one who has been certified within the past 12 months as being unable to perform at least two activities of daily living (such as eating, bathing, dressing, or toileting) for a minimum of 90 days, or who requires substantial supervision due to severe cognitive impairment. Maintenance or personal care services refer to assistance needed due to the individual's qualifying disabilities. Licensed health care practitioners include physicians, registered nurses, licensed social workers, and others as defined by the Secretary.

HOME MODIFICATIONS FOR MEDICAL NEEDS¹¹⁶

A complication arises when the home requires modification to accommodate a medical need. Although these modifications are typically of a capital nature, some portion of the cost may be deductible when undertaken to address a resident's chronic condition.¹¹⁷ They may be deductible to the extent that they do not increase the value of the residence.

Example 12. Due to diabetes, Ethan lost the use of both legs, making it necessary for him to use a wheelchair. This change made it difficult to use the doors in his home beginning in early 2024.

Ethan pays a contractor \$15,000 in 2024 to widen the doorways. Before construction, a real estate appraisal values Ethan's house at \$150,000. After the contractor finishes in August, the same appraiser values the home at \$160,000, an increase of \$10,000 (\$160,000 value after improvements – \$150,000 value before improvements). The appraisal means that Ethan can include \$5,000 (\$15,000 total cost of medical improvement to home – \$10,000 increase in home value due to medical improvements) as a medical expense. His Worksheet A, *Capital Expense Worksheet*, from IRS Pub. 502, *Medical and Dental Expenses*, follows.

¹¹⁵. IRC §7702B(c).

¹¹⁶. IRS Pub. 502, *Medical and Dental Expenses*.

¹¹⁷. Treas. Reg. §1.213-1(e)(1)(iii).

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For Example 12

Worksheet A. Capital Expense Worksheet Keep for Your Records



Instructions: Use this worksheet to figure the amount, if any, of your medical expenses due to a home improvement.

1. Enter the amount you paid for the home improvement 1. \$15,000
2. Enter the value of your home immediately after the improvement 2. \$160,000
3. Enter the value of your home immediately before the improvement 3. 150,000
4. Subtract line 3 from line 2. This is the increase in the value of your home due to the improvement 4. 10,000
 - If line 4 is more than or equal to line 1, you have no medical expenses due to the home improvement; stop here.
 - If line 4 is less than line 1, go to line 5.
5. Subtract line 4 from line 1. These are your medical expenses due to the home improvement 5. \$ 5,000

6

During 2024, Ethan's only income is \$60,000 in dividend income because he cannot work. He pays \$25,000 for other medical bills that insurance does not reimburse. He has \$30,000 of eligible medical expenses for 2024 (\$5,000 deductible for the home improvement + \$25,000 of other medical payments). Because his AGI is \$60,000, only \$25,500 ($\$30,000 - (\$60,000 \text{ AGI} \times 7.5\%)$) is deductible medical expense on Schedule A.

NURSING HOME AND IN-HOME CARE EXPENSES

Acute care needs usually prompt a hospital stay, resulting in substantial expenditures. If the proper insurance is in place, an insurance company or Medicare bears at least some portion of those expenditures. In other circumstances, the taxpayer must shoulder some portion of the cost.

During 2024, the median price of a private room in a nursing home was almost \$128,000, reflecting a 9% increase over 2023.¹¹⁸ Americans aged 65 have a 70% chance of needing LTC.¹¹⁹ On average, men can expect LTC for 2.2 years, while women can expect LTC for 3.7 years.¹²⁰

¹¹⁸. Calculate the cost of long-term care near you. 2025. Genworth Financial, Inc. [www.carescout.com/cost-of-care] Accessed on Jun. 12, 2025.

¹¹⁹. How Much Care Will You Need? Feb. 18, 2020. Administration for Community Living. [acl.gov/ltc/basic-needs/how-much-care-will-you-need] Accessed on Dec. 11, 2024.

¹²⁰. Ibid.

Deductions

When not reimbursed by insurance or otherwise, taxpayers are allowed a deduction for medical expenses paid during the tax year for medical care of the taxpayer, spouse, or dependent if they itemize deductions on Schedule A.¹²¹ The Consolidated Appropriations Act of 2021 made the 7.5% AGI threshold a permanent part of the Code.¹²² Typically, taxpayers with high medical expenses relative to their income benefit the most from this deduction.

Taxpayers can include the cost of medical care in a nursing home, a home for the aged, or a similar institution as a medical expense.¹²³ If the main reason for their stay at the nursing home is to receive medical care, the taxpayer can deduct all costs, including the cost of meals and lodging. If the stay is **primarily for nonmedical reasons** (e.g., safety, lack of support, or convenience), then only the actual medical care costs (e.g., doctor visits, prescribed therapies) are deductible. Meals, lodging, and custodial care (help with bathing, dressing, etc.) are not deductible.



Practitioner Planning Tip

Practitioners should request monthly invoices from the skilled nursing facility for their clients who live in such a facility. Not all charges assessed to a taxpayer residing in a skilled nursing facility are tax-deductible. For example, if the facility has a barbershop or a beauty parlor, charges for their services may appear on monthly invoices. However, they are not deductible medical expenses, even if a licensed doctor has ordered full nursing care for the taxpayer.

Example 13. After suffering a severe stroke, Karen moves to Coventry Oaks, an assisted care facility. She has lost the ability to care for herself, and her family is unable to provide the level of care she requires. The assisted care facility provides housing, nursing care, 21 weekly meals, and a beauty salon where she occasionally has her hair done.

Coventry Oaks sends her a monthly statement, which Karen's children review and pay. The total includes an amount for nursing care, her room, and her meals, which are deductible because her principal reason for residence at Coventry Oaks is medical care necessitated by the stroke. However, the charges for hair care are not tax-deductible. Her children review the statement carefully to ensure only eligible medical expenses are included.

¹²¹. IRC §213(a).

¹²². IRC §213(f); *Consolidated Appropriations Act of 2021*, PL 116-260, §§101(a) and (b) amending IRC §213(f).

¹²³. IRS Pub. 502, *Medical and Dental Expenses*, p. 11 (2023).

Paying with Retirement Assets¹²⁴

Sometimes, taxpayers younger than 59½ require skilled nursing care or must reside in a nursing home. They can withdraw funds for medical purposes without incurring the 10% additional tax on an early distribution.¹²⁵

However, this only applies to medical expenses **exceeding 7.5%** of their AGI. The withdrawal of retirement assets corresponding to the first 7.5% of AGI is still subject to the 10% additional tax. If under age 59½, they must file Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to report the early distribution and possible exceptions that may apply to the early tax. On this form, the exception number “05” indicates a distribution from a qualified retirement plan that is used to pay for unreimbursed medical expenses **exceeding 7.5%** of a taxpayer’s AGI.¹²⁶

Example 14. In 2024, Irwin worked for the Bank of Michigan, earning \$60,000. During the year, he celebrated his 35th birthday. He became ill with a genetic disorder and had to receive care in a nursing home for four weeks. Although he had insurance, the amount he had to pay exceeded his regular savings, so he had to withdraw \$40,000 from his IRA to pay the \$45,000 medical and nursing home bills. Irwin has no other sources of income.

Thus, Irwin’s AGI for 2024 is \$100,000 (\$60,000 salary + \$40,000 withdrawal from IRA). He is eligible for an itemized medical expense deduction to the extent that his qualified medical bills exceed 7.5% of his AGI or \$7,500 (\$100,000 AGI × 7.5%). Irwin is not liable for the 10% additional tax on early distributions from IRAs on \$32,500 of this withdrawal from his IRA (\$40,000 withdrawal from IRA – \$7,500 not an eligible exception from the early withdrawal penalty).

Irwin is liable for an additional tax of \$750 (\$7,500 × 10%) as calculated on the following Form 5329.

¹²⁴. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*, p. 25 (2023).

¹²⁵. E.g., IRC §72(t).

¹²⁶. Instructions for Form 5329.

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For Example 14

Form 5329 Department of the Treasury Internal Revenue Service	Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts Attach to Form 1040, 1040-SR, 1040-NR, or 1041. Go to www.irs.gov/Form5329 for instructions and the latest information.	OMB No. 1545-0074 2024 Attachment Sequence No. 29
Name of individual subject to additional tax. If married filing jointly, see instructions. Irwin Krankenhaus		Your social security number ***-**-4444
Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return	Home address (number and street), or P.O. box if mail is not delivered to your home Apt. no.	
	City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below. See instructions.	
	Foreign country name	Foreign province/state/county
		If this is an amended return, check here ☐ Foreign postal code
If you only owe the additional 10% tax on the full amount of the early distributions, you may be able to report this tax directly on Schedule 2 (Form 1040), line 8, without filing Form 5329. See instructions.		
Part I Additional Tax on Early Distributions. Complete this part if you took a taxable distribution (other than a qualified disaster distribution) before you reached age 59½ from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Schedule 2 (Form 1040)—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions. See instructions.		
1 Early distributions includible in income (see instructions). For Roth IRA distributions, see instructions.		1 40,000
2 Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: <u>05</u>		2 32,500
3 Amount subject to additional tax. Subtract line 2 from line 1		3 7,500
4 Additional tax. Enter 10% (0.10) of line 3. Include this amount on Schedule 2 (Form 1040), line 8		4 750
Caution: If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10%. See instructions.		
Part II Additional Tax on Certain Distributions From Education Accounts and ABLER Accounts. Complete this part if you included an amount in income, on Schedule 1 (Form 1040), line 8z, from a Coverdell education savings account (ESA) or a qualified tuition program (QTP), or on Schedule 1 (Form 1040), line 8q, from an ABLER account.		
5 Distributions included in income from a Coverdell ESA, a QTP, or an ABLER account		5
6 Distributions included on line 5 that are not subject to the additional tax (see instructions)		6
7 Amount subject to additional tax. Subtract line 6 from line 5		7
8 Additional tax. Enter 10% (0.10) of line 7. Include this amount on Schedule 2 (Form 1040), line 8		8
Part III Additional Tax on Excess Contributions to Traditional IRAs. Complete this part if you contributed more to your traditional IRAs for 2024 than is allowable or you had an amount on line 17 of your 2023 Form 5329.		
9 Enter your excess contributions from line 16 of your 2023 Form 5329. See instructions. If zero, go to line 15		9
10 If your traditional IRA contributions for 2024 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-		10
11 2024 traditional IRA distributions included in income (see instructions)		11
12 2024 distributions of prior year excess contributions (see instructions)		12
13 Add lines 10, 11, and 12		13
14 Prior year excess contributions. Subtract line 13 from line 9. If zero or less, enter -0-		14
15 Excess contributions for 2024 (see instructions)		15
16 Total excess contributions. Add lines 14 and 15		16
17 Additional tax. Enter 6% (0.06) of the smaller of line 16 or the value of your traditional IRAs on December 31, 2024 (including 2024 contributions made in 2025). Include this amount on Schedule 2 (Form 1040), line 8		17
Part IV Additional Tax on Excess Contributions to Roth IRAs. Complete this part if you contributed more to your Roth IRAs for 2024 than is allowable or you had an amount on line 25 of your 2023 Form 5329.		
18 Enter your excess contributions from line 24 of your 2023 Form 5329. See instructions. If zero, go to line 23		18
19 If your Roth IRA contributions for 2024 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-		19
20 2024 distributions from your Roth IRAs (see instructions)		20
21 Add lines 19 and 20		21
22 Prior year excess contributions. Subtract line 21 from line 18. If zero or less, enter -0-		22
23 Excess contributions for 2024 (see instructions)		23
24 Total excess contributions. Add lines 22 and 23		24
25 Additional tax. Enter 6% (0.06) of the smaller of line 24 or the value of your Roth IRAs on December 31, 2024 (including 2024 contributions made in 2025). Include this amount on Schedule 2 (Form 1040), line 8		25
For Privacy Act and Paperwork Reduction Act Notice, see your tax return instructions.		
Cat. No. 13329Q		Form 5329 (2024)

In-Home Skilled Nursing Care

In some cases, the need for skilled nursing is not so severe as to require the patient to live temporarily in a skilled nursing or rehabilitation center. In these situations, a visiting nurse can assist with care needs in a patient's home if they require attention on an occasional basis. The patient must generally be able to take care of themselves, even if there are certain activities they cannot perform.

Example 15. Amy had delighted audiences with her ice skating for ten years when she fell and suffered a broken arm. After being hospitalized for three days and being in a rehabilitation facility for the rest of a week, her doctor discharged her to recover at home, where she lived alone. Amy has diabetes and, before her fall, would self-administer insulin daily.

With one arm in a sling, however, Amy requires assistance bathing and administering insulin injections. Therefore, a visiting nurse stops by every day to assist her with bathing and administering the insulin. Even though she is still in her twenties, Amy requires skilled nursing assistance during her recovery.

Amy pays for this with distributions from her employer's MSA. She has a medical need for these services; therefore, they are eligible to be paid by her MSA. Her arm heals rapidly, and she can again address her medical needs without assistance within four weeks.

Taxpayers can deduct the costs for nursing services regardless of whether the person providing them is a licensed nurse. The services must be:

*[O]f a kind generally performed by a nurse... such as giving medication or changing dressings, as well as bathing and grooming the patient.*¹²⁷

Only expenditures directly affecting medical concerns are eligible for the Schedule A medical deduction. For example, if a visiting licensed nurse does dishes and laundry for a person who requires skilled nursing care, only the portion of the payment for the nursing services is deducted. The amount paid to the nurse for washing dishes and laundering clothing is not tax-deductible, even if the medical condition created the need for dishwashing or laundry.

Caution. Taxpayers should ensure they have sufficient supporting documentation from the care provider before taking this deduction.

Continuing Care Retirement Communities Entry Fees

Continuing care retirement communities (CCRCs) generally have living options that address increasing care needs as its residents age, starting with independent living for residents requiring very little care, assisted living for those requiring occasional care regularly, and skilled nursing for residents with limited ability to address their needs.¹²⁸

Typically, residents pay entry fees, often structured as significant lump-sum payments, and ongoing monthly fees to cover housing and associated convenience services.¹²⁹ In 2017, about 75% of CCRCs required payment of an entry fee. These fees may be retained in trust or made available directly to the CCRC, depending on the arrangement. In certain models, the entry fee provides residents with access to discounted skilled nursing care when needed. Alternatively, some contracts include refund provisions, allowing residents or their heirs to recover a portion of the entry fee upon move-out or death.¹³⁰

¹²⁷ Ibid.

¹²⁸ *Continuing Care Retirement Communities Can Provide Benefits, but Not Without Some Risk*. Jun. 2010. Government Accounting Office. [www.gao.gov/assets/gao-10-611.pdf] Accessed on Jun. 6, 2025.

¹²⁹ Ibid.

¹³⁰ *Continuing Life Communities Thousand Oaks LLC, Spieker LCL LLC, Tax Matters Partner v. Comm'r*, TC Memo 2022-31 (Apr. 6, 2022); *Retirement home residents face losing some or all entrance fees as facility struggles to pay debts*. McCoppin, Robert. Feb. 9, 2024. The Union Democrat. [www.uniondemocrat.com/lifestyle/article_a6cba2f8-c771-11ee-abb1-6ba710e193c6.html] Accessed on Jan. 2, 2025.

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In a notable California case involving a CCRC, residents believed they had secured housing arrangements similar to condominium ownership. However, they did not have a secured interest in real estate; they just had a promissory note in favor of themselves, a trust, or their heirs for a percentage of their entry fee. Thus, they were **unsecured creditors**, not fee simple real estate owners. If their entry fees were kept in a separate trust, as required by the State of California, they would be relatively secure.¹³¹ However, if the CCRC used the entry fees, refunds of entry fees could be impaired if the facility had difficulty paying its bills.

In the case of a CCRC in Bartlett, Illinois, over \$50 million of entry fees were owed to residents or their heirs when the facility had trouble making payments on outstanding debt. This debt had already been renegotiated in two previous bankruptcies.¹³² Because the facility had very little money to repay its liabilities, including those owed to former residents or their heirs, financial concerns forced it to seek a buyer. Previously, a state regulatory agency forced it to suspend the issuance of new continuing care contracts, which would have brought in cash from new entry fees.¹³³

In this case, the residents and their heirs were unsecured creditors with substantial losses on the unrefunded entry fees. In December 2024, the former residents and their heirs agreed to release the new owner from any claims in exchange for a payout of approximately 3.5% of the outstanding balances due on the repayment of entry fees.

Tax Treatment of the Unrefunded Entry Fee.¹³⁴ If a CCRC defaults on an unrefunded entry fee, it may constitute a nonbusiness bad debt under IRC §166(d). These debts can result in a taxpayer recognizing a short-term capital loss if the following criteria are met.¹³⁵

- **Genuine debt and a debtor-creditor relationship.** There should be a promissory note or other document indicating unequivocally the CCRC's obligation to return a portion of the entry fee.
- **No intention of a gift.** If the owners of the CCRC have no relationship with the residents and a promissory note exists, there should be no consideration that the residents intended to make a gift to the CCRC.
- **Basis in the entry fee.** The taxpayer claiming the nonbusiness bad debt should have a basis in it. This requirement is satisfied when a CCRC resident pays the entry fee with cash or with amounts on which they have already paid income tax. The requirement would **not** be satisfied if a related third party, such as their children, paid the entry fee. Furthermore, if the residents claimed a medical loss deduction for a portion of the entry fee, they would have no basis in that amount.
- **Complete worthlessness.** Any nonbusiness bad debt must be completely worthless to be treated as a capital loss. In the case of an entry fee owed by a CCRC, the repayment obligation may have been extinguished in bankruptcy, or the creditor-resident may have agreed to a rescission of the amount due. In any case, there must be no further hope of repayment of the entry fee before the resident, or their heirs, can claim a capital loss.

¹³¹. *Continuing Life Communities Thousand Oaks LLC, Spieker LCL LLC, Tax Matters Partner v. Comm'r*, TC Memo 2022-31 (Apr. 6, 2022). Although this case concerns the CCRC, not the residents, the court's opinion discusses the protections that the California legislature implemented on behalf of CCRC residents and their heirs.

¹³². *Retirement home residents face losing some or all entrance fees as facility struggles to pay debts*. McCoppin, Robert. Feb. 9, 2024. The Union Democrat. [www.uniondemocrat.com/lifestyle/article_a6cba2f8-c771-11ee-abb1-6ba710e193c6.html] Accessed on Jan. 2, 2025.

¹³³. *Retirement home residents face losing some or all entrance fees as Bartlett facility struggles to pay debts*. McCoppin, Robert. Feb. 7, 2024. Chicago Tribune. [www.chicagotribune.com/2024/02/06/bartlett-retirement-home] Accessed on Jan. 7, 2025.

¹³⁴. IRS Pub. 550, *Investment Income and Expenses*.

¹³⁵. *Ibid.*; IRC §166; Treas. Reg. §1.166-5.

Reporting the Loss.¹³⁶ Unfortunately, not all CCRCs are financially able to repay these obligations. If the facility experiences financial distress, the elderly taxpayers, their heirs, or their advisors must be vigilant to preserve any favorable tax consequences of the default on the repayment obligation. If the loss can be treated as a nonbusiness bad debt, reporting a loss from a defaulted refund of an entry fee starts with Form 8949, *Sales and Other Dispositions of Capital Assets*. Taxpayers should treat the nonbusiness bad debt as a short-term loss, even if they have lived in the facility longer than one year.¹³⁷

In part I, line 1 of Form 8949, taxpayers should enter the name of the CCRC as the debtor and “bad debt statement attached.” This statement should contain the following information and be attached to the taxpayer’s tax return for the year that their claim for an entry fee refund became completely worthless.

- A description, such as “Unpaid Refund of Nursing Home Entry Fee,” with a reference to the unpaid balance entry fee refund and the date that it should have been repaid.
- The name of the CCRC and the relationship between the taxpayer and the CCRC.
- A description of the efforts to collect the unpaid entry fee.
- The reason why the taxpayer determined that the refund claim was worthless and would not be repaid.

For example, the heirs of a former CCRC resident may agree to a receiver’s offer to settle a debt for a small payment.¹³⁸ In that case, the promissory note becomes worthless in the year the final payment is received. In the cases of a CCRC’s inability to refund entry fees, receipt of a small settlement in lieu of full payment of the balance due generally sets the time when the promissory note becomes fully worthless.

DIFFICULTY OF CARE PAYMENTS

Some caregivers receive payments from Medicaid waiver programs for providing in-home care to individuals with disabilities who live together in the same home. These payments, known as **difficulty of care** payments, may be excluded from gross income under certain conditions. This section explains when and how to report these payments on a tax return.

Conditions for Income Tax Exclusion¹³⁹

Per IRS Notice 2014-7, a caregiver is **not** eligible to exclude income if they are legally responsible for the care recipient, as would be the case with their minor child.¹⁴⁰ The state making the Medicaid payment must certify the individual as an “eligible individual.” The IRS advised that beginning in 2014, it would treat the caregiver of a person biologically related to them as a qualified foster care provider under IRC §131.

IRC §131(c) provides that compensation that an individual receives for providing **additional care of a qualified foster individual** is excluded from income if it is:

[R]equired by reason of a physical, mental, or emotional handicap... with respect to which the State has determined that there is a need for additional compensation, and provided in the home of a foster care provider.

¹³⁶ IRS Pub. 550, *Sales and Trades of Investment Property*, p. 83 (2023).

¹³⁷ IRC §166(d)(1)(B).

¹³⁸ *Receivership: What It Is, How It Works*, vs. *Bankruptcy*. Tardi, Carla. Jun. 10, 2024. Investopedia. [www.investopedia.com/terms/r/receivership.asp] Accessed on Dec. 19, 2024. A court generally appoints an attorney to represent creditors in the restructuring of debt when a debtor defaults on debt payments.

¹³⁹ IRS Notice 2014-7, 2014-4 IRB 445.

¹⁴⁰ 42 CFR §440.167(a)(2).

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Definition of Foster Family Home.¹⁴¹ Another issue the IRS had to settle was what “foster family home” meant, considering the term’s use in the Code. Before IRS Notice 2014-7 became effective, the IRS had challenged the tax exclusion of difficulty of care payments for eligible persons because they lived in their parents’ homes. This is because a state agency had not “placed” the parents in the home or designated the home an official “foster family home.”

In Notice 2014-7, the IRS commented that §131 does not define foster family home and concluded that Tax Court rulings indicated that “a person’s ‘home’ is where he resides.”¹⁴² Thus, the home maintained by parents could be considered a foster family home for purposes of §131 and difficulty of care payments.

Income Tax Compliance¹⁴³

A parent may receive a state Medicaid payment that could be excluded from gross income, provided it meets the standards established in §131. If the state designates the parent as a certified Medicaid provider and provides difficulty of care payments, the parent may exclude their payments from taxable income. This typically results in a Form W-2 with no amount in box 1, *Wages, tips, other compensation*, or box 2, *Federal income tax withheld*.

Certified Medicaid providers may make payments under a waiver program, as discussed previously. Those providers can rely on a written statement by the receiving payments that they care for an individual living in their home who has a plan of care. The IRS provides the following sample statement.

Under penalties of perjury, I declare that I am an individual care provider receiving payments under a state Medicaid Home and Community-Based Services waiver program for the care I provide to [recipient's name], who lives in my home under the recipient's plan of care.

Signed: _____ *Date:* _____

To report the exempt difficulty of care payments, practitioners should consider the following steps.

1. Review Form W-2 from the Medicaid agency.
2. Decide whether or not to include the payment in gross income. Although Medicaid waiver payments are excludable from gross income, these payments can be included in earned income for purposes of the earned income credit or the additional child tax credit.
3. Retain the written statement and certification for their records.

Employment Tax Implications

Assuming that the Medicaid provider agency has accepted the caregiver as an employee, not an independent contractor, the agency withholds social security and Medicare taxes but not federal income tax. The agency must have no reason to question the statement provided by the individual care provider.

As a result, the care provider receives a Form W-2 with the difficulty of care payments reported in boxes 3, *Social Security wages*, and 5, *Medicare wages and tips*, even though no amount appears in box 1.

Note. If the caregiver meets the exclusion requirements, the amount reported in boxes 3 and 5 of Form W-2 (social security and Medicare wages) is not included in box 1 (wages). The caregiver does not report this income on Form 1040. However, social security and Medicare taxes may still apply.

¹⁴¹. IRC §131(b)(2).

¹⁴². *Stromme v. Comm’r*, 138 TC 213, 218 (2012), citing *Dobra v. Comm’r*, 111 TC 339 (1998).

¹⁴³. *Certain Medicaid waiver payments may be excludable from income*. Aug. 25, 2024. IRS. [www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income] Accessed on Dec. 20, 2024.

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Example 16. Theodore was born with Down syndrome, which adversely affected his development both physically and intellectually. His parents have regularly cared for him in their Illinois home. He still needs regular care from his parents when he attains majority in August 2024.

Monica, his mother, becomes Theodore's certified foster care provider, effective January 1, 2025. During that year, she receives \$21,000 in difficulty of care payments from the Medicaid agency that employs her. In January 2026, she receives the following Form W-2.

a Employee's social security number ***-**-6564		OMB No. 1545-0008		Safe, accurate, FAST! Use				Visit the IRS website at www.irs.gov/efile .	
b Employer identification number (EIN) 54-5424461				1 Wages, tips, other compensation		2 Federal income tax withheld			
c Employer's name, address, and ZIP code US CIL, Acting as Agent for Monica Patrick 1142 Washington Ave Scranton PA 18509				3 Social security wages 21000.00		4 Social security tax withheld 1302.00			
				5 Medicare wages and tips 21000.00		6 Medicare tax withheld 304.50			
				7 Social security tips		8 Allocated tips			
d Control number				9		10 Dependent care benefits			
e Employee's first name and initial Monica 145 Main St. Maple Park IL 60151 f Employee's address and ZIP code				11 Nonqualified plans		12a See instructions for box 12			
				13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐		12b			
				14 Other		12c			
						12d			
15 State Employer's state ID number		16 State wages, tips, etc.		17 State income tax		18 Local wages, tips, etc.		19 Local income tax	
								20 Locality name	

Form **W-2** Wage and Tax Statement

2024

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Because Monica meets all the requirements — care in her home, certification by the state, and care for a qualified individual — her \$21,000 in payments are excluded from gross income. She still receives a Form W-2 showing social security and Medicare wages, but no income is reported in box 1.

Note. If a taxpayer elects not to include difficulty of care payments and those payments are included on page 1 of Form 1040, the taxpayer can subtract those payments on Schedule 1, line 8s.

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2025 Workbook

COMPARISON OF PLANS

The following table compares the tax treatment of various funding sources commonly used to pay for LTC expenses. It includes information on contribution deductibility, tax-free growth, tax-free withdrawals, reporting requirements, and key considerations for each option.

Funding Source	Contribution Deductibility	Tax-Free Growth	Tax-Free Withdrawals	Reporting Forms	Special Considerations
HSA	Yes	Yes	Yes, for qualified medical expenses	Form 8889	Must have HDHP; Contribution limits apply
Archer MSAs	Yes	Yes	Yes, for qualified medical expenses	Form 8853	Limited availability; Contribution limits apply
LTC Insurance	Yes, up to age-based limits	No	Yes, for qualified LTC expenses	None	Premiums deductible up to age-based limits; Benefits may be taxable if they exceed actual expenses
Hybrid Life Insurance with LTC Riders	No	Yes	Yes, for qualified LTC expenses	None	Premiums not deductible; Benefits generally tax-free
Retirement Accounts (IRAs, §401(k)s)	Yes	Yes	No, although early withdrawal penalties avoided for qualified medical expenses exceeding 7.5% of AGI	Form 5329 (for early withdrawals)	Early withdrawal penalties may apply; Special rules for medical expenses
Medicaid Waiver Payments	N/A	N/A	Yes, if difficulty of care criteria are met	None	Must be certified Medicaid provider; Payments excluded from income if criteria met

THEFT LOSSES RELATED TO INTERNET SCAMS

Internet scams are becoming increasingly common, and many taxpayers receive multiple emails, text messages, and phone calls each year that appear genuine but are a part of a scam.¹⁴⁴ The most common Internet scams are phishing and spoofing. **Phishing** scams are emails or texts that trick recipients into sending sensitive information or clicking on malicious links. With this information, scammers can gain access to financial accounts, including bank accounts, retirement accounts, and other types of accounts. **Email spoofing** occurs when someone uses what appears to be a trusted source, such as an email address or website, to deceive the victim into believing their information is safe.¹⁴⁵

The FBI's Internet Crime Complaint Center reported 859,532 complaints in 2024, resulting in over \$16.6 billion in reported losses. The complaints involving phishing and spoofing account for 30% of the complaints; however, investment Internet scams result in over \$6.5 billion in theft losses.¹⁴⁶

DEDUCTIBLE THEFT LOSSES UNDER §165

Theft losses from Internet scams that fall under §165 are deductible if the taxpayer's situation meets all of the following conditions.

1. Theft must be criminal under federal or state law.
2. Transaction must have been entered into for profit.
3. No reasonable prospect of recovering the stolen funds at the end of the tax year.

Criminal Conduct¹⁴⁷

A theft loss must stem from criminal conduct that constitutes theft under the applicable state or federal law. This means that the actions of the perpetrator must meet the legal definition of theft, larceny, embezzlement, or a similar crime. If the actions do not legally constitute theft, the loss is not deductible as a theft loss.

Profit Motive¹⁴⁸

The underlying transaction must have been entered into for profit. This requirement covers situations involving investments, schemes, and actions taken to protect existing investments. Therefore, both theft by external parties and internal malfeasance are covered if they are connected to an Internet scam and involve profit motive. Investment scams can include Ponzi schemes and fake digital asset platforms.

Ponzi Schemes.¹⁴⁹ A Ponzi scheme, named for Charles Ponzi, who carried out a notorious scam in the 1920s, is a financial scam that lures potential investors with promises of high returns. In reality, investors are merely receiving a portion of their original capital or that of future investors. The scheme eventually collapses when there are not enough new investors to pay returns to earlier investors.

After the most famous scheme perpetrated by Bernie Madoff, where investors lost an estimated \$65 billion,¹⁵⁰ the IRS issued Rev. Rul. 2009-9¹⁵¹ and Rev. Proc. 2009-20¹⁵² to define and distinguish a Ponzi-type scheme from other fraudulent investment losses and outline the procedures for deducting such losses.

¹⁴⁴. *Internet Crime Report 2024*. FBI. [www.ic3.gov/AnnualReport/Reports/2024_IC3Report.pdf] Accessed on Jun. 2, 2025.

¹⁴⁵. Ibid.

¹⁴⁶. Ibid.

¹⁴⁷. IRC §165(b).

¹⁴⁸. IRC §165(c)(2).

¹⁴⁹. Rev. Rul. 2009-9, 2009-14 IRB 735; Rev. Proc. 2009-20, 2009-14 IRB 749.

¹⁵⁰. *Bernie Madoff victims get \$159 million from Ponzi recovery fund in latest payout*. Breuninger, Kevin. Dec. 12, 2023. NBC News. [www.nbcnews.com/news/us-news/bernie-madoff-victims-get-159-million-ponzi-recovery-fund-latest-payou-rcna129239] Accessed on May 19, 2025.

¹⁵¹. Rev. Rul. 2009-9, 2009-14 IRB 735.

¹⁵². Rev. Proc. 2009-20, 2009-14 IRB 749.

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The Ponzi scheme safe harbor is a special tax relief mechanism provided by the IRS in Rev. Proc. 2009-20. It simplifies the process for victims of Ponzi-type investment frauds to claim theft loss deductions under §165. The safe harbor allows eligible taxpayers to:

- Deduct theft losses in the year the fraud is discovered.
- Use a simplified method to calculate the deductible amount.
- Avoid disputes over the timing and amount of the deduction.

For purposes of the Ponzi safe harbor, a qualified loss is a loss from a fraudulent arrangement. For a loss to be considered a qualified loss under the special rules for Ponzi schemes, one of the lead figures must have been charged by indictment or information under state or Federal law with a crime that would meet the definition of theft. The lead figure must have been the subject of a state or Federal criminal complaint alleging the commission of theft and either:

1. The complaint alleged an admission by the lead figure or the execution of an affidavit by that person admitting the crime, or
2. The receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

Taxpayers can deduct 95% of their net investment if they do not pursue third-party recovery. If they are pursuing recovery (e.g., lawsuits or insurance claims), they can deduct 75% of the net investment.

Note. For a more thorough description of Ponzi-type schemes and the requirements for taxpayers to deduct these losses, see the 2009 *University of Illinois Federal Tax Workbook*, Chapter 4: Individual Taxpayer Problems. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

Digital Asset Losses. A taxpayer who is misled into investing in a fake digital asset platform with the intent to earn a profit and suffers a loss may qualify to deduct the theft loss under §165(c)(2). This includes platforms that appear legitimate but are actually spoofs or fraudulent investment schemes. **Losses from market volatility, poor investment decisions, or declines in legitimate digital asset values are not theft losses.** Only losses from fraudulent platforms where the taxpayer was deceived into transferring funds qualify.

Example 17. Jordan, a 38-year-old software engineer, was researching cryptocurrency investments when he came across a platform called “CryptoGrowX.” The website appeared professional, included testimonials, and had a registration number from the Securities Exchange Commission. On March 1, 2024, Jordan transferred \$50,000 from his brokerage account to CryptoGrowX, expecting to earn high returns.

Over several months, the platform showed increasing balances, but when Jordan attempted to withdraw funds, he was blocked. He later discovered the site was a spoof and reported the fraud to the FBI and his bank. His insurance claim was denied, and law enforcement confirmed the platform was part of a criminal fraud ring.

Jordan can deduct the \$50,000 in 2024 (the year he discovered the fraud and determined there was no reasonable prospect of recovery) because he had a profit motive, the scam involved criminal conduct (fraud and false pretenses), and he took reasonable steps to recover the funds but was unsuccessful. He should document his loss and the circumstances surrounding it to support his deduction on his tax return.

No Reasonable Recovery¹⁵³

IRC §165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss. No portion of the loss is deductible if, at the end of the year, there is a reasonable prospect of recovery. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

Example 18. In January 2023, Ivant Momony, a 42-year-old used car salesman, received an email from an old high school friend, Cate, stating she had some success investing through a website. Skeptical but curious, Ivant visited the investment website and decided to make an investment. Surprisingly, during the next few months, his small investment appears to increase, and he keeps his money in his account on the investment website.

On July 14, 2024, he attempts to withdraw the entire amount from his account. However, the funds will not transfer to his bank account. Ivant calls his bank thinking there is an error, but the bank explains the investment website is not a valid website but a spoof of the real website. Ivant realizes he is a victim of a scam. If his loss is deductible, Ivant recognizes the loss in 2024 even though he deposited funds into the account in 2023.

A victim should take reasonable steps to pursue recovery, such as filing a police report, notifying financial institutions, and exploring legal remedies or insurance claims. A reasonable recovery exists when the taxpayer has a claim for recoupment from third parties and when there is a substantial possibility that such claims will be decided in their favor.¹⁵⁴ After taking reasonable steps to pursue recovery and a claim for recoupment has been denied, the taxpayer should establish there is no possibility of recovery based on the facts and documents relevant to the loss.

Example 19. Use the same facts as **Example 18**, except that Ivant is successful in withdrawing the funds, which reinforces his belief the investment was legitimate. In August 2023, Ivant invests an additional \$50,000 using the same investment website. In November 2023, the investment website announces it is undergoing maintenance due to its success, and balances in accounts are frozen until the beginning of 2024 to allow the investment company time to prepare for the end of the year. In February 2024, after months of trying to log into his account without success, Ivant contacts his friend Cate to find out if she can provide a contact for the investment website. Cate states she never emailed him, and she does not know what he is talking about.

After realizing he is a victim of an impersonation scam, Ivant promptly contacts his bank and the police. Ivant then files a claim with his insurance company, but it is immediately denied. Ivant took reasonable steps to pursue recovery and without any other avenues to take, he establishes there is no reasonable chance of recovery. Ivant's loss is caused by a criminal activity, his loss was due to an activity that was profit motivated, and he established there is no reasonable recovery; therefore, his loss is deductible.

Caution. If the taxpayer recovers any portion of the theft loss in future years through recovery methods such as insurance claims, other reimbursements, or legal settlements, they should file an amended return for the tax year in which they claimed the theft loss.

¹⁵³. IRC §165; *Jepps v. Comm'r*, 128 F.3d 1410 (10th Cir. 1997).

¹⁵⁴. *Ramsay Scarlett & Co. v. Comm'r*, 61 TC 795, (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975).

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IRS Recordkeeping Requirements.¹⁵⁵ To claim a theft loss, the IRS requires taxpayers keep certain records to show:

- That the taxpayer owned the property,
- That it was stolen,
- When the taxpayer discovered the theft, and
- Whether the taxpayer expect any reimbursement.



Practitioner Planning Tip

Practitioners should advise their clients to keep copies of their records to prove the deduction. Documentation may include police or incident reports, evidence of ownership such as purchase statements, insurance claim paperwork with denial or settlement letters, and any correspondence or screenshots showing loss of control of the property. Without this documentation, the taxpayer risks having a theft loss disallowed because they lack necessary documentation to prove a loss.

NONDEDUCTIBLE LOSSES¹⁵⁶

Theft losses incurred due to romance scams, imposter scams, or other **non-investment** scams are not deductible theft losses because they lack the necessary criminal intent or a profit motive. In a romance scam, when a taxpayer transfers funds to a scammer, the payment is deemed a gift. Therefore, it lacks the necessary element of criminal intent, and it does not qualify as a deductible theft loss. Imposter scams that ask the taxpayer to send money to assist a friend or relative are deemed to be sent without a profit motive and, thus, are also not a qualifying theft loss. Lastly, other non-investment scams often lack proper documentation and are difficult to prove intent.

ALLOWABLE LOSS¹⁵⁷

The amount of a loss that is allowed as a deduction is generally limited to the taxpayer's adjusted basis in the property (typically the amount paid) under IRC §1011 and not the FMV of the property at the time of the loss. This means that a taxpayer generally may not take a loss deduction for income or the unrealized gain from an investment that has not been included in gross income for tax purposes. Additionally, the deductible amount must be reduced by any insurance or other reimbursement received or expected to be received, in accordance with §165(a).

TAX TREATMENT

To report a deductible theft loss, the taxpayer must complete Form 4684 using Section B, *Business and Income-Producing Property*, to report theft losses related to income-producing property or profit-motivated transactions. The resulting deductible loss flows to Schedule A as an itemized deduction.¹⁵⁸

Example 20. Use the same facts as **Example 19**. Ivant completes Form 4684 and Schedule A, portions of which follow, to report his loss.

¹⁵⁵. IRS Pub. 547, *Casualties, Disasters, and Thefts*; IRM 4.2.2 (2024).

¹⁵⁶. CCA 202511015 (Mar. 14, 2025).

¹⁵⁷. IRC §165(b); Treas. Reg. §1.165-1(c).

¹⁵⁸. See IRS Pub. 547, *Casualties, Disasters, and Theft*; and Instructions for Form 4684.

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For Example 20

Form **4684**
Department of the Treasury
Internal Revenue Service

Casualties and Thefts

Attach to your tax return.
Use a separate Form 4684 for each casualty or theft.
Go to www.irs.gov/Form4684 for instructions and the latest information.

OMB No. 1545-0177

2024
Attachment
Sequence No. **26**

Name(s) shown on tax return

Ivant Momony

Identifying number

***-**-**4444**

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes. For tax years 2018 through 2025, if you are an individual, casualty or theft losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. You must use a separate Form 4684 (through line 12) for each casualty or theft event involving personal-use property. **If reporting a qualified disaster loss, see the instructions for special rules that apply before completing this section.**)

If the casualty or theft loss is attributable to a federally declared disaster, check here ☐ and enter the DR- _____ or EM- _____ declaration number assigned by FEMA. (See instructions.)

- 1 Description of properties (show type, location (city, state, and ZIP code), and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft. If you checked the box and entered the FEMA disaster declaration number above, enter the ZIP code for the property most affected on the line for Property A.

	Type of Property	City and State	ZIP Code	Date Acquired
Property A				
Property B				
Property C				
Property D				

	Properties			
	A	B	C	D
2 Cost or other basis of each property	2			
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions) Note: If line 2 is more than line 3, skip line 4.	3			
4 Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4			
5 Fair market value before casualty or theft	5			
6 Fair market value after casualty or theft	6			
7 Subtract line 6 from line 5	7			
8 Enter the smaller of line 2 or line 7	8			
9 Subtract line 3 from line 8. If zero or less, enter -0-	9			
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10			10,500
11 Enter \$100 (\$500 if qualified disaster loss rules apply; see instructions)	11			500
12 Subtract line 11 from line 10. If zero or less, enter -0- Caution: Use only one Form 4684 for lines 13 through 18.	12			10,000
13 Add the amounts on line 4 of all Forms 4684	13			
14 Add the amounts on line 12 of all Forms 4684. If you have losses not attributable to a federally declared disaster, see the instructions Caution: See instructions before completing line 15.	14			
15 • If line 13 is more than line 14, enter the difference here and on Schedule D. Do not complete the rest of this section. • If line 13 is equal to line 14, enter -0- here. Do not complete the rest of this section. • If line 13 is less than line 14, and you have no qualified disaster losses subject to the \$500 reduction on line 11 on any Form(s) 4684, enter -0- here and go to line 16. If you have qualified disaster losses subject to the \$500 reduction, subtract line 13 from line 14 and enter the smaller of this difference or the amount on line 12 of the Form(s) 4684 reporting those losses. Enter that result here and on Schedule A (Form 1040), line 16; or Schedule A (Form 1040-NR), line 7. If you claim the standard deduction, also include on Schedule A (Form 1040), line 16, the amount of your standard deduction (see the Instructions for Form 1040). Do not complete the rest of this section if all of your casualty or theft losses are subject to the \$500 reduction.	15			
16 Add lines 13 and 15. Subtract the result from line 14	16			
17 Enter 10% of your adjusted gross income from Form 1040, 1040-SR, or 1040-NR, line 11. Estates and trusts, see instructions	17			
18 Subtract line 17 from line 16. If zero or less, enter -0-. Also, enter the result on Schedule A (Form 1040), line 15; or Schedule A (Form 1040-NR), line 6. Estates and trusts, enter the result on the "Other deductions" line of your tax return	18			

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 129970

Form **4684** (2024)

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2025 Workbook

For Example 20

Instructions		15	
Other Itemized Deductions	16 Other—from list in instructions. List type and amount:		
	Casualty and theft losses of income-producing property (Form 4684 line 38b) \$50,000	16	50,000
Total Itemized Deductions	17 Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 12	17	
	18 If you elect to itemize deductions even though they are less than your standard deduction, check this box ☐		

For Paperwork Reduction Act Notice, see the Instructions for Form 1040. Cat. No. 17145C Schedule A (Form 1040) 2024

Caution. Depending on the source of the funds used in the scam, there may be additional negative tax consequences. For example, taxpayers who take early withdrawals from retirement accounts or investment accounts to send money to scammers may be liable for income tax and capital gains taxes on the withdrawn funds, as well as potential penalties for early withdrawal. In addition, any withdrawals could increase ordinary income, potentially leading to higher taxes and causing a taxpayer to be shifted into a higher tax bracket. Additionally, a taxpayer may be required to recognize cancellation of debt income if a debt is fraudulently incurred in their name and later discharged.

RETIREES

The retirement decisions individuals must make are often linked to tax-related issues and planning opportunities. Clients may seek advice from tax practitioners to understand and evaluate retirement decisions and opportunities. Current or prospective retirees should consider the optimal age to retire based on their facts and circumstances, after analyzing various savings and tax planning strategies.

Note. The Social Security Fairness Act, passed on January 5, 2025, made several changes to how social security benefits are calculated. For more information on the impact of this Act, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 8: New Developments.

DETERMINING AN AGE TO RETIRE

Individuals should consider several factors when deciding on an age to retire. While some considerations are not tax-related, clients may seek general guidance from tax practitioners.

Selecting the optimal age to retire may depend on whether the retiree intends to collect social security benefits or Medicare, both of which have age-specific requirements.

Social Security Considerations

When deciding on an age to retire, individuals should consider their monthly social security benefits. Workers who pay into social security earn credits toward their social security benefits. They must earn at least 40 credits to receive benefits. The credits are based on the wages and net self-employment (SE) earnings an individual receives during the year, with workers allowed to earn a maximum of 4 credits a year starting after 1978. For 2024, one credit is received for every \$1,730 earned (net earnings for self-employed individuals). Additionally, there are special rules for earning credits for certain types of work, including domestic work, farm work, and nonprofit or religious organizations that do not pay social security taxes.¹⁵⁹

¹⁵⁹ *How You Earn Credits*, pp.1-2. SSA. [www.ssa.gov/pubs/EN-05-10072.pdf] Accessed on Dec. 3, 2024.



Practitioner Planning Tip

Tax practitioners can provide an important service to clients employed by S corporations in which they own more than 2% of the company's stock. Shareholders may set their own salary to minimize employment taxes, ignoring the impact on their future social security benefits. Increasing income may not only help them comply with regulations for reasonable compensation, but it may also help them diversify their sources of retirement income.

Workers who are eligible for social security benefits must decide when to start receiving benefits. In addition to the amount earned over a career, the age at which an individual retires also impacts the social security benefits they receive. There are three age categories.

- **Early Retirement.**¹⁶⁰ Workers can start drawing social security benefits at age 62. However, collecting benefits before the full retirement age (FRA) is considered early, resulting in individuals receiving reduced benefits. Their benefit is reduced by $\frac{5}{9}$ of 1% for each month up to 36 months before the individual's FRA. It is reduced even further to $\frac{5}{12}$ of 1% per month if the number of months to the FRA age exceeds 36 months. Early retirement benefits can be reduced by as much as 30% of an individual's full retirement benefit.
- **Full (Normal) Retirement.**¹⁶¹ When workers reach FRA, they are eligible for full retirement benefits. For workers born in 1954 or earlier, the normal retirement age is 66. The age gradually increases for those born between 1955 and 1960 until it reaches age 67. Anyone born after January 1, 1960, is eligible for full retirement benefits at age 67.
- **Delayed Retirement.** Workers who choose to delay their retirement beyond their FRA can increase their benefits in the following ways.
 - ♦ Every year an individual works beyond their FRA is another year of earnings that may count towards their benefit amount. Higher lifetime earnings result in higher benefits.
 - ♦ For every month social security is delayed beyond FRA, an additional $\frac{2}{3}$ of 1% is added to their benefit amount until the individual starts receiving benefits or reaches age 70.¹⁶²

¹⁶⁰. *Starting Your Retirement Benefits Early*. SSA. [www.ssa.gov/benefits/retirement/planner/agereduction.html] Accessed on Dec. 3, 2024; and *Benefit Reduction for Early Retirement*. SSA. [www.ssa.gov/oact/quickcalc/earlyretire.html] Accessed on Dec. 9, 2024.

¹⁶¹. *Retirement Benefits*, p. 2. SSA. [www.ssa.gov/pubs/EN-05-10035.pdf] Accessed on Dec. 3, 2024. Individuals born on January 1 of any year receive benefits as if they had been born in the previous calendar year.

¹⁶². *Social Security Benefits*. Aug. 19, 2010. SSA. [www.ssa.gov/benefits/retirement/planner/delayret.html] Accessed on Jan. 22, 2025.



Practitioner Planning Tip

Collecting social security benefits under early retirement provisions can also reduce the amount eligible spouses can receive.¹⁶³ Depending on the primary beneficiary's age, the spousal benefit can be reduced by up to 35%. This should be a factor for individuals with spouses when deciding on an age to start taking benefits.

The optimal age for an individual to start receiving social security benefits varies based on the situation. Some factors for advisors to consider when consulting with individuals include:¹⁶⁴

- **Income needs.** Some individuals may need additional income as early as age 62 for living expenses despite the reduction in benefits. Others may find they are in a financial position to delay their benefits to maximize their income. Individuals should ensure they have enough money to support themselves and any dependents during their retirement. The amount required varies depending on lifestyle preferences, health, goals, and projected expenses. For many retired individuals, social security benefits are an important income source.
- **Family situation.** The individual's family dynamic will play a factor. If one spouse wishes to retire early and start collecting benefits, they can use the additional income, and the other can wait until FRA or later so they can still receive one of their full benefits.
- **Income tax.** If one spouse continues to work, their income may impact the taxability of the other spouse's benefits if the other spouse chooses to collect.
- **Employment status.** If individuals want to continue working, they may consider delaying their benefits so they can maximize their payments when they do decide to collect.
- **Life expectancy.** Individuals should consider their health and anticipated life expectancy. Those in declining health may want to take their benefits earlier than those who expect to live longer than the average life expectancy.
- **Health insurance.** Once people stop working, they may lose their employer-provided health insurance, and most individuals are not eligible for Medicare until age 65. If an individual wants to retire before they or their spouse turns 65, they should consider the cost of health care.

¹⁶³. See *Benefit Reduction for Early Retirement*. Nov 25, 2008. SSA. [www.ssa.gov/OACT/quickcalc/earlyretire.html] Accessed on Jan. 22, 2025.

¹⁶⁴. *Guide on Taking Social Security: 62 vs. 67 vs. 70*. Charles Schwab. [www.schwab.com/learn/story/guide-on-taking-social-security] Accessed on Dec. 11, 2024; *What Important Things to Consider When Planning for Retirement*. SSA. [www.ssa.gov/benefits/retirement/planner/otherthings.html] Accessed on Dec. 3, 2024.

Calculating Social Security Benefits.¹⁶⁵ The Social Security Administration (SSA) calculates a retiree's social security benefit using a formula based on the first year the worker is eligible for benefits. Generally, this is when the worker reaches age 62. The benefit that a worker would receive at FRA is called the primary insurance amount (PIA), which is computed using a 3-step calculation.

1. The first step in the formula is calculating the worker's average indexed monthly earnings (AIME), which is the average monthly earnings over the worker's 35 highest-earning years. This amount is adjusted for inflation and accounts for the general rise in the standard of living over the individual's work period.

To compute this amount, the SSA determines the number of years to use in the calculation, up to 35 years. The AIME calculation uses months, so if an individual works for 35 years or more, the maximum number of months used in the calculation is 420 (35 years $\times$ 12 months per year).¹⁶⁶

Then, the worker's normal earnings for each year are indexed for inflation to bring the wages to approximate current wage levels. The earnings are limited to the social security annual contribution and benefit base amount, commonly referred to as the taxable amount for social security. For 2025, the base is \$176,100. Earnings above the annual contribution and benefit base are not considered for the AIME calculation.

The SSA uses the national average wage indexing series to index earnings to the average wage level for two years before a person first becomes eligible to receive benefits. For an individual who turns 62 in 2025, their wages are indexed to the average wage index for 2023, which is \$66,621.80. Earnings prior to 2023 are multiplied by the indexing factor, which is the ratio of \$66,621.80 to the average wage index for the given year. Earnings in 2023, 2024, and 2025 are not indexed.¹⁶⁷

The highest indexed earnings up to the maximum of 35 years are used in the benefit computation and summed together. They are then divided by the number of months of earnings (up to 420 maximum) to calculate the AIME, which is rounded to the next lowest dollar.

Example 21. Beatrice was born in 1960 and turns 62 in 2022. In 2020, when she celebrates her 60th birthday, she earns \$97,650 in taxable wages. To index her wages for 2020 to 2023, the 2023 average wage index, \$66,621.80, is divided by the 2020 average wage index of \$55,628.60 to calculate the index factor of 1.1976, shown next.¹⁶⁸

2023 average wage index	\$66,621.80
2020 average wage index	$\div$ 55,628.60
2020 index factor	1.1976

The 1.1976 index factor is then multiplied by the normal wages for the year to calculate the 2020 indexed wages of \$116,945.

2020 index factor	1.1976
2020 Beatrice's unindexed earnings	$\times$ \$97,650
2020 indexed earnings	\$116,945

2. After calculating the AIME, the SSA calculates the PIA using the following formula. The formula uses bend points, which are indexed dollar amounts that change every year. For workers becoming eligible in 2025, the bend points are \$1,226 and \$7,391. The bend points for previous years can be found at [uofi.tax/25x6x1 \[www.ssa.gov/oact/cola/bendpoints.html\]](https://www.ssa.gov/oact/cola/bendpoints.html).
 - 90% $\times$ AIME up to the first bend point
 - 32% $\times$ AIME between the first and second bend points
 - 15% $\times$ AIME above the second bend point

¹⁶⁵ *Primary Insurance Amount*. SSA. [www.ssa.gov/oact/COLA/piaformula.html] Accessed on Dec. 3, 2024.

¹⁶⁶ *Social Security Benefit Amounts*. SSA. [www.ssa.gov/oact/cola/Benefits.html] Accessed on Dec. 3, 2024.

¹⁶⁷ *Indexing Factors For Earnings*. SSA. [www.ssa.gov/oact/COLA/awifactors.html]. Accessed on Dec. 3, 2024.

¹⁶⁸ *National Average Wage Index*. SSA. [www.ssa.gov/oact/COLA/AWI.html] Accessed on Dec. 3, 2024.

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For a retiree who first becomes eligible for benefits in 2025, the PIA formula is the sum of the following, rounded down to the next lower multiple of \$0.10.¹⁶⁹

1. $90\% \times$ the first \$1,226 of AIME
2. $32\% \times$ AIME over \$1,226 and through \$7,391
3. $15\% \times$ AIME over \$7,391

The PIA amount is reduced for workers who take benefits early and increased for those who delay retirement. The benefit amount a worker receives is rounded down to the next dollar.

Example 22. Albert retires in 2025 and starts receiving social security benefits.¹⁷⁰ He is 62 years old, and his AIME is \$5,435. To calculate his PIA, Albert uses the following calculations.

AIME to first bend point	\$1,226.00	
Percent of AIME	$\times .90$	
AIME included	\$1,103.40	\$1,103.40
AIME between first and second bend point (\$5,435 — \$1,226)	\$4,209.00	
Percent of AIME	$\times .32$	
AIME included	\$1,346.88	1,346.88
AIME above second bend point (\$0 because \$5,435 < \$7,391)	\$ 0.00	
Percent of AIME	$\times .15$	
AIME included	\$ 0.00	0.00
PIA (rounded to the next lower \$0.10)		\$2,450.20

Because Albert is at the early retirement age, his benefit is reduced by 30% for 60 months of early retirement.

Benefit reduction first 36 months	$(5/9) \times 1\%$	
First 36 months before FRA	$\times 36$	
Reduced benefit percentage	20%	20%
Benefit reduction over 36 months	$(5/12) \times 1\%$	
Remaining months before FRA (60 — 36)	$\times 24$	
Reduced benefit percentage	10%	10%
Total reduced benefit percentage		30%

Because his benefits are reduced by 30%, Albert receives 70% of his PIA.

PIA	\$2,450.20
Early retirement percentage of benefits	$\times 70\%$
Early retirement monthly benefit amount (rounded down to the nearest dollar)	\$1,715.00

¹⁶⁹. 42 USC §415(a)(1)(A).

¹⁷⁰. Example adapted from *Social Security Benefit Amounts*. SSA. [www.ssa.gov/oact/cola/Benefits.html] Accessed on Dec. 3, 2024.

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Example 23. Use the same facts as **Example 22**, except that Albert delays receiving his benefit until he turns 69.¹⁷¹ His PIA amount is unchanged from **Example 22** because it is calculated using information from the first year he is eligible for benefits.

For every month Albert delays his retirement, he receives a credit. Because he is born after 1943, his credit is $\frac{2}{3}$ of 1% each month he delays his retirement.¹⁷² Because Albert delays retirement by 24 months (69 is two years past the full retirement age of 67), he receives a 16% increase in benefits.

Credit for each month's delayed retirement	$(\frac{2}{3} \times 1\%)$
Months delayed retirement	$\times 24$
Benefit increase percentage	16%

By delaying retirement 24 months, Albert's estimated monthly social security benefit increases to \$2,842 (rounded down to the nearest dollar).

PIA	\$2,450.20	\$2,450.20
Delayed retirement increase percentage	$\times 16\%$	
Delayed retirement increase amount	\$ 392.03	392.03
Delayed retirement monthly benefit amount (rounded down to the nearest dollar)		\$2,842.00

Note. The SSA website has a variety of online benefits calculators and other tools available for individuals approaching retirement age at [uofi.tax/25x6x2](https://www.ssa.gov/benefits/calculators) [www.ssa.gov/benefits/calculators].

For more information, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Elder Issues. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

Earnings Impact on Benefits.¹⁷³ Individuals can work and collect social security benefits at the same time, but if a worker is younger than their FRA, their benefits are reduced if they earn over a certain amount. This reduction is referred to as the retirement earnings test (RET). The amount that is deducted from benefits depends on whether a worker is in the year they attain FRA or before that year. The following are the 2025 limits for individuals.

- A worker who is under the FRA for the entire year will have their benefits reduced by \$1 for every \$2 earned over \$23,400.
- A worker who reaches FRA in 2025 will have their benefits reduced by \$1 for every \$3 over \$62,160. Earnings for this test are only counted for every month prior to the month before reaching FRA.

Beginning with the month a worker reaches FRA, their benefits are no longer reduced regardless of the amount earned. When the worker reaches FRA, the SSA recalculates the benefit amount to give the individual credit for the months reduced because of the excess earnings.

¹⁷¹. Example adapted from 20 CFR §404.313; *What are delayed retirement credits and how do they increase my old-age benefit amount?* SSA. [www.ssa.gov/OP_Home/cfr20/404/404-0313.htm] Accessed on Dec. 3, 2024.

¹⁷². 20 CFR §404.313; *What are delayed retirement credits and how do they increase my old-age benefit amount?* SSA. [www.ssa.gov/OP_Home/cfr20/404/404-0313.htm] Accessed on Dec. 3, 2024.

¹⁷³. *Receiving Benefits While Working*. SSA. [www.ssa.gov/benefits/retirement/planner/whileworking.html] Accessed on Jan. 23, 2025.

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For purposes of calculating earnings for reduced benefits, the SSA uses wages, including bonuses, commissions, vacation pay, and net profit from SE income. For wages, the amounts are counted when they are earned and not paid. SE income is counted when it is received except in the case when it is paid in a year after the taxpayer becomes entitled to social security benefits and earned before they became entitled. Investment income, pensions, annuities, veteran benefits, or other government or military retirement benefits are not considered.

Note. For more information about the RET, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Elder Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Special Rule for Year of Retirement.¹⁷⁴ People who retire during the year may have already earned more than the earnings limit prior to their date of retirement. A special rule for the first year of retirement allows workers to receive full social security benefits for an entire month they are considered retired, regardless of their yearly earnings. For 2025, the SSA considers the following individuals retired.

- Individuals who are under FRA for the entirety of 2025 with earnings of \$1,950 or less in any month and do not perform substantial SE services
- Individuals who reach FRA in 2025 with earnings of \$5,180 or less in any month and do not perform substantial SE services

For self-employed individuals, substantial services mean working more than 45 hours a month in SE activity or between 15 and 45 hours for a business in a highly skilled occupation.

Income Tax.¹⁷⁵ The amount of social security benefits included in federal taxable income is determined by an individual's modified adjusted gross income (MAGI). The following MAGI thresholds determine how much of a taxpayer's benefits are taxed.

- Less than \$25,000 (\$32,000 MFJ): benefits are tax-free
- Between \$25,000 and \$32,000 (\$32,000 and \$44,000 MFJ): up to 50% of benefits are included in taxable income
- Greater than \$34,000 (\$44,000 MFJ): up to 85% of benefits are included in taxable income

Income Tax Withholdings.¹⁷⁶ Individuals who pay income tax on a portion of their social security benefits can choose to have federal income tax withheld on their monthly payments or pay the IRS directly. To request income tax withholdings, taxpayers can mail or fax a Form W-4V, *Voluntary Withholding Request* to the SSA. Available withholdings are 7%, 10%, 12%, or 22%.

Medicare Premium Considerations

Medicare is health insurance for individuals who are 65 years or older (or individuals with disabilities, or certain diseases).¹⁷⁷ There are separate Medicare parts that cover different costs: Part A covers hospital insurance, Part B covers medical insurance costs, and Part D covers drug costs.

The SSA uses filing status to determine Medicare premiums and bases the premiums on AGI, which is modified by adding tax-exempt income.¹⁷⁸ Because tax returns are not available immediately, income differences resulting from different filing statuses can also affect Medicare premium amounts two years later.

¹⁷⁴. *Special Earnings Limit Rule*. SSA. [www.ssa.gov/benefits/retirement/planner/rule.html] Accessed on Dec. 8, 2024.

¹⁷⁵. *Income Taxes and Your Social Security Benefit*. SSA. [www.ssa.gov/benefits/retirement/planner/taxes.html] Accessed on Dec. 3, 2024.

¹⁷⁶. *Request to withhold taxes*. SSA. [www.ssa.gov/manage-benefits/request-withhold-taxes] Accessed on Dec. 3, 2024.

¹⁷⁷. *Getting Started with Medicare*. Medicare.gov. [medicare.gov/basics/get-started-with-medicare] Accessed on Jan. 23, 2025.

¹⁷⁸. *Premiums: Rules for Higher-Income Beneficiaries*. SSA. [www.ssa.gov/benefits/medicare/medicare-premiums.html] Accessed on Jan. 23, 2025.

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Individuals who have paid Medicare payroll taxes for at least 40 quarters are not charged a premium for Part A. Medicare Part B premium payments are calculated based on income thresholds. Individuals who earn less than the threshold amount pay the same premium rate. For 2025, taxpayers with MAGI less than \$106,000 (\$212,000 MFJ) pay a premium of \$185.¹⁷⁹

For individuals whose MAGI exceeds these thresholds, a surcharge is applied. This additional amount is called the income-related monthly adjustment amount (IRMAA), and it is determined by the SSA. The surcharge is based on the MAGI reported on the individual's tax return from two years prior. Generally, the surcharge is deducted from the individual's monthly social security benefit.¹⁸⁰

The following table shows the difference that filing status makes at different MAGI levels.

Note. The single column includes head of household (HoH), qualified widow(er) with dependent child, and MFS (if spouses did not live together during the year.) The MFS column is for separated spouses who lived together for part of the tax year.¹⁸¹

2023 MAGI (Single)		2023 MAGI (MFJ)		2023 MAGI (MFS)		2025 Monthly Medicare Part B Premium
Over	But Not Over	Over	But Not Over	Over	But Not Over	
\$ 0	\$106,000	\$ 0	\$212,000	\$ 0	\$106,000	\$185.00
106,000	133,000	212,000	266,000		N/A	\$259.00
133,000	167,000	266,000	334,000		N/A	\$370.00
167,000	200,000	334,000	400,000		N/A	\$480.90
200,000	500,000	400,000	750,000	106,000	394,000	\$591.90
500,000		750,000		394,000		\$628.90

Note. Of the six rows of data in this table, the second, third, and fourth contain no data for MFS taxpayers. Consequently, a \$1 increase in MAGI above \$106,000 (first row) promotes an MFS taxpayer from the first row to the fourth row with a Medicare premium more than three times higher. In this extreme case, a taxpayer's monthly premium increases from \$185.00 to \$591.90 in 2025. There are no intermediate brackets for MFS taxpayers, as there are for all other filing statuses.



Practitioner Planning Tip

Practitioners with clients approaching age 65 should use the two years prior to their client's Medicare enrollment as a tax planning opportunity, offering guidance to lower their MAGI if they are above the threshold for the IRMAA.

¹⁷⁹. 2025 Medicare Part A & B Premiums and Deductibles. CMS. [www.cms.gov/newsroom/fact-sheets/2025-medicare-parts-b-premiums-and-deductibles] Accessed on Dec. 3, 2024.

¹⁸⁰. Premiums: Rules for Higher-Income Beneficiaries. SSA. [www.ssa.gov/benefits/medicare/medicare-premiums.html] Accessed on Dec. 3, 2024.

¹⁸¹. Form SSA-44, Medicare Income-Related Monthly Adjustment Amount – Life-Changing Event.

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Appealing IRMAA.¹⁸² Taxpayers subject to an IRMAA who experience a life-changing event that reduces their income can submit this information to the SSA for consideration to lower their IRMAA. The life-changing event must occur in the same year or earlier than the year the taxpayer requests the SSA to use to calculate their IRMAA. Life-changing events include the following.

- Marriage, divorce/annulment, or death of spouse
- Taxpayer or spouse work stoppage or reduction in hours
- Loss of income-producing property not due to taxpayer or spouse discretion
- Taxpayer or spouse loss of pension due to scheduled cessation, termination, or reorganization of employer's pension plan
- Employer settlement payment from an employer or former employer due to the employer's bankruptcy or reorganization



Practitioner Planning Tip

Taxpayers approaching retirement may experience large increases in income that last only one year. The spike in income might result from the following situations.

- Large withdrawals from qualified plans, Roth conversions, or IRA distributions generate ordinary income.
- Rebalancing of an investment portfolio, which is a valuable financial tactic, but one that can generate significant capital gain income when appreciated stock is sold.

Tax practitioners are encouraged to inform clients of potential Medicare premium increases. Even a one-year spike in income can trigger the IRMAA, potentially creating significant increases in Medicare premiums for one year.

These unwelcome surprises can be avoided by planning effectively. Tax practitioners can work with their clients to build a multiple-year plan, the execution of which generates sufficient cash to repay debt. For example, the plan's objective might be to eliminate mortgage debt or credit card debt without triggering the IRMAA increase in Medicare premiums.

¹⁸². Ibid.

SAVING AND TAX PLANNING STRATEGIES FOR RETIREMENT

This section discusses some of the tax-advantaged accounts and tax planning strategies that individuals can utilize when saving for retirement.

Traditional IRA¹⁸³

A traditional IRA is a retirement savings account that allows for tax-deductible contributions if the taxpayer's MAGI for IRA purposes is below certain phase-out limits.¹⁸⁴ Taxpayers with income above these limits can contribute to a traditional IRA but without the tax deduction. For tax-deductible contributions made to a traditional IRA, withdrawals (both earnings and contributions) from the account for taxpayers aged 59½ or older are included in taxable income upon distribution. Distributions for contributions that were not tax-deductible are not included in taxable income, but the **earnings** on the contributions are included.

Contribution Limits. The 2025 traditional IRA contribution limit is the lesser of \$7,000 or the taxpayer's earned compensation.¹⁸⁵ The regular contribution limit for taxpayers aged 50 and older is increased by \$1,000 for catch-up contributions (covered later).

If a taxpayer is not covered by an employer's retirement plan, they can generally treat the IRA contribution as an above-the-line tax deduction. Active participants in employer retirement plans may have limited deductibility for their IRA contributions. Depending on their MAGI for IRA purposes, they may be ineligible for the adjustment to their gross income because of the IRA deduction limitation.¹⁸⁶

Contributions are **tax deductible** for taxpayers covered by a workplace plan if their MAGI is less than a phaseout range. If their MAGI is within the phaseout range, the contributions are **partially** deductible. Taxpayers with MAGI greater than the phaseout range cannot deduct their IRA contributions. For 2025, the following table shows phaseout ranges of MAGI that apply for **traditional IRA contributions**.¹⁸⁷

Filing Status	2025 MAGI Phaseout Ranges
Single, HoH	\$ 79,000–89,000
MFJ (contributing spouse is covered by workplace retirement plan)	126,000–146,000
MFJ (contributing spouse is not covered by workplace retirement plan and other spouse is covered by workplace retirement plan)	236,000–246,000
MFS	0–10,000

¹⁸³. IRC §408.

¹⁸⁴. MAGI for IRA deduction purposes includes AGI, any foreign earned income excluded, any foreign housing allowance excluded or deducted, any excluded adoption benefits excluded as shown on Form 8839, *Qualified Adoption Expenses*, any U.S. savings bond interest, and any student loan interest deducted. Although the same abbreviation is often used, this amount is different from the MAGI used for Medicare purposes. See IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*, for more information.

¹⁸⁵. IRS Notice 2024-80, 2024-47 IRB 1120; IRC §219(b)(5)(A).

¹⁸⁶. Treas. Reg. §1.219-2(d).

¹⁸⁷. IRS Notice 2024-80, 2024-47 IRB 1120.

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Concerning these phaseout ranges, the following general rules apply.

- Taxpayers with MAGI amounts below the ranges shown are entitled to deduct the full amount of their IRA contributions up to the \$7,000 per-taxpayer maximum for 2025 (plus the additional \$1,000 that the taxpayer may contribute starting at age 50), subject to the earned income limitation.
- Taxpayers with MAGI amounts within the phaseout range are entitled to a reduced IRA deduction.¹⁸⁸
- Taxpayers with MAGI amounts above their phaseout range cannot deduct any of the amounts contributed.¹⁸⁹
- For MFJ filers, when neither spouse is covered under a workplace retirement plan, there is no applicable phaseout range (and the spouses can deduct 100% of their contributions up to the maximum allowable amounts for each spouse).¹⁹⁰

Required Minimum Distributions. RMDs are the minimum amounts a taxpayer must withdraw from the retirement account each year.¹⁹¹ For traditional IRAs, account owners must begin taking RMDs when they reach the required beginning date. The required beginning date is April 1 of the calendar year following the year during which the taxpayer attains their applicable age.¹⁹²

Applicable Age. A taxpayer's applicable age triggers the beginning of RMDs. The SECURE 2.0 Act raised the applicable ages for taxpayers based on the year they were born, as shown in the following chart.¹⁹³

Date of Taxpayer's Birth	Applicable Age
December 31, 1950, or before	70½
January 1, 1951, through December 31, 1959	73
January 1, 1960, and after	75

Example 24. Because Serena was born on August 1, 1950, her applicable age is 70½. She reached her applicable age on February 1, 2021. Before that date, she had not received any distributions from her IRA. Her required beginning date is April 1, **2022**, the year following the year she turns 70½.

Example 25. Elmer was born on September 1, 1951, and his applicable age is 73. He attained age 73 on September 1, 2024. His required beginning date is April 1, **2025**.

If taxpayers wait until after December 31 of the year in which they attain their applicable age to take their first RMD, they must receive two RMDs during the subsequent year.¹⁹⁴

Caution. Taxpayers who receive two RMDs in a year may trigger an IRMAA that could force them to pay a higher Medicare premium two years later.

Calculating RMD.¹⁹⁵ RMDs for qualified plans are usually calculated by the plan administrator or IRA trustee. Taxpayers must calculate their RMD separately for each IRA but have the option to take the total RMD amount from a combination of their IRAs, as long as the annual requirement is met.

¹⁸⁸. IRC §219(g)(2).

¹⁸⁹. Ibid.

¹⁹⁰. IRC §§219(c)(2), (f)(2), and (g)(1).

¹⁹¹. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*.

¹⁹². IRC §401(a)(9)(C)(i).

¹⁹³. *SECURE 2.0 Act of 2022*, PL 117-328, §107.

¹⁹⁴. IRC §401(a)(9)(C)(i).

¹⁹⁵. IRS News Rel. IR-2024-309 (Dec. 10, 2024).

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IRA trustees or plan administrators are required to report the RMD or offer to calculate it for the account owner. However, it is ultimately the account owner's responsibility to ensure the correct RMD is withdrawn. The IRS has worksheets available to calculate the RMD and payout periods.

Note. Taxpayers can reduce or eliminate their RMDs through Roth conversions and QCDs, both of which are discussed in detail later.

Penalties.¹⁹⁶ Account owners can take more than the RMD in any year, but if they fail to withdraw the full amount of the RMD, the amount not withdrawn is subject to an excise tax. The SECURE 2.0 Act reduced the excise tax from 50% to 25%. Taxpayers may qualify for a reduced excise tax of 10% if they withdraw the full amount of their RMD within the correction window and submit a tax return reflecting the additional tax. The correction window begins with the date the additional tax is imposed and ends on the earliest of:

- The date of mailing of a deficiency notice in regard to the excise tax,
- The date the tax is assessed, or
- The last date of the second year after the end of the taxable year in which the additional tax is imposed.

Reporting.¹⁹⁷ Taxpayers who fail to take their RMD should file Form 5329 for the year in which the RMD was not fully withdrawn.

Roth IRA¹⁹⁸

A Roth IRA is a retirement savings account to which taxpayers contribute after-tax funds, allowing earnings to grow tax-free. Income thresholds limit taxpayers' abilities to make contributions directly to a Roth IRA. Distributions of both earnings and contributions from a Roth IRA after a taxpayer turns 59½ are not included in their taxable income.

Note. The following section covers contributions to Roth IRAs. For more information on distributions from Roth IRAs, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Retirement Plan Distributions. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

Contribution Limits. The 2025 Roth IRA contribution limit is \$7,000, and the regular catch-up contribution is \$1,000 for taxpayers aged 50 and over.¹⁹⁹ The SECURE 2.0 Act enables taxpayers ages 60 to 63 to make larger contributions, as discussed later.²⁰⁰

For 2025, Roth IRA contribution limits are reduced (phased out) in the following situations.²⁰¹

- MFJ or qualifying surviving spouse with MAGI at least \$236,000 (eliminated if MAGI is \$246,000 or more)
- Single, HoH, or MFS and spouses did not live together at any time during the year with MAGI at least \$150,000 (eliminated if MAGI is \$165,000 or more)
- MFS, spouses lived together at any time during the year, with MAGI more than zero (eliminated if MAGI is \$10,000 or more)

The contribution deadline to a Roth IRA is the filing deadline for the tax return, not including extensions.²⁰²

^{196.} SECURE 2.0 Act of 2022, PL 117-328, §302.

^{197.} Instructions for Form 5329.

^{198.} IRC §408A.

^{199.} IRS Notice 2024-80, 2024-47 IRB 1120.

^{200.} SECURE 2.0 Act of 2022, PL 117-328, §109.

^{201.} IRS Notice 2024-80, 2024-47 IRB 1120.

^{202.} IRC §408A(d)(7).



Practitioner Planning Tip

Taxpayers may receive bonuses or experience life events like getting married that impact the amount they can contribute to a Roth IRA.²⁰³ Taxpayers have until the due date of their tax return, including an extension, to remove excess contributions from a Roth IRA. Excess contributions that are not removed timely incur a 6% penalty each year they remain in the account. Tax practitioners should include a question in their tax questionnaires asking taxpayers if they contributed to an IRA so they can advise if taxpayers need to remove excess contributions before the return is due.

RMDs.²⁰⁴ Roth IRAs also do not require RMDs while the account owner is alive, but beneficiaries of an inherited Roth IRA must take RMDs.

Roth Conversions²⁰⁵

Converting funds from a traditional IRA to a Roth IRA is an option for individuals to withdraw tax-free funds during retirement. Taxpayers expecting to fall into a higher tax bracket during retirement than when they contribute may consider this option for potential tax savings in the future.

Because Roth IRAs do not have RMDs, taxpayers can lower their AGI during retirement by converting their traditional IRA to a Roth IRA before retirement. Lowering AGI during retirement can impact the amount of taxable social security benefits and the IRMAA. Taxpayers approaching retirement age should consider timing implications of a Roth conversion, including when they anticipate falling into a higher tax bracket and when their income is considered for the IRMAA surcharge, which is based on MAGI from two years prior.

Roth IRAs can form an integral part of an estate strategy, as they allow savings to pass to beneficiaries without incurring income tax on withdrawals. RMDs for inherited Roth IRAs are tax-free if the original Roth IRA was funded for five years or more and any funds that were converted have also been in the account for a minimum of five years. A spouse who inherits a Roth IRA can roll the inherited amounts into their own Roth IRA. In doing this, they avoid having to take the required minimum distributions from the inherited account.

Timing Requirements and Deadlines. Roth conversions are treated as rollovers if the distribution from the traditional IRA is contributed to the Roth IRA within 60 days. If the distribution is not completed within 60 days, the 10% penalty on distributions may apply.

The deadline for converting funds from a traditional IRA to a Roth IRA is December 31 each year. Upon conversion, any tax-deductible contributions and associated earnings are included in taxable income, so taxpayers opting to convert need to ensure they have the funds to cover the tax liability. There are no income limits for Roth conversions and no limit to the amount of funds a taxpayer can convert to a Roth IRA each year.

As mentioned, taxpayers have a 5-year waiting period to withdraw funds from Roth IRA accounts without incurring a 10% additional tax unless an exception applies. The 5-year waiting period begins at the start of the tax year in which the conversion is made, and each conversion has its own 5-year period. The exceptions include the taxpayer being at least age 59½, among others.

²⁰³. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements*.

²⁰⁴. IRC §408A(c)(4).

²⁰⁵. IRC §408A(c); Treas. Reg. §1.408A-4.

Example 26. Jennifer converts from a traditional IRA to a Roth IRA on October 10, 2025. The 5-year waiting period for penalty-free distributions of the principal from conversion starts on January 1, 2025. Jennifer turns 59½ on January 2, 2026, so she can receive distributions from her Roth IRA without incurring the 10% additional tax on that date, even though fewer than three months have elapsed since the conversion.

Reporting.²⁰⁶ Form 8606, *Nondeductible IRAs*, is used to report amounts converted from a traditional IRA to a Roth IRA in the year the conversion occurs. Nondeductible contributions are reported on the tax return for which the contributions were made. This requirement includes those contributions made between January 1 of the next calendar year and the filing deadline (not including extensions).

Example 27. Cathy is 55 years old and a single taxpayer with a MAGI of \$200,000 in 2025. On February 27, 2026, before filing her 2025 tax return, she contributes \$8,000 to a traditional IRA for 2025. On March 2, 2026, she converts the amount from her traditional IRA to a Roth IRA.

Cathy reports the nondeductible contribution of \$8,000 to the traditional IRA on her 2025 Form 8606. Because the conversion happened in 2026, the information related to that is reported on her 2026 Form 8606.

Backdoor Roth IRA²⁰⁷

A backdoor Roth IRA is a retirement planning strategy for taxpayers who are above the income thresholds for receiving both a tax deduction from a traditional IRA and contributing directly to a Roth IRA. In a backdoor Roth IRA, taxpayers make nondeductible contributions to a traditional IRA and then convert the funds to a Roth IRA. This allows high-income earners the ability to use a Roth IRA for retirement savings.

The deadline for contributing to a traditional IRA is the due date of the tax return, not including extensions. Taxpayers then convert the funds from the traditional IRA to the Roth IRA, ideally soon after conversion, but they have until the end of the year. If the account value increases while the funds are in the traditional IRA, the increase is taxed.

Note. For more information about backdoor Roth IRA conversions, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 8: Retirement Plan Issues for Individuals. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Example 28. Alex is 60 years old and nearing his retirement. He is interested in diversifying his retirement savings beyond his §401(k) plan. He is married with a MAGI of \$250,000 in 2024. Alex wants to contribute to an IRA, but because he is covered by a retirement plan with his employer, his MAGI was too high to deduct traditional IRA contributions. His MAGI is also greater than the Roth IRA contribution limits, precluding him from contributing directly to a Roth IRA.

He decides to use a backdoor Roth IRA. On June 10, 2024, he contributes \$8,000 (\$7,000 regular contribution + \$1,000 catch-up contribution) to a traditional IRA for 2024. Immediately after contributing to the traditional IRA, he converts the \$8,000 to a Roth IRA.

Alex's financial institution will issue a 2024 Form 1099-R, reporting the \$8,000 distribution from his traditional IRA. He reports the non-deductible \$8,000 contribution to the traditional IRA and the amount converted to a Roth IRA on his 2024 Form 8606. On line 4a of Form 1040, he reports \$8,000 and 0 on line 4b.

²⁰⁶. Instructions to Form 8606.

²⁰⁷. Ibid.

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Enhanced Catch-Up Provisions²⁰⁸

In 2025, the SECURE 2.0 Act increases catch-up contributions in 2025 to retirement plans for individuals ages 60 to 63. These enhanced catch-up contributions apply to retirement plans that currently offer catch-up contributions, including §401(k), §403(b), and §457(b) plans, the federal government's Thrift Savings Plan, and SIMPLE IRAs.

The increased catch-up contribution limit for **§401(k), §403(b), §457(b) plans, and the federal government's Thrift Savings Plan** is the greater of:

- \$10,000 or
- 50% more than the regular catch-up contribution amount for the tax year (\$7,500 in 2025).

For the tax year 2025, the increased catch-up contribution limit is \$11,250 (greater of \$10,000 or 150% x \$7,500). Accordingly, eligible individuals contributing to one of these plans can contribute a maximum of \$34,750 in 2025 (\$23,500 regular contributions + \$11,250 catch-up contribution).²⁰⁹

The increased catch-up contribution limit for **SIMPLE IRAs** is the greater of:

- \$5,000 or
- 150% of the regular catch-up contribution amount for the tax year (\$3,500 in 2025).

For tax year 2025, the increased catch-up contribution limit for SIMPLE IRAs is \$5,250 (greater of \$5,000 or 150% of \$3,500). Accordingly, eligible individuals can contribute a maximum of \$21,750 in 2025 (\$16,500 regular contributions + \$5,250 catch-up contribution).²¹⁰

Eligibility. Individuals aged 60, 61, 62, or 63 generally qualify for increased catch-up contributions. Once individuals are 64, they are no longer eligible and can only contribute up to the regular catch-up contribution limits.

Example 29. Flora's 61st birthday is June 4, 2025. She is a participant in her employer's §401(k) plan that permits catch-up and enhanced catch-up contributions. Because Flora is 61 at the end of 2025, she is eligible to defer \$34,750 (\$23,500 regular contribution + \$11,250 enhanced catch-up contribution) of her compensation to the plan in 2025.

Example 30. Raymond's 64th birthday is November 15, 2025. He is a participant in his employer's §401(k) plan that permits catch-up and enhanced catch-up contributions. Because he turns 64 in 2025, he is only eligible to defer \$31,000 (\$23,500 regular contribution + \$7,500 regular catch-up contribution) of his compensation to the plan in 2025.

Simplified Employee Pensions²¹¹

SEPs are tax-advantaged retirement savings options for business owners and self-employed individuals that offer higher contribution limits than other retirement accounts. Employers are generally allowed to contribute to a traditional IRA for themselves and on behalf of their employees. A self-employed individual can contribute to a SEP even if they do not have any employees. Accordingly, individuals who own businesses, are near retirement age, and who are eligible to contribute should consider loading up their contributions into an account to save for the future.

Participants in a SEP are immediately vested in the plan, so all the money contributed belongs to them. The employer receives the tax benefit when contributing to a SEP. The funds in the account grow tax-deferred and are taxed as ordinary income upon distribution.

²⁰⁸. SECURE 2.0 Act of 2022, PL 117-328, §109.

²⁰⁹. IRS News Rel. IR-2024-285 (Nov. 1, 2024).

²¹⁰. Ibid.

²¹¹. IRC §408(k).

Contribution Limits. SEPs offer higher contribution limits than other retirement plans, so they are an attractive option for those saving for retirement. For 2025, contributions limits are the lesser of 25% of the first \$350,000 of compensation or \$70,000.²¹² These higher limits allow individuals to contribute more for retirement savings than relying on traditional or Roth IRAs and employees contributing to their employer-sponsored §401(k) plans. Taxpayers have until the deadline for filing their tax return, **including extensions**, to contribute to a SEP for the year.

Additionally, an individual can continue to contribute after the self-employed individual or employee turns age 70½, but the individual must also take the RMD.²¹³

Example 31. Anne is a 40-year-old sole proprietor with net SE earnings of \$150,000 in 2025.²¹⁴ Her business does not have any employees. In prior years, she only made backdoor Roth IRA contributions for her retirement savings, but starting in 2025, she would like to start saving more. Her tax practitioner suggests a SEP.

Because Anne is self-employed, to calculate her maximum SEP contribution, the 25% limit is applied to SE earnings (after the deduction for SE tax) less her plan contribution. Her 2025 SE tax on \$150,000 is \$21,194. Accordingly, her adjusted net SE income is \$139,403 (\$150,000 SE income – (\$21,194 × 50% deductible SE tax)).

Because her SE earnings are reduced by the plan contribution, her maximum plan contribution is 20% ($0.25 \div 1.25$) of her adjusted net SE earnings before the contribution deduction.

Accordingly, Anne can contribute up to \$27,881 (\$139,403 × .20) to a SEP in 2025. She can also make a backdoor Roth IRA contribution of \$7,000 in 2025. If she makes both contributions, her total retirement account savings for 2025 amounts to \$34,881 (\$27,881 SEP + \$7,000 backdoor Roth).

Disadvantages.²¹⁵ Despite the higher contribution limits that allow self-employed individuals to load up retirement savings, SEPs have some disadvantages.

- They offer no catch-up contributions for individuals aged 50 or over.
- They offer no Roth IRA option, only traditional, so the income is included in ordinary income upon distribution unless the individual does a Roth IRA rollover.
- RMD are imposed, which may impact other retirement benefits and costs.
- Employers must make the same percentage contribution to the plan for all eligible employees.

²¹² IRS Notice 2024-80, 2024-47 IRB 1120.

²¹³ IRC §408(k).

²¹⁴ IRS Pub. 560, *Retirement Plans for Small Business*.

²¹⁵ Ibid.

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LIVING ON INVESTMENT INCOME

Clients may ask their tax practitioners for **tax advice** regarding recommendations for living off investment income. Some factors they should consider include the following.

- **Retirement expenses.** A starting point for calculating how much savings an individual will need to live off their investment income in retirement is to determine how much they intend to spend each year after they no longer have earned income to support them. There is no set method for calculating expenses, but individuals should consider healthcare, income tax, property tax, living expenses, dependents, and lifestyle choices and goals.
- **Retirement portfolio.** Individuals should also consider the amount they have saved and the income sources they plan to draw from in retirement, including §401(k) or §403(b) accounts, IRAs, pensions, annuities, and social security benefits. The amount of passive income a retirement savings portfolio generates depends on the account's value, as well as the income generated by its assets. There are common methods for individuals to calculate how much they can expect to withdraw from their portfolio without drawing from the principal.
- **Inflation.** It is important to have retirement savings that can withstand higher prices in the future. Individuals collecting social security benefits or pensions with cost-of-living adjustments have some inflation protection, but they should also consider whether their other investments return higher yields than the average inflation rate.

Caution. Because retirement planning is a financial matter, practitioners should be cautious about offering anything other than tax advice unless licensed to do so.

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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

IRS RELEASES “DIRTY DOZEN” LIST OF TAX SCAMS FOR 2025¹

The IRS issued its “dirty dozen” list of tax scams and reminded taxpayers to remain vigilant to these schemes throughout the year. Although these scams may peak during tax season, taxpayers may encounter them anytime.

A recap of this year’s top scams follows.

1. **Phishing and smishing.** Scammers pose as legitimate organizations and send unsolicited text messages (smishing) or emails (phishing) to entice unsuspecting victims into providing their personal and financial information. The thieves then use that information for identity theft. The IRS reminds everyone that it initiates most contact through postal mail rather than email, text, or social media.
2. **Fraudulent form filing and bad advice.** The IRS has observed individuals using social media to recommend fraudulent tax practices such as filling out fraudulent Forms W-2, *Wage and Tax Statement*. The scheme encourages individuals to file these forms using false and inaccurate information to get a larger refund.

In response to the surge in social media-fueled scams, the IRS, state tax agencies, and other various partners have launched the Coalition Against Scam and Scheme Threats (CASST). The CASST aims to combat the growing threat of scams and schemes that target taxpayers and tax systems. This coalition has over 60 groups from the private sector, which include software and financial companies along with national tax professional associations. This initiative enhances the IRS’s ability to keep taxpayers informed by enabling swift responses to emerging threats and timely alerts about new and evolving scams.²

3. **Third-party scammers offering to set up free IRS online accounts.** Taxpayers should not accept help from third parties who offer to help taxpayers set up IRS online accounts. The scammers can use that valuable information for fraudulent gains once the taxpayer provides the third party with their personally identifiable information (PII). Taxpayers should establish their online accounts without outside help other than the IRS or their tax practitioners.
4. **Fake charities.** Defrauders set up fake charitable organizations to exploit donors’ generosity, especially whenever a crisis or natural disaster strikes. The scammers acquire taxpayers’ money and PII to exploit them. However, individuals can only claim itemized deductions if they donate to qualified tax-exempt IRS-approved organizations.
5. **False fuel tax credit claims.** The fuel tax credit is available for off-highway and farming use. Most taxpayers are not eligible for the credit. Unscrupulous practitioners and promoters entice taxpayers to inflate their tax refunds by incorrectly claiming the credit on Form 4136, *Credit for Federal Tax Paid on Fuels*.
6. **Credits for sick leave and family leave.** The sick leave and family leave credits are not available for self-employed individuals after 2021. The IRS is seeing instances where taxpayers are claiming the credit based on income earned as an employee and not as a self-employed individual on Form 7202, *Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals*.

¹. *Dirty Dozen tax scams for 2025: IRS warns taxpayers to watch out for dangerous threats.* Mar. 6, 2025. IRS. [www.irs.gov/newsroom/dirty-dozen-tax-scams-for-2025-irs-warns-taxpayers-to-watch-out-for-dangerous-threats] Accessed on Apr. 8, 2025.

². *IRS, states, tax industry announce new joint effort to combat growing scams and schemes; ongoing coordination to follow in footsteps of Security Summit’s identity theft efforts to help taxpayers and protect revenue.* Aug. 16, 2024. IRS. [www.irs.gov/newsroom/irs-states-tax-industry-announce-new-joint-effort-to-combat-growing-scams-and-schemes-ongoing-coordination-to-follow-in-footsteps-of-security-summits-identity-theft-efforts-to-help-taxpayers-and] Accessed on Apr. 9, 2025.

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7. **Bogus self-employment tax credit.** The IRS has issued a warning about misleading claims that are circulating on social media regarding the “Self-Employment Tax Credit.” Scammers are marketing this credit as a way for self-employed individuals to receive large payments related to the COVID-19 pandemic period. This misleading information is causing taxpayers to file false claims in which they believe they qualify for a refund when they do not.

Note. This is similar to the employee retention credit (ERC) scams that the IRS listed on the dirty dozen list in previous years.

8. **Improper household employment taxes.** Taxpayers create a fictional household employee and file a Schedule H (Form 1040), *Household Employment Taxes*, to claim a refund on wages they never paid.

Observation. This is a new addition to the dirty dozen for 2025.

9. **The overstated withholding scam.** The IRS has recently seen this scheme circulating on social media that encourages an individual to use software to fill out a Form W-2 or other information returns such as Form 1099-NEC, *Nonemployee Compensation*, or other Forms 1099 to include false income and withholding information to get a larger refund due to the larger fraudulent withholding.

Observation. This is a new addition to the dirty dozen for 2025.

10. **Offer in compromise (OIC) mills.** IRS OICs help individuals unable to pay their total tax liability to settle with the IRS. However, OIC mills aggressively promote OICs to individuals who do not meet the qualifications, often costing the taxpayer thousands of dollars.

Note. For more information on legitimate OICs, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

11. **Bogus tax preparers.** Common warning signs of a corrupt tax preparer include charging a contingency fee based on the size of the refund, refusing to sign the return as the preparer, or refusing to provide their preparer tax identification number (PTIN).
12. **Spear phishing and new client scams aimed at tax practitioners.** Tax practitioners are common targets for data thieves because they extensively use clients’ PII. The IRS warns tax practitioners that cybercriminals use spear phishing to gain access to clients’ sensitive data, sometimes by embedding malware that maliciously sends this data to a remote computer. Sometimes, the cybercriminal pretends to be a potential tax client seeking help. Although these criminals take advantage of tax professionals’ busy schedules during tax season, they may attack throughout the year. They may also attack unrelated businesses if they anticipate gaining access to valuable information.

Note. More information on each of these scams can be found at [uofi.tax/25x7x1](https://www.irs.gov/newsroom/dirty-dozen) [www.irs.gov/newsroom/dirty-dozen].

COMMUNICATION WITH THE IRS

Staffing shortages continue to be a challenge for the IRS, for both telephone and in-person assistance. Taxpayers and practitioners are experiencing an extended period on hold which often leads to an abrupt end to the call without ever speaking to a representative. When taxpayers and practitioners cannot speak to a representative on the phone, resolving IRS issues or receiving guidance is challenging. The next step is to attempt to speak to a representative at an IRS location. However, staffing shortages also continue to impact the ability to obtain in-person assistance. This leaves taxpayers and practitioners without a way to resolve an issue or ask a general question in person at an IRS location or through telephone assistance.

To overcome these challenges and provide additional resources to taxpayers and practitioners, the IRS has invested in enhancing online tools that taxpayers and practitioners can access without limitations on staffing, hours, or location. These tools, such as the interactive tax assistant, *Where's My Refund?*, and *Where's My Amended Return?*, are becoming increasingly popular with both taxpayers and practitioners, who now commonly use them to get answers to general tax questions, track the status of refunds, and monitor their amended return progress.

INTERACTIVE TAX ASSISTANT³

The interactive tax assistant (ITA) is a self-service tool that helps taxpayers and practitioners find answers to common tax questions. The ITA can be found at **uofi.tax/25x7x2** [www.irs.gov/help/ita]. The ITA covers topics such as the following.

- Filing requirements
- Tax forms and due dates
- Filing status and dependents
- Retirement income
- Other income categories
- Deductions
- Credits
- International issues
- Other topics

Example 1. Trina Maxwell's brother passed away in 2025. As the executor of his estate, she is unsure whether she needs to file a final tax return for her brother. Trina visits the ITA, selects the topic "Do I need to file a return for a deceased person?", and answers a series of guided questions. The ITA then informs her about filing requirements for a decedent and what documents she needs to proceed.

Note. Taxpayers and practitioners can access additional topics that are not part of ITA such as frequently asked questions, tax scams, identity theft resources, and local IRS contact information through page links on the ITA home page.

³. *Interactive Tax Assistant (ITA)*. Apr. 8, 2025. IRS. [www.irs.gov/help/ita] Accessed on May 21, 2025.

CHATBOTS⁴

To improve taxpayer service and reduce wait times, the IRS introduced artificial intelligence (AI)-powered chatbots across several platforms. These tools are designed to assist taxpayers with routine inquiries and provide general self-service options for resolving common issues.

The IRS chatbot is available 24/7 on select IRS.gov pages and is capable of instantly answering questions related to notices, payment options, and identity verification. The chatbot uses natural language processing to simulate human conversation and guide users through step-by-step solutions.

Through chatbots, users can request more time to respond, check if the IRS received their reply, and learn what steps to take next. If the chatbot cannot resolve the issue, users can select the “representative” option to be connected to a live IRS assistor. Additionally, chatbots have the option to authenticate the user’s identity to discuss case-specific information.

Observation. The chatbot is part of the IRS’s broader digital modernization strategy, which includes expanding online accounts and secure document upload tools. These efforts aim to reduce reliance on phone and in-person assistance, especially during the peak of filing season.



Practitioner Planning Tip

Practitioners should encourage clients to use the chatbot for basic inquiries before calling the IRS. This can save time and help clients resolve issues more efficiently. If escalation is needed, the chatbot provides a direct path to live support.

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VOICEBOTS⁵

The IRS has implemented AI-powered voicebots on several toll-free phone lines. These bots assist taxpayers with routine collection and payment inquiries, allowing faster resolution of simple issues without waiting for a live representative.

Voicebots have guided prompts to provide users with the ability to select certain information grouped by topics and are available in both English and Spanish. Eligible taxpayers can use voicebots to verify their identity and set up or modify payment plans without speaking to a representative, although there is an option to escalate to a live IRS phone representative.

Voicebots can help callers understand IRS collection notices and provide guidance on next steps. Additionally, callers can make secure one-time payments through the bot interface, as well as request account and return transcripts.

⁴. IRS News. Rel. IR-2023-178 (Sep. 26, 2023).

⁵. IRS News. Rels. IR-2022-127 (Jun. 17, 2022) and IR-2022-56 (Mar. 10, 2022); *Using voice and chat bots to improve the collection taxpayer experience*. May 29, 2025. IRS. [www.irs.gov/about-irs/using-voice-and-chat-bots-to-improve-the-collection-taxpayer-experience] Accessed on Aug. 14, 2025.

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SECURE MESSAGING⁶

The IRS offers secure messaging to allow taxpayers and their authorized representatives to send and receive messages and documents securely during audits or other casework, reducing the need for paper correspondence and improving response times. Taxpayers can exchange messages and upload documents directly with IRS employees handling their case in a manner similar to email communication, but more secure as all communications are encrypted. **Currently, this tool is voluntary and by invite only.**

IRS DOCUMENT UPLOAD TOOL⁷

The IRS document upload tool is a secure online tool that allows taxpayers and practitioners to upload documents to respond to an IRS notice or letter. The upload tool can be found at **uofi.tax/25x7x3** [www.irs.gov/help/irs-document-upload-tool]. The tool streamlines the process by providing immediate confirmation of receipt and eliminates standard mail delays. The document upload tool is available for the following CP series notices.

- CP04, Combat Zone Status
- CP05A, Information Request Related to a Refund
- CP06/CP06A, Premium Tax Credit
- CP08, Child Tax Credit
- CP09, Earned Income Credit (EIC) Claim
- CP75, EIC Verification
- CP75A, EIC Verification
- CP75D, EIC and Other Credits Verification

The document upload tool is also available for the following.

- Identity verification letters (e.g., Letter 5071C, *Potential Identity Theft During Original Processing with Online Option*, or CP5071)
- Central Withholding Agreement Program⁸
- Requests for additional documentation
- Notices about return discrepancies
- Audit-related correspondence
- Collection notices requesting financial information

Taxpayers who receive one of the above CP series notices will be given a link and unique code to access the upload tool. If an access code was not provided, taxpayers can use the notice number, letter number, or title. In addition, users need the taxpayer's first and last name or the business name, and either the taxpayer's social security number or the business's employer identification number (EIN). Taxpayers can upload scans, photos, or digital copies of documents in JPG, PNG, or PDF format.

⁶ *Communicate securely with the IRS online*. Apr. 9, 2025. IRS. [www.irs.gov/help/communicate-securely-with-the-irs-online] Accessed on Aug. 14, 2025; IRS Pub. 5896, *Introduction to Taxpayer Digital Communication (TDC) Secure File Sharing — Secure Messaging (SFS-SM)*; *IRS Secure Messaging help*. May 12, 2025. IRS. [www.irs.gov/help/irs-secure-messaging-help] Accessed on Aug. 14, 2025.

⁷ *IRS Document Upload Tool*. Oct. 23, 2024. IRS. [www.irs.gov/help/irs-document-upload-tool] Accessed on May 13, 2025; *IRS expands secure digital correspondence for taxpayers*. May 29, 2025. IRS. [www.irs.gov/newsroom/irs-expands-secure-digital-correspondence-for-taxpayers] Accessed on May 13, 2025.

⁸ *Document Upload Tool for Central Withholding Agreement and Letters*. Jan. 14, 2025. IRS. [www.irs.gov/credits-deductions/individuals/document-upload-tool-for-central-withholding-agreements-and-letters] Accessed on Jul. 24, 2025.

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The IRS is continuing to evaluate the document upload tool and has identified 53 other notices that could be appropriate for this type of secure digital communication.⁹ The list of these additional notices is not publicly available at this time.

Caution. If a taxpayer receives a notice with a link, they should carefully check it for credibility. It should include “https” and “irs.gov.” The IRS recommends taxpayers and practitioners verify it is from the IRS prior to sending any documentation.

Users should receive a confirmation message like the following after successfully uploading their document.

Your documents have been successfully uploaded. You may be contacted at a future date regarding your response. You should allow at least 30 days for a reply from the IRS.

Upload Confirmation

Name: John Doe

Notice: LTR1948C - Civil Penalty Explained

Date: April 11, 2025

Note. The IRS is unable to send emails through the document upload tool to confirm receipt of documents. Therefore, the IRS advises that practitioners and taxpayers take screenshots of the upload confirmation.

7

PRACTITIONER PRIORITY SERVICE¹⁰

The Practitioner Priority Service (PPS) is usually the first point of contact for taxpayer account-related issues and transcripts. PPS provides tax professionals with priority access to IRS customer service representatives who are specially trained to handle practitioners’ account-related questions. PPS is available at (866) 860-4259 to all tax practitioners with a valid Form 2848, *Power of Attorney and Declaration of Representative*, Form 8821, *Tax Information Authorization*, or Form 8655, *Reporting Agent Authorization*.

Practitioners commonly call PPS to obtain access to transcripts. Due to the rise in identity theft, the IRS implemented changes to protect taxpayer information. Transcripts are now deposited into a practitioner’s secure object repository (SOR) only after a practitioner calls the PPS. SOR is a secure email account within IRS e-Services.¹¹

To access a taxpayer’s transcript, practitioners must pass authentication checks and verify their short identification (ID). The **short ID** is a unique 8-10 alphanumeric code that is systemically assigned when an IRS account is established. After the practitioner passes the authentication check and has verified their short ID, the transcript is sent to the practitioner’s SOR account.

Note. If the IRS cannot verify the taxpayer’s identity, transcripts will only be mailed to the address of record.

⁹ *IRS expands secure digital correspondence for taxpayers.* May 29, 2025. IRS. [www.irs.gov/newsroom/irs-expands-secure-digital-correspondence-for-taxpayers] Accessed on May 13, 2025.

¹⁰ *Practitioner Priority Service.* Sep. 3, 2024. IRS. [www.irs.gov/tax-professionals/practitioner-priority-service-r] Accessed on May 12, 2025.

¹¹ e-Services is a suite of web-based tools for practitioners, reporting agents, mortgage lenders, and payers to interact with the IRS and can be accessed at [www.irs.gov/e-services]. For more information on SOR, see [www.irs.gov/tax-professionals/instructions-to-access-the-secure-object-repository-sor-mailbox].

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The IRS encourages practitioners to utilize the following alternative avenues before contacting PPS.

- **Income Verification Express Services (IVES) program.** IVES allows third- and fourth-party assistors (such as mortgage lending companies, including banks, credit unions, etc.) to request transcripts. The assistors should receive the transcripts within two business days from receipt. There is a \$2 fee for each request. This program is suitable for bulk processing. The IRS provides additional information at **uofi.tax/25x7x4** [www.irs.gov/individuals/income-verification-express-service].
- **Transcript Delivery System (TDS).** TDS is available to both business and individual taxpayers and allows eligible tax professionals with a valid power of attorney (POA) on file to access account transcripts, tax return transcripts, wage and income documents, and non-filing verification. The IRS provides additional information at **uofi.tax/25x7x5** [www.irs.gov/tax-professionals/transcript-delivery-system-tds].

Note. Tax practitioners who are registered for e-Services and have a valid third-party authorization recorded on the Centralized Authorization File (CAF) are not required to contact the PPS to obtain a transcript. These practitioners can access transcripts directly through e-Services. Access to TDS is granted only through an approved e-file application and is limited to electronic return originators (EROs), Circular 230 practitioners, and reporting agents. To qualify, EROs must have successfully submitted at least five accepted e-filed returns in the current or prior year.

- **Unmasked wage and income transcript.** Practitioners with a Tax Pro Account and a valid POA with access to TDS can get unmasked wage and income transcripts sent to the practitioner's SOR mailbox. The IRS provides additional information at **uofi.tax/25x7x6** [www.irs.gov/individuals/about-tax-transcripts].

TAX PRO ACCOUNT¹²

The IRS Tax Pro Account is a secure, online self-service portal that allows tax practitioners to manage client authorizations, view taxpayer information, and interact with the IRS digitally. It streamlines submitting and managing POA and tax information authorization (TIA) forms and provides real-time access to client data. Attorneys, CPAs, enrolled agents, actuaries, and retirement plan agents with valid IRS credentials can access their accounts through **irs.gov/taxproaccount**. **Users must have an IRS secure access account (ID.me) and a valid CAF number, and clients must have an IRS online account.**

Tax practitioners can perform the following activities through their Tax Pro Account.

- Submit and manage POA (Form 2848) and TIA (Form 8821) requests online
- View and withdraw active authorizations
- Access client tax information (e.g., balances, notices)
- Make payments on behalf of individual clients
- Link and manage their CAF number

¹² *Tax Pro Account.* Jul. 3, 2025. IRS. [www.irs.gov/tax-professionals/tax-pro-account] Accessed on May 27, 2025; *Tax pros: Save time with tax pro account - YouTube video text script.* Jul. 12, 2024. IRS. [www.irs.gov/newsroom/tax-pros-save-time-with-tax-pro-account-youtube-video-text-script] Accessed on May 27, 2025.

POA and TIA

One of the main benefits of the Tax Pro Account is the ability to submit and manage POA and TIA requests in real time, rather than waiting for Forms 2848 or 8821 to be processed on paper. To complete the request, a practitioner must complete the following steps.¹³

1. Enter tax practitioner's and taxpayer's details
 - a. Practitioner name, address, and CAF number

Caution. If the practitioner has not linked their CAF number to their Tax Pro Account and they are requesting a POA or TIA, the address entered must agree with the CAF file at the IRS.

- b. Taxpayer's name, address, and tax identification number (TIN)
2. Select tax matter(s) and period(s)
3. For POA: Check box as electronic signature and submit for validation



Practitioner Planning Tip

Practitioners should advise the taxpayer to approve the request in their online account to ensure a quick response.

7

Active Authorizations

Tax practitioners who link their CAF number to their Tax Pro Account can view taxpayer information. The information shown is limited to the forms and tax periods for which the practitioner has approved authorization. This includes active POAs and TIAs from individuals and businesses that practitioners submitted through their Tax Pro Account.

Practitioners can request authorizations for calendar-year filers for periods from the last **20 years** through the current year, plus three future years (except where noted) for:

- Form 1040, *Individual Income Tax Return*
- Split Spousal Assessment or Form 8857, *Request for Innocent Spouse Relief*
- Shared Responsibility Payment (2014 or later)
- Shared Responsibility Payment - Split Spousal Assessment (2014 or later)
- Civil Penalty (limited to periods of March, June, September, and December)

Additionally, practitioners can view their history of all requests they have submitted through the Tax Pro Account. Any taxpayer-approved authorizations should appear immediately in the Tax Pro Account. If any of the following occur, the Tax Pro Account will not display a status.

- The taxpayer rejects the authorization.
- The taxpayer approves the authorization, but the processing fails.

Note. Practitioners should contact the taxpayer for information on any request status before processing has been completed.

¹³ IRS Pub. 5333-B, *How to Manage Authorizations Using Tax Pro Account*.

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Practitioners can withdraw an authorization in real time through their Tax Pro Account. The authorization is immediately removed from the CAF database. Practitioners who need to correct an authorization that the taxpayer approved on the same day can submit a new request. If the correction is for the same form and tax period, the taxpayer must wait a day to approve the request.

Note. For detailed information on managing CAF numbers, including linking and withdrawing authorizations, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

Caution. The Tax Pro Account has designated hours of service. Services may be unavailable outside of these times. Currently, those hours are:

- Monday 6 AM to Saturday 9 PM Eastern Time
- Sunday 10 AM to 12 AM Eastern Time (occasionally down for maintenance)

INFORMATION DOCUMENT REQUESTS¹⁴

To determine the accuracy of a return, establish tax liability, or collect any related tax obligations, the IRS is authorized to examine any books, records, or data relevant to the inquiry.¹⁵ An information document request (IDR) is a formal request from the IRS for specific documents and information during an examination or audit. An IDR must include a clear statement identifying the specific issue under examination.

When a taxpayer receives a Form 4564, *Information Document Request*, it is essential they read the request and provide all the documentation requested carefully. The request should specify what documentation the IRS requests or if the request is asking for additional information or supporting documentation.



Practitioner Planning Tip

Taxpayers and practitioners should only provide what is asked for in the complete documentation. If the practitioner is uncertain about the requested materials, they should call the requester for clarification.

Additionally, practitioners should organize the documentation and provide an explanation for any missing documentation to facilitate a smooth audit. Practitioners should retain an exact copy of all documents they submit to the IRS. If the documents requested in the IDR seem exorbitant and beyond the scope of the audit, practitioners should discuss the request with the IRS examiner. Practitioners should be cautious of requested documents that are subject to attorney-client privilege or tax practitioner privilege under IRC §7525.

¹⁴ IRM 4.46.4 (2023); *Responding to an IRS information document request*. Kossman, Seth. Oct. 1, 2023. The Tax Advisor. [www.thetaxadviser.com/issues/2023/oct/responding-to-an-irs-information-document-request] Accessed on Jun. 4, 2025.

¹⁵ IRC §7602(a).

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After verifying a clear understanding of the requested items, the taxpayer or representative establishes a reasonable date to respond to the IDR. **It is crucial to provide the documentation by the due date** listed on the IDR and submit the request in person at the next appointment or mail the documentation. The IRS will state the method and date by which the taxpayer should submit the requested information at the bottom of Form 4564, as shown next.

Information Due By _____ At Next Appointment ☐ Mail in ☐

From: Name and Title of Requester Employee ID number Date (mmddyyyy)

Office Location Telephone Number ()

Catalog Number 23145K www.irs.gov Part 1 - Taxpayer's File Copy Form **4564** (Rev. 9-2006)

Enforcement and Penalties

When a taxpayer fails to respond to an IDR in a timely or complete manner, the IRS may initiate a structured **IDR enforcement process**, as outlined in IRM 4.46.4.7.1 and related subsections. This enforcement process consists of **three graduated steps**.

1. An initial follow-up with a delinquency notice
2. Managerial involvement
3. Potential issuance of a summons

If the taxpayer continues to withhold the requested information, the IRS may pursue **summons enforcement through the courts**, which can lead to judicially imposed penalties for failure to comply with a lawful summons. IRS summons are covered later.

While IRM 4.46.4 does not impose a specific civil penalty solely for failing to respond to an IDR, it makes clear that **noncompliance can escalate to legal enforcement**, and that such behavior may be considered **uncooperative conduct**. This can influence the examiner's decision to assert other penalties, such as **accuracy-related penalties** under IRC §6662, especially if the lack of documentation impedes the IRS's ability to verify return positions.



Practitioner Planning Tip

Practitioners should advise clients to treat IDRs with the same seriousness as formal notices. Timely and complete responses not only help avoid escalation but also demonstrate good faith cooperation, which may be relevant in defending against broader penalty assertions later in the examination.

7

Potentially Unagreed Issues

During the execution phase of an IRS examination, **unagreed issues** — those where the taxpayer and the IRS do not reach consensus — require careful documentation and procedural adherence. According to IRM 4.46.4, before issuing a notice of proposed adjustment (NOPA), the issue team must solicit an **acknowledgment of facts (AOF)** from the taxpayer. This step ensures that all relevant facts, including those disputed or newly introduced by the taxpayer, are clearly documented and considered. The AOF process is critical in promoting transparency and reducing misunderstandings that could escalate into formal disputes.

Notice of Proposed Adjustment

The NOPA is a critical component of the IRS examination process, particularly in Large Business and International (LB&I) cases. As outlined in IRM 4.46.4, a NOPA is issued using Form 5701, *Notice of Proposed Adjustment*, which provides a concise summary of the proposed tax adjustment. This form is typically accompanied by Form 886-A, *Explanations of Items*, which offers a detailed explanation of the items in question, including the factual background, legal analysis, and the IRS's rationale for the adjustment.

The issuance of a NOPA marks a formal step in the examination process, signaling that the IRS has completed its factfinding and legal analysis and is ready to present its position to the taxpayer.

The NOPA serves not only as a communication tool but also as a foundation for further administrative resolution or litigation. Taxpayers may agree with the proposed adjustment, partially agree, or fully disagree, in which case the issue may proceed to Appeals or Tax Court. The clarity and completeness of the NOPA and its supporting documentation are therefore essential to the integrity of the examination process.

IRS SUMMONS¹⁶

If a taxpayer fails to respond to an IDR or other IRS inquiries, the IRS can issue a summons to obtain the requested information. Taxpayers and practitioners should carefully read the summons. Failure to comply with a summons can lead to significant consequences, including the IRS petitioning a federal district court to enforce the summons. If the court orders compliance and the taxpayer still refuses to comply, they may be held in contempt of court, which can result in **fines, penalties, or even imprisonment**. Prompt and cooperative responses are essential to avoid escalating legal action.¹⁷

A summons from the IRS is an order to produce information, testimony, or documentation to aid in an IRS investigation. The IRS can issue summons to investigate merely on suspicion that the law is being violated or even just because it wants assurance that the law is not being violated. The purpose of the summons is to fully develop the investigation by obtaining documents and testimony from the taxpayer and/or third parties, such as banks, employers, or business associates, who may possess relevant information. The investigation could be ascertaining the correctness of the return, substituting a return, determining tax liability, collecting unpaid tax liabilities, or inquiring into any offense connected with the administration or enforcement of the internal revenue laws.¹⁸ Noncompliance of a summons can lead to court enforcement, contempt of court, or possible criminal penalties in extreme cases.¹⁹

¹⁶ IRC §7602(a); IRM 25.5.3 (2025).

¹⁷ IRM 25.5.10.3 (2023); IRC §§7210 and 7604.

¹⁸ *Summonses*. 2024. IRS. [www.irs.gov/pub/irs-pgld/ppt2-summons.pdf] Accessed on May 15, 2025.

¹⁹ IRC §7604(a).



Practitioner Planning Tip

Although taxpayers and practitioners can answer the summons without legal representation, it is strongly advised that taxpayers and practitioners promptly seek legal representation when a summons is received. An attorney ensures that taxpayer and practitioner rights are protected throughout the process.

Before issuing the summons, the examiner should explore all other means of obtaining the information. To obtain court authorization to issue a summons, the examiner must show the summons relates to an investigation of a particular person or group. If the summoned party does not comply, the IRS may petition a federal court to enforce the summons. In doing so, the IRS must demonstrate that the summons meets the standards established in *U.S. v. Powell*, including that the information is relevant, not already possessed by the IRS, and that proper procedures were followed.²⁰ The court typically makes its determination based on the petition and supporting affidavits submitted by the IRS.

The IRS can summon not only financial professionals (e.g., bookkeepers, CPAs) but also friends, neighbors, and coworkers.²¹ Communications between a taxpayer and a federally authorized tax practitioner are protected under §7525, similar to attorney-client privilege, in noncriminal tax matters.

Note. In rare cases at the taxpayer's request, the IRS can issue a summons to obtain relevant documents used to prepare tax forms from third parties such as relevant books, papers, records, or other data.²²

Quash Summons

There are situations when a taxpayer or practitioner may have grounds to **quash the summons**. A taxpayer or practitioner has 20 days to file a petition in U.S. District Court to quash the summons.²³ The taxpayer or practitioner can “challenge the summons on any appropriate grounds.”²⁴ To quash the summons, they must show one of the following.²⁵

1. There has already been an examination of the books and records.
2. The tax years under investigation are closed by the statute of limitations.
3. Enforcing the summons violates the taxpayer's constitutional rights or common law privileges.
4. The summons has been issued for an **improper purpose**. An improper purpose includes harassing the taxpayer, pressuring the taxpayer to settle a collateral dispute, or any other purpose reflecting negatively on the good faith of the investigation.

²⁰ *U.S. v. Powell*, 379 U.S. 48 (1964).

²¹ IRC §7602.

²² *Summons and Enforcement*. Johnson, George and Friedlander, Marvin. 1993. IRS. [www.irs.gov/pub/irs-tege/eotopicg93.pdf] Accessed on May 15, 2025.

²³ IRC §7609(b)(2)(A).

²⁴ Ibid.

²⁵ *Summons and Enforcement*. Johnson, George and Friedlander, Marvin. 1993. IRS. [www.irs.gov/pub/irs-tege/eotopicg93.pdf] Accessed on May 15, 2025.

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Summons Response

If the taxpayer or practitioner is unable to quash the summons and chooses not to obtain legal representation, they will need to prepare their response. The first step is to carefully read the summons and understand what it is requesting. Practitioners and taxpayers should pay close attention to the periods involved, who is summoned, what documents are required, and the date, time, and place of appearance.²⁶ The taxpayer or practitioner should clarify any questionable or confusing requests with the examiner. Next, the taxpayer or practitioner should gather any documents or information requested by the summons. If the taxpayer or practitioner needs more time, they should communicate this clearly and work with the examiner.

Those who are summoned must attend all scheduled appointments and be prepared to present and explain any documentation they provide. The taxpayer should also organize the documents by the categories listed in the summons for easy retrieval. Typically, the IRS requires any documentation to be the original copy unless otherwise specified.²⁷ Therefore, taxpayers should retain and safeguard any responsive documents and make copies of any documents provided to the IRS.

When a summons is issued, the individual named (the summonee) is required to appear in person at the time and place specified. Representation by another party is not permitted in lieu of personal appearance. However, the IRS examiner may grant an extension for valid reasons, such as illness.

If the summonee provides advance notice of noncompliance, the examiner must not imply that noncompliance is acceptable. Instead, the examiner must inform the summonee that:

1. They are required to appear with the summoned records;
2. They may either comply or refuse to comply at the examination;
3. If they refuse, they must state their reasons; and
4. Failure to comply may result in a summons enforcement proceeding.²⁸

To ensure proper documentation and support, the examiner should arrange for another IRS employee to be present, particularly if the summonee is expected to assert constitutional or common law privileges. Prior to the interview, the examiner must advise the summonee of their right to legal representation.²⁹

The examiner retains discretion over who may be present during the interview. Individuals not representing the summonee — such as a corporate attorney who does not also represent the individual — may be excluded. If the summonee refuses to proceed with the interview due to the exclusion of a companion, the examiner should prioritize completing the interview. Allowing the companion to remain may be preferable to terminating the session. If the companion disrupts the interview, the examiner must document the interference in a memorandum.

²⁶ IRM 25.5.3.4 (2025).

²⁷ IRM 4.10.4.2.7 (2011).

²⁸ IRM 25.5.5.4.7 (2022).

²⁹ Ibid.

MOBILE-FRIENDLY AND ADAPTIVE FORMS³⁰

The IRS has introduced mobile-friendly and adaptive digital forms to improve accessibility and reduce reliance on paper-based processes. These forms are designed to be completed on smartphones, tablets, or desktop devices and submitted securely online.

The mobile-friendly forms are HTML versions of IRS forms that can be filled out directly on cell phones and tablet devices. The forms automatically adjust to fit the screen size of smartphones and tablets, making them easier to complete on the go. These mobile-friendly forms allow the IRS to receive electronically submitted documents, eliminating the manual processing of paper submissions. Users can save in-process drafts and the forms ensure that all required fields are completed before submission, which should reduce errors and speed up processing. Some forms require an IRS Online Account (via ID.me) for submission and digital signature.

Observation. As of May 2025, the IRS offers over 71 mobile-adaptive forms with more on the way. These include Form 656, *Offer in Compromise*, and Form 637, *Application for Registration for Certain Excise Tax Activities*.

IRS ONLINE ACCOUNTS FOR BUSINESSES³¹

As part of the Inflation Reduction Act of 2022,³² the IRS launched business tax accounts (BTA), an online self-service tool for tax management and compliance. BTAs enable businesses to view their information on file with the IRS, control which individuals in the company have access to the account, view any tax balances due, make payments for either amounts due or tax deposits, and view payment history.³³ Additionally, the BTA will provide deadlines ahead of time and will help eliminate late fees and penalties. The BTA will help practitioners be familiar with the standard forms the client needs to file, such as payroll tax forms, and remind them of impending deadlines.

A designated official (DO) is an individual authorized to act on behalf of a business or organization within the IRS BTA system. To qualify as a DO, the individual must be an officer or managing member of the business (such as a president, CEO, or treasurer), a current employee who received a Form W-2 for the most recent tax year, and legally authorized to bind the business. Each DO must register separately and revalidate their role annually to maintain access. DOs are granted **full access** to the BTA, which allows them to view all account information, manage access for other users, and perform actions such as authorizing designated users (DUs). Additionally, DOs with full access can view their business information on file, make payments, and access payment history. Tax records, including tax transcripts, tax compliance reports, and tax certificates for award use, can also be viewed. Additional features such as notices and letters, as well as the management of third-party authorizations, are also available.³⁴

³⁰ *Mobile-friendly forms*. Aug. 12, 2025. IRS. [www.irs.gov/forms-pubs/mobile-friendly-forms] Accessed on Aug. 14, 2025; IRS News Rel. IR-2024-196 (Jul. 25, 2024); *IRS launches paperless processing initiative*. Jul. 3, 2025. IRS. [www.irs.gov/newsroom/irs-launches-paperless-processing-initiative] Accessed on Aug. 14, 2025.

³¹ IRS News Rel. IR-2023-194 (Oct. 20, 2023).

³² *Inflation Reduction Act*, PL 117-169.

³³ *Business tax account*. Apr. 17, 2025. IRS. [www.irs.gov/businesses/business-tax-account] Accessed on Apr. 24, 2025.

³⁴ *Business Tax Account now available for Corporate Designated Officials; Income Verification Express Service open to designated officials and sole proprietors*. May 29, 2025. IRS. [www.irs.gov/newsroom/business-tax-account-now-available-for-corporate-designated-officials-income-verification-express-service-open-to-designated-officials-and-sole-proprietors] Accessed on Jun. 15, 2025.

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DUs can access specific tax periods authorized by the DO and view and/or make payments related to tax forms authorized by the DO. They cannot manage access or accept or reject authorization requests. Unlike DOs, they do not need to be a partner, shareholder, or officer of the business or entity. A DU must be revalidated by a DO or sole proprietor every January and June to maintain their role.

The following entities can have full access in BTA.

- Sole proprietorship
- C corporation
- S corporation (DO)

With **limited access**, only certain business information on file can be viewed. The balance can be checked, payments on balance due modules can be made, and both payment history and tax transcripts can be accessed, but often, the user does not have the ability to make authorizations. The following have limited access.

- Individual partners in a partnership
- Individual shareholders in an S corporation
- Shareholders and individual partners in a single-member limited liability company (SMLLC)
- Government entities have no access

Note. At the current time, neither exempt organizations nor government entities can use BTA online. A DO role is coming soon for SMLLC but is not currently available.

ACCESS AND SETUP³⁵

Setting up an online BTA involves several steps. Users must first register and verify their identity through a third-party identity authentication provider, such as ID.me. The IRS will then establish the user's relationship with the business entity and determine the information they can access. The IRS ensures that only authorized individuals can access business accounts, complying with federal tax information protection regulations. Users must maintain the confidentiality of their login credentials to prevent unauthorized access.



Practitioner Planning Tip

When the account setup is complete, practitioners and taxpayers can use it to effectively maintain compliance and avoid penalties. Taxpayers and practitioners should regularly maintain the account to help taxpayers keep accurate records. If there is a business change, taxpayers or practitioners should update the account information promptly.

³⁵. Ibid.

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Users should ensure that all required fields are filled in, the EIN is entered correctly and matches the business records, and verify they have the correct legal name exactly as it appears in official documents.

Caution. IRS customer service representatives are available to help practitioners and taxpayers with tax and payment questions. However, they cannot access the BTA.

CAPABILITIES AND FEATURES³⁶

The IRS is continuously adding new capabilities to the BTA. Currently, the following features are available.

- Access and manage tax balances, including making payments or scheduling federal tax deposits
- Review payment history and set up future payments
- Request a tax compliance verification for business-related purposes
- Download IRS notices and tax documents directly from the account
- Confirm business name and address as recorded with the IRS
- Approve or deny transcript authorization requests submitted by third parties, such as lending institutions
- Business owners can assign designated users to perform specific tasks within the BTA

IRS ONLINE ACCOUNTS FOR INDIVIDUALS³⁷

As part of its ongoing digital modernization efforts, the IRS has significantly expanded the capabilities of its online account system for individual taxpayers. This secure, self-service platform allows individuals to manage their federal tax obligations, access key documents, and interact with the IRS more efficiently.

Creating an online account is a foundational step in helping clients stay compliant and informed. Through the account, taxpayers can do the following.

- View their adjusted gross income (AGI), wage and income transcripts, and other tax records.
- Check balances due, view up to five years of payment history, and make or schedule payments.
- Access digital copies of IRS notices and letters, reducing reliance on physical mail.
- Retrieve or apply for an identity protection PIN (IP PIN) to help prevent identity theft.
- View and electronically sign authorization requests from tax professionals.
- Monitor **audit status** for certain correspondence audits.
- Check eligibility and file an OIC online.

Starting in 2025, taxpayers can access information return documents, including Forms W-2 and 1095-A, *Health Insurance Marketplace Statement*, directly within their online account. These documents are available under the “Records and Status” tab and help consolidate critical tax data in one location.³⁸ These enhancements provide a more comprehensive view of a taxpayer’s IRS interactions and obligations, making the online account a valuable year-round resource.

³⁶ *Business Tax Account and its users*. May 29, 2025. IRS. [www.irs.gov/newsroom/business-tax-account-and-its-users] Accessed on Aug. 15, 2025.

³⁷ *Online account for individuals*. Jun. 13, 2025. IRS. [www.irs.gov/payments/online-account-for-individuals] Accessed on Jun. 15, 2025.

³⁸ IRS News Rel. IR-2025-28 (Feb. 27, 2025).

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ACCESS AND SETUP³⁹

To create an online account, individuals must verify their identity through a third-party authentication provider, such as ID.me or Login.gov. This process includes submitting a government-issued photo ID and completing biometric or knowledge-based verification. Once verified, users can access their account using a secure login.

Common setup issues include the following.

- **Identity verification failures.** Name mismatches, outdated records, or incomplete ID.me profiles can prevent successful authentication.
- **Locked accounts.** Multiple failed login attempts may trigger a temporary logout.
- **Missing records.** If the IRS has not processed a recent return, some account features may be limited.



Practitioner Planning Tip

Practitioners should encourage clients to complete the setup process well before tax season to avoid delays in accessing critical documents or making payments.

Caution. IRS customer service representatives can assist with general tax questions but do not have access to individual online accounts. Individuals must manage their accounts directly or authorize a representative using the appropriate IRS forms.

IRS ELIMINATES PAPER CHECKS FOR PAYMENTS⁴⁰

Effective September 30, 2025, the IRS will discontinue the issuance of paper checks for all tax-related refunds. All payments from the IRS will be made electronically via direct deposit, electronic funds transfer, prepaid debit cards, or other approved digital methods. Tax professionals must ensure that clients are prepared to receive refunds electronically using IRS Direct Pay, Electronic Federal Tax Payment System, or other authorized platforms.

Exceptions to the mandate may apply in limited circumstances, including hardship cases, national security-related transactions, and individuals without access to digital banking infrastructure. Practitioners should update intake procedures and client communications to reflect this transition.

Caution. Executive Order 14247, signed on March 25, 2025, suggests that all payments made to the IRS will be required to be made electronically “as soon as practicable.”⁴¹ Preparers should encourage their clients to make preparations for this possible elimination of paper checks for making payments to the IRS.

³⁹ *New online identity verification process for accessing IRS self-help tools.* Dec. 7, 2021. IRS. [www.irs.gov/newsroom/new-online-identity-verification-process-for-accessing-irs-self-help-tools] Accessed on Jun. 15, 2025.

⁴⁰ *Treasury Announces Federal Government Will Phase Out Paper Checks on September 30th.* Aug. 14, 2025. U.S. Department of the Treasury. [home.treasury.gov/news/press-releases/sb0223] Accessed on Aug. 15, 2025.

⁴¹ *Modernizing Payments To and From America's Bank Account.* Mar. 25, 2025. The White House. [www.whitehouse.gov/presidential-actions/2025/03/modernizing-payments-to-and-from-americas-bank-account] Accessed on Sep. 5, 2025.

INSTALLMENT AGREEMENT

Taxpayers who are unable to pay their tax liability on their tax return or IRS notice can request an installment agreement (IA) by filing Form 9465, *Installment Agreement Request*.⁴² A guaranteed IA is automatically accepted if the tax owed, including penalties and interest, is not more than \$10,000 and all the following apply.⁴³

- During the past five years, the taxpayer (and their spouse, if married filing jointly) have timely filed all income tax returns, paid any income tax due, and have not entered into an IA for the payment of income tax.
- The taxpayer agrees to pay the full amount owed within three years and to comply with the tax laws while the agreement is in effect.
- The taxpayer is financially unable to pay the liability in full when due.

Note. The preceding discussion does not intend to suggest taxpayers with larger amounts owed are precluded from entering an installment plan. For those taxpayers, the IRS will likely require more information on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or Form 433-B, *Collection Information Statement for Businesses*. Depending on the size of the debt and the taxpayer's history of payment, the IRS may also file liens against property owned by the taxpayer/debtor.

ONLINE PAYMENT PLANS⁴⁴

Qualified taxpayers and authorized representatives with a POA can apply online for a payment plan, including an IA, to pay off tax balances over time. Applicants receive immediate notification of whether the payment plan is approved.

Individual Payment Plan

Payment options for individuals include full payment, a short-term payment plan (paid in 180 days or less), and a long-term payment plan like an IA (paid in more than 180 days). Individuals qualify to apply online for a long-term payment plan if they owe \$50,000 or less in combined tax, penalties, and interest, and have filed all required returns. Individuals qualify for a short-term payment plan if they owe less than \$100,000 in combined tax, penalties, and interest. When applying for a payment plan online without calling, mailing, or visiting the IRS, individuals need to create an IRS online account. To create an IRS account, an individual needs photo identification. If applying for a direct debit payment plan, an individual needs their bank routing and account number. Taxpayers who recently filed their tax return, or whose tax return was examined but have not received a balance notice from the IRS need the balance shown on their notice.

Note. Sole proprietors and independent contractors apply for a payment plan as individuals.

Simple Payment Plans.⁴⁵ The IRS has introduced simple payment plans for individual taxpayers, offering a streamlined approach to establish IAs. Simple payment plans are offered online or when collaborating with an IRS employee. To qualify, an individual must owe the IRS no more than \$50,000 in taxes, penalties, and interest and must be current on filing their tax returns. Individuals who qualify are not required to provide a collection information statement or undergo a lien determination.

⁴² Instructions for Form 9465.

⁴³ IRM 5.14.5.3 (2021).

⁴⁴ *Apply Online for a Payment Plan*. Apr. 14, 2025. IRS. [www.irs.gov/payments/online-payment-agreement-application] Accessed on Apr. 15, 2025.

⁴⁵ *Simple payment plans for individual taxpayers*. Apr. 4, 2025. IRS. [www.irs.gov/payments/simple-payment-plans-for-individual-taxpayers] Accessed on Apr. 17, 2025.

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Individuals can establish automatic monthly payments from their bank accounts via direct debit process. This results in a reduced user fee to establish the plan, in addition to increased convenience. Most taxpayers have up to their collection statute expiration date (CSED) to pay off their balance. Under IRC §6502, the IRS generally has 10 years from the date of tax assessment to collect the tax assessed. The final day of this 10-year period is referred to as the CSED. A request for relief from liability for an unpaid tax amount generally must be made before the CSED to be considered timely. Moreover, IRC §6511 provides a deadline for a refund claim. A refund claim must be made before the latter of three years from the time the return was filed or two years from the time the tax was paid.

Note. The IRS estimated that **more than 90%** of individuals with a balance due will qualify for a simple payment plan.

Business Payment Plan

There are two payment plan options available for a business. They are full payment and an IA paid in more than 180 days. A business qualifies to apply online for an IA if it has filed all required returns and owes less than \$25,000 in combined tax, penalties, and interest. To apply, a business must log in with their IRS username or ID.me credentials and provide the following information.

- EIN
- Date the business was established (month and year)
- Caller ID from notice

Taxpayers may also need to provide the amount of the balance due, tax form filed or examined, and the tax period filed or examined.

STREAMLINED IA⁴⁶

Most taxpayers with a balance due of up to \$25,000 meet the criteria for streamlined processing of their IA request. To qualify, all taxpayers must be current with all required return filings. Generally, an IA can be set up without the completion of a collection information statement or a determination to file a notice of federal tax lien.

The streamlined processing criteria apply to the following types of taxpayers.

- In-business taxpayers with income tax only assessed balances up to \$25,000
- Out-of-business taxpayers with assessed balances up to \$25,000
- Out-of-business sole proprietors with an assessed balance of tax, penalties, and interest up to \$50,000

Processing Criteria

Taxpayers have the lesser of up to 72 months or the number of months necessary to satisfy their liability in full by the expiration date of the statute of limitations.

The IRS may issue a public notice of federal tax lien to out-of-business sole proprietors with employees that owe more than \$25,000 and are not paying through direct debit. The tax lien can be accessed by other creditors.

⁴⁶ *Streamlined installment agreements for businesses.* Mar. 28, 2025. IRS. [www.irs.gov/businesses/small-businesses-self-employed/streamlined-installment-agreements-for-businesses] Accessed on Apr. 11, 2025.

User Fees and Waivers⁴⁷

The IRS charges user fees for setting up IAs. As of April 11, 2025, the fees are as follows.

- **Regular IA:** \$69 (online); \$178 (phone, mail, or in person)
- **Direct Debit IA:** \$22 (online); \$107 (phone, mail, or in person)

Low-Income Taxpayer Waivers. Low-income taxpayers, defined as those with AGI at or below 250% of the federal poverty guidelines, may qualify for a waiver or reimbursement of the user fee.

Note. Entering into an IA does not directly affect a taxpayer's credit score. The IRS does not report tax debt to credit bureaus. However, if a taxpayer defaults on the agreement and the IRS files a tax lien, it can appear in public records and indirectly affect their creditworthiness.⁴⁸

IRS Collection Actions⁴⁹

When a taxpayer requests an IA, the IRS generally suspends collection actions while the request is pending. An IA request is often pending until it can be reviewed, and an IA is established, or the request is withdrawn or rejected. If the requested IA is **rejected**, the collection period is suspended for 30 days. Similarly, if the taxpayer defaults on the IA payments and the IRS proposes to terminate the IA, the collection period is suspended for 30 days. Lastly, if the taxpayer appeals either an IA rejection or termination, the collection period is suspended from the time the appeal is pending until the date the appealed decision becomes final.

7

LB&I PASS-THROUGH COMPLIANCE UNIT⁵⁰

In October 2024, the Pass-through Compliance Unit (Unit), part of the IRS's LB&I division, was established to enhance the efficiency and effectiveness of audits involving pass-through entities, including partnerships, S corporations, and trusts. This unit is part of the IRS's broader strategy to address compliance issues and to increase fairness in enforcement while improving service. The IRS aims to reverse historically low audit rates for complex arrangements.

PURPOSE AND STRUCTURE

The unit's purpose is to identify and address noncompliance by targeting specific areas, consolidating case-working expertise, removing the entity-size barrier, and increasing audit rates in this complex area. This multifaceted approach aims to streamline procedures and efficiently identify taxpayers who are not in compliance with the law. The key features of the unit are the following.

- **Geographically based teams.** Field operations and exam functions will be geographically located to enhance the coordination and efficiency of the unit.
- **Unified approach.** The LB&I division and the Small Business/Self-Employed (SB/SE) will be combined to build a modern pass-through compliance structure and a unified approach.
- **Enhanced expertise.** This specialized group comprises current IRS employees and new hires who possess a blend of expertise and skills.

⁴⁷. *Additional information on payment plans.* Apr. 14, 2025. IRS. [www.irs.gov/payments/payment-plans-installment-agreements] Accessed on Apr. 16, 2025.

⁴⁸. *Does an IRS Payment Plan Affect your Credit Score?* Jan. 25, 2025. Accounting Insights. [www.accountinginsights.org/does-an-irs-payment-plan-affect-your-credit-score/] Accessed on Apr. 11, 2025.

⁴⁹. *Additional information on payment plans.* Apr. 14, 2025. IRS. [www.irs.gov/payments/payment-plans-installment-agreements] Accessed on Apr. 16, 2025.

⁵⁰. IRS News Rel. IR-2024-276 (Oct. 22, 2024).

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Complex Partnerships⁵¹

The unit will target complex partnerships and other key areas where noncompliance has increased rapidly. **Complex partnerships** make compliance and audit oversight challenging because they may own interest in other partnerships and have other complexities. Complex partnerships may also include private equity and hedge funds, multi-state or international operations, syndicated conservation easements, and partnerships that undergo frequent changes in ownership or have special allocations of income, loss, or credits. Complex partnerships are often a part of the IRS's key target strategy because they frequently obscure beneficial ownership or income flows.

Additionally, the IRS has identified certain **basis-shifting transactions** involving related-party partnerships as a key area of noncompliance. These transactions often involve multi-step strategies that shift basis between assets without meaningful economic change, resulting in inflated deductions or reduced gains. **Practitioners should be alert** to transactions involving transfers, distributions, or liquidations among related partnerships, especially those that span multiple years.

Note. For more information on basis shifting and the IRS response to abusive partnerships, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 13: New Developments, and the 2025 *University of Illinois Federal Tax Workbook*, Chapter 8: New Developments.

IDENTIFYING COMPLIANCE ISSUES⁵²

To enhance audit effectiveness and ensure compliance among complex pass-through entities, the unit will employ advanced data analytics and risk assessment tools to identify and address any compliance issues. These tools enable the IRS to process large volumes of taxpayer data, identify patterns of potential noncompliance, and prioritize high-risk cases for examination. By leveraging technology and examiner insights, the unit aims to conduct more targeted, efficient, and fair audits.

Data Analytics Tools

The unit uses data analytics to analyze large volumes of data and identify potential compliance risks. These tools include the following.

- **Machine-sensible records.** The unit uses records and documentation for analysis and assesses the availability and quality of machine-sensible records.
- **Data analytics software.** The unit uses specialized software to analyze data and identify trends, patterns, and anomalies that may indicate noncompliance.
- **Examiner feedback.** The unit incorporates feedback from examiners to refine its data analytics processes and improve the accuracy of its risk assessments.

Risk Assessment Tools

Risk assessment tools will help the unit evaluate the likelihood of non-compliance and prioritize audits. These tools include the following.

- **Risk analysis factors.** A taxpayer's application for or filing a change in accounting method will be evaluated by the unit, considering various risk analysis factors.
- **Targeted audits.** The unit uses risk assessment tools to identify high-risk entities and conduct targeted audits, focusing on specific issues and areas of concern.
- **Compliance risk management.** The unit employs compliance risk management techniques to assess and mitigate potential risks, ensuring that audits are conducted efficiently and effectively.

⁵¹ *New IRS, Treasury guidance focuses on "basis shifting" transactions used by partnerships.* Jun. 17, 2024. IRS. [www.irs.gov/newsroom/new-irs-treasury-guidance-focuses-on-basis-shifting-transactions-used-by-partnerships] Accessed on Jun. 15, 2025.

⁵² IRM 4.46.3.3.1 (2024).



Practitioner Planning Tip

Tax practitioners should stay informed about the developments within the unit, as updates to the unit's structure, focus, and strategic goals will be crucial for effectively navigating the evolving landscape of pass-through entity compliance. Additionally, practitioners should advise taxpayers to maintain detailed documentation, including any changes in partnership allocations and basis calculations. Practitioners should anticipate high-risk audit triggers and ensure the taxpayer is aware of all compliance regulations.

ALTERNATIVE DISPUTE RESOLUTION

Alternative dispute resolution (ADR), also known as mediation, is an informal and confidential avenue to pursue when a taxpayer has an unresolved issue with the IRS or disagrees with an IRS decision or action. The IRS continues to make efforts to foster early, fair, and efficient resolution of tax controversies outside of traditional appeals or litigation. Recognizing that prolonged disputes can be costly and time-consuming for both taxpayers and the government, the IRS has developed ADR programs that emphasize fairness balanced with efficiency.⁵³

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Note. In April 2024, the IRS Independent Office of Appeals announced the creation of a new ADR Program Management Office.⁵⁴ This office is tasked with revitalizing existing ADR programs and piloting new initiatives to help taxpayers resolve disputes earlier and more efficiently. The goal is to make ADR options more accessible, collaborative, and cost-effective. Key responsibilities of the new office include the following.

- **Modernizing programs** like Fast Track Settlement (FTS), Fast Track Mediation, and Post-Appeals Mediation (PAM).
- **Piloting new ADR models** to resolve disputes earlier in the examination process.
- **Removing barriers** to participation, such as prior restrictions on PAM eligibility.
- **Coordinating training**, outreach, and data collection to improve program effectiveness.

ADR is voluntary and nonbinding, meaning both the taxpayer and the IRS retain full control over whether to settle the case. No one, including the mediator, can compel either party to accept a resolution. Mediation is most effective when both parties are committed to resolving the issue and have already exchanged information and clarified their positions. It is not a forum for introducing new issues or evidence, nor is it a substitute for the audit or collection process.⁵⁵

⁵³ *Appeals mediation — Alternative Dispute Resolution (ADR)*. Aug. 20, 2024. IRS. [www.irs.gov/appeals/appeals-mediation-programs] Accessed on Jun. 12, 2025.

⁵⁴ IRS News Rel. IR-2024-119 (Apr. 24, 2024).

⁵⁵ *Appeals mediation — Alternative Dispute Resolution (ADR)*. Aug. 20, 2024. IRS. [www.irs.gov/appeals/appeals-mediation-programs] Accessed on Jun. 12, 2025.

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After a taxpayer initiates an ADR, an appeals officer (AO) is assigned and works with the taxpayer and the IRS agent assigned to the taxpayer's case. The AO is trained in mediation and assists the parties in reaching an agreement.⁵⁶

The AO helps facilitate communication and assists the parties in identifying the issues delaying a settlement. If deemed necessary, the AO can assist in identifying potential settlement terms which can help to ensure a level playing field and mutual respect between the parties remains during the mediation sessions.⁵⁷

These ADR programs are in addition to more traditional dispute resolution options such as the following.

- **OICs.**⁵⁸ An OIC allows taxpayers to settle their tax debt for less than the full amount owed. It is accepted when there is doubt as to liability, doubt as to collectability, or a determination that full payment would create an economic hardship.

Note. For more information on OICs, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

- **Currently not collectible (CNC) status.**⁵⁹ Taxpayers facing significant financial hardship may qualify for CNC status, in which the IRS suspends collection activities. While the debt remains legally owed, the IRS will defer collection action until the taxpayer's financial situation improves. CNC is reviewed by the IRS every one to two years to ensure the taxpayer's financial situation still meets the guidelines to qualify for CNC.⁶⁰
- **IAs.**⁶¹ IAs, discussed previously, are payment arrangements allowing taxpayers to pay their tax debt over time. Types include the following.
 - ♦ **Guaranteed IA.** Required acceptance if the liability is \$10,000 or less and the taxpayer meets other statutory requirements.
 - ♦ **Streamlined IA.** Available for liabilities up to \$50,000 without financial disclosure.
 - ♦ **Traditional IA.** Used for larger debts or more complex financial profiles that require detailed financial disclosure.

These options are generally available after the IRS has determined an amount is due and there is generally no dispute about the amount due. Typically, they are used to contest a collection action and offer an alternative collection action that differs from the one the IRS has presented.

ADR OPTIONS⁶²

To promote early and efficient resolution of tax disputes, the IRS offers several structured mediation programs. Among the most widely used are FTS, which facilitates resolution during the examination phase; Fast Track Mediation — Collection (FTMC), which addresses disputes over collection actions; and PAM, which provides a final opportunity for resolution after traditional appeals but before litigation.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ IRC §7122; Treas. Reg. §301.7122-1.

⁵⁹ IRM 5.16.1.

⁶⁰ *Currently Not Collectible*. Oct. 30, 2020. IRS. [www.taxpayeradvocate.irs.gov/notices/currently-not-collectible] Accessed on May 27, 2025.

⁶¹ IRC §6159(c).

⁶² IRS News Rel. IR-2024-119 (Apr. 24, 2024).

Fast Track Settlement⁶³

FTS is an ADR process that allows taxpayers and the IRS Examination Division to resolve factual or legal disputes early in the examination process. FTS happens before the case goes to the IRS Independent Office of Appeals. FTS is available to taxpayers who have at least one open year under examination and have not agreed on specific issues.⁶⁴

The following are key features of FTS.

- **Voluntary and nonbinding.** Both the taxpayer and the IRS must agree to participate, and either party may withdraw at any time. If no agreement is reached, the taxpayer retains the right to pursue a traditional appeal or litigation.
- **Facilitated by a neutral mediator** from the IRS Independent Office of Appeals, who helps clarify issues, promote communication, and may offer settlement proposals—but cannot impose a resolution.
- **Designed for speed.** The IRS aims to resolve small business FTS cases within **60 days** of application acceptance.
- **Cost-effective.** FTS can significantly reduce the time and expense associated with traditional appeals or court proceedings.

Taxpayers initiate FTS by submitting Form 14017, *Application for Fast Track Settlement*.

Note. Different rules and time frames exist for large business, international taxpayers, tax-exempt organizations and government entities, and taxpayers with collection issues (covered next).

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Fast Track Mediation — Collection⁶⁵

FTMC is for taxpayers involved in collection disputes. Mediation services are available to taxpayers with disputes related to OICs and trust fund recovery penalties. FTMC is available to both individual taxpayers and businesses, with a focus on expediting resolutions without resorting to litigation. The goal of the IRS is to resolve FTMC cases **within 40 days** from the date the Fast Track application is accepted. The mediator does not have settlement authority.⁶⁶

Taxpayers or collections initiate FTMC by submitting Form 13369, *Agreement to Mediate*.

Example 2. Troy is a small business owner who is facing financial hardship after closing his business. He currently owes the IRS \$50,000 and received a notice of intent to levy. He promptly contacts the revenue officer assigned to his case. However, Troy feels that the revenue officer is being unfair by demanding payment in full and has not taken his financial hardship into consideration.

Troy requests FTMC and refuses to speak further with the revenue officer. The revenue officer fills out a Form 13369 and sends the form to Troy, who signs the form. Then, the revenue officer forwards the form to the collections group manager, who signs it and submits the form to the office of appeals. An AO mediator is assigned to Troy's case and facilitates discussions between Troy and the revenue officer. The mediator schedules several meetings and helps both parties clarify their positions by assisting them as they move towards a resolution. The revenue officer suggests several resolution solutions, such as an OIC, IA, or CNC status. After several meetings, Troy demonstrates financial hardship, and the revenue officer agrees to process the forms for CNC status.

⁶³ Rev. Proc. 2003-40, 2003-25 IRB 1044; Rev. Proc. 2016-57, 2016-49 IRB 786; Rev. Proc. 2017-25, 2017-14 IRB 1039; *Fast Track*. Apr. 15, 2025. IRS. [www.irs.gov/appeals/fast-track] Accessed on Jun. 12, 2025.

⁶⁴ IRS Ann. 2025-6, 2025-5 IRB 526.

⁶⁵ IRM 8.26.3 (2017); IRS Pub. 3605, *Fast Track Mediation — Collection*; Rev. Proc. 2016-57, 2016-49 IRB 786.

⁶⁶ IRM 8.26.3.1.3 (2017).



Practitioner Planning Tip

FTMC offers a quick and informal way to resolve disputes when a taxpayer faces collection actions. FTMC may be especially helpful for taxpayers who are experiencing a revenue officer that is not taking into consideration the financial hardship a taxpayer is facing, does not offer any alternative collection options, or is not responding in a timely manner. Practitioners should inform clients that using FTMC may move the case along without litigation.

Post-Appeals Mediation⁶⁷

PAM is a voluntary, non-binding mediation process between the taxpayer and the AO. PAM is conducted after the appeals process has begun but before the case is docketed in Tax Court. PAM is particularly useful for narrowing legal or factual disagreements that remain unresolved after traditional appeals consideration.

Once a PAM application is accepted, the IRS aims to resolve the case within **60 to 90 days**. A trained mediator from Appeals, who is independent of the AO or settlement officer previously involved in the case, facilitates the session. As with the other ADR options, the mediator's role is to help both parties clarify issues, explore settlement options, and reach a mutually acceptable resolution. However, **no one — including the mediator — can impose a decision**, and both parties retain full control over the outcome.

PAM is particularly useful for narrowing disputes and avoiding the time, cost, and uncertainty of litigation. Taxpayers must first make a good-faith effort to resolve all issues with their assigned AO before requesting mediation. PAM is **not available** for certain types of cases, including the following.

- Docketed cases
- Cases designated for litigation
- Certain collection cases (except some OIC and trust fund recovery penalty cases)
- “Whipsaw” issues (where resolution with one party could result in inconsistent treatment without the other party's participation)

To apply, taxpayers must submit a written request to their AO, including a specific request for PAM and a written statement outlining their position on the disputed issue(s).

Note. Previously, taxpayers who engaged in FTS could not use PAM. However, the IRS removed this restriction in 2025 as part of its pilot program changes to FTS.⁶⁸ This expands access for taxpayers who previously were ineligible.

⁶⁷ Rev. Proc. 2014-63, 2014-53 IRB 1014; IRC §7123(b)(1); *Post-appeals mediation*. Apr. 16, 2025. IRS. [www.irs.gov/appeals/post-appeals-mediation] Accessed on Jun. 12, 2025.

⁶⁸ IRS Ann. 2025-6, 2025-05 IRB 526.

PILOT PROGRAMS⁶⁹

The IRS, to modernize and streamline the examination and appeals processes, has implemented various **pilot programs**. These initiatives are designed to provide taxpayers and IRS compliance personnel with expedited mechanisms to resolve factual and legal disputes **at the earliest possible stage**. This is often done **before** a case is formally transferred to the IRS Independent Office of Appeals.

FTS Enhancements

Previously, if one issue in a case was ineligible for FTS, the entire case was excluded. Now, taxpayers can use FTS for **eligible issues**, even if others are not. The pilot aligns FTS availability across IRS divisions such as LB&I, SB/SE, and Tax-Exempt/Government Entities divisions, ensuring consistent access regardless of taxpayer type. Additionally, if a request for FTS is denied, the IRS must now provide a written explanation, and the denial must be approved by a first-line executive.

Example 3. In 2025, James receives a notice from the IRS Examination team stating that he underreported his income by \$50,000. James is surprised and disputes the IRS's findings, believing that some of his sales receipts have been overlooked or misclassified. His case involves multiple issues, but only the income discrepancy qualifies for FTS.

Under the enhanced FTS pilot program, James requests FTS for the eligible issue, even though other parts of his case are not eligible. An AO facilitates the mediation while the case is still under the jurisdiction of the Examination function.

During the mediation session, the AO listens carefully to James' perspective, reviewing the initial audit findings along with James's supporting documentation. The AO helps both parties engage in open dialogue, clarify misunderstandings, and evaluate the evidence. As a result, the IRS agrees that James should pay additional taxes on a reduced amount of \$15,000, rather than the original \$50,000 in dispute. Both sides also agreed that James would implement better recordkeeping practices moving forward. This resolution avoids escalation to the IRS Independent Office of Appeals and demonstrates the flexibility and efficiency of the enhanced FTS process.

Last Chance FTS

Last Chance FTS is a new pilot program under the SB/SE division. It is initiated after a protest is filed in response to a 30-day letter and before appeals begin. It is the last opportunity for resolution prior to the full appeals process. Upon submission of a protest to a **30-day letter**, the SB/SE group manager will prompt appeals to contact the taxpayer to see if the last chance FTS is an option.

Changes to PAM

The IRS implements several changes to PAM through the 2-year pilot. As mentioned previously, the IRS has eliminated the prior restriction that prevented taxpayers who had participated in FTS from later requesting PAM. This change enables taxpayers to pursue PAM even after engaging in earlier ADR efforts.

Additionally, the pilot introduces issue-based mediation, allowing PAM to be applied to specific unresolved issues rather than requiring the entire case to qualify. This targeted approach enhances the efficiency of the process and increases the likelihood of resolution without litigation.

Lastly, to promote fairness and transparency, the IRS now requires that any denial of a PAM request must be approved by a first-line executive, and taxpayers must receive a written explanation if their request is denied. These enhancements reflect the IRS's commitment to making ADR more accessible, consistent, and responsive to taxpayer needs.

⁶⁹ Ibid.; IRS News Rel. IR-2025-14 (Jan. 15, 2025).

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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SOCIAL SECURITY FAIRNESS ACT¹

The Social Security Fairness Act (SSFA), signed into law on January 5, 2025, marks one of the most significant changes to social security policy in decades. By repealing the Windfall Elimination Provision (WEP) and the Government Pension Offset (GPO), the SSFA eliminates long-standing reductions in social security benefits for individuals who receive pensions from noncovered employment—typically public sector workers such as teachers, police officers, and federal employees under the Civil Service Retirement System (CSRS).

The Social Security Administration (SSA) expects the SSFA to affect 3.2 million taxpayers. These individuals reside in all 50 states, U.S. possessions, military facilities outside the United States, and even foreign countries. Although recipients are scattered across the country, 60% are concentrated in the following nine states.²

- California
- Colorado
- Florida
- Georgia
- Illinois
- Louisiana
- Massachusetts
- Ohio
- Texas

For tax practitioners, this legislative change presents both opportunities and challenges. Many clients may see increases in their monthly social security benefits, receive retroactive payments, or experience changes in their tax liability, Medicare premiums, income-related monthly adjusted amount (IRMAA), and retirement planning strategies. Understanding who is affected, how benefits are recalculated, and what planning opportunities arise is essential for providing accurate and proactive advice.

This section is designed to equip tax professionals with the knowledge and tools needed to navigate the SSFA's implications. It begins with a review of the now-repealed WEP and GPO provisions, followed by guidance on identifying affected clients and quantifying the impact of the law. The section then explores tax consequences, planning strategies, and estate considerations.

Note. For more information about the WEP and the GPO before repeal, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Elder Issues. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

¹ *Social Security Fairness Act of 2023*, PL 118-273.

² *The Social Security Fairness Act of 2023*. Li, Zhe. Jan. 31, 2025. Congressional Research Service. [www.congress.gov/crs_external_products/IF/PDF/IF12890/IF12890.1.pdf] Accessed on Mar. 19, 2025.

REPEAL OF WEP AND GPO

Understanding the WEP and GPO is central to understanding the SSFA and the repeal of the two provisions. This section examines their basics before looking at which clients may be affected and how to identify them.

WEP³

The WEP reduced social security benefits paid to retirees who also received pension payments from employment not covered by social security. Typically, this is from state or local government jobs where social security taxes were not withheld. Congress enacted the WEP in 1983 to address what it viewed as an unintended advantage: the social security benefit formula is progressive and designed to replace a higher percentage of income for low earners. However, individuals with substantial noncovered earnings could appear to have low lifetime earnings under social security's formula, resulting in a higher-than-intended benefit.⁴ The WEP adjusted the formula to reduce this perceived windfall. It applied regardless of whether the social security-covered work occurred before or after the noncovered employment, as long as the individual qualified for both a social security benefit and a noncovered pension.

The Congressional Budget Office (CBO) projects that the WEP repeal will increase the average monthly benefit for individuals formerly subject to it by \$360. The CBO also projects the average increase in monthly benefits received by a spousal beneficiary to increase by \$700, while the benefit received by a widow(er) would increase by \$1,190.⁵

GPO⁶

The GPO provision reduced the social security benefits paid to spouses and widow(er)s if the spouse or widow(er) received a noncovered pension. Thus, the GPO applied when a spouse was entitled to social security benefits that their spouse had earned in addition to their own noncovered pension. Unlike WEP, which affects benefits based on a person's own earnings, the GPO only applies to benefits based on another person's earning record.

Congress enacted the GPO in 1977 to establish equity between public-sector retirees and private-sector spouses. The rationale was that a government retiree with their own pension should not receive full spousal or survivor benefits in addition to their pension, just as a private-sector spouse with their own social security benefit would see a reduced spousal benefit.

The GPO reduced the social security benefits paid to a spouse or a survivor by two-thirds of the individual's noncovered government pension. This reduction can significantly diminish or even eliminate the social security benefit, especially in cases where the pension is large relative to the spousal benefit.

³. *The Social Security Act of 1935*, PL 74-271, §§215(a)(7) and (d)(3); 42 USC §§402, 415(a), and (d); 20 CFR §§404.213 and 404.243; The term “windfall elimination provision” is colloquial and does not appear in the text of the legislation.

⁴. *Social Security Amendments of 1983*. PL 98-21; Also, see the associated conference report at *Social Security Amendments of 1983*, pp. 120–121. U.S. Congress, Committee of Conference. [www.finance.senate.gov/imo/media/doc/Conf-98-47.pdf] Accessed on Mar. 20, 2025.

⁵. *The Social Security Fairness Act of 2023*. Li, Zhe. Jan. 31, 2025. Congressional Research Service. [www.congress.gov/crs_external_products/IF/PDF/IF12890/IF12890.1.pdf] Accessed on Mar. 19, 2025.

⁶. *Program Explainers: Government Pension Offset*. May 2024. SSA. [www.ssa.gov/policy/docs/program-explainers/government-pension-offset.html] Accessed Jun. 30, 2025.

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Example 1. Ron worked his entire career in covered employment for the manufacturing company in town. His wife, Tricia, whom he married when they were both 25 years old, worked for the municipal government for most of her adult life and started receiving a \$3,000 per month government pension when she retired in December 2023.

Ron retired when he turned 67 in March 2023 and had been planning on receiving a \$4,200 monthly social security benefit after retirement. Unfortunately, Ron died about a week after he retired and before he received his first social security benefit payment.

At this point, Tricia was entitled to a surviving spouse's benefit from social security equal to the full amount Ron would have received, or \$4,200. However, the SSA reduced her surviving spouse's social security benefit by \$2,000, two-thirds of her municipal pension ($\$3,000 \times \frac{2}{3}$) because of the GPO. Thus, in addition to her \$3,000 monthly municipal pension, Tricia receives a check from Ron's social security record of \$2,200 per month (\$4,200 surviving spouse's record – \$2,000 two-thirds of municipal pension).

Example 2. Use the same facts as **Example 1**, except Ron dies in 2025. As a result, Tricia's survivor benefit is recalculated without the GPO reduction. She is entitled to the full \$4,200 monthly survivor benefit based on Ron's record, in addition to her \$3,000 municipal pension.

Lump-Sum Payments⁷

The SSFA retroactively eliminated the WEP and GPO effective January 1, 2024, even though it became law approximately one year later. Because social security benefits are paid one month in arrears, most affected beneficiaries began receiving their increased monthly benefit in April 2025 (for their March 2025 benefit). The SSA began adjusting monthly benefit payments on February 25, 2025, using automated systems to expedite processing.

If a beneficiary was due additional benefits because of the repeal, the SSA issued a one-time lump-sum payment covering the increase in benefits retroactive to January 2024. These payments were deposited directly into the bank accounts SSA had on file. In many cases, beneficiaries received these deposits before receiving a mailed notice explaining the change.



Practitioner Planning Tip

Practitioners may need to explain the SSFA to clients who were not expecting payments, and why they are receiving a one-time lump-sum benefit that covers the period from January 1, 2024, until the time their lump-sum payment was issued. The clients should expect a decrease in 2026 social security payments because the lump-sum payment will not repeat.

For more complex cases that could not be processed automatically, the SSA is manually updating records and expects to complete all adjustments by early November 2025. Affected individuals may receive two separate notices: one when the WEP or GPO indicator is removed from their record, and another when their monthly benefit amount is updated.

⁷ *Social Security Fairness Act: Windfall Elimination Provision (WEP) and Government Pension Offset (GPO) update.* Jun. 23, 2025. SSA. [www.ssa.gov/benefits/retirement/social-security-fairness-act.html] Accessed on Jun. 25, 2025.



Practitioner Planning Tip

These retroactive lump-sum payments for underpaid 2024 benefits can cause spikes in 2025 income, which may affect tax liability, estimated tax payments, and Medicare premiums. Practitioners should be alert to these timing issues when preparing 2025 returns and advising clients on withholding and estimated tax strategies.

Affected Taxpayers⁸

The repeal of the WEP and GPO under the SSFA affects a wide range of individuals who receive pensions from noncovered employment and are also eligible for social security benefits. While the specific impact varies by employment history and benefit type, the following examples illustrate common scenarios in which the following taxpayers may experience increased social security benefits due to the repeal.

- Retired public school teachers
- Other retired state and local employees
- Retired clergy
- Retired federal employees



Practitioner Planning Tip

Practitioners should pay close attention to clients who bring both Forms W-2, *Wage and Tax Statement*, and Forms 1099-R, *Distributions From Pensions, Annuities, Retirement, or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* These clients may have income from both covered and noncovered employment, making them more likely to benefit from the repeal of the WEP or GPO. A useful indicator is box 7 on Form 1099-R, because this can indicate income that was distributed from a retirement fund other than an individual retirement arrangement (IRA), simplified employee pension (SEP), or savings incentive match plan for employees (SIMPLE). If the IRA/SEP/SIMPLE checkbox is **not** marked, the taxpayer **may** have pension income from noncovered employment, such as a government pension or a pension from a church or church association.

While the absence of a checkmark in box 7 does not confirm WEP or GPO applicability, it can serve as a helpful screening tool during tax preparation to identify clients who may be affected by the SSFA.

⁸. Ibid.

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Retired Public School Teachers. In some states, public school teachers make contributions to state pensions rather than pay social security taxes.⁹ When they retire, they receive distributions from their state's pension fund, not social security. However, if they have also worked in jobs that were covered by social security, they may also be eligible for social security benefits in addition to benefits from the state teachers' retirement system.

Example 3. Joseph taught mathematics at Central High, starting shortly after college at age 22. He learned to paint houses from his father, and although he loved math, he also loved refreshing homes with a new coat of paint. His neighbor was a painting contractor eager to hire Joseph whenever he was available.

The neighbor hired Joseph to paint during spring breaks and summers from June 15 through August 15. Because Joseph earned more than the earnings needed for one quarter of coverage, he earned two quarters each year. By the time he was 42, he had worked 20 summers and earned the 40 social security credits that qualified him for social security benefits when he retired.

When Joseph retires in 2023 at age 66, he is able to receive a pension from his state's teachers' retirement system, as well as social security. However, his social security payments are reduced because of the WEP. He is pleased when he receives a letter from the SSA in 2025 advising him that he will receive a lump-sum payment for the amount by which his social security benefits were reduced by the WEP starting January 1, 2024.

Example 4. Use the same facts as **Example 3**. Joseph's friend Mike teaches mathematics at a private school and enjoys painting. Joseph's neighbor hires Mike to paint houses with Joseph during spring breaks and summer vacations. Mike works the same years as Joseph and earns approximately the same income from painting.

Mike's private school does not participate in the public-school pension system. Instead, the school makes a SIMPLE IRA plan available to its teachers.

Mike's salary at the private school is subject to social security withholding, and he works enough throughout the year to earn four credits just from school.

When Mike retires in 2023 at age 66, his social security income from his covered employment at both the school and his painting work is not reduced by the WEP.

Other State and Local Retired Employees. Some states maintain pension programs for state and municipal employees, such as Illinois, California, and Texas.¹⁰ Retired state employees who have also worked in employment covered by social security may have received reduced social security benefits before the SSFA.

Example 5. Larry has been a licensed plumber in Illinois since age 25. He worked for a plumbing contractor and paid into social security from age 22 until age 33. By that time, he had earned over 40 credits during his 11 years of working a private sector job and was qualified to receive social security when he reached age 62. At age 34, he started working as a plumber for the State of Illinois.

As a state employee, Larry participates in the State Employees' Retirement System (SERS). He plans to work for 30 more years and start his SERS pension at age 64, his scheduled retirement. Larry completes his 30 years of employment in 2021. He waits to claim social security benefits until his full retirement age (FRA) a few years later, in December 2022. During 2023, Larry's SERS pension paid him \$4,000 per month, and his social security benefit would have been \$1,600 per month if it were not for WEP.

Because Larry had benefits from both covered and noncovered employment, his social security benefits were reduced when paid in 2023. The 2024 reduction in his benefits was paid to Larry in a lump-sum benefit in April 2025.

⁹ *Why Aren't All Teachers Covered by Social Security?* Aldeman, Chad. Aug. 14, 2019. TeacherPensions.org. [www.teacherpensions.org/blog/why-aren't-all-teachers-covered-social-security] Accessed on Jun. 30, 2025.

¹⁰ *Illinois among states most affected by Social Security Fairness Act.* Schlenker, Charlie. Jan. 8, 2025. NPR Illinois. [www.nprillinois.org/illinois/2025-01-08/illinois-among-states-most-affected-by-social-security-fairness-act] Accessed on Jun. 30, 2025.

Retired Clergy.¹¹ Retired members of the clergy and religious organizations represent less obvious potential beneficiaries of the WEP's and GPO's repeal. Because clergy members and ministers can opt out of social security coverage,¹² they may make themselves susceptible to WEP if they have earnings outside of ministry and also qualify for a pension through their religious organization. They can register their personal objection or vow of poverty with the IRS by filing Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*. When accepted by the IRS, they are exempted from self-employment tax, and their ministerial work is no longer covered employment.

Example 6. Steve is a pastor of a church that conscientiously objects to social security, and he files Form 4361 with the IRS on a timely basis. His friend Bob is the pastor of a church with no objection to social security, and Bob has never filed Form 4361. Both men were ordained to the ministry at age 35, and both were born in 1956.

They became friends when they worked together at a manufacturing company in their city. They were required to participate in social security coverage when they worked for this company. After 10 years working for this employer, they attended seminary, after which they were both called to lead churches that provided them with pensions.

Because Steve filed Form 4361, his social security income was subject to reduction under WEP when he retired in 2021. His retired minister's pension started the same year, and he started to receive monthly payments of \$576 in October 2021.

The enactment of the SSFA was good news for Steve. Because his social security benefits had been reduced under the WEP due to his ministerial pension and his prior opt-out via Form 4361, the repeal of WEP leads to a meaningful increase in his monthly social security income. Although the exact amount of the increase depends on several factors, Steve notices a significant improvement in his retirement income beginning in 2025.

Meanwhile, Bob's social security benefits are unaffected because all his earnings are from covered employment.

Retired Federal Employees.¹³ The SSFA potentially affects retired federal employees who also qualify for social security benefits, depending on the retirement system under which they served. Federal employees with service before January 1, 1984, generally participate in the CSRS, which provides a defined benefit pension but does not include social security coverage. In contrast, employees who started on or after that date are covered by the Federal Employees Retirement System (FERS), which includes social security participation and defined contribution plan through the Thrift Savings Program.

Because FERS-covered earnings are subject to social security tax, retirees under FERS were not subject to WEP or GPO and are not affected by the SSFA.¹⁴ However, CSRS retirees who also worked in social-security-covered employment may have had their benefits reduced because of WEP. Their spouses' retirement benefits may be reduced by GPO. In some cases, these reductions left retirees with a small social security benefit that did not cover their Medicare premiums. In these situations, the repeal of the WEP and GPO provisions may result in a meaningful increase in monthly income.

¹¹ *The Windfall Elimination Provision (WEP)*. Clergy Financial Resources. [www.clergyfinancial.com/the-windfall-elimination-provision-wep] Accessed on Mar. 13, 2025.

¹² IRC §1402(e).

¹³ *CSRS Information*. U.S. Office of Personnel Management. [www.opm.gov/retirement-center/csrs-information] Accessed on Jun. 30, 2025; *FERS Information*. U.S. Office of Personnel Management. [www.opm.gov/retirement-center/fers-information] Accessed on Jun. 30, 2025.

¹⁴ *Social Security Benefits for Federal Workers*. SSA. [www.ssa.gov/benefits/retirement/planner/fedgovvees.html] Accessed on Mar. 18, 2025; *How Will The Social Security Fairness Act Affect Federal Employees & Retirees?* Jan. 25, 2025. My Federal Retirement. [www.myfederalretirement.com/social-security-fairness-federal-employees] Accessed on Mar. 18, 2025.

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Example 7. Margaret began her career in the private sector, working for a telecommunications company from age 22 to 32. During that time, she paid into social security and earned more than 40 credits, qualifying her for future benefits. At age 33, she accepted a position with a federal agency and was enrolled in the CSRS, which did not withhold social security taxes.

Margaret retired from federal service in 2013 with a CSRS pension and began receiving social security benefits in 2020 based on her earlier private-sector work. However, because she received a pension from noncovered employment, her social security benefit was reduced under the WEP.

With the passage of the SSFA, the WEP was repealed. As a result, Margaret's social security benefit was recalculated without the WEP reduction, leading to a meaningful increase in her monthly income beginning in 2025.

CALCULATING SOCIAL SECURITY BENEFITS

The computation of social security benefits is notoriously complex. The Congressional Research Service has stated that one justification for the SSFA is that the WEP and GPO has resulted in the overpayment of benefits.¹⁵

To understand how social security benefits are calculated and how those calculations were affected by the WEP and GPO, it is essential to understand two foundational components: the **average indexed monthly earnings (AIME)** and the **primary insurance amount (PIA)**. The PIA is a person's benefit if they begin receiving benefits at their FRA. At FRA, the benefit is neither reduced for early retirement nor increased for delayed retirement.¹⁶

Note. For a detailed discussion and examples calculating social security benefit amounts, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 6: Individual Taxpayer Issues.

AIME¹⁷

Computing social security retirement benefits uses AIME as the foundation for subsequent calculations. Annual earnings before the individual reaches age 60 are indexed for inflation. If they worked more than 35 years in covered employment, the highest 35 years of indexed earnings are used in the calculation. If they worked fewer than 35 years in covered employment, all years are included in the calculation.¹⁸ The national average wage indexing service for 2013 to 2023 (the last year available) follows.¹⁹

Year	Index
2013	\$44,888.16
2014	46,481.52
2015	48,098.63
2016	48,642.15
2017	50,321.89
2018	52,145.80
2019	54,099.99
2020	55,628.60
2021	60,575.07
2022	63,795.13
2023	66,621.80

¹⁵ *The Social Security Fairness Act of 2023*, p.2. Li, Zhe. Jan. 31, 2025. Congressional Research Service. [www.congress.gov/crs_external_products/IF/PDF/IF12890/IF12890.1.pdf] Accessed on Mar. 19, 2025.

¹⁶ *Primary Insurance Amount*. SSA. [www.ssa.gov/oact/cola/piaformula.html] Accessed on Jun. 25, 2025.

¹⁷ *Social Security Benefit Amount*. SSA. [www.ssa.gov/oact/cola/Benefits.html] Accessed on Mar. 13, 2025.

¹⁸ Ibid.

¹⁹ *National Average Wage Index*. SSA. [www.ssa.gov/oact/cola/AWI.html] Accessed on Mar. 13, 2025.

Computing Indexed Wages.²⁰ The index adjusts earnings only to the year in which the individual turned age 60 generally, which is called the **indexing year**. Any earnings after age 60 are not indexed. The average is calculated by adding the indexed earnings and dividing the sum by the total number of months in the benefit computation years. This is generally 420 months (35 years × 12 months per year). However, a period during which social security disability benefits were received may reduce the number of months. If fewer than 35 years of earnings are counted, \$0 is assumed for the balance, and the total is still divided by 420 months. Finally, the amount is rounded to the next lower whole dollar amount unless it is already an integer multiple of \$1.

PIA²¹

The PIA is the sum of three separate percentages applied to portions of the AIME.²² The percentages of the PIA formula are fixed by law, and the dollar amounts in the formula are adjusted annually for changes in the national average wage index. These dollar amounts, called **bend points**, govern which portions of the AIME are subject to which percentage.²³

The bend points in the 2025 PIA formula are \$1,226 and \$7,391, and they apply to individuals who first become eligible for retirement benefits in 2025.²⁴ For most individuals, the bend points are fixed in the year they turn 62, not the year they retire. However, the bend point may be fixed earlier for individuals who become disabled or die before age 62.²⁵ The PIA for 2025 is calculated as follows.

1. 90% of the individual's AIME up to the first bend point (\$1,226 for 2025), **plus**
2. 32% of the individual's AIME greater than the first bend point (\$1,226 for 2025) but less than or equal to the second bend point (\$7,391 for 2025), **plus**
3. 15% of the individual's AIME greater than the second bend point (\$7,391 for 2025).
4. This amount is then rounded down to the next lower integer multiple of \$0.10 unless the sum itself is an integer multiple of \$0.10.²⁶

²⁰ *Social Security Handbook: Chapter 7 Figuring the Cash Benefit Rate*. SSA. [www.ssa.gov/OP_Home/handbook/handbook.07/handbook-toc07.html] Accessed on Jun. 30, 2025. See §§700 – 706.

²¹ *Primary Insurance Amount*. SSA. [www.ssa.gov/oact/cola/piaformula.html] Accessed on Jul. 1, 2025.

²² Up to 35 years of a worker's earnings are indexed to reflect the change in general wage levels that occurred during their years of employment. The indexing series for the years 1951–2023 is available from the SSA on the web page *National Average Wage Index*. SSA. [www.socialsecurity.gov/OACT/COLA/AWI.html] Accessed on Jul. 1, 2025; *Primary Insurance Amount*. SSA [www.ssa.gov/oact/cola/piaformula.html] Accessed on Jul. 1, 2025.

²³ *Social Security Benefit Amounts*. SSA. [www.socialsecurity.gov/OACT/COLA/Benefits.html#aime] Accessed on Jul. 1, 2025.

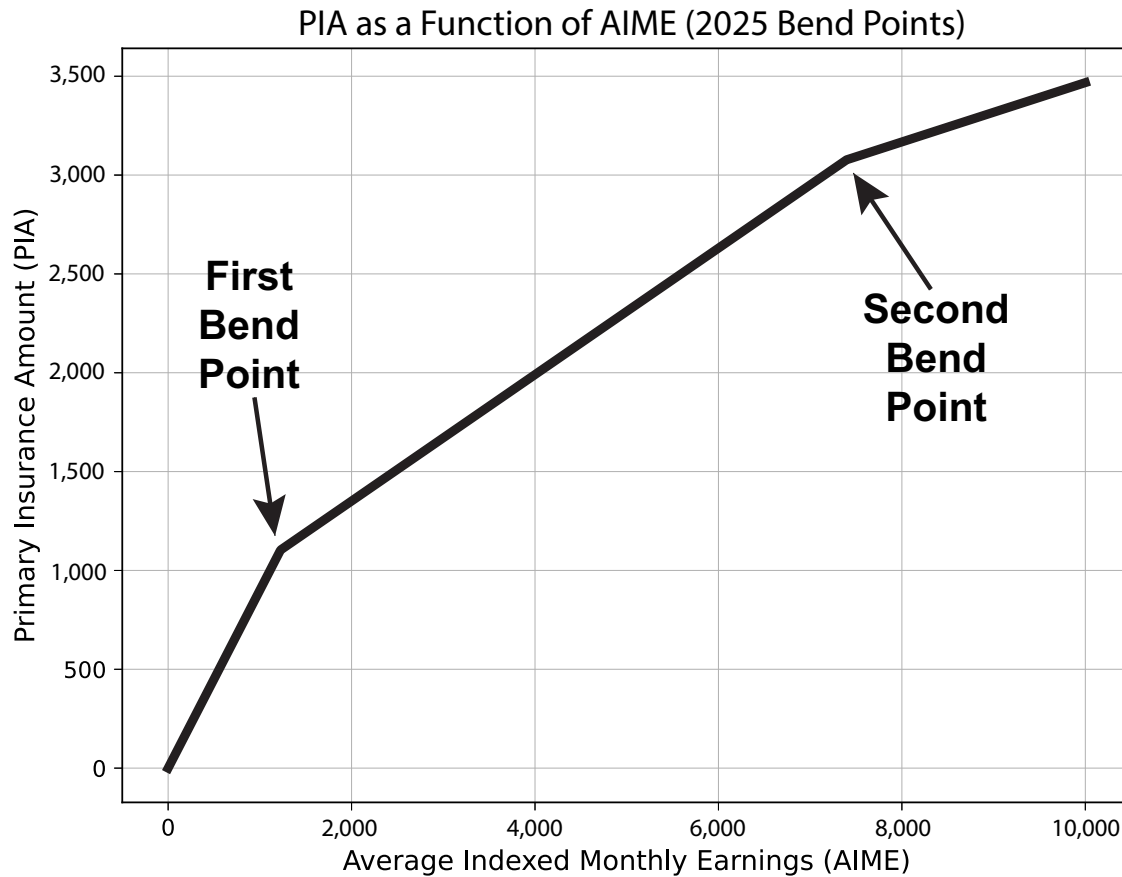
²⁴ *Social Security Primary Insurance Amount*. SSA. [www.ssa.gov/OACT/COLA/piaformula.html] Accessed on Jul. 1, 2025.

²⁵ 20 CFR §404.212(b).

²⁶ 20 CFR §404.212(c).

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The following graph illustrates the relationship between AIME and PIA for individuals not affected by WEP or GPO.



In subsequent years, social security benefits are adjusted for inflation.²⁷

IMPACT ON BENEFICIARIES

Not all individuals are affected by the cancelation of WEP and GPO provisions. Some individuals might have no change, others may have a small change, and a third group may have an increase in social security benefits of over \$1,000 per month.²⁸

No Impact

Individuals who never worked in noncovered employment are not affected by the SSFA because the WEP provisions did not affect them in the first place.²⁹ Additionally, workers with 30 years or more of social security coverage were fully exempt from the WEP.³⁰ Therefore, the removal of WEP provisions did not impact the amount of their social security benefits.

²⁷ *Cost-of-Living Adjustment (COLA) Information for 2025*. SSA. [ssa.gov/cola] Accessed on Jul. 1, 2025.

²⁸ *Social Security Fairness Act: Windfall Elimination Provision (WEP) and Government Pension Offset (GPO) update*. Mar. 18, 2025. SSA. [www.ssa.gov/benefits/retirement/social-security-fairness-act.html] Accessed on Mar. 21, 2025.

²⁹ A majority of state and local government employees, 72%, work in covered employment according to *Social Security Fairness Act: Windfall Elimination Provision (WEP) and Government Pension Offset (GPO) update*. Jun. 23, 2025. SSA. [www.ssa.gov/benefits/retirement/social-security-fairness-act.html?tl=1%2C13] Accessed on Jul. 1, 2025.

³⁰ *Program Operations Manual System (POMS) RS 00605.362*. Jan. 16, 2024. SSA. [secure.ssa.gov/apps10/poms.nsf/lnx/0300605362] Accessed on Jun. 25, 2025.

Similarly, some spouses who do not receive pensions from noncovered employment experience no consequence of the GPO.³¹ For example, a widow may receive a social security benefit based on her deceased husband's years of covered service as a corporate employee. Her survivor social security benefit would not be affected by the SSFA because it was never affected by the GPO.

Example 8. Use the same facts as **Example 5**, except that Larry worked for a plumbing contractor until age 55, attaining 33 years' covered employment. Each year, he was paid in excess of the substantial earnings amount. He worked for the Illinois Department of Public Health, testing plumbers as part of their license applications. He applied his long years of experience to ensure that plumbers were knowledgeable about plumbing codes.

In 2023, Larry retired at age 66, having qualified for a SERS pension. Because he had 30 or more years of substantial earnings in covered employment, the WEP did not reduce his social security benefits. Consequently, the SSFA does not affect him.

Moderate Impact³²

Before the enactment of the SSFA, when the SSA applied the PIA formula, "the percentage of career average earnings paid to lower-paid workers [was] greater than higher paid workers."³³ Individuals with a large AIME, extending well above the first bend point in the PIA formula may experience a small impact on their social security benefit amounts. Because WEP affects only the first tier of AIME, a WEP-triggered social security benefit reduction is unlikely to reduce a small portion of their social security benefit. Most of their benefit is derived from the second and third tiers of AIME, which were not affected by WEP.

In other situations, workers with lower PIA amounts may have a moderate impact because they have fewer than 30 years of substantial earnings. Before the enactment of the SSFA, less than 90% of their earnings up to the first bend point were added to their PIAs. The applicable percentage depended on the number of years in covered employment, as seen in the following table.

Years of Substantial Earnings	Applicable Percentage
30 or more	90%
29	85%
28	80%
27	75%
26	70%
25	65%
24	60%
23	55%
22	50%
21	45%
20 or less	40%

GPO. Many persons whose social security benefits were previously reduced by the GPO may have already noticed a moderate increase in those benefits due to the SSFA. The GPO previously reduced their benefits by two-thirds of their government pension, which often reduced the benefits substantially. In some cases, the social security benefit could be eliminated. With the SSFA now in effect, the GPO reduction no longer applies, so surviving spouses likely see a moderate increase in their social security benefits if they also have a government pension.

³¹ *Government Pension Offset*, p.1–2. Mar. 2025. SSA. [www.ssa.gov/pubs/EN-05-10007.pdf] Accessed on Jul. 1, 2025.

³² *Windfall Elimination Provision*, p.1. SSA. [www.ssa.gov/pubs/EN-05-10045.pdf] Accessed on Jul. 1, 2025.

³³ Ibid.

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Example 9. After graduating from law school, Samantha began her career at age 25 as an associate attorney at a law firm specializing in merger and acquisition work. She soon distinguished herself and was promoted accordingly. By age 50, she was exhausted and wanted to perform work that she felt would be more personally rewarding. After indexing for inflation, her AIME from her work as an attorney was \$15,000 when she turned 60.

Samantha became a public high school teacher and again distinguished herself. She contributed a portion of her salary to the state's pension system, and in 2023, at age 64, she retired with a teacher's pension.

Under the rules in effect at the time, Samantha's social security benefit would have been reduced by the WEP because she had fewer than 30 years of substantial earnings in covered employment. Specifically, in 2024, WEP would have reduced the percentage applied to the first portion of her AIME (i.e., up to the first bend point) from 90% to 65% because she had 25 years of substantial earnings. This would have resulted in a \$249 monthly reduction in her benefit (\$996 amount of first bend point in 2021 when Samantha first became eligible for social security $\times (90\% - 65\%)$).

However, the SSFA, enacted in January 2025 and retroactive to January 2024, repealed WEP. As a result, Samantha is entitled to the full benefit amount without the WEP reduction. She should receive a retroactive payment of \$2,988 (\$249 per month $\times 12$ months) from the SSA to cover the underpaid benefits for 2024, before being adjusted for increases in the cost of living.

Significant Impact

The WEP had a disproportionately large impact on individuals whose AIME was near the first PIA bend point. Because the WEP only modified the percentage applied to the portion of AIME below the first bend point, individuals with modest lifetime earnings saw a much larger percentage reduction in their social security benefits compared to higher earners. For example, someone with an AIME just above the first bend point might have lost 20–40% of their expected benefit due to WEP, while someone with a much higher AIME would have experienced a smaller relative reduction. This made WEP particularly punitive for lower-income workers who also received a pension from noncovered employment, such as certain public-sector jobs. The repeal of WEP under the SSFA therefore provides the greatest relative benefit to these lower-earning individuals, restoring the full 90% factor to the first portion of their AIME and significantly increasing their monthly social security payments.

Additionally, the repeal of the GPO most significantly benefits:

- Widow(er)s who were previously denied survivor benefits due to their noncovered pension.
- Spouses of social security-covered workers who also had a noncovered government pension.
- Retired public-sector workers who were financially dependent on a spouse's social security record.

Example 10. Sarah is a single individual who worked in private and public sectors, in low-paying jobs. She spent 20 years as a secretary in a manufacturing company where her income was subject to social security taxes. Subsequently, at age 42, she worked as a public-school administrative assistant, where she was covered by a state pension system but not the social security program. Sarah retired after 20 years at the school in 2023 at age 62.

Sarah receives a modest pension from the school system based on her 20 years of relatively low pay. She also applies for social security benefits, to which she is entitled.

Sarah had not expected the WEP to reduce her relatively small monthly social security income. In March 2025, Sarah received a large deposit from the SSA, and the next month, she started to receive the full amount she had been expecting when she planned her retirement. For Sarah, the repeal of WEP significantly improved her financial well-being in retirement.

TAX IMPLICATIONS

Over the long term, an individual's income may grow if the WEP had reduced it. In the short run, individuals may experience a spike in their 2025 income from retroactive payments of 2024 WEP reductions, which may result in additional Medicare premiums that exceed their social security benefit.

Increased Taxable Income³⁴

The WEP reduction depended on the number of years the individual earned substantial earnings in covered employment. Once the taxpayer stopped working in covered employment, this number was fixed and the WEP percentage reduction did not change.

In some cases, a cap also applies. The WEP reduction could not exceed half of the social security benefit.³⁵ Because these rules are stable and predictable, repealing the WEP causes a permanent increase in social security benefits for affected individuals. This increase in benefits also leads to a permanent increase in taxable income. Even if up to 85% of social security benefits are taxable,³⁶ affected taxpayers still benefit from a permanent benefit increase.



Practitioner Planning Tip

To accommodate the tax effect of the social security benefit increase, taxpayers affected by the SSFA should consider increasing the percentage of income tax withheld from their benefits. Form W-4V, *Voluntary Withholding Request*, offers individuals the option for withholding 0%, 7%, 10%, 12%, or 22% federal income tax. Medicare premiums are excluded from the calculation of social security withholding. Practitioners should monitor the actual amounts withheld to ensure adequate withholding.

State Tax Consequences. Tax practitioners may need to discuss the effect of state income tax on increased social security benefits with some of their clients residing in certain states. Although 41 states do not tax social security benefits, the following nine states tax some portion.³⁷

- Colorado
- Connecticut
- Minnesota
- Montana
- New Mexico
- Rhode Island
- Utah
- Vermont
- West Virginia

³⁴ *Windfall Elimination Provision*, p. 2. Mar. 2025. SSA. [www.ssa.gov/pubs/EN-05-10045.pdf] Accessed on Jul. 1, 2025.

³⁵ 42 USC §415(d)(3)(B)(ii); Laurence J. Kotlikoff, Philip Moeller & Paul Solman, *Get What's Yours: The Secrets to Maxing Out Your Social Security*, p. 229 (2nd ed., New York, 2016).

³⁶ IRC §86(a)(2)(B).

³⁷ *States that Tax Social Security Benefits in 2025*. Schubel, Kate. Kiplinger. [www.kiplinger.com/retirement/social-security/603803/states-that-tax-social-security-benefits] Accessed on Mar. 18, 2025.

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Retroactive Payments³⁸

Individuals affected by the repeal of the WEP and the GPO can receive retroactive social security benefits covering 2024 in 2025 as the SSA catches up with Congress's decision to repeal these limitations retroactively to the beginning of 2024.

IRMAA Effects.³⁹ A one-time increase in income can trigger an increase in Medicare premiums for both Part B (medical insurance) and Part D (Medicare drug coverage).⁴⁰ If the increase in 2025 income pushes the taxpayer into a higher IRMAA bracket, they may face higher Medicare premiums in 2027. The delay in processing income tax returns makes 2027 the first year the SSA can determine that an increase in Medicare premiums is required.

Estimated Tax Effects.⁴¹ Receiving two years of increased social security benefits in 2025 may create a potential pitfall for estimated tax planning. While the taxpayer may avoid an underpayment penalty for 2025 by relying on safe harbor rules based on their 2024 income, the increase in income for 2025 may result in significantly increased estimated tax obligation for 2026.

Required Minimum Distributions

For retirees who are already drawing from their IRA, IRC §401(k), or other qualified plans, the additional social security income from the repeal of WEP and GPO may allow them to reduce their withdrawals from these accounts. If an individual typically withdraws more than the legally required minimum distribution (RMD) to meet living expenses, they may now reduce their withdrawals, which preserves more of their retirement savings.

Note. For recent changes in RMD rules, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 13: New Developments. For additional information about RMD rules, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Retirement Plan Distributions. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

This shift from drawing income from fully taxable retirement accounts to receiving partially taxable social security benefits (no more than 85% are taxable) could reduce taxable income. In many cases, taxpayers are taxed on the entire distribution from retirement accounts because they have no basis in their retirement accounts.⁴² For example, if a taxpayer reduces IRA withdrawals by \$1,000 and replaces that amount with social security income, only \$850 of that replacement income may be taxable, resulting in a 15% reduction in taxable income for that portion.

³⁸ *Social Security Announces Expedited Retroactive Payments and Higher Monthly Benefits for Millions — Actions that Support the Social Security Fairness Act*. Apr. 18, 2025. SSA. [blog.ssa.gov/social-security-announces-expedited-retroactive-payments-and-higher-monthly-benefits-for-millions-actions-support-the-social-security-fairness-act] Accessed on Jul. 1, 2025.

³⁹ *Fact Sheet: How income affects your Medicare drug coverage premiums*, p. 1. May 2025. Medicare.gov. [www.medicare.gov/publications/11469-income-and-drug-premiums.pdf] Accessed on Jul. 1, 2025.

⁴⁰ *Fact Sheet: 2025 Medicare costs*, pp. 1–3. Dec. 2024. Medicare.gov. [www.medicare.gov/publications/11579-medicare-costs.pdf] Accessed on Jul. 1, 2025.

⁴¹ IRC §6654(d)(1).

⁴² Treas. Reg. §1.408-4(a).

Example 11. Kathy, a retired single individual, faced financial challenges due to the WEP effect on her social security benefits. In 2024, she had a pension from her noncovered employment and a social security benefit of \$2,000 from her work in a private sector job. She knew that the WEP reduced this benefit by \$360. As she is 70 years old, she has no RMD but still receives distributions of \$1,000 each month from her IRA to cover expenses. On December 31, 2024, she has no basis in her \$200,000 IRA; therefore, the entire IRA withdrawal creates taxable income.

With the passage of the SSFA, Kathy's social security benefit increases to \$2,360. Accordingly, Kathy reduces her monthly IRA distributions by \$360. This action has two beneficial effects.

First, Kathy has reduced her taxable income by a small amount because no more than 85% of the social security benefit is subject to federal income tax. Her taxable income decreases by \$54 (\$360 increase in social security benefits $\times$ 85% – \$360 decrease in IRA) because of shifting her income from IRA withdrawals to larger social security benefits.

Second, Kathy has extended the time her IRA will be available. Using the conservative assumption that her IRA does not increase in value, Kathy would have 200 months (\$200,000 $\div$ \$1,000 per month) or 16+ years of withdrawals from her IRA, lasting until she is 86 (age 70 + 200 months $\div$ 12 months per year). By applying the increased social security benefit to reduce her monthly IRA distribution, Kathy can extend her IRA to 312 months (\$200,000 $\div$ \$640 per month) or 26 years, an extra 10 years. As it would last until she is age 96 (age 70 currently + 26 years), Kathy has additional assurance that she will not outlive her source of funds.

Other Financial Issues

Increased income from social security may negatively affect benefits, such as the following.

- Increased income may cause a reduction in the subsidy that some individuals receive when acquiring health insurance under Affordable Care Act plans.⁴³
- A taxpayer may no longer qualify for certain tax credits, such as the lifetime learning credit, when their modified adjusted gross income exceeds a certain amount.⁴⁴ This is also true for the American opportunity credit,⁴⁵ the child tax credit,⁴⁶ and the earned income credit. However, individuals receiving social security benefits are less likely to encounter these credits.
- Some social security beneficiaries may also benefit from other programs, such as the supplemental nutrition assistance program.⁴⁷ If their social security benefits increase so that their income rises above 130% of the federal poverty level, the social security beneficiaries may lose access to these subsidies.
- Increased income may adversely impact a taxpayer's eligibility for certain state and local tax-saving programs, such as property tax assessment freezes.
- Taxpayers can modify estate planning as a result of their increased income. For example, a surviving spouse may be able to retain retirement assets longer because their social security benefits may be increased. By exhausting assets more slowly, they can fund an inheritance with them. Some individuals may not have received spousal or survivor benefits based on how the GPO reduced the income of widow(er)s. Other individuals may enjoy the increase in income by making charitable gifts to people or organizations that are important to them.

⁴³ *Premium Tax Credit: Claiming the credit and reconciling advance credit payments*. May 29, 2025. IRS. [www.irs.gov/affordable-care-act/individuals-and-families/premium-tax-credit-claiming-the-credit-and-reconciling-advance-credit-payments] Accessed on Jul. 1, 2025.

⁴⁴ IRC §25A(d).

⁴⁵ Ibid.

⁴⁶ IRC §24(b).

⁴⁷ *SNAP Eligibility*. Feb. 21, 2025. Food and Nutrition Service, U.S. Department of Agriculture. [www.fns.usda.gov/snap/recipient/eligibility] Accessed on Mar. 19, 2025.

UPDATES TO FORM 1099-DA AND FINAL REGULATIONS

In the past year, the IRS and Treasury Department have issued significant guidance and finalized regulations that reshape how digital asset transactions are reported for tax purposes. These developments culminated in the release of Form 1099-DA, *Digital Asset Proceeds From Broker Transactions*, a new information return designed to standardize the reporting of digital asset sales and exchanges by brokers.

This section highlights the most impactful changes from the past year, including the following.

- **IRS Notice 2025-33.**⁴⁸ Provides transitional relief for digital asset brokers, including backup withholding delays, taxpayer identification number (TIN) matching flexibility, and exemptions for foreign persons.
- **Congressional Nullification of TD 10021.**⁴⁹ Rejection and repeal of the expansion to decentralized finance (DeFi) platforms
- **Form 1099-DA.** Implementation timelines and compliance requirements

NOTICE 2025-33⁵⁰

Issued in April 2025, IRS Notice 2025-33 provides critical transitional relief and clarifying guidance for digital asset brokers preparing to comply with the new Form 1099-DA reporting requirements. The notice addresses several implementation challenges and delays certain enforcement provisions to ease the transition into the new reporting regime.

- **Backup Withholding Relief.** No backup withholding is required for **2025 transactions**, even though brokers must report gross proceeds on Form 1099-DA. For **2026 transactions**, backup withholding is **not required** if the broker confirms the payee's name and TIN using the IRS's TIN Matching Program, and the broker had a relationship with the customer **before January 1, 2026**. Starting in **2027**, backup withholding applies **unless** the payee has provided a **certified TIN** (typically via Form W-9, *Request for Taxpayer Identification Number and Certification*).



Practitioner Planning Tip

2025 Forms 1099-DA will report gross proceeds only — no basis or withholding. As a result, **accurate basis tracking remains the taxpayer's responsibility**. Practitioners should proactively work with clients to gather acquisition records, wallet histories, and transaction logs. Encouraging clients to adopt a **basis tracking system**, even a simple spreadsheet, can prevent reporting errors and reduce audit risk when basis reporting becomes mandatory in 2026.

⁴⁸. IRS Notice 2025-33, 2025-27 IRB 4.

⁴⁹. TD 10021, 89 Fed. Reg. 106,928 (Dec. 30, 2024); H.J. Res. 25, PL 119-5.

⁵⁰. IRS Notice 2025-33, 2025-27 IRB 4.

- **TIN Certification Flexibility.** Brokers may rely on **uncertified TINs** through 2027 if:
 - ♦ The TIN is validated through the IRS’s TIN Matching Program, and
 - ♦ The account was opened **before January 1, 2026.**

Practitioner Planning Tip

Practitioners should encourage clients to update their TIN certifications and ensure their brokers have accurate information on file before the 2026 and 2027 enforcement deadlines.

Note. For more information on TIN certification, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: IRS Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

- **Exempt Foreign Persons.** Brokers are **not required** to file Form 1099-DA or withhold tax for **exempt foreign persons** through 2027, provided:
 - ♦ The customer has a **non-U.S. address**,
 - ♦ The broker has **not previously classified** the customer as a U.S. person, and
 - ♦ The account was opened **before January 1, 2026.**

Note. Brokers have until the end of 2026 to collect Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, or other appropriate documentation.

NULLIFICATION OF TD 10021⁵¹

In late 2024, the Treasury Department issued TD 10021, a final regulation that significantly expanded the scope of digital asset broker reporting, which had been deferred six months earlier when it issued TD 10000.⁵² For the first time, DeFi platforms, which operate without traditional intermediaries, were classified as brokers under IRC §6045 and required to report gross proceeds from digital asset transactions on Form 1099-DA. This move was part of the IRS’s broader effort to close the “crypto tax gap” and improve transparency in the digital asset ecosystem. However, the regulation quickly became controversial.

TD 10021 expanded the definition of “broker” to include DeFi platforms, wallet providers, and other non-custodial actors. Additionally, it required these entities to report gross proceeds from digital asset sales, even if they lacked access to customer identity or basis information. It set an effective date for 2025 transactions, with reporting due in early 2026.

⁵¹ IRS Notice 2025-33, 2025-27 IRB 4.

⁵² TD 10000, 2024-31 IRB 185; *Treasury’s Crypto Tax Reporting Rules Defer on DeFi*. Forst, David; McElroy, Sean; Kirby, Kevin; and Dimon, Matthew. Jul. 3, 2024. Fenwick & West LLP. [www.fenwick.com/insights/publications/treasurys-crypto-tax-reporting-rules-defer-on-defi] Accessed on Apr. 11, 2025.

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The regulation was met with strong opposition from the digital asset industry, privacy advocates, and bipartisan members of Congress. Critics expressed the following concerns.

- DeFi platforms lack the infrastructure to collect and report user information.
- The rule would stifle innovation and drive DeFi activity offshore.
- It imposed unrealistic compliance burdens on software developers and protocol operators.

In response, Congress passed House Joint Resolution 25, which the president signed, formally nullifying TD 10021.⁵³ The resolution was signed into law on April 10, 2025.

As a practical matter, DeFi platforms are not brokers under the current law and, therefore, are not required to file Form 1099-DA. Individuals using DeFi protocols will not receive third-party reporting for these transactions.

Note. Because practitioners will not receive a Form 1099-DA with the necessary information, they must rely on client-provided wallet records, blockchain explorers, or third-party aggregators.

Despite the nullification of TD 10021, taxable events still occur in DeFi, including:

- Token swaps
- Liquidity provision
- Staking and yield farming
- Airdrops and governance token distributions

FORM 1099-DA REPORTING

As digital assets gained value and significance in commerce, the IRS introduced Form 1099-DA for tax reporting. Form 1099-DA is used to report **each** digital asset transaction.

*For each digital asset sale that a broker has effected for a customer in 2025, the broker must complete Form 1099-DA.*⁵⁴

It is speculated that the broker rule may result in over **eight billion** new digital asset returns on Form 1099-DA.⁵⁵ However, the implementation of the broker reporting rules has been delayed twice. In 2024, the IRS postponed the original reporting deadlines by a year when it waived penalties for not reporting.⁵⁶ Almost a year later, IRS Notice 2025-33 delayed the backup withholding requirement and added flexibility for digital asset brokers for TIN collection and reporting for exempt foreign persons.⁵⁷

⁵³ H.J. Res. 25, PL 119-5.

⁵⁴ 2025 Instructions for Form 1099-DA. See page 1.

⁵⁵ *Carey, Cruz Lead Effort to Reverse IRS Overreach on Digital Assets*. Carey, Mike. Jan. 22, 2025. U.S. House of Representatives. [carey.house.gov/2025/01/22/carey-cruz-lead-effort-to-reverse-irs-overreach-on-digital-assets] Accessed on Apr. 11, 2025.

⁵⁶ IRS Notice 2024-56, 2024-29 IRB 64.

⁵⁷ IRS Notice 2025-33, 2025-27 IRB 4.



Practitioner Planning Tip

Tax practitioners should treat Form 1099-DA as a starting point rather than a complete record of a client's digital asset activity. Because not all taxable digital asset transactions are reported on Form 1099-DA, and basis information may be missing, incomplete, or inaccurate, practitioners should carefully review gross proceeds reported to confirm that their client actually sold, exchanged, or otherwise disposed of the assets listed. They should also verify whether the basis field is blank or zero and reconcile it with client records when possible. If the form indicates that the asset is a noncovered security (covered later) basis may not be reported at all. Finally, practitioners should confirm that transactions classified as sales are not, in fact, nontaxable transfers, such as movements between wallets.

Digital Asset Brokers⁵⁸

Form 1099-DA is to be filed by **digital asset brokers**. Brokers are persons, natural or otherwise, who can “effect the sales of digital assets.” They may offer to redeem assets that they issue or create, or they may act as a middleman to dispose of digital assets on behalf of a customer.

Brokers of digital assets are not required to file Form 1099-DA for certain recipients. For example, brokers are not required to file Form 1099-DA for the transactions of charitable organizations, IRAs, Archer medical savings accounts (MSAs), and health savings accounts (HSAs). Similarly, brokers do not need to provide Forms 1099-DA to corporations or other digital asset brokers. The broker should request a Form W-9 from all recipients, as this would allow them to indicate their exemption.

DeFi⁵⁹

DeFi refers to a rapidly growing sector of the digital asset ecosystem that enables users to engage in financial activities, such as lending, borrowing, trading, and earning interest, without relying on traditional financial intermediaries like banks or brokerages.

Instead of centralized control, DeFi platforms operate using **smart contracts** on public blockchains (most commonly Ethereum). These contracts are self-executing code that automatically enforce the terms of an agreement, such as a loan or token swap.

Some key characteristics of DeFi platforms include the following.

- **Non-custodial.** Users retain control of their assets through private wallets (e.g., MetaMask, Ledger).
- **Permissionless.** Anyone with an Internet connection can access DeFi protocols without approval.
- **Transparent.** Transactions are recorded on public blockchains and can be audited in real time.
- **Interoperable.** Many DeFi applications are designed to work together, creating a composable financial ecosystem.

⁵⁸ 2025 Instructions for Form 1099-DA.

⁵⁹ *Decentralized finance*. Jun. 3, 2025. Wikimedia Foundation, Inc. [en.wikipedia.org/wiki/Decentralized_finance] Accessed on Jul. 2, 2025.

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Taxation of DeFi Transactions.⁶⁰ DeFi transactions are often unreported and never appear on any Form 1099, making them difficult to understand and complicating the task of tax reporting for them. The following DeFi activities can trigger taxable events.

- Swapping tokens (e.g., exchanging Ethereum for Bitcoin)
- Providing liquidity to a pool (e.g., Uniswap, Curve)
- Earning interest or staking rewards
- Borrowing or lending cryptocurrencies
- Receiving governance tokens or airdrops
- Participating in yield farming or liquidity mining

Although DeFi platforms are not currently required to issue Forms 1099-DA (following the nullification of TD 10021), **transactions conducted through DeFi protocols are still taxable.**⁶¹ This includes the following.

- Capital gains from token swaps
- Interest income from lending or staking
- Income from airdrops or liquidity mining

Note. For more information on how to calculate taxes associated with digital assets and reporting, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 11: New Developments. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Because DeFi platforms do not collect or report user information, **taxpayers are responsible for tracking and reporting their own activity.**

Impact of Treasury Decisions.⁶² As mentioned previously, the nullification of TD 10021 has several key implications for DeFi platforms and the broader digital asset ecosystem. First, the nullification exempts DeFi platforms from the stringent reporting requirements of TD 10021 that were set to take effect, thereby reducing the regulatory burden on these platforms. This move preserves user privacy and operational flexibility. Additionally, the nullification may encourage further innovation and participation in the DeFi space, as platforms and users will not be subject to the same scrutiny and compliance costs. However, it also raises concerns about potential gaps in tax compliance and transparency, which were the primary goals of the original regulation.

Key Deadlines

As digital asset reporting requirements take effect for the 2025 tax year, tax practitioners should be aware of several key deadlines and phased-in compliance obligations. While Form 1099-DA will be filed for the first time in 2026, not all reporting elements are required immediately. The IRS has implemented a staggered rollout for critical components such as basis reporting and backup withholding, giving brokers and practitioners time to adjust.

Form 1099-DA. The *General Instructions for Certain Information Returns (2025)* provide overall instructions for filing Form 1099-DA. Because 2025 is the first year for reportable digital asset transactions, required entities must follow the directions and deadlines that the instructions provide for Forms 1099-DA.

As with other 1099-series information forms, Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, must be sent with any paper-filed Forms 1099-DA.

⁶⁰ *Complete Guide to Defi Taxes (2025 Update)*. Gordon Law Ltd. [gordonlaw.com/learn/defi-tax-guide/] Accessed on Jul. 2, 2025.

⁶¹ IRS News Rel. IR-2024-18 (Jan. 22, 2024).

⁶² TD 10021, 89 Fed. Reg. 106,928 (Dec. 30, 2024); H.J. Res. 25, PL 119-5.

Basis Reporting.⁶³ Brokers do not have to report the **basis** of digital asset transactions occurring during 2025, but basis information is required for 2026 transactions. Although basis information for digital assets acquired in 2026 and after must be reported, basis and acquisition dates do not need to be reported for noncovered securities, qualifying stablecoins, and specified nonfungible tokens (NFTs).

Noncovered Securities. In general, a noncovered security is a security for which the broker is not required to report basis information to the IRS. This standard also applies to digital assets. Digital asset brokers are not required to report basis information for the following digital assets.

- Digital assets acquired by a customer before January 1, 2026.
- Digital assets for which the broker did not provide custodial services at the time of acquisition.
- Digital assets transferred to another broker providing custodial services.
- Digital assets sold because they were acquired by an exempt recipient, such as a corporation, or a foreign person or entity.

Thus, all digital assets acquired in 2025 are considered noncovered securities, and brokers are not required to provide the cost basis for these assets.

Qualifying Stablecoins.⁶⁴ The volatility of some cryptocurrencies motivated the development of stablecoins, which are designed to have relatively stable values. Stablecoins are designed to track a single convertible currency issued by a government or central bank, such as the U.S. dollar. These assets employ stabilization mechanisms and may be accepted as payment by business entities other than the issuer. Institutional investors may invest in stablecoins, as may individual retail investors. Institutional investors can use stablecoins to manage their liquidity or to hedge against volatility. Retail investors may use them to pay for personal transactions or to participate in DeFi platforms.

On Form 1099-DA, brokers may elect to report sales of qualifying stablecoins⁶⁵ using the **optional reporting method**, which allows them to aggregate designated sale transactions. They are aggregated for each type of qualifying stablecoin on a single form. Box 11b, *number of transactions*, contains the number of transactions reported when using the optional reporting method. With this election, brokers need not report acquisition dates or basis amounts for these transactions.

Consequently, the optional reporting method provides a streamlined reporting process for qualifying stablecoins. Taxpayers who receive a Form 1099-DA that uses the optional reporting method for stablecoin transactions benefit in the following ways.

- **Simplified reporting.** The optional reporting method allows brokers to **aggregate** designated sale transactions for each type of qualifying stablecoin on a single Form 1099-DA, reducing the number of Forms 1099-DA.
- **Clarity and consistency.** By using the optional reporting method, brokers provide a clear and consistent format for reporting stablecoin transactions, resulting in a simpler tax preparation process.
- **Reduced penalties.** Brokers using the optional reporting method are not required to report basis and acquisition dates.

⁶³ TD 10000, 2024-31 IRB 185.

⁶⁴ 2025 Instructions for Form 1099-DA.

⁶⁵ Treas. Reg. §1.6045-1(d)(10)(ii).

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Specified Nonfungible Tokens.⁶⁶ The IRS uses the following definition of an NFT.

*An 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.*⁶⁷

Specified NFTs are NFTs that are indivisible, cannot be replicated, and do not directly or indirectly provide the holder with an interest in certain excluded property. Excluded property may include precious metals or real estate, but is more commonly associated with art, music, or gaming. While individuals are typically drawn to the uniqueness and potential appreciation of these assets, large financial institutions may invest in them because of their potential for high-value transactions.

When reporting specified NFTs on Form 1099-DA, brokers may use the optional reporting method.⁶⁸ This method allows brokers to aggregate all specified NFT transactions for a customer on a single form, simplifying the reporting process. Brokers using this method are not required to report acquisition dates or basis amounts, even if the digital assets are covered securities. This approach reduces the complexity of reporting and minimizes the risk of errors, benefiting both brokers and recipients by providing a streamlined tax reporting process. However, it places the burden of recording basis and acquisition dates on the taxpayer.

Backup Withholding.⁶⁹ As mentioned previously, under Notice 2025-33, **backup withholding** has the following rollout schedule.

- **For 2025 transactions.** Backup withholding is not required for digital asset sales in 2025, even though the IRS requires reporting gross proceeds for digital asset transactions during the year.
- **For 2026 transactions.** Backup withholding is not required only if the broker confirms the combination of the payee's name and their TIN with the IRS's TIN matching program. However, this flexibility is only allowed if the broker did business with the customer or payee before January 1, 2026.
- **For 2027 and later transactions.** Brokers have a backup withholding requirement unless the U.S. customer or payee has certified their name and TIN under penalties of perjury. This is typically done with Form W-9.

If the customer or payee has not complied with these requirements, the digital asset broker, as payer, must deduct and withhold the payment at the "fourth lowest rate of tax applicable under section 1(c)."⁷⁰ That rate is currently 24%.

Limitation of Tax Withheld.⁷¹ Starting with transactions closed in 2027, digital asset brokers must withhold 24% of the proceeds of any U.S. customer's digital asset transactions if the broker does not have a certification for that customer. The amount withheld, however, is limited to 24% of the gross proceeds. It limits the backup withholding obligation to 24% of the asset received, even if it is less than 24% of the value at the time of the trade. Particularly when the transaction swaps one digital asset for another, this limitation is relevant when the value has fallen or is volatile. If the digital asset's value drops before liquidation, the digital asset broker might not be able to cover the full 24% withholding obligation. This provision encourages brokers to liquidate customers' digital assets to meet backup withholding obligations as soon as possible, yet it provides penalty relief when market conditions make full withholding impossible.

⁶⁶ *Non-fungible token*. Apr. 7, 2025. Wikipedia. [en.wikipedia.org/wiki/Non-fungible_token] Accessed on Apr. 16, 2025.

⁶⁷ IRS News Rel. IR-2023-50 (Mar. 21, 2023).

⁶⁸ Treas. Reg. §1.6045-1(d)(10)(iv)(A).

⁶⁹ IRS Notice 2025-33, 2025-27 IRB 4, §3.01.

⁷⁰ IRC §1(c), as modified in *Tax Cuts and Jobs Act*, PL 115-97, §11001.

⁷¹ IRS Notice 2025-33, 2025-27 IRB 4, §3.05.

REPORTING TRANSACTION FEES AND DIGITAL ASSET SWAPS

As digital asset transactions become more complex, tax practitioners must be prepared to calculate gain or loss when Form 1099-DA does not provide complete information. One common scenario involves the **exchange of one digital asset for another**, where the taxpayer incurs a **transaction fee** and receives no cash. In these cases, the practitioner must determine the gross proceeds, subtract any fees, and calculate the gain or loss using the taxpayer's basis records.

As a general rule, transaction fees are expressed as a fraction of the value of one unit of the digital asset.⁷² When a taxpayer uses one digital asset to pay for the acquisition of another digital asset, then the costs are allocated entirely to the proceeds received from the disposition of the original digital asset.⁷³ If the taxpayer acquires a digital asset, then the transaction costs are allocated to the digital asset purchased.⁷⁴

Example 12. In late October 2024, Heather invests in a cryptocurrency after a chance discussion with a friend, Margie. She follows her friend's recommendation and opens an account at GeekPurse, LLC, a digital asset broker, with \$100,000 that she received as an inheritance. On the evening of October 30, 2024, she purchases 1.263686690 units of Bitcoin at the prevailing price of \$71,869.26 per unit of Bitcoin. Her basis in this digital asset is \$90,820.23 (\$71,869.26 per unit $\times$ 1.263686690 units). Assume Heather incurred no transaction costs to acquire Bitcoin.

On April 21, 2025, Heather again meets Margie, who now recommends Ethereum. That afternoon, Heather purchases 70.0000 units of Ethereum with her 1.263686690 units of Bitcoin. When she executes the transaction, the value of Bitcoin is \$87,215.92 per unit, and the value of Ethereum is \$1,574.48. The price for this conversion, similar to an exchange rate, is 0.0180526670 (\$1,574.48 $\div$ \$87,215.92). Heather is assessed a transaction fee equal to 0.073% of the value of each unit of Bitcoin she exchanges. Heather's Geekpurse cryptocurrency ledger that evening shows the following ledger.

Pair	Type	Price	Quantity	Fee	Amount	Time
ETH/BTC	Buy	0.0180526670	1.269686690	.00073	70.0000	Mon Apr 21 20:33:00 UT 2025

The gross proceeds of Heather's sale of Bitcoin are \$110,213.60 (\$87,215.92 $\times$ 1.263686690 units). She is assessed a transaction fee of \$80.46 (\$110,213.60 $\times$ 0.00073 transaction fee), which is subtracted from the gross proceeds credited to her. Thus, Heather has sold Bitcoin to yield net proceeds of \$110,133.14 (\$110,213.60 gross proceeds $-$ \$80.46 transaction fee). Her gain on this transaction is \$19,313 (\$110,133.14 net proceeds $-$ \$90,820.23 cost of property).

Heather holds the Ethereum in her cryptocurrency wallet at Geekpurse through the end of 2025. In late January 2026, Heather receives the following Form 1099-DA from Geekpurse.

⁷² *What is a Transaction Fee in Crypto and How is It Calculated?*. Nov. 23, 2023. Tangem AG. [tangem.com/en/blog/post/what-is-a-transaction-fee-and-why-do-we-need-it/] Accessed on Apr. 21, 2025.

⁷³ Treas. Reg. §1.1012-1(h)(2)(ii)(B).

⁷⁴ Treas. Reg. §1.1012-1(h)(2)(ii)(A).

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For Example 12

☐ CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. GeekPurse, LLC 650 S Congress Ave Austin TX 78701		Applicable checkbox on Form 8949 H	OMB No. 1545-2330 2025 Form 1099-DA	Digital Asset Proceeds From Broker Transactions
FILER'S TIN 14-5678901		1a Code for digital asset 4H95J0R2X		Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		1b Name of digital asset Bitcoin		
RECIPIENT'S TIN ***-**-7132		1c Number of units 1.263686690000000000		
RECIPIENT'S name Heather Field		1d Date acquired 10/30/2024	1e Date sold or disposed 04/21/2025	
Street address (including apt. no.) 123 Main St		1f Proceeds \$ 110133.14	1g Cost or other basis \$	
City or town, state or province, country, and ZIP or foreign postal code Monticello IL 61856		1h Accrued market discount \$	1i Wash sales loss disallowed \$	
Account number 177582736		2 Check if basis reported to IRS ☐	3a Reported to IRS: ☒ Gross proceeds ☐ Net proceeds	
CUSIP number 		3b Check if proceeds from: ☐ Reserved for future use ☐ QOF	4 Federal income tax withheld \$	
5 Check if loss is not allowed based on amount in 1f ☐	6 Gain or loss: ☒ Short-term ☐ Ordinary ☐ Long-term		7 Check if 1f is only cash ☐	
9 Check if digital asset is a noncovered security ☒	10		11a Check if gross proceeds reported in 1f is an aggregate amount for: ☐ Qualifying stablecoins ☐ Specified NFTs	
11b If 11a checked, number of transactions 	11c For aggregate reporting of specified NFTs, aggregate gross proceeds reported in 1f that are attributable to first sales by creator or minter \$	12a Number of units transferred in 	12b If transferred in, provide transfer-in date 	13
14 State name 		15 State identification no. 		16 State tax withheld \$

Form **1099-DA** (Keep for your records) www.irs.gov/Form1099DA Department of the Treasury - Internal Revenue Service

Because all digital asset sales before 2026 are considered noncovered securities, box 9 is checked, and box 1g is not completed.

In mid-February, Heather visits her long-time tax practitioner, Ralph, and gives him this form. Heather also gives Ralph her records of her digital asset transactions, which provide him with her basis in the Bitcoin assets she sold. Ralph completes the following Form 8949, *Sales and Other Dispositions of Capital Assets*, to report Heather's gain on her first digital asset transaction.



Practitioner Planning Tip

Candid discussions about the tax consequences of new investments are appropriate before clients make them. This applies whether clients are interested in digital assets, common stocks, or any other asset that does not generate enough cash, such as interest or dividends, to pay estimated taxes. If the investment does not generate the cash needed to pay taxes, the client must have other sources from which to make such payments.

UPDATES TO AUTOMATIC ACCOUNTING METHOD CHANGES⁷⁵

On June 9, 2025, the IRS issued Rev. Proc. 2025-23, which updates automatic accounting method changes, streamlines compliance, and reduces administrative burdens. This guidance is a key resource when advising clients on method changes that a taxpayer can make without prior IRS consent.

The IRS continues to refine the list of automatic changes eligible for streamlined filing under Rev. Proc. 2015-13.⁷⁶ In this latest update, several new designated change numbers (DCN) are introduced, while others are modified or retired. These changes are generally effective for Forms 3115, *Application for Change in Accounting Method*, filed on or after June 9, 2025, for a year of change ending on or after October 31, 2024.

ACCOUNTING METHOD CHANGE⁷⁷

An accounting method change refers to a modification in how a taxpayer treats specific income or expense items for tax purposes. Common examples are switching from cash to accrual accounting or changing how inventory costs are capitalized. These changes impact the timing of income recognition and deductions, which can affect overall tax liability.

Generally, the IRS requires taxpayers to obtain consent before changing a method of accounting. Automatic changes allow streamlined filing with no user fee by referencing a DCN and submitting Form 3115. In contrast, non-automatic changes require formal IRS review, a user fee (often exceeding \$11,000), and a more complex submission process.

Note. For a thorough discussion on automatic changes and how to complete a Form 3115, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 2: Capitalization vs. Repair Review. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

⁷⁵ Rev. Proc. 2025-23, 2025-24 IRB 1476.

⁷⁶ Rev. Proc. 2015-13, 2015-05 IRB 419.

⁷⁷ IRC §446.

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NEW, MODIFIED, AND RETIRED DCNs

The following table illustrates some of the changes in Rev. Proc. 2025-23.

DCN	IRC Section	Description
New DCNs		
252	§451	Clarifies the timing of income recognition under the all-events test (i.e., all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy) and book conformity rule (i.e., accrual-method taxpayers recognize income no later than the year in which it is recognized as revenue in their applicable financial statement (AFS)).
265	§174	Implements Tax Cuts and Jobs Act (TCJA) rules requiring capitalization and amortization of research and experimental expenditures.
270	§168(k)	Covers the mechanics of electing or revoking bonus depreciation as the phase-out continues.
Modified DCNs		
33	§263A	Inventory capitalization now excludes construction, film, and long-term contracts.
107	§168	Clarifies rules for depreciation method changes.
150	§451	Updates the treatment of advance payments under post-TCJA guidance.
Retired DCNs		
21	§§471, 472	Valuation methods were removed due to complexity.
63	§460	Long-term contract methods have been retired.
99	§168	Cost recovery methods conflicting with bonus depreciation were removed.
132	§263A	Cost allocation methods have been removed from automatic eligibility.

The DCN related to IRC §263A, which governs the capitalization of inventory and production costs, was previously available to a wide range of manufacturers and resellers under the automatic method change procedures. However, Rev. Proc. 2025-23 narrows the scope of “eligible property” for this DCN. Eligible property now excludes specific complex manufacturing processes, long-term contract arrangements, and industries such as construction or film production, which often face unique cost-tracking challenges. Taxpayers engaging in these activities are no longer eligible for the automatic change. They must instead request non-automatic consent, subjecting them to closer IRS scrutiny due to the higher complexity or risk associated with their capitalization methods.

The new procedure provides greater transparency on automatic change exclusions; however, taxpayers under exam, subject to specific IRS initiatives, or requesting retroactive or recurring changes are generally ineligible. Industry-specific exclusions apply and may require closer scrutiny by the IRS. For example, long-term construction projects under §263A would fall under this exclusion.



Practitioner Planning Tip

Rev. Proc. 2025-23 emphasizes the importance of practitioners having an eligibility checklist to help confirm whether a change qualifies for automatic treatment. This includes verifying the taxpayer is not under IRS exam, ensuring the change does not fall under industry-specific exclusions, and confirming compliance with scope limitations. Practitioners should use the most current DCN list, maintain detailed records of computations, and review prior-year filings to avoid duplication or misclassification.

Caution. Common pitfalls, such as citing incorrect DCNs, omitting narrative components, or failing to calculate the IRC §481(a) adjustment accurately, can trigger an IRS inquiry. Practitioners should ensure that clients understand the timing and effects of elections, especially where choices are irrevocable, and weigh filing costs against the benefits of accelerated deductions or deferred income.

DISASTER RELIEF PROVISIONS

Natural disasters challenge communities all over the United States, and the IRS responded in 2025 with a series of expanded relief measures aimed at easing the tax burden for affected individuals and businesses. These provisions include extending filing deadlines, extending payment deadlines, and penalty relief to address the practical challenges taxpayers face in federally declared disaster areas.

GENERAL RELIEF

After the president signs a major disaster or emergency declaration, the IRS can authorize tax relief. Typically, a preliminary damage assessment is done by the Federal Emergency Management Agency (FEMA) when a state governor of the affected state requests it. The request for federal assistance is then submitted, and a formal disaster declaration is issued after the president's approval.⁷⁸

This declaration allows the IRS to respond swiftly to disasters, like severe storms, flooding, or wildfires by postponing filing and payment deadlines for affected taxpayers. For example, in 2025, the IRS granted relief to all counties in Tennessee following severe weather beginning April 2, 2025.⁷⁹

⁷⁸ *Disaster assistance and emergency relief for individuals and businesses*. Feb. 24, 2025. IRS. [www.irs.gov/businesses/small-businesses-self-employed/disaster-assistance-and-emergency-relief-for-individuals-and-businesses] Accessed on May 21, 2025.

⁷⁹ IRS News Rel. IR-2025-47 (Apr. 14, 2025).

Types of Relief

When a federal disaster is declared, the IRS may offer several forms of tax relief to affected individuals and businesses.

For federally recognized disaster areas, the IRS typically offers several forms of tax relief to affected individuals and businesses. These provisions are designed to reduce the administrative and financial burdens that arise during recovery. The most common types of relief include:

- Extensions of time to file tax returns and make payments,
- Abatement of certain penalties, and
- Automatic qualification for taxpayers in the disaster area.

Extended Filing Deadlines.⁸⁰ Individual and business tax returns, including quarterly estimated payments, may be postponed. For instance, taxpayers in Tennessee have until November 3, 2025, to file income tax returns originally due between April 2 and November 3, 2025. The November 3 extended filing deadline also applies to payroll tax and excise tax returns otherwise due April 30, July 31, and October 31.

Extended Payment Deadlines.⁸¹ Under usual IRS disaster relief procedures, individual income tax payments and estimated tax payments may be postponed to the end of the relief period. Payroll and excise tax deposits, however, must typically be made within a short grace period (often around two weeks after the disaster start date) to qualify for penalty abatement. The related tax forms may still be filed later under the extended deadline.

For example, relief for the Tennessee storms includes extended due dates for individual income tax payments until November 3 for 2024 balances due April 15. Similarly, taxpayers with 2025 estimated tax payments due April 15, June 16, and September 15 have until November 3 to pay. However, **excise tax deposits** due after April 1 and before April 17 must be **paid by April 17** to be eligible for penalty abatement, even though the related form is not due until November. Similarly, **payroll tax deposits** due during the same period must be paid by **April 17** to be eligible for penalty abatement, even though the quarterly payroll tax forms are due November 3.

Penalty Relief.⁸² Penalties for failing to make payroll and excise tax deposits are abated if deposits are made within a specified grace period (e.g., by April 17, 2025, for Tennessee).⁸³ Income tax relief is broader and includes automatic penalty and interest suspension for the duration of the disaster relief period.

Automatic Relief.⁸⁴ Taxpayers with an IRS address of record in the disaster area automatically qualify for postponed deadlines for filing federal income tax returns and making tax payments. Those outside the area may still qualify if their records were destroyed or they were forced to relocate. They should contact the IRS to request relief.

Eligible returns and payments include the following.

- Calendar year 2024 partnership and S corporation returns normally due on March 17
- 2024 individual income tax returns and payments normally due on April 15
- Quarterly estimated tax payments normally due on April 15
- Calendar year 2024 corporate and fiduciary income tax returns and payments normally due on April 15

Caution. A federal disaster declaration does not automatically trigger corresponding relief or filing extensions at the state level. **Tax practitioners should verify with the appropriate state taxing authority whether similar relief provisions have been adopted.**⁸⁵

⁸⁰ *IRS announces tax relief for Tennessee storm victims; various deadlines postponed to Nov. 3.* Apr. 17, 2025. IRS. [www.irs.gov/newsroom/irs-announces-tax-relief-for-tennessee-storm-victims-various-deadlines-postponed-to-nov-3] Accessed on May 21, 2025.

⁸¹ *Ibid*; IRC §7508A.

⁸² IRC §6656.

⁸³ IRS News Rel. IR-2025-47 (Apr. 14, 2025).

⁸⁴ IRS News Rel. IR-2025-41 (Apr. 4, 2025).

⁸⁵ *Tax Relief in disaster situations.* Jun. 12, 2025. IRS. [www.irs.gov/newsroom/tax-relief-in-disaster-situations] Accessed on Jun. 23, 2025.

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FEDERAL DISASTER TAX RELIEF ACT OF 2023⁸⁶

Signed into law on December 12, 2024, the Federal Disaster Tax Relief Act of 2023 provides targeted tax relief for individuals and businesses affected by federally declared disasters. This legislation builds upon prior disaster-related tax frameworks and introduces several key enhancements designed to simplify and expand access to relief.

Key provisions of the Act include the following.

- The Act eliminates the requirement that personal casualty losses must exceed 10% of adjusted gross income (AGI) to be deductible. Instead, each separate casualty is deductible once it exceeds a \$500 floor, and taxpayers may claim this deduction above the line, even if they do not itemize.
- Taxpayers may exclude from gross income any compensation received for losses or damages resulting from qualified wildfire relief payments, including amounts for:
 - ♦ Additional living expenses
 - ♦ Lost wages (excluding employer-paid wages)
 - ♦ Personal injury, death, or emotional distress (this exclusion applies to payments received in tax years beginning after December 31, 2019, and before January 1, 2026)

The Act applies to major disasters declared by the president between January 1, 2020, and February 10, 2025, with incident periods beginning on or after December 28, 2019, and ending no later than January 11, 2025.

The Act provides specific relief to for victims of the East Palestine, Ohio train derailment. Relief payments related to the February 3, 2023, train derailment in East Palestine, Ohio, are treated as qualified disaster relief payments under IRC §139(b). These payments may be excluded from gross income if received from government agencies or Norfolk Southern Railway (or its affiliates), and cover losses, damages, expenses, and impacts on real property value.

SECURE 2.0 DISASTER RELIEF PROVISIONS⁸⁷

The SECURE 2.0 Act, signed into law in December 2022, introduces several important tax provisions aimed at easing the financial burden on individuals and businesses affected by federally declared disasters. This legislation builds on prior relief frameworks but expands and clarifies key areas, making it especially relevant for tax professionals advising clients in disaster-prone regions. Key provisions of the legislation include the following.

- Waiver of the 10% early withdrawal penalty for up to \$22,000 in qualified disaster distributions from retirement accounts.
- Option to spread income from such distributions over three years.
- Ability to recontribute withdrawn amounts to retirement accounts.
- Expanded casualty loss deductions without the requirement to itemize or meet the 10% adjusted gross income (AGI) threshold.
- A disaster-related employee retention credit for eligible employers.

These provisions apply to federally declared disasters occurring on or after January 26, 2021.

Note. For comprehensive examples, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 13: New Developments.

⁸⁶ *Federal Disaster Tax Relief Act of 2023*, PL 118-148.

⁸⁷ *SECURE 2.0 Act of 2022*, PL-117-328, §331.

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2025 DISASTERS⁸⁸

The following table shows the disaster relief guidance issued by the IRS through July 31, 2025.

State	Disaster	Deadline Extension	IRS References
Arkansas	Storms	Nov. 3	AR-2025-03, IR-2025-49
California	Wildfires	Oct. 15	CA-2025-01, IR-2025-10
Kentucky	Severe storms, straight-line winds, flooding, landslides	Nov. 3	KY-2025-02
Mississippi	Severe storms, straight-line winds, tornadoes, flooding	Nov. 3	MS-2025-01
Missouri	Severe storms, straight-line winds, tornadoes, wildfires	Nov. 3	MO-2025-02
New Mexico	Severe storms, flooding, landslides	Feb. 2, 2026	NM-2025-03
North Carolina	Storms	Sept. 25	NC-2025-01
Oklahoma	Wildfires and straight-line winds	Nov. 3	OK-2025-02
Texas	Severe storms and flooding, straight-line winds	Feb. 2, 2026	TX-2025-03, TX-2025-04
Tennessee	Severe storms (April 2 onward)	Nov. 3	TN-2025-02, IR-2025-47
Virginia	Severe winter storms and flooding	Nov. 3	VA-2025-03
West Virginia	Storms	Nov. 3	WV-2025-02, IR-2025-34



Practitioner Planning Tip

To assist clients who may be affected by disasters, tax professionals should:

- Monitor the IRS's *Tax Relief in Disaster Situations* web page for up-to-date lists of eligible localities,⁸⁹
- Advise business clients to make deposits of payroll and excise taxes following the established deadlines,
- Advise clients to update their IRS address if they have relocated to or from a disaster area, or
- Contact the IRS Special Services line at 866-562-5227 for clients who may qualify for relief but did not receive it automatically.

⁸⁸ *Tax relief in disaster situations*. Jul. 17, 2025. IRS. [www.irs.gov/newsroom/tax-relief-in-disaster-situations] Accessed on Jul. 31, 2025.

⁸⁹ *Ibid*.

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Filing Relief for Natural Disasters Act⁹⁰

Passed on July 24, 2025, the Filing Relief for Natural Disasters Act authorizes the IRS to postpone federal tax deadlines for taxpayers affected by a qualified **state-declared** disaster, upon written request by the state governor. Qualified state-declared disasters include the following.

- Natural catastrophes
 - ♦ Hurricanes
 - ♦ Tornados
 - ♦ Storms
 - ♦ High water
 - ♦ Winddriven water
 - ♦ Tidal waves
 - ♦ Tsunamis
 - ♦ Earthquakes
 - ♦ Volcanic eruptions
 - ♦ Landslides
 - ♦ Mudslides
 - ♦ Snowstorms
 - ♦ Droughts
- Sufficiently severe damages caused by the following.
 - ♦ Fire
 - ♦ Flood
 - ♦ Explosion

For purposes of qualified state-declared disasters, states include the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

Further guidance is expected to be released.

Note. For more information about the disaster-related provisions, see the *2025 University of Illinois Federal Tax Workbook*, Chapter 6: Individual Taxpayer Issues.

⁹⁰ *Filing Relief for Natural Disasters Act*, PL 119-29.

NEW FAQs FOR THE ERC⁹¹

The employee retention credit (ERC)⁹² has been a critical relief measure for businesses during the COVID-19 pandemic. As the IRS continues to issue guidance and frequently asked questions (FAQs), tax practitioners must stay informed about the latest developments. This update summarizes recent IRS FAQs issued in April 2025, highlighting their implications for tax reporting, compliance, and audit readiness.

Although five years have passed since the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act⁹³ was enacted, it continues to influence tax policy and compliance, as reflected in the IRS's recent updates to the ERC FAQs. The ERC provided money to many small businesses during the early stages of the COVID-19 pandemic. New questions continue to emerge around claiming ERC and associated scams, as recent additions to the IRS FAQ webpage testify. The five new questions follow.

- 1. Claiming the ERC, Q7: Does the ERC affect my income tax return?** Beyond answering “yes,” the IRS explains that the ERC reduces the amount of wage expense a taxpayer can report on their income tax return for the year in which the qualified wages are paid or incurred. However, if wage expense is capitalized, either into the basis of an asset or inventory cost, the ERC reduces the capitalized amount instead. This may affect depreciation or the cost of goods sold. The IRS also outlines options for amending prior returns or making adjustments, depending on whether the ERC claim was allowed or disallowed.
- 2. Income Tax and ERC, Q1: Should I have reduced my wage expense on my income tax return when I filed for the Employee Retention Credit (ERC)?** The IRS's answer states that the ERC reduces the amount of wage expense a taxpayer can report on their income tax return for the year in which the qualified wages are paid or incurred. Under general tax rules, taxpayers cannot deduct an expense if “they have a right or reasonable expectation” that they may be reimbursed for the expense at the time the expense is incurred. Because taxpayers who may be eligible for the ERC have a reasonable expectation that they may receive a reimbursement for a portion of their wage expense, they should not deduct the portion of wages that the ERC reimburses.
- 3. Income Tax and ERC, Q2: I claimed the ERC but didn't reduce my wage expenses on my income tax return. The ERC claim was paid in a subsequent year. What do I do?** The IRS answers that an amended return or administrative adjustment request (AAR) is not necessarily required if the taxpayer claimed the ERC but did not reduce their wage expense in the year the qualified wages were paid or incurred. Instead, the taxpayer can include the overstated wage expense as **gross income** for the tax year when they received the ERC. The IRS cites the **tax benefit rule**, which requires taxpayers to include in income any previously deducted amount if a later event — such as receiving the ERC — is inconsistent with the original deduction. However, if the wage expense was capitalized (e.g., into inventory or asset basis), the taxpayer may need to make a different adjustment, such as reducing basis or depreciation, rather than including the amount in gross income. The IRS provides an example illustrating this treatment and warns taxpayers that they may be seeking a double benefit if they fail to adjust their wage expense.

⁹¹ *Frequently asked questions about the Employee Retention Credit*. Apr. 22, 2025. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Apr. 29, 2025.

⁹² IRC §3134.

⁹³ *Coronavirus Aid, Relief, and Economic Security Act*, PL 116-136.

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4. Income Tax and ERC, Q3: What can I do if my ERC claim was disallowed and I'd already reduced my wage expense on my income tax return by the amount of ERC I expected? This question reverses the previous question. Here, a taxpayer learns that the IRS disallowed their ERC claim, but they have already reduced wage expense by the amount of the expected credit. The taxpayer has the following options under this question.

- Once the disallowance is final (i.e., the taxpayer is no longer contesting it), they may increase their wage expense by the amount it was reduced on their current year's return. The increased wage expense is reported on the return for the year that the claim disallowance is final. The disallowance is considered final when the business no longer contests the disallowed ERC and has exhausted all arguments against the disallowance.
- They may file an amended return for the year they claimed the ERC.
- They may file a protective claim for a refund for the year they claimed the ERC. A protective claim is made when a taxpayer's right to a refund is contingent upon a future event that may occur after the statute of limitations has expired.⁹⁴
- They may file an AAR for the year they claimed the ERC.

This flexibility helps taxpayers avoid issues with expired statutes of limitations and aligns with the special statutory rules under the CARES Act and IRC §3134, which treat the ERC as a form of expected reimbursement. The IRS emphasizes that this treatment is consistent with how taxpayers should handle any business expense for which reimbursement was reasonably expected but ultimately not received.

5. ERC Scams, Q3: How do I report fraud regarding ERC? The IRS requests that taxpayers report ERC-related fraud, abusive tax schemes, and tax return preparers who knowingly file improper returns. Individuals should complete Form 14242, *Report Suspected Abusive Tax Promotions or Preparers*, and include any supporting materials, such as promoter's literature. While providing contact information is optional, it can help the IRS follow up if needed. The completed form and materials should be sent to the IRS Lead Development Center by mail or fax.

Mail:

Internal Revenue Service
Lead Development Center MS7900
1973 N. Rulon White Blvd.
Ogden, UT 84404

Fax: 877-477-9135

CORPORATE ALTERNATIVE MINIMUM TAX DEVELOPMENTS⁹⁵

On June 2, 2025, the IRS issued Notice 2025-27, providing interim guidance on the corporate alternative minimum tax (CAMT). This notice introduces a new simplified method for determining applicable corporation status and extends penalty relief for underpayment of estimated CAMT liabilities. These updates are part of the evolving implementation of the CAMT, which was enacted under the Inflation Reduction Act of 2022.⁹⁶ It was designed to ensure that large corporations pay a minimum level of tax.

⁹⁴ IRS Pub. 17, *Tax Guide for Individuals*, p. 19 (2024).

⁹⁵ IRS Notice 2025-27, 2025-26 IRB 1611.

⁹⁶ *Inflation Reduction Act of 2022*, PL 117-169, §10101.

OVERVIEW OF CAMT

The CAMT applies a 15% minimum tax on the adjusted financial statement income (AFSI) of **applicable corporations**. A corporation is generally considered “applicable” if it has an average annual AFSI exceeding \$1 billion⁹⁷ over a 3-year period. For U.S. subsidiaries of foreign-parented multinational groups, the threshold is \$100 million, provided the aggregated group meets the \$1 billion threshold.⁹⁸

Once a corporation is classified as an applicable corporation, it generally remains subject to CAMT unless it can demonstrate five consecutive years of falling below the AFSI threshold or undergoes a qualifying ownership change, as outlined in proposed regulations from 2024.⁹⁹ The CAMT liability is calculated as the excess of 15% of AFSI over the sum of regular tax liability and the base erosion and anti-abuse tax, with a foreign tax credit allowed under IRC §59(l).

Note. For more information on how to calculate CAMT, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 11: New Developments. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

INTERIM SIMPLIFIED METHOD AND PROCEDURAL RELIEF

In Notice 2025-27, the IRS introduces an interim simplified method for determining applicable corporation status. This method provides a streamlined approach for corporations to assess their CAMT liability without engaging in the full complexity of AFSI adjustments. The simplified method reduces the AFSI thresholds to \$800 million (or \$80 million for foreign-parented groups) and disregards many financial statement adjustments, making the determination process more accessible.

Additionally, the notice provides relief from estimated tax penalties under IRC §6655 for underpayments related to CAMT. This waiver applies to tax years beginning after December 31, 2023, and before January 1, 2025, acknowledging the compliance challenges posed by the evolving CAMT framework.

COMPLIANCE AND FORM 4626¹⁰⁰

Corporations subject to CAMT must file Form 4626, *Alternative Minimum Tax — Corporations*, which has been significantly revised to reflect the new AFSI-based regime. The form requires detailed disclosures, including adjustments to book income, tracking of CAMT basis, and coordination with related entities. The IRS has emphasized the importance of accurate AFSI computation, as errors can lead to substantial underpayment penalties.

To ease compliance, the IRS has preserved the safe harbor provisions initially introduced in earlier notices and incorporated them into the 2024 proposed regulations. These provisions allow corporations to bypass full Form 4626 filing if they meet the simplified method criteria. Specifically, under Notice 2025-27, corporations may apply an interim simplified method using the reduced AFSI thresholds. If a corporation can demonstrate that it falls below these thresholds, it is not required to file Form 4626, provided it was not classified as an applicable corporation in a prior year.

The safe harbor is optional, and corporations may still choose to perform the full AFSI test. However, once a corporation is classified as applicable, it must continue filing unless it qualifies for exit under the 5-year or qualifying ownership change rules.

⁹⁷ IRC §59(k)(1).

⁹⁸ Ibid.

⁹⁹ REG-112129-23, 2024-42 IRB 787.

¹⁰⁰ See Instructions for Form 4626.



Practitioner Planning Tip

Tax practitioners should advise clients to do the following.

- Evaluate AFSI thresholds to determine applicable corporation status.
- Maintain detailed financial records that reconcile book income to AFSI.
- Monitor ownership changes along with other shifts that may affect CAMT applicability.
- Utilize the interim simplified method where eligible to reduce compliance burdens.
- Prepare for increased IRS scrutiny, particularly in areas involving intercompany transactions and foreign tax credits.

WITHDRAWAL OF BASIS-SHIFTING TRANSACTION REGULATIONS

In a rare reversal, the IRS has withdrawn a set of controversial regulations targeting basis-shifting transactions within partnerships. IRS Notice 2025-23¹⁰¹ marks a significant policy shift, effectively halting the implementation of some disclosure rules introduced just a year earlier under IRS Notice 2024-54.¹⁰² For tax practitioners, this development not only removes a layer of compliance complexity but also signals a broader change in the IRS's enforcement priorities under the current administration.

BACKGROUND¹⁰³

For some time, the IRS has scrutinized partnership transactions that result in one partner receiving a tax benefit because of unequal inside and outside bases. These basis-shifting transactions had some of the following characteristics.

- They involved transactions between partners and persons related to them.
- They resulted in increases in the basis of property under IRC §§732, 734(b), or 743(b).
- They generated either increased depreciation or reduced capital gains.

When the IRS released Notice 2024-54 in June 2024, it announced its intent to issue regulations to designate certain related-party basis-shifting transactions as “transactions of interest.” This designation would force **material advisors** to make disclosures, including filing Form 8918, *Material Advisor Disclosure Statement*, and maintaining lists of clients. A material advisor is any person who provides advice, promotion, or other “material aid” for a transaction that the IRS wants to monitor closely.¹⁰⁴ If these services are provided to individuals, the Code considers them material advisors if they receive gross income exceeding \$50,000. This threshold increases to \$250,000 if taxpayers other than natural persons receive these services.

¹⁰¹. IRS Notice 2025-23, 2025-19 IRB 1428.

¹⁰². IRS Notice 2024-54, 2024-28 IRB 24.

¹⁰³. Ibid.; See, e.g., *Santa Monica Pictures, LLC v. Comm’r*, TC Memo 2005-104 (May 11, 2005); *Southgate Master Fund, LLC v. U.S.*, 659 F.3d 466 (5th Cir. 2011).

¹⁰⁴. IRC §6111(b).

Executive Order 14219 establishes the legal foundation for **withdrawing** Notice 2024-54.¹⁰⁵ Issued in February 2025, the order directs federal agencies to identify and rescind regulations that are unconstitutional, exceed statutory authority, or undermine national interests. In response, the IRS and Treasury determined that the basis-shifting disclosure rules introduced in Notice 2024-54 met these criteria and announced their withdrawal in Notice 2025-23. Notice 2025-23 announces the IRS's intent to withdraw Notice 2024-54 and the related regulations, pending finalization of proposed rules.

EFFECT OF NOTICE 2025-23

The background section of Notice 2025-23 cites Executive Order 14219 as the legal basis for withdrawing Notice 2024-54, but stops short of identifying the specific category of regulatory concern (e.g., constitutional issues or lack of statutory authority) that applies to the withdrawn rules. This notice has the following effects.

- Withdraws Notice 2024-54
- Announces proposed regulations that will eventually withdraw Treas. Reg. §1.6011-18
- Provides relief from penalties under IRC §§6707, 6707A, and 6708 for the following groups of taxpayers
 - ♦ Participants in transactions that potentially involve basis-shifting under IRC §6011
 - ♦ Material advisors who must file disclosure statements identifying transactions of interest and lists of clients they are advising

Form 8918 Relief

Under prior guidance in Notice 2024-54, material advisors involved in basis-shifting transactions were required to file Form 8918 to report their involvement and disclose client lists. Notice 2025-23 provides relief from these filing obligations and associated penalties for transactions that would have been reportable solely under the withdrawn notice. Advisors should still evaluate whether other reportable transaction categories apply, but no Form 8918 filing is required for basis-shifting transactions under the withdrawn rules.

Reportable Transactions

Although the IRS has withdrawn its designation of certain basis-shifting transactions as “transactions of interest” under Notice 2025-23, these arrangements remain structurally similar to those previously flagged for scrutiny. A common pattern involves transferring a partnership interest to a related party, where the transferring partner has a high outside basis and a low inside basis. If the partnership has an IRC §754 election in place, the transferee partner may benefit from a step-up in basis under §743(b), resulting in increased depreciation or amortization deductions. These deductions typically reduce the partner's share of income reported on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, particularly in part III, boxes 1 through 3.

- Box 1, Ordinary business income (loss)
- Box 2, Net rental real estate income (loss)
- Box 3, Other net rental income (loss)

Note. For more information about the effect of §§734(b) and 743(b) adjustments, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

¹⁰⁵. 90 Fed. Reg. 10583 (Feb. 25, 2025).

Example 13. Partnership ABC has three partners: Albert and his two daughters, Betty and Carla. ABC made a valid §754 election when it was formed five years ago. Albert has a substantial outside basis in the partnership, \$1 million, but his share of the inside basis is only \$200,000. Betty and Carla have outside bases of \$200,000 each. Albert sells his partnership interest to Betty and Carla in a manner that the two women continue as equal partners.

Following the rules of §743(b), the partnership must adjust the **inside** basis of the assets by \$800,000. If the anti-basis-shifting rules of Notice 2024-54 are not applied, Betty and Carla will benefit from a substantial increase in their depreciation deduction attributable to the \$800,000 step-up in basis (\$1 million Albert’s outside basis – \$200,000 inside basis before being increased). The increased depreciation likely decreases income on their Schedules K-1, boxes 1, 2, or 3, depending on the type of income the partnership generates.

When applied to transactions of interest, IRC §6111 invests the IRS with substantial power because it can define types of transactions as reportable transactions without Congressional approval. The only limitation placed on the IRS is that it must determine that the type of transaction has the **potential** for tax avoidance or evasion.¹⁰⁶

Thus, the effect of Notice 2025-23 is significant in that it removes the reporting and disclosure obligations that would have applied to certain basis-shifting transactions under Notice 2024-54. In **Example 13**, while the §743(b) basis adjustment still applies and affects the partners’ depreciation deductions, the transaction is no longer classified as a “transaction of interest,” and therefore does not trigger the reporting requirements or penalties that would have applied under the withdrawn rules.

IRS ENFORCEMENT BEYOND BASIS-SHIFTING RULES

Although Notice 2025-23 withdraws the controversial basis-shifting disclosure rules introduced in Notice 2024-54, the IRS continues to scrutinize partnership transactions through other channels. Two key pieces of guidance issued on June 17, 2024, remain in effect and signal the agency’s ongoing enforcement priorities.

1. Rev. Rul. 2024-14¹⁰⁷
2. News Release IR-2024-166¹⁰⁸

Rev. Rul. 2024-14: Application of the Economic Substance Doctrine

This revenue ruling applies the **economic substance doctrine** under IRC §7701(o) to certain related-party transactions. Asserting an origin in common law, this doctrine disallows a transaction’s tax benefits if the transaction lacks economic substance or a business purpose.¹⁰⁹ It presents hypothetical scenarios where partnerships engage in basis-shifting arrangements that, while technically permissible under subchapter K, lack a legitimate business purpose or economic substance.

- The IRS emphasizes that transactions designed solely to generate tax benefits — such as artificial losses or depreciation deductions — may be disallowed.
- The ruling draws on historical Congressional intent to maintain parity between inside and outside basis, reinforcing that tax benefits must align with economic reality.

News Release IR-2024-166: Enforcement Priorities for Large Partnerships

This news release outlines the IRS’s broader enforcement strategy targeting potentially abusive partnership transactions, particularly those involving high-net-worth individuals and large partnerships.

The news release announces a series of steps targeting wealthy taxpayers’ attempts to reduce their taxes with certain partnership transactions.

- Formation of a dedicated enforcement group within the Office of Chief Counsel
- Increased audit activity, including 76 large partnerships
- Enhanced disclosure expectations for transactions of interest

¹⁰⁶. IRC §6707A(c)(1).

¹⁰⁷. Rev. Rul. 2024-14, 2024-28 IRB 18.

¹⁰⁸. IRS News Rel. IR-2024-166 (Jun. 17, 2024).

¹⁰⁹. IRC §7701(o)(5)(A).

Chapter 9: Various Specialized Trusts

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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A common tool for estate planning, trusts are arrangements under which an individual, known as the **grantor, settlor, trust maker, or trustor**, transfers legal title to property to an individual or corporate trustee to administer per a trust agreement for the benefit of beneficiaries who may be identified by name or by class (e.g., “my children who survive me,” or “my grandchildren”). Trusts are one means for managing and transferring property, as they offer flexibility in establishing criteria and timing provisions for handling both the principal or corpus of the trust as well as any income earned by the trust.¹ Consequently, a trust agreement provides the settlor who creates a trust, a level of control over the disposition of their accumulated wealth and property that can extend for several generations, although not into perpetuity. Tax planners also use trusts to implement tax-saving strategies for settlors, and for those beneficiaries to whom the trust corpus and/or income will be distributed during the life of the trust, as well as at the termination of the trust.

Additionally, trusts may allow property and assets to pass outside of probate, at least for solvent estates. **Probate** is a legal and public process where documents, such as the decedent’s will and sometimes the inventory of probate assets, are filed with the court and become public records. Probate avoidance may be achieved by titling property in the name of a trustee, or, where state law permits (e.g., Colorado², Nevada³), in the name of the trust (known as funding the trust). In avoiding probate, trusts may allow a degree of privacy regarding a grantor’s probate estate, as well as provide cost savings associated with court fees and other administrative expenses related to the probate process.

As trusts gained popularity as estate planning instruments over time, the types of trusts and the ways in which grantors and their tax and legal advisors utilized them have risen as well. This chapter reviews and describes notable specialized trusts that may serve taxpayer’s estate planning goals and achieve more favorable estate and income tax outcomes. While there are many specialized trust techniques available and this chapter is not intended to be a comprehensive analysis of every specialized trust, the scope of this chapter is to highlight frequently used specialized trusts and the uses of such trusts when facing certain fact patterns.

Note. This chapter is intended to provide information about various types of trusts, not a step-by-step analysis of estate planning. Practitioners are most likely either to receive a trust document and be asked to do the tax accounting and return preparation for it, or be asked by clients about trust alternatives to accomplish goals (e.g., protect an asset, build wealth, control distributions, minimize taxes, etc.).

Caution. The drafting, amending, and terminating of trusts should involve an attorney. Likewise, questions about fiduciary accounting and breach of fiduciary duty are legal interpretations of the trust agreement, Uniform Prudent Investor Act (UPIA)/Uniform Fiduciary Income and Principal Act (UFIPA), and other state law that are best handled by a legal expert. Practitioners should understand the purpose of a trust, know how the trust was funded, issue-spot potential tax problems (e.g., estate inclusion, gift taxes, settlor exerting control) with how the trust is being administered, prepare the annual tax accounting and returns, and track the lifetime exclusion vis-a-vis the applicable exclusion amounts.

¹. *Trusts and estates: Uses and tax considerations*. Pippin, Sonja E. Feb. 2017. Journal of Accountancy. [www.journalofaccountancy.com/issues/2017/feb/trusts-and-estates-uses-tax-considerations.html] Accessed on Feb. 23, 2025.

². Colorado Revised Statutes, §38-30-108.5.

³. Nevada Revised Statutes, §0.039.

REVOCABLE TRUSTS

Trusts can either be revocable or irrevocable. The concept of a trust's revocability describes the grantor's ability or inability to alter the terms of the trust. A trust is **revocable** if the grantor or a nonadverse party can alter or cancel trust provisions in whole or in part (such as changing the beneficiaries of the trust, or terminating the trust and reacquiring the property in the trust).⁴ As a consequence of retaining a level of control over the trust assets, assets titled in a revocable trust can avoid the probate process but the trust assets do **not** avoid inclusion in the grantor's gross taxable estate for federal **estate tax** purposes.

Caution. Grantor trusts do not provide protection of assets for Medicaid planning purposes.⁵

Note. The terms of a trust (e.g., powers retained by the grantor to change or revoke the trust, authority of a trustee to make allocations between income and principal, powers of appointment granted to beneficiaries) are described in a **trust instrument**. A trust instrument is an agreement between the grantor and the trustee (the individual or corporate entity who will administer the trust) governing how the property held in the trust may be used and the conditions under which the legal rights of the beneficiaries of the trust vest.

All revocable trusts are, by definition, grantor trusts. A trust can be treated as a grantor trust if any of the grantor trust definitions contained in the following Code sections apply.

- IRC §671 — Under the general rule, when the grantor or another person is regarded as the owner of any portion of a trust, the income, deductions, and credits attributable to that portion of the trust are included in calculating the taxable income and credits of the grantor or other person.
- IRC §673 — The grantor has retained a reversionary interest (meaning ownership of the trust assets will revert at some point to the grantor) in the trust.
- IRC §674 — The grantor or a nonadverse party (see IRC §§672(a) and (b) for definitions) has certain powers over the beneficial interests under the trust such as the ability to choose who will enjoy the trust assets or how the assets will be managed.
- IRC §675 — The grantor or a nonadverse party retains certain administrative powers (such as the power to substitute assets of equivalent value) over the trust assets.
- IRC §676 — The grantor or a nonadverse party has the power to revoke the trust or return the corpus to the grantor.
- IRC §677 — The grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse.

Income earned by a revocable trust is generally taxable income to the grantor.⁶ Consequently, income earned by the trust is taxed at the grantor's income tax rate. Generally, the grantor can report this income directly on their Form 1040, *U.S. Individual Income Tax Return*, provided the grantor gives their name, social security number (SSN), and address to all the payors of income.⁷ Otherwise, the grantor reports the income on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, under the trust's employer identification number (EIN).⁸

⁴ IRC §§674 and 676.

⁵ See *How Medicaid Planning Trusts Protect Assets and Homes from Estate Recovery*. Dec. 27, 2024. American Council on Aging. [medicaidplanningassistance.org/asset-protection-trusts] Accessed on Aug. 18, 2025.

⁶ IRC §§671 and 677; Treas. Regs. §§1.677(a)-1(b) addresses ownership of the income; 1.671-2(a) requires the owner of the income to report the income on the owner's tax return; and 1.671-2(c) elaborates on 2(a) by saying that the owner is treated as having received the income directly.

⁷ Treas. Reg. §1.671-4(b).

⁸ Instructions for Form 1041 and Instructions for Form SS-4.

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FILING METHODS⁹

There are four optional filing methods that the trustee may choose to report a grantor trust's income and expenses. These methods apply **only** to grantor trusts and not to nongrantor trusts. **Methods 1 and 2 are only available to a grantor trust owned by one grantor** or one person treated as the owner of the trust. For this purpose, a trust owned entirely by a husband and wife is treated as owned by one grantor as long as they file a joint return.

Method 1. The trustee, who may be the grantor, gives the **grantor's** name and tax identification number (TIN) to all the payors of income. As a practical matter, the grantor does this by giving the payor their own SSN and address. This income is then reported on the grantor's individual tax return as if earned directly by the grantor.

If the grantor is not the trustee of the trust, the trustee has additional reporting obligations, as set forth in Treas. Reg. §1.671-4(b)(2)(ii). The trustee must furnish the grantor (or other person treated as the owner of the trust) with a statement detailing the following information.

- The trust's items of income, deduction, and credit for the tax year
- The identification of the payor of each item
- The information necessary to take each item into account in computing the grantor's or other owner's taxable income
- Notice to the grantor (or other owner) that the items of income, deduction, and credit and other information shown on the statement must be included in calculating the taxable income and credits of the grantor (or other person) on the income tax return of the grantor (or other person)

The trustee is not required to obtain an EIN or file a return with the IRS under this method.

Example 1. Carson and Vanessa are married taxpayers who file a joint return. They are co-trustees of the CV Trust. Under the grantor trust rules, they are treated as co-owners of the trust property because the trust is revocable. All the income is taxed to them. The trust received capital gain and dividend income during the tax year, and Carson and Vanessa furnished the payors with Vanessa's SSN and home address. For reporting purposes, Carson and Vanessa simply report the trust's capital gain and dividend income on their joint return.

Method 2. The trustee gives the **trust's** name, address, and EIN to all payors of income during the tax year. After the tax year ends, the trustee issues the proper Form 1099 (i.e., interest, dividends, capital gains, etc.) to the grantor (or other person treated as owner) to report the income or gross proceeds paid to the trust during the tax year. These forms show the trust as the payor and the grantor (or other owner) as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately.

If the grantor is not the trustee of the trust, the trustee has additional reporting obligations, as set forth in Treas. Reg. §1.671-4(b)(2)(iii). The trustee must furnish the grantor (or other person treated as the owner of the trust) with a statement detailing the following information.

- The trust's items of income, deduction, and credit for the tax year
- The information necessary to take the items into account in calculating the grantor's (or other owner's) taxable income
- A notice to the grantor (or other owner) that the items of income, deduction, and credit and other information shown on the statement must be included in calculating the taxable income and credits of the grantor (or other owner) on the income tax return of the grantor (or other owner)

⁹ Instructions for Form 1041; Treas. Reg. §1.671-4(b).

Method 3. This method is available for a trust treated as owned by two or more grantors or other persons. The trustee gives all payors of income during the tax year the name, address, and EIN of the trust. After the tax year ends, the trust files Forms 1099 with the IRS for the trust income that is treated as owned by the grantors or other persons. Each Form 1099 should show the trust as the payor and an individual grantor (or other person treated as owner of the trust) as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately. Each grantor or other owner must be given a copy of the Form 1099 along with a statement containing income and expense information necessary to properly complete their own tax return.

Method 4. This method is available for trusts that have an EIN and Form 1041 is used.¹⁰ If the entire trust is a grantor trust, only the entity information should be entered on the form. No dollar amounts are entered on Form 1041; instead, dollar amounts of income and expenses are shown on an attachment to the form.

In some circumstances, part of a trust can be considered a grantor trust and the other part considered a nongrantor trust.

Note. For further details on the characterization of a trust as a grantor or nongrantor trust, see the instructions for Form 1041.

In addition to the four methods mentioned previously, if only part of the trust is a grantor-type trust, the portion of the income, deductions, etc., that is allocable to the nongrantor part of the trust is reported on Form 1041. The amounts allocable to the grantor are shown only on an attachment to the form. The attachment should include all of the following information.

- The name, identifying number, and address of the person or persons to whom the income is taxable
- The trust income, deductions, and credits that must be reported on the individual returns of the grantor or other person under IRC §§671 through 678
- Any deductions or credits that apply to this income

If the grantor trust has been filing Form 1041 and the trustee wants to change to optional method 1, 2, or 3, the trustee can file a final return for the tax year that immediately precedes the first year for which the trustee reports under an alternative method. On the top of the final return, the trustee must write “Pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust.”¹¹ The “final return” box must also be checked. In subsequent years, the information that had been reported on the Form 1041 is reported on the grantor’s Form 1040.

Note. At the death of the grantor who created the revocable trust, the trust becomes irrevocable. The trust name that refers to “revocable” does not need to be changed.

¹⁰. Instructions for Form 1041.

¹¹. Treas. Reg. §1.671-4(g)(1).

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BASIC EXCLUSION AMOUNT

A central objective of many irrevocable trust strategies is to reduce the value of the grantor's estate by leveraging the basic exclusion amount (BEA), otherwise known as the lifetime gift and estate tax exclusion amount, under IRC §2010. This exclusion allows individuals to transfer a significant amount of wealth during life or at death without incurring federal estate or gift tax.

The BEA functions as a unified credit: it is first applied to the decedent's lifetime taxable gifts, and any remainder is applied to the decedent's taxable estate.¹² In addition, a surviving spouse may use any **deceased spouse unused exclusion (DSUE)** amount, resulting in a combined **applicable exclusion amount (AEA)** under §2010(c)(2).

Note. For years after 2010, the estate of the first spouse to die can elect to “port” the unused BEA of the deceased spouse to the surviving spouse.¹³ The amount of exclusion ported from the deceased spouse's estate is known as the DSUE. In 2025, the BEA is \$13,990,000,¹⁴ and in 2026, it will be \$15 million.¹⁵

For more information on the marital deduction and making a portability election, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

As part of the One Big Beautiful Bill Act (OBBBA), Congress has extended the higher BEA for estate and gift tax purposes. Originally set to sunset at the end of 2025, the BEA, currently \$13.99 million per individual, was scheduled to revert to approximately \$7 million (adjusted for inflation) in 2026.

The new legislation makes the elevated exclusion **permanent**, preserving the \$10 million base (indexed for inflation) established under the Tax Cuts and Jobs Act (TCJA). For 2026, the inflation-adjusted BEA is \$15 million.¹⁶ This change removes the urgency for taxpayers to “use it or lose it” before year-end and provides long-term certainty for estate planning strategies involving lifetime gifts and irrevocable trusts.

Clawback

In anticipation of the TCJA sunset on December 31, 2025, many estate planners encouraged clients to use the elevated exclusion before it was to revert to pre-2018 levels. The IRS addressed concerns about retroactive taxation in **Treas. Reg. §20.2010-1(c)**, which confirmed that completed gifts made under the higher exclusion would not be “clawed back” into the estate if the BEA were lower at the time of death.

The OBBBA does not alter the IRS's existing position on clawback. The new legislation **preserves this protection**, providing continuity for taxpayers who leveraged the elevated exclusion during the TCJA window, and now under the OBBBA.

¹² *Estate and Gift Tax FAQs*. Sep. 13, 2024. IRS. [www.irs.gov/newsroom/estate-and-gift-tax-faqs] Accessed on Apr. 22, 2025.

¹³ *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, PL 111-312.

¹⁴ Rev. Proc. 2024-40, 2024-45 IRB 1100.

¹⁵ *One Big Beautiful Bill Act*, PL 119-45, §11021.

¹⁶ *One Big Beautiful Bill Act*, PL 119-21, §11021.

MARITAL DEDUCTION¹⁷

The purpose of the marital deduction as it exists today is essentially to treat spouses as a single economic unit for purposes of the estate and gift taxes. This allows their combined wealth to be taxed only once. There must, however, be at least one opportunity for it to be taxed, and that usually occurs when “the value of the assets leaves the marital unit.”¹⁸

If property includable in the estate of the first spouse to die satisfies the requirements for the marital deduction, then the value of that property must be treated as qualifying for the marital deduction, unless said property qualifies for one of the exceptions under IRC §2056(b).¹⁹

An unlimited estate tax marital deduction is permitted for property passing to the surviving spouse, assuming the surviving spouse is a U.S. citizen. To permit taxpayers to waive the marital deduction would extend to residents of common law property states an advantage not available to residents of community property states.

Note. For restrictions on the marital deduction for a surviving spouse who is not a U.S. citizen, see §2056(d) and Treas. Reg. §20.2056A-1.

To qualify for the marital deduction, the property must satisfy the following requirements.

1. It must be included in the gross estate of the first spouse to die (i.e., be a deductible interest²⁰).
2. It must pass to the surviving spouse.²¹
3. It must be includable in the estate of the surviving spouse if the property is still owned by that spouse at death.²²

Example 2. Henry and Wanda have total assets of \$30 million, all owned as joint tenants with right of survivorship or tenants by the entirety. **When Henry dies, the BEA is \$15 million.** Because only half the value of the joint property is includable in his gross estate under IRC §2040(b), Henry’s gross estate is \$15 million. The entire \$15 million passes to Wanda as the surviving joint owner. If Wanda still has the property at her death, it is includable in her gross estate. It therefore qualifies for the marital deduction in Henry’s estate, meaning his taxable estate is zero and there is no estate tax. Consequently, none of his BEA is used.

When Wanda dies, her estate is valued at \$30 million. Absent any portability election, only \$15 million can be transferred to her beneficiaries free of estate tax using her BEA. The remaining \$15 million is subject to estate tax unless the executor of Henry’s estate made a portability election under §2010, allowing Wanda to use Henry’s unused exemption amount in addition to her own. Assuming a 40% estate tax rate, Wanda is liable for estate tax of \$6 million ($(\$30 \text{ million taxable estate} - \$15 \text{ million BEA}) \times 40\% \text{ tax rate}$) without a portability election. She owes \$0 estate tax with a portability election ($\$30 \text{ million taxable estate} - \$15 \text{ million Wanda’s BEA} - \$15 \text{ million Henry’s BEA}$). Therefore, the portability election saves Wanda \$6 million in estate tax.

¹⁷ IRC §2056.

¹⁸ *Estate of Anenberg v. Comm’r*, 162 TC 9 (2024).

¹⁹ *Estate of La Sala v. Comm’r*, 71 TC 752 (1979); Rev. Rul. 59-123, 1959-1 CB 248. Section 2056 provides that the taxable estate shall be determined by taking into account the marital deduction.

²⁰ Treas. Reg. §20.2056(a)-2.

²¹ If the surviving spouse is the only non-charitable beneficiary of a charitable remainder trust, then the marital deduction will not apply to the remainder interest received by the surviving spouse, under IRC §2056(b)(8) and Treas. Reg. §20.2056(b)-8(a).

²² IRC §2056; Treas. Reg. §20.2056(a)-1(b).

SPOUSAL PLANNING TRUSTS²³

A married couple may use a joint trust or a marital trust, each a type of continuing trust, which, by definition, does not terminate upon the death of a grantor. Trusts usually terminate when they are no longer funded, have achieved their stated purpose, or have completed administration and distributions to the beneficiaries.²⁴ For a **joint trust**, the married couple transfers their assets to a common trust that usually becomes **irrevocable** upon the death of the **first** spouse. Both spouses serve as co-trustees of the revocable joint trust, while the surviving spouse becomes the sole trustee of either the now-irrevocable joint trust and/or of the revocable survivor's trust, which holds the assets distributed to the surviving spouse from the joint trust. In contrast, a **marital trust** is not funded until the death of the first spouse.

Note. While the terms “marital trust” and “spousal planning trust” are often used interchangeably, they refer to distinct concepts in estate planning. A **marital trust** is a specific type of trust that qualifies for the **marital deduction** under §2056, typically structured to defer estate tax until the death of the surviving spouse. Common examples include qualified terminable interest property (QTIP) trusts, general power of appointment trusts, and estate trusts.

In contrast, **spousal planning trusts** is a broader term encompassing any trust arrangement that benefits a spouse, including a joint revocable trust, survivor's trust, and spousal lifetime access trust (SLAT). These may or may not qualify for the marital deduction, depending on their structure and the citizenship of the surviving spouse.²⁵ The key distinction lies in the **tax treatment and timing of funding**: marital trusts are typically funded at the death of the first spouse and are designed to qualify for the marital deduction, while spousal planning trusts may be funded during life or at death and serve broader planning purposes, such as asset protection, income access, or portability planning.

Upon the death of the first spouse, the assets of a marital trust are divided according to the terms of the trust agreement. These trusts are often structured to provide income to the surviving spouse for life while preserving the principal for distribution to other beneficiaries (such as children from a prior marriage or a charity) upon the surviving spouse's death. A marital trust may also be designed to achieve creditor protection for the surviving spouse, minimize estate and income taxes, and ensure that the ultimate disposition of assets aligns with the deceased spouse's goals. Tax efficiency is often achieved by leveraging the unlimited marital deduction under IRC §2523, the inflation-adjusted BEA under §2010, and the deferral of gift and estate tax on qualifying property under §2056.

The following are brief descriptions of the most common types of these arrangements.

1. **A/B trust (aka bypass trust, credit shelter trust, exemption trust, or family trust).** This estate planning structure uses the classic marital deduction formula to allocate the decedent's applicable exclusion amount to a bypass trust. This trust (also known as a credit shelter trust, exemption trust, or family trust) shelters that portion of the estate from estate tax. Any remaining assets in excess of the exclusion amount are directed either to a separate marital deduction trust or directly to the surviving spouse, qualifying for the marital deduction under §2056. The arrangement allows both spouses to fully use their respective applicable exclusion amounts, although this is rarely necessary under current law due to the high unified credit.

Caution. Individual state regulations may vary.

²³ IRC §2523 and Treas. Reg. §25.2523(a)-1 for gifts between couples during life; IRC §2056 and Treas. Reg. §20.2056(a)-1 for the marital deduction.

²⁴ UTC §410(a) (amended 2010).

²⁵ See IRC §§2056, 2056A, and 2523.

2. **QTIP.** This structure allows the surviving spouse, who must be a U.S. citizen, to receive income from the trust during their lifetime. After the surviving spouse's death, the assets in the trust go to beneficiaries (such as children or other family members) as designated by the first spouse to die. The assets in a QTIP trust qualify for a marital deduction upon the death of the first spouse, which means the value of the assets is not subject to gift and estate taxes when transferred to the surviving spouse pursuant to §2056(b)(7). However, the assets are includable in the surviving spouse's gross estate for estate tax purposes at their death. QTIPs are covered in detail later.

Note. A qualified domestic trust (QDOT) is a specialized trust designed to help non-citizen spouses benefit from the marital estate tax deduction when inheriting assets from their U.S. citizen spouse. A QDOT can qualify for the marital deduction to provide the deferred estate and tax benefits of a QTIP to a non-citizen spouse. For more information on QDOTs, see Treas. Reg. §20.2056A-2, IRC §2056A, and the instructions for Form 706-QDT, *U.S. Estate Tax Return for Qualified Domestic Trusts*.

3. **Marital deduction trust.** A marital deduction trust allows the entire estate of the deceased spouse to be transferred to the surviving spouse without incurring estate taxes at the time of transfer.²⁶ However, the surviving spouse will generally pay estate taxes when they pass away, as the assets are included in their estate. An alternative to this arrangement is for the surviving spouse to receive a **general power of appointment** over the assets under IRC §2041. A general power of appointment does not limit the surviving spouse to an ascertainable standard or restrict the surviving spouse's ability to invade trust principal. Under §2041, assets over which a decedent (in this case, the surviving spouse) holds a general power of appointment are included in the decedent's gross estate.²⁷

Whether a marital trust is revocable or irrevocable depends on the specific type of trust and how it is set up.

- a. **Revocable marital trust.** Depending upon the terms of the trust, a joint or marital trust can be revocable until the death of one or both spouses. A **survivor's trust** is a revocable sub-trust created when the first grantor of a joint trust dies, and it holds the surviving spouse's share of the assets from the original joint trust.
- b. **Irrevocable marital trust.** In many cases, marital trusts are irrevocable, meaning once the trust is established, it cannot be changed or revoked by the grantor. This is typical for some types of marital trusts, like those set up to take full advantage of estate tax exemptions, where the trust becomes a permanent part of the estate plan.²⁸

Note. A QTIP trust is irrevocable; however, it can be drafted as part of a revocable trust oftentimes alongside a credit shelter or family trust, thereby allowing the trust maker to make changes during their lifetime. Upon the trust maker's death, the assets are typically transferred into the QTIP trust if the conditions for a QTIP election are met (e.g., providing income to the surviving spouse for life, with the remainder going to other beneficiaries). QTIP trusts are generally **irrevocable** after the death of the first spouse because the terms are set to provide income to the surviving spouse and then transfer the remaining assets to the designated beneficiaries.

²⁶ IRC §2056 and Treas. Reg. §20.2056(b)-5.

²⁷ The Ninth Circuit found in *Davis v. Comm'r*, 394 F.3d 1294, 1301 (9th Cir. 2005), that "Sections 2041 and 2056 are distinct provisions of the Internal Revenue Code. These sections do not cross-reference each other, and the requirements under section 2056 are different than those under section 2041."

²⁸ In jurisdictions that have adopted the Uniform Trust Code (UTC, amended in 2010), irrevocable trusts may be modified by non-judicial settlement agreements (UTC §111), or by court proceeding for a noncharitable irrevocable trust (UTC §411(b)) after the grantor's death. In all jurisdictions, statutes or case law may give a trustee or beneficiary standing to seek relief from a court for a trust that has become uneconomical to administer, or reformation of the trust agreement is desired.

FAMILY TRUSTS

A **family trust** is a trust that may be revocable or irrevocable, that is created to manage and distribute a family's assets to designated beneficiaries, usually a spouse, children, or grandchildren. It may be funded during the settlor's life (inter vivos), or via the settlor's will (testamentary).²⁹ It may become irrevocable upon the grantor's death and is often used in conjunction with estate tax planning strategies such as bypass or credit shelter trusts.

Although the traditional use of a family trust (also known as a bypass or credit shelter trust) was to preserve the decedent's exclusion amount before portability was enacted in 2010, these trusts remain valuable tools for asset protection, control over distribution, and planning for blended families. They can also help preserve appreciation outside the surviving spouse's estate and provide generation-skipping transfer (GST) tax planning opportunities.

For family trusts settled by married couples:

- **Revocable family trusts** allow changes to, or revocation of, the trust instrument usually until the first spouse dies; whereas
- **Irrevocable family trusts** require planning with respect to the amount of gifting by each spouse to the trust under Treas. Reg. §25.2511-2(g).³⁰

Note. Once a revocable family trust becomes irrevocable (typically upon the death of the first spouse), it may be required to file Form 1041 and issue to beneficiaries a Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*

In estate planning with respect to minimizing the amount of estate tax liability, the family trust (i.e., "bypass" or "credit shelter" trust) usually exhausts the decedent's lifetime gift and estate tax exemption under §2010, and the presently unlimited marital deduction may be used to pass assets that qualify to the surviving spouse. Thus, a family trust offers the ability to customize which beneficiaries receive which assets, and under which conditions.

Whether a trust may hold the settlor's interest in a business (e.g., closely held corporation, family limited partnership, limited liability company), depends upon the following.

- Whether the corporate governance documents (e.g., corporation bylaws, partnership agreement, operating agreement), which form the contract between the equity owners of that business:
 - ♦ Permit ownership of shares or an interest by a trust,
 - ♦ Specify conditions under which a trust may hold or must surrender shares or an interest, or
 - ♦ Require a deceased party's shares or interest be transferred to a voting trust³¹ for disposition or administration by the entity
- The requirements under §1361 for a trust to make a timely QSST and electing small business trust (ESBT), or to pursue timely relief under IRC §1362 for an inadvertent termination of an S corporation election by transfer of an ownership interest to or between trusts³²
- Whether the terms and use of a trust to hold only the settlor's interest in a business, presumably to perpetuate family control over the business, violate the trustee's duty to diversify under the UPIA and duty to benefit beneficiaries (by diversifying) under the Uniform Trust Code (UTC).³³

²⁹ *Family Trust*. Legal Dictionary. May 24, 2015. [legaldictionary.net/family-trust] Accessed on Jun. 24, 2025.

³⁰ See Ltr. Rul. 201507008 (Feb. 13, 2015) for an analysis of an incomplete gift by a trustor to an irrevocable trust.

³¹ IRC §1361(c)(2)(A)(iv).

³² Ltr. Rul. 202407005 (Feb. 16, 2024).

³³ *Holding Family Business Interests in Trust*. Leibell, David Thayne, Daniels, Daniel L., and Mejia, Paulina. NAEPC Journal. Mar. 2012. [www.naepcjournal.org/journal/issue13d.pdf] Accessed on Jun. 24, 2025.

QUALIFIED TERMINABLE INTEREST PROPERTY

A **terminable interest** in property is an interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency.³⁴ While QTIPs themselves are irrevocable, a trust that contains a QTIP provision allows a decedent's personal representative or a donor to elect to treat the trust property as qualifying for the marital deduction, even though the surviving spouse has received a terminable interest in the property.³⁵ This election enables the trust to defer estate tax on the property until the surviving spouse's death.

The value of the QTIP is includable in the estate of the surviving spouse even though it is otherwise a terminable interest that would not be subject to inclusion under any other provision of the estate tax.³⁶ The value of the property at the death of the surviving spouse is included in their taxable estate rather than the value at the time the QTIP election is made. As a consequence of QTIP assets being included in the estate of the surviving spouse, such property qualifies for the fair market value (FMV) basis adjustment at the time of the surviving spouse's death.³⁷

Note. Although QTIP assets are generally intended to pass automatically to successor beneficiaries, the surviving spouse may be granted either a general or limited power of appointment to redirect the remainder at their death. In some cases, advanced planning techniques such as splitting the QTIP trust before the surviving spouse gifts any portion of their income interest, may be used to achieve specific tax objectives, though such strategies can have income tax consequences. Additionally, under IRC §2207A, the estate of the surviving spouse is authorized to recover from the remainder beneficiaries any estate tax attributable to the inclusion of the QTIP property in the surviving spouse's estate.

Taxpayers must meet **all** the following requirements to make a valid QTIP election.³⁸

1. The property must be included in the gross estate of the deceased spouse and must pass from the decedent in the same manner as for the marital deduction.
2. The surviving spouse must be entitled to a qualifying income interest for life. This means that all income must be distributable at least annually only to the surviving spouse.
3. No other beneficiary may have any rights in the property during the surviving spouse's life, including the power to appoint any part of the property to any person other than the surviving spouse. Any principal distributions must, under the terms of the instrument, be made only to the surviving spouse and to no one else.
4. An irrevocable election must be made to treat the property as QTIP.

QTIP ELECTION

The executor of the decedent's estate makes the QTIP election on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. The executor lists the QTIP assets on Schedule M (Form 706), *Bequests, etc., to Surviving Spouse*, and reports its value.³⁹ The QTIP election must be made on the estate tax return that is either:⁴⁰

1. Filed on time (within 9 months after the date of the decedent's death)⁴¹, including any extensions (automatic 6 months)⁴², or
2. If the return is late, then the first one the executor files after the deadline.

³⁴ Treas. Reg. §20.2056(b)-1(b).

³⁵ Treas. Reg. §20.2056(b)-7.

³⁶ IRC §2044(b)(1)(A).

³⁷ IRC §1014.

³⁸ IRC §2056(b)(7).

³⁹ Instructions for Form 706.

⁴⁰ Treas. Reg. §20.2056(b)-7(b)(4)(i); Ltr. Rul. 202517010 (Apr. 25, 2025).

⁴¹ Instructions for Form 706.

⁴² Ibid.

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A **protective QTIP election** can be made if, when the estate return is filed, there is a bona fide issue concerning the includability of an asset in the decedent's gross estate or the amount or nature of the property to which the surviving spouse is entitled.⁴³ For a lifetime QTIP, which must benefit a spouse who is a U.S. citizen, Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, is used to report the gifts.

The QTIP election can be made with respect to all assets of a trust or a partial interest if it relates to a defined fraction or percentage of the entire trust in assets, or by means of a formula election.⁴⁴ For example, a taxpayer could use a formula to treat as QTIP only the trust assets necessary (after taking into account the decedent's applicable exclusion amount) to reduce the decedent's estate tax to zero.

Note. A QTIP election can permit spouses who want to use their separate assets to benefit the surviving spouse but ultimately want those separate assets to go to their children. This is permitted if the total value of the assets is in excess of the first spouse's BEA. Even if estate tax is not an issue, an irrevocable trust may be used to direct income (and possibly principal) for distribution to the surviving spouse with the remainder to the deceased spouse's children.

Example 3. Oscar and Angela have each been married before and each has children from their prior marriages. They have no children together. Angela dies in 2025 with a gross estate of \$14.49 million when the estate and gift tax exclusion was \$13.99 million. To avoid estate tax completely at her death, she needs a \$500,000 marital deduction. Angela's wishes are to leave the entire \$14.49 million in trust to pay the income to Oscar for life and, upon his death, distribute the remaining trust assets among her children.

Angela's personal representative qualified the \$500,000 of Angela's estate for the marital deduction by making a QTIP election for that amount, with the remainder \$13.99 million covered by the exclusion amount.

LAND TRUSTS

Land trusts are generally grantor trusts created for the singular purpose of holding title to real estate property.⁴⁵ A grantor appoints a trustee to manage the trust, but typically limits the trustee's control, allowing the grantor to maintain the rights and responsibilities of owning the property. The beneficiary of the trust is usually the grantor, with successor beneficiaries identified in the event the grantor is no longer living. However, as with other grantor trusts, there is flexibility in naming beneficiaries, which may include relatives, other parties, or non-profit organizations.

The primary benefit of and reason for establishing a land trust is to make ownership of real estate property private.⁴⁶ In doing so, land trusts may offer a form of **asset protection** against creditors, lawsuits, and other claims.⁴⁷ The anonymity of the owner makes it difficult for creditors, plaintiffs, or claimants to seize or demand possession of the property.

⁴³ Ibid.

⁴⁴ Treas. Reg. §20.2056(b)-7(b)(2)(i).

⁴⁵ *Land trust*. Mar. 2022. Cornell Law School. [www.law.cornell.edu/wex/land_trust] Accessed on Jun. 25, 2025.

⁴⁶ *Abusive trust tax evasion schemes - Special types of trusts*. Oct. 9, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/abusive-trust-tax-evasion-schemes-special-types-of-trusts] Accessed on Jun. 25, 2025.

⁴⁷ *What Is a Land Trust?* Sep. 3, 2024. Western & Southern Financial Group. [www.westernsouthern.com/retirement/land-trust] Accessed on Nov. 22, 2024.

Provisions for land trusts do not exist in either the Code or treasury regulations. Rather, land trust provisions are contained in statutes of a handful of states, including Illinois,⁴⁸ Indiana,⁴⁹ South Dakota,⁵⁰ Florida,⁵¹ Virginia,⁵² and Hawaii.⁵³ While some states do not have statutory law explicitly codifying the legality of land trusts, the lawful purpose of such trusts are supported by case law.⁵⁴ Even if the legality and purpose of land trusts are not addressed by statute or case law, the creation of trusts to hold real estate is still commonplace in all 50 states.

For federal income tax purposes, the IRS ruled that a land trust is not a trust under Treas. Reg. §301.7701-4(a), as the sole responsibility of a trustee of a land trust is to hold and transfer title as directed by the grantor.⁵⁵

Consequently, for filing purposes, income activity from a land trust is generally reported directly on the grantor's income tax return.⁵⁶

Note. If provisions for a land trust are contained within or as part of a simple, complex, or other grantor trust, the filing requirements of such a trust must adhere to the type of trust and the terms of the trust as described in the trust document.⁵⁷

Example 4. In 2025, Susan purchases farmland. Before finalizing the sale, Susan is concerned about privacy regarding her ownership of the farmland. After further consultation of the matter, Susan creates a land trust to which she titles the purchased farmland. During 2025, Susan earns \$12,000 of income from growing field crops on the farmland in the land trust. Susan reports the \$12,000 of income on her Schedule F, *Profit or Loss From Farming*, flowing through to her 2025 Form 1040, and pays self-employment (SE) tax.

Note. Nonprofit organizations under IRC §501(c)(3) operating for the purpose of preserving and conserving land may be land trusts as an entity. Taxpayers donating permanent **conservation easements** to such land trusts can receive various tax benefits, including charitable contribution deductions from taxable income, estate tax benefits at death from the exclusion of the value of the easement from the taxpayer's estate, and a possible reduction in property taxes (depending on applicable state law). For more information on conservation easements, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Agricultural Issues and Rural Investments. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

⁴⁸. 765 ILCS 405/1.

⁴⁹. IC 30-4-2-1.

⁵⁰. South Dakota Codified Law 55-1A-9.

⁵¹. Florida Statute 689.071.

⁵². Code of Virginia §55.1-117.

⁵³. Hawaii Revised Statutes Chapter 558.

⁵⁴. *Validity of Illinois Land Trusts*. Aug. 2, 1993. The American College of Trust and Estate Counsel. [actec.matrixdev.net/wp-content/uploads/2023/08/Study15.pdf] Accessed on Dec. 11, 2024.

⁵⁵. Rev. Rul. 92-105, 1992-2 CB 204.

⁵⁶. Treas. Reg. §1.6012-3(a)(9) refers to IRC §167 and Treas. Reg. §1.671-4 for trusts treated as owned by the grantor (i.e., a grantor trust); Treas. Reg. §1.671-4(a) states that, for grantor trusts (i.e., under Treas. Regs. §§1.671-4(b)(6)(v) and (7)) states that the income “is treated as owned by the grantor” and does not appear on the Form 1041. Form 1041 Instructions for 2024 under “Grantor Type Trusts” states in part, “In general, a grantor trust is ignored for income tax purposes and all of the income, deductions, etc., are treated as belonging directly to the grantor.”

⁵⁷. *Abusive trust tax evasion schemes - Special types of trusts*. Oct. 9, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/abusive-trust-tax-evasion-schemes-special-types-of-trusts] Accessed on Dec. 11, 2024.

SPECIAL NEEDS TRUST⁵⁸

Trusts are frequently used to help provide benefits for individuals with special needs due to a disability. The beneficiaries of these trusts often are incapable of caring for themselves, and planning for their care can be difficult once the caregiver is gone. To meet these needs, assets can be transferred to a trust where they can be properly managed and used for the benefit of the individual. For example, parents may create such a trust in order to ensure that a child is provided for after the parents die.

A type of trust that is used increasingly to meet these demands is the so-called **special needs trust (SNT)**. The SNT is often referred to as a **supplemental needs trust**. It is designed primarily to provide benefits to special needs individuals in such a way that the beneficiary will not lose any governmental benefits that otherwise are available.

Special needs individuals are entitled to a variety of benefits provided by federal, state, and local governments. For example, a major benefit is supplemental security income (SSI). SSI makes monthly payments to people with low income and limited resources who are 65 or older, blind, or disabled. A child under age 18 can qualify if they meet the Social Security Administration's definition of disability for children, and if their income and resources fall within the eligibility limits. The amount of the SSI payment is different from one state to another because some states add to the federal SSI payment.

Many of the benefits available to special needs individuals are based upon need and are often subject to restrictions. In addition, SSI must be spent on food, clothing, and shelter expenses. This is where a SNT can be extremely beneficial. In a properly drafted SNT, the assets are not counted for purposes of qualification for certain governmental benefits. For example, an unlimited amount of assets could be held by a SNT. Moreover, they could be funded with life insurance. In addition, SNT assets can be used to pay for items that cannot be purchased with SSI such as additional care, a motorized wheelchair, vacations, grooming supplies, video games, cable television, Internet access, legal fees, and more. If Medicaid does not pay for certain medical care or treatment, the trust can step in and provide these. Typically, SNTs are designed so that none of the assets can be used for food, clothing, and shelter, or services provided by government programs. If trust funds are available for such purposes, the governmental benefits received by the disabled person could be lost.

SNTs normally are established in one of two ways. The trust could be created by a third party (e.g., the parent of a disabled child). Alternatively, the SNT could be established by the disabled individual with their own funds. This might occur when there is a recovery from a lawsuit or the disabled individual is a beneficiary of an estate or an insurance policy. **The type of SNT affects the tax consequences.** An SNT created by a third party is normally treated as a separate taxable entity. In contrast, an SNT created by the disabled individual with their own funds is usually a grantor trust.

⁵⁸ *Program Operations Manual System (POMS) SI 01120.203*. May 2024. SSA. [secure.ssa.gov/poms.nsf/lnx/0501120203] Accessed on Aug. 19, 2025.

TAX TREATMENT⁵⁹

For income tax purposes, the SNT is generally treated like any other irrevocable trust. It is a separate taxable entity with its own federal identification number. Its TIN is neither the grantor's nor the beneficiary's SSN.

An SNT may qualify as a **qualified disability trust** for tax purposes if:

1. It is created solely for those under 65 years of age who are disabled,⁶⁰ and
2. All beneficiaries of the trust are certified as disabled for some part of the tax year within the meaning of 42 USC §1382c(a)(3) by the commissioner of Social Security.

Qualified disability trusts generally are taxed like other irrevocable trusts. However, such trusts are entitled to an exemption of \$4,150 adjusted for inflation.⁶¹ In 2025, the amount is \$5,100.⁶² Normally, the exemption is \$100 for complex trusts and \$300 for simple trusts. Distributions are not subject to the kiddie tax.

IRREVOCABLE TRUSTS

A trust is **irrevocable** if the grantor or a nonadverse party cannot alter or cancel trust provisions in whole or in part (such as changing the beneficiaries of the trust or terminating the trust and reacquiring the property in the trust). Irrevocable trusts can play an important role in estate planning to preserve the grantor's intentions and as a tool for tax planning.

Irrevocable trust tax planning strategies often seek to retain some of the flexibility found in a revocable grantor trust under IRC §§671-679 during the grantor's lifetime. However, these strategies typically rely on specific Code provisions that govern either the types of assets held in the trust or the designation of beneficiaries to achieve tax savings.

For example, an intentionally defective grantor trust (IDGT) may include a power under §675(4)(C) that allows the grantor to substitute trust property with assets of equivalent value. This enables the grantor to exchange a low-basis asset initially contributed to the trust for an asset with a relatively higher basis before death, allowing the low-basis asset to receive a step up in basis under IRC §1014, without triggering income tax consequences.⁶³ IDGTs are covered in detail later.



Practitioner Planning Tip

When taxpayers gift assets into an irrevocable trust, the trust's basis in the assets is a carryover basis.⁶⁴ This moves any future appreciation out of the settlor's estate. However, it also means that the beneficiaries of the trust will not receive a stepped-up basis.

⁵⁹ IRC §642(b)(2)(C).

⁶⁰ See 42 USC §1396p(c)(2)(B)(iv) for definition of disabled.

⁶¹ IRC §642(b)(2)(C)(iii).

⁶² Instructions for Form 1041.

⁶³ *The grantor trust rules: An exploited mismatch*, Nov. 1, 2021. Hubers, Jesse. The Tax Adviser. [www.thetaxadviser.com/issues/2021/nov/grantor-trust-rules-exploited-mismatch] Accessed on Apr. 22, 2025.

⁶⁴ Rev. Rul. 2023-2, 2023-10 IRB 658.

SIMPLE VERSUS COMPLEX TRUSTS

The nature of reporting income tax from an irrevocable trust largely depends on whether it is a **simple trust** or a **complex trust**. A trust may be a simple trust in one year, and a complex trust in another year. The distinction between simple and complex trusts is determined by the distributions made by the trust. A simple trust meets **all three** of the following requirements.⁶⁵

1. The trust instrument requires that all income be distributed currently for the tax year (regardless of whether the current income distributions are actually made).
2. The trust instrument must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes.
3. The trust does not make distributions of principal (corpus) during the year.

A trust that qualifies as a simple trust for the tax year is allowed to deduct from gross income any income amounts required to be distributed to beneficiaries regardless of whether or when income is distributed.⁶⁶ Each beneficiary of the trust receives a Schedule K-1 (Form 1041) reporting their distributive share of income and expenses to report on their Form 1040 for the taxable year.⁶⁷ Consequently, this distributive income is taxed at the beneficiary level subject to the individual income tax bracket of the beneficiary.

Example 5. During her lifetime, Miranda placed her assets into the “Miranda Revocable Trust.” When she died in 2023, the trust became irrevocable. The trust document does not require any amount to be paid, permanently set aside, or used for charitable purposes. However, it does require that the income be distributed annually. The following excerpt appears in the trust document.

The Trustee shall pay to my husband, Darren, the net income from the trust at least annually. In addition, the Trustee may distribute to my husband so much or all the principal of the trust as the Trustee in the Trustee’s sole discretion determines is needed for his health, support, maintenance, and education.

In 2025, the trust earns \$4,000 in interest income. It does not pay any expenses in 2025 and does not make any distributions. The trust is treated as a simple trust for tax purposes in 2025. Even though no distributions are made, the trust receives a distribution deduction on its Form 1041, and Darren includes the \$4,000 as income on his 2025 Form 1040.

A complex trust is any trust that does not qualify as a simple trust.⁶⁸ As such, complex trusts may have undistributed income in a tax year that was not required to be distributed to beneficiaries of the trust. Complex trusts do not receive an income distribution deduction for undistributed income which is taxed at the trust level subject to the trust’s tax bracket.

⁶⁵ Treas. Reg. §1.651(a)-1; Instructions for Form 1041.

⁶⁶ IRC §§651(a) and 661; Treas. Reg. §1.651(a)(2).

⁶⁷ Instructions for Schedule K-1 (Form 1041).

⁶⁸ Treas. Reg. §1.643(b)-1.



Practitioner Planning Tip

The tax brackets for trusts and estates are more compressed than tax brackets for individuals. Generally, lower levels of income are taxed at a higher rate at the trust level compared to the individual level. Strictly from an income tax perspective, it is generally more favorable for complex trusts to distribute income to beneficiaries who are individuals to be subject to the individual income tax rates. Practitioners should consider relaying this information to trustees of complex trust clients when discussing tax planning strategies.

Example 6. Use the same facts as **Example 5**, except that the excerpt from the trust document provides that the Trustee may distribute income annually from the trust to Darren at the Trustee's discretion. The trust is therefore a complex trust. In 2025, the Trustee distributes \$3,000 to Darren of the \$4,000 of interest income earned by the trust. The trust deducts \$3,000 of its distributable net income on its 2025 Form 1041. The remaining \$1,000 of taxable income, disregarding any exemptions (\$4,000 interest income – \$3,000 income distribution deduction) is taxable to the trust. Darren receives a Schedule K-1 (Form 1041) from the trust reporting the \$3,000 of interest income distributed to him for inclusion on his 2025 Form 1040.

Example 7. Use the same facts as **Example 6**, except that the trust distributes \$5,000 to Darren. Darren's Schedule K-1 (Form 1041) reports interest income of \$4,000, reflecting the fact that the trust distributed 100% of the \$4,000 of interest income to Darren. The other \$1,000 distributed to Darren would be from the trust's corpus (aka principal) and would not be subject to income tax.

COMMONLY USED PROVISIONS IN IRREVOCABLE TRUSTS

The name “irrevocable” trust suggests that the terms of the trust may not be changed. For example, an irrevocable life insurance trust (ILIT) cannot be amended once established (ILITs are covered in detail later.) Some irrevocable trusts may be modified with court approval or through non-judicial settlement agreements, generally if the modifications do not defeat the purpose of the trust and if all beneficiaries agree to the changes. Irrevocable trusts usually have the purpose of avoiding any retained interests or powers in the grantor that would result in the inclusion of the trust's assets in the grantor's gross estate upon the grantor's death.

Beneficiaries of irrevocable trusts can be granted different types of powers of appointment, which are either general or limited in scope. A **general power of appointment** allows the holder of the power to appoint income or assets (i.e., the holder's interest in the trust) to anyone, including the holder of the power, the holder's creditors, or the holder's estate. A **limited power of appointment** allows the holder to appoint income or assets to anyone **except** the holder, the holder's creditors, or the holder's estate. Powers of appointment can be granted either in a will (“testamentary”), or within the trust agreement itself. Two types of powers of appointment that are commonly used pertain to Crummey powers and to the “five and five” power.

Crummey Power

A **Crummey power** allows contributions to an irrevocable trust to qualify for the annual gift tax exclusion (\$19,000 for tax year 2025) by the trust giving the beneficiaries an unrestricted right to withdraw the annual contribution for a specified period of time.⁶⁹ The Crummey power has become a widely recognized estate planning tool, with its benefits increasing as it leverages the annual exclusion to maximize the amount of gift-tax-free transfers to an irrevocable trust.

⁶⁹ IRC §2503; *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).

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The IRS did not acquiesce to the *Crummey* decision, which addressed whether a minor child beneficiary had a present or future interest under IRC §2503(b) in a gift made to an irrevocable trust.⁷⁰ However, the IRS can still argue that the beneficiary's power to withdraw is illusory, especially if the timeframe between the gift being made and the deadline for withdrawal is very short,⁷¹ or if the beneficiary holds only a remote interest or contingent interest in the trust corpus.⁷²

An ongoing issue is whether beneficiaries must receive written notice for the contribution to the irrevocable trust to be considered a present interest. The *Crummey* decision did not address the notice requirement. The IRS has maintained that a beneficiary must receive notice⁷³; however, the U.S. Tax Court has not sustained the Service's position.⁷⁴

Example 8. Gerald creates an irrevocable trust for the benefit of his two children. Gerald's wife, Hilda, serves as the trustee. Gerald contributes \$30,000 annually to the trust as a gift. Immediately after each annual contribution, Hilda notifies her two children (or their legal guardians) that they have 30 days to withdraw the \$30,000 contribution from the trust. If the children do not withdraw the \$30,000 contribution within the 30-day period, the withdrawal right lapses, and the \$30,000 contribution is added to the trust's principal. Therefore, the \$30,000 transfer qualifies for the annual gift tax exclusion.

5 and 5 Power

A 5 and 5 power, in accordance with IRC §2514(e), is a common power of appointment included in many trusts allowing for beneficiary withdrawals from the trust for the greater of \$5,000 or 5% of the entire trust's FMV each year.⁷⁵ Under §2041(b)(2), the lapse of the power each year is considered a release by the person holding the power of appointment. An ordering rule can be applied when a beneficiary holds multiple withdrawal rights in a given year. This rule allows the trust to treat the lapses as occurring in a specific order — typically applying the lapse to the oldest withdrawal right first, to avoid exceeding the annual 5 and 5 safe harbor limit under §2514(e).

TRANSFERS WITHIN THREE YEARS OF DEATH⁷⁶

Under IRC §2035(a), certain transfers made within three years of a decedent's death are included in the decedent's gross estate for estate tax purposes. This 3-year rule applies when the decedent transferred an interest in property or relinquished a power that would have caused estate inclusion under IRC §§2036, 2037, 2038, or 2042 had the interest or power been retained until death.

Common examples include the following.

- Transfers of life insurance policies⁷⁷
- Transfers involving retained life interests⁷⁸
- Relinquishment of powers to revoke or amend a trust⁷⁹

This rule is particularly relevant when evaluating the estate tax consequences of funding irrevocable trusts, such as an ILIT or qualified personal residence trust (QPRT), shortly before death.

⁷⁰ Rev. Rul. 73-405, 1973-2 CB 321.

⁷¹ GCM 38006 (Jul. 10, 1979).

⁷² TAM 9045002 (Nov. 9, 1990); TAM 9141008 (Oct. 11, 1991). Both TAMs concluded that the annual gift tax exclusion amount was available only for gifts to the primary beneficiaries, the settlor's children, not to the grandchildren.

⁷³ Rev. Rul. 81-7, 1981-1 CB 474.

⁷⁴ See *Estate of Turner v. Comm'r*, TC Memo 2011-209 (Aug. 30, 2011); *Holland v. Comm'r*, TC Memo 1997-302 (Jun. 30, 1997).

⁷⁵ *Using a Crummey Trust to Preserve Gift Tax Exclusion*. Ellentuck, Albert B. Nov. 1, 2014. AICPA & CIMA. [www.thetaxadviser.com/issues/2014/nov/case-study-nov2014.html] Accessed on May 3, 2025.

⁷⁶ IRC §2035(a).

⁷⁷ See IRC §2042.

⁷⁸ IRC §2036.

⁷⁹ *Ibid*.

IRREVOCABLE LIFE INSURANCE TRUST

Proceeds from a life insurance policy are usually excluded from the recipient's gross income under IRC §61(a)(9). If the deceased policyholder retained any **incidents of ownership** in the policy, such as a reversionary interest, or if the policy is payable to the deceased policyholder's estate, then the proceeds of the life insurance policy are generally included in the deceased policyholder's taxable estate.⁸⁰ Additionally, if the owner of a life insurance policy gifts a policy to another person within three years of the policy owner's death, the death benefit of that policy is included in the deceased policy owner's taxable estate.⁸¹

One strategy to exclude life insurance proceeds from a taxable estate is the use of ILIT. To fund an ILIT, the grantor must use their lifetime estate and gift tax exemption. Funding an ILIT with cash (versus existing life insurance policies) and having the trustee of the ILIT purchase the life insurance policy(s) can avoid the 3-year rule under §2035(a). The grantor should not serve as trustee of the ILIT. Also, mandatory (versus discretionary) provisions in the ILIT agreement, such as requiring the ILIT to pay the grantor's estate taxes with the insurance proceeds, can pull the proceeds back into the deceased grantor's taxable estate.

An ILIT is both owner and beneficiary of one or more life insurance policies. After the death of the insured, the ILIT receives the life insurance proceeds, and administers the trust for one or more beneficiaries.⁸²

Example 9. Nadine is 47 years old and in good health with a successful career as an interior designer in New York. Nadine's only major asset is her business. She has two adult children and no spouse. Her daughter, Candice, works full time with Nadine in the interior design business, and has expressed an interest in continuing the business for the long-term. Nadine's son, Jackson, is not involved in the business and plans to begin a career in journalism after his graduation.

Nadine has a succession plan in place to pass on the interior design business to her daughter and decides to establish an ILIT to equalize her treatment of both children. She funds the ILIT with sufficient cash to obtain an amount of insurance she believes will equal the value of the business. For the face amount of the insurance policy, she can use an estimated value for the business based on her life expectancy or other amount she feels is appropriate. She is still young and healthy enough for life insurance to be cost effective for this purpose. The ILIT will own the life insurance policy and will also be the beneficiary of the policy.

Nadine names her sister, Lucinda, as trustee of the ILIT. At Nadine's death, Candice will receive the business and the ILIT will receive the life insurance proceeds. The ILIT agreement contains a formula that gives Candace 10% and Jackson 90% of the life insurance proceeds if the business still exists at Nadine's death. Otherwise, if the business no longer exists at Nadine's death, Candice and Jackson will each receive half of the life insurance proceeds from the ILIT. Thus, Nadine uses an ILIT as an equalization tool to treat both children on more equal terms.

QUALIFIED PERSONAL RESIDENCE TRUST⁸³

A QPRT is an irrevocable trust into which a grantor transfers their principal residence to the trust while retaining the right to use the property as a principal residence for a specified term. At the end of the term, the trust property is distributed to the beneficiaries of the trust and is excluded from the grantor's taxable estate for estate tax purposes. Any appreciation in value of the trust property is thus excluded from the grantor's gross estate.

⁸⁰ IRC §2042.

⁸¹ IRC §2035(a).

⁸² *Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique (Part 1)*. Abrahams, Adam. 2013. American Bar Association. [www.americanbar.org/content/dam/aba/publishing/aba_tax_times/14win/7-abrahams.pdf] Accessed on May 3, 2025.

⁸³ Treas. Reg. §25.2702-5(c).

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When creating a QPRT, the grantor must calculate the value of the remainder interest in the property that they gift to the QPRT. This gift is reported on the grantor's annual gift tax return, Form 709.

Note. The remainder interest value is likely to exceed the annual gift tax exemption in the year the grantor establishes the QPRT. Consequently, the grantor must allocate part of their lifetime estate and gift tax exclusion against the transfer of the interest. With the value of the remainder interest only comprising a fraction of the total value of the property, the grantor is able to save more of their exclusion for allocation to future transfers.

The formula to calculate the value of the taxable remainder comprises the following.

- The IRC §7520 rate at the time of the gift⁸⁴
- The grantor's age at the time of the gift
- The term of the grantor's retained use of the property

Caution. A higher interest rate and older grantor age will result in a lower remainder interest value. Thus, taxpayers receive better mathematical benefits by waiting until later in their life to create and fund QPRTs. However, in doing so, there is a greater likelihood the taxpayer will pass away before the end of the QPRT term, where the entire value of the property is included the grantor's taxable estate. This negates the benefit of the QPRT strategy.

An individual may create only two QPRTs during their lifetime. Notably, separate trusts holding fractional interests in the same residence are considered one trust. Therefore, a married couple could each have three residences in trust, consisting of two for separately owned properties and another holding a fractional interest in a jointly owned property.

To qualify as a QPRT, a trust must satisfy detailed requirements set forth in the Treasury regulations. These requirements must be included in the trust document and remain in effect throughout the trust term. If not, the trust will be disqualified. Key requirements include the following.

- **Prohibition on sale back to the grantor.** The trust must prohibit the sale of the residence back to the grantor, the grantor's spouse, or any entity controlled by the grantor or the grantor's spouse.
- **Exception for reversionary interests.** A trust will **not** be deemed to have made a prohibited sale if it includes a reversionary interest, or a testamentary power of disposition in the event the grantor dies before the trust term ends.
- **Permitted remainder beneficiaries.** At the end of the trust term, the residence may be distributed to the grantor, the grantor's spouse, or a grantor trust.
- **Post-term rental.** After the trust term ends, the grantor may rent the residence from the trust, provided the rent reflects FMV.

⁸⁴ Current and prior IRC §7520 rates can be found at *Section 7520 interest rates*. Nov. 18, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates] Accessed on May 3, 2025.

During the initial QPRT term, the QPRT is usually considered to be a grantor trust under §677(a). The grantor may contribute cash to the QPRT for the trustee to pay for expenses such as property taxes, repairs, and improvements made within six months of the addition of the cash to the separate account holding QPRT cash for expenses.⁸⁵ Excess cash must be distributed.⁸⁶ After the initial QPRT term ends, the terms of the QPRT agreement determine whether the QPRT continues as a grantor trust, in which case the grantor is paying market rate rent to themselves, or as a non-grantor trust.

Additionally, no distributions can be made to anyone other than the grantor during the trust's term. All income must be distributed at least annually. Except for some cash, the trust is allowed to hold only one residence that must be used as a principal residence by the term holder. Funds for improvements to the residence may be added to the trust, providing the residence continues to be used as a personal residence. If the residence is damaged or destroyed and becomes unusable, the trust ceases to be a QPRT two years after the date of damage, unless the term ends earlier, or the residence is repaired or replaced. No commutation (i.e., converted to a lump sum) is allowed. Any cessation of use as a personal residence ends the trust. If the trust or any of the trust assets cease to be a QPRT, those assets must be distributed to the term holder or meet the requirements of a grantor-retained annuity trust (GRAT) for the remainder of the term within 30 days.

Example 10. In January 2025, Jeremy is 62 years old and owns a primary residence valued at \$2.5 million and a vacation property valued at \$1 million. Assuming an appreciation rate of 5% per year, both properties will be worth \$5.7 million after 10 years $((\$2.5 \text{ million primary residence} + \$1 \text{ million vacation property}) \times (5\% \text{ appreciation rate} + 1)^{10})$. If Jeremy retains both properties, the \$5.7 million value of the properties is included in his estate subject to potential estate tax.

Anticipating the potential estate tax consequences, Jeremy decides to transfer the two properties into a QPRT in January 2025, setting the term of the trust for Jeremy to use the properties for the next 10 years. Jeremy names his two children, Beth and Roger, as the beneficiaries of the trust. Using an §7520 rate of 5.2% for January 2025, Jeremy's attorney calculates the remainder value of the transfer at \$1.75 million. In 2026, Jeremy timely prepares and files his 2025 Form 709 showing a taxable gift of \$1.75 million. In doing so, Jeremy transfers the two properties to Beth and Roger using only \$1.75 million of his lifetime gift and estate tax exclusion instead of using \$5.7 million by retaining the properties.

INTENTIONALLY DEFECTIVE GRANTOR TRUST

An IDGT is structured so that the transfer of assets from the grantor to the trust is treated as a completed gift for estate and gift tax purposes, while the trust is treated as a **grantor trust** for income tax purposes. This is typically accomplished by having the grantor (or a third party) retain certain powers under §§671–679 that trigger grantor trust status without causing estate inclusion.

Because the transfer is a completed gift, the grantor transferring assets to an IDGT may allocate a portion of their lifetime estate and gift tax exclusion to offset any gift tax liability. If the trust is properly drafted as irrevocable, and the grantor does not retain any powers or interests that would cause estate inclusion under IRC §§2036–2038, the transferred assets are excluded from the grantor's gross estate.⁸⁷

⁸⁵ Treas. Reg. §20.2702-5(5)(c)(5)(ii)(A)(1)(ii).

⁸⁶ Treas. Reg. §20.2702-5(5)(c)(5)(ii)(A)(2).

⁸⁷ *Intentionally Defective Grantor Trusts*. Nevius, Alistair M. Nov. 1, 2008. Journal of Accountancy. [www.journalofaccountancy.com/issues/2008/nov/intentionally-defective-grantor-trusts.html] Accessed on May 3, 2025.

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The IDGT strategy is often used to “freeze” the value of appreciating assets for estate tax purposes. The grantor pays income tax on the trust’s earnings, allowing the trust assets to grow without erosion from income tax liability — effectively making additional tax-free gifts to the beneficiaries. This structure is particularly useful for transferring interests in closely held businesses, real estate, or other appreciating assets.

Note. Generally, an IDGT is based upon interpretations of various Code provisions and regulatory guidance, as well as Tax Court cases and IRS revenue rulings. An IDGT is not specifically authorized by Code provisions and supporting regulations.

Additionally, because the trust is also treated as a grantor trust, any sale of assets from the grantor to the trust is not taxable because the grantor trust is considered a disregarded entity for income tax purposes.⁸⁸ Thus, a sale (or other transaction) between the trust and the grantor are not income tax events, and the trust’s income, losses, deductions, and credits are reported by the grantor on the grantor’s individual income tax return.

Transferring assets to an IDGT requires careful planning, particularly with respect to the type and timing of the assets being transferred. The strategy should reflect the overall estate planning objectives and consider the characteristics of the assets — such as their potential for appreciation or income generation. One common implementation involves establishing an operating account for the IDGT, which can be used to facilitate transactions such as seed funding or installment sales.

- The taxpayer provides the IDGT with an initial gift, usually cash, called **seed money**. The taxpayer uses the lifetime estate and gift tax exclusion to eliminate gift tax on the seed money that is transferred to the trust.
- The taxpayer subsequently transfers the desired assets (e.g., business ownership interests, portfolio investments, or other assets that are anticipated to appreciate over the duration of the IDGT). Reasons why the taxpayer may not want to include such assets in their estate for estate tax purposes may include a limited lifetime gift and estate tax exclusion amount and an increasing growth in the assets’ value.

Note. The grantor may transfer assets to the IDGT by gift, sale, or a combination of gift and sale. If a gift is used, some or all of any remaining lifetime exemption amount may be used to reduce or eliminate gift tax. If the taxpayer wishes to preserve the lifetime exemption amount (or has no remaining amount to allocate to the IDGT transfer), a sale may be used to transfer assets into the IDGT. For purposes of this discussion, it is assumed that the taxpayer sells assets to the IDGT.

- In consideration for the assets sold to the IDGT, the trust provides the grantor with a cash down payment (usually taken from the initial seed money transfer) and a promissory note that calls for payments of interest to the grantor over a term of years. The grantor’s transfer of growth assets to the IDGT in exchange for the promissory note is a nontaxable sale of assets to the trust. The treatment of the sale as nontaxable is attributed to the trust being a grantor trust. Therefore, no gain or loss is recognized, and the annual interest payments are not taxable to the grantor.

Note. The interest rate on the note must be at least the applicable federal rate (AFR) for the term of the promissory note. These interest rates are established by the IRS and are updated monthly. Current and historical AFRs may be found at [uofi.tax/16b5x6](https://apps.irs.gov/app/picklist/list/federalRates.html) [apps.irs.gov/app/picklist/list/federalRates.html].

⁸⁸ IRC §671.

At the end of the note's term, the trust assets (presumably having grown over the term of the note) pass to the beneficiaries. The IDGT reaches the end of its life and is typically dissolved under the terms of the trust document.

Observation. The assets transferred and all the growth on those assets over the IDGT's term passes to the beneficiaries in a manner that avoids inclusion in the grantor's estate and corresponding estate tax liability. Consequently, the beneficiaries do not receive the benefit of stepped-up basis in inherited assets.⁸⁹

One IDGT technique involves the grantor selling highly appreciating or high income-producing assets to the IDGT for FMV in exchange for a promissory note.⁹⁰ The IDGT transaction is structured so that a completed gift occurs for gift tax purposes with no resulting income tax consequences.⁹¹ In doing so, IDGTs allow taxpayers to shift large amounts of wealth to their heirs and create estate tax benefits. Such benefits derive from the value of the assets passing to the beneficiaries exceeding the value of the assets transferred into the trust, resulting in an "estate freeze" technique.

Example 11. Emily is 68 years old and the sole member of Mood & Motif, LLC, an established and growing interior design business in Chicago. The value of the business has gradually grown over the past several years, and Emily is concerned about the large value of the business passing into her estate upon her death. Her ownership interest in the LLC is currently valued at \$1 million. She would like to transfer her interest to her daughter, Alison, as part of her estate planning strategy.

Emily establishes an IDGT with a 10-year term. After transferring an appropriate amount of seed money, which her attorney determines should be \$100,000 (\$1 million value of the LLC membership × 10%), she sells her LLC membership interest to the IDGT in exchange for a small cash down payment and a promissory note. The note bears the required AFR rate. Each year, Emily receives her annual interest payment on the note, which is paid from the income of the business.

At the end of the 10-year IDGT term, Emily is 78 years old and the membership interest is worth \$2.4 million. The LLC membership interest held by the IDGT is distributed to Alison without triggering gift tax liability, because the transfer was structured as a completed sale rather than a gift. Therefore, Emily was able to pass on the substantial growth in the value of the LLC membership to Alison without using any of her lifetime gift tax exclusion.

Observation. An IDGT provides the most advantage if the asset growth (which remains in the IDGT to be passed to beneficiaries) has a rate that exceeds the AFR rate (which establishes the amount paid out of the trust to the grantor and does not remain in the IDGT for further asset growth in favor of the beneficiaries). To maximize the length of time the interest and principal payments remain in the IDGT (to provide asset growth to be passed to beneficiaries), the note can be structured so that a balloon payment is made to the grantor at the end of the note's term.

⁸⁹ Rev. Rul. 2023-2, 2023-16 IRB 665.

⁹⁰ The grantor should make an initial seed gift of at least 10% of the total transfer value to the trust so that the trust has sufficient capital to make its payments to the grantor. See Silverman, D. (2000, Oct. 31). Installment Sales to Intentional Defective Grantor Trusts. *American Bar Association Newsletter, Section of Taxation*, 11-12. See also Ltr. Rul. 9535026 (May 31, 1995).

⁹¹ IRC §1015. Because the transfer is a completed gift, the trust receives a carryover basis in the gifted assets.

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Advantages

Some advantages of IDGTs include the following.

- An IDGT has the effect of freezing the value of the assets that are sold to it in the grantor's estate at the value of the principal and low interest rate on the promissory note which is especially useful in a period of high inflation.
- There is no capital gain taxes due on the promissory note, and the income on the note is not taxable to the grantor.
- Because the grantor pays the income tax on the trust income, more assets are left in the IDGT for the remainder beneficiaries.
- Valuation adjustments (discounts) may increase the effectiveness of the sale for estate tax purposes.

Disadvantages

Disadvantages of IDGTs may include the following.

- If the grantor dies during the term of the promissory note, the note is included in the grantor's estate.
- There is no stepped-up basis in trust-owned assets upon the grantor's death.⁹²
- Because the trust income is taxable to the grantor during the grantor's life, the grantor could experience a cash-flow problem if the grantor does not earn sufficient income to pay the corresponding tax liability if the trust terms do not provide for tax reimbursement to the grantor.

Proper Structuring of Sale to the IDGT

To achieve the intended estate and income tax benefits of an IDGT, it is essential that any promissory note used in connection with the sale of assets to the trust be treated as **bona fide debt**. If the note is instead recharacterized as an equity interest, the transaction may trigger adverse tax consequences, including the following.

- Application of the **special valuation rules** under IRC §§2701 and 2702, which can result in a large taxable gift
- Inclusion of the transferred assets in the grantor's estate under §2036

The following are some key Code sections to consider when structuring the sale to an IDGT.

- **IRC §2701** applies to transfers of interests in corporations or partnerships to family members when the transferor or a family member retains an "applicable retained interest." However, a creditor interest in bona fide debt is not treated as an applicable retained interest.⁹³
- **IRC §2702** applies when a seller transfers a remainder interest in trust assets but retains a term interest in the income. For example, a sale in exchange for an interest-only note with a balloon payment may be treated as a retained equity interest if the final payment exceeds 120% of the prior payments, disqualifying it as a qualified annuity interest.
- **IRC §2036** causes estate inclusion if the grantor retains the right to possess, enjoy, or designate the enjoyment of the transferred property. However, if the note is bona fide debt, the grantor is not treated as retaining an interest in the transferred property, and estate inclusion under §2036 does not apply.

⁹² IRC §1015; Rev. Rul. 2023-2, 2023-16 IRB 658.

⁹³ Ltr. Rul. 9535026 (May 31, 1995).

To withstand IRS scrutiny and avoid recharacterization, the transaction should be structured to resemble a sale to an unrelated third party. The following factors support the classification of the note as bona fide debt.⁹⁴

- Providing sufficient seed money to the trust
- Having the beneficiaries personally guarantee a small portion of the note (e.g., 10%)
- Ensuring that note payments are not tied to the performance of the trust assets
- Adhering to a fixed payment schedule in both timing and amount
- Making payments from the trust corpus, not from outside sources
- Avoiding any retained control by the grantor over the transferred property
- Keeping the term of the note relatively short

Administrative Issues

An IDGT is treated as a separate legal entity. Interest payments to the grantor must be tracked, and annual records of the trust must be maintained, including records showing that the trust was administered in accordance with its trust document.

SPOUSAL LIFETIME ACCESS TRUST⁹⁵

SLAT is an irrevocable trust that is created for the primary benefit of the grantor's spouse and oftentimes the secondary benefit of the grantor's descendants. In using this type of trust, a taxpayer can gift assets during their lifetime to the trust using the unified estate and gift tax exclusion. This in turn can allow assets in the trust to appreciate in value without impacting the taxable estate of the grantor. Simultaneously, the grantor's spouse has access to the trust assets, providing financial flexibility while keeping the trust's assets out of both the grantors and their spouse's taxable estates.

Note. For more information on the unified estate and gift tax exclusion, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 2: Individual Taxpayer Issues.

RECIPROCAL TRUST DOCTRINE IN SPOUSAL TRUST PLANNING⁹⁶

When spouses each create irrevocable trusts for the benefit of the other, such as dual SLATs, they must be careful to avoid triggering the **reciprocal trust doctrine**. This judicial doctrine, developed through case law (not statute), allows the IRS to **uncross** two trusts that are essentially mirror images of each other, thereby including the trust assets in each grantor's gross estate under §§2036 or 2038.

The doctrine applies when:

- Two individuals create **interrelated trusts**,
- Each names the other (or someone closely related) as a beneficiary, and
- The trusts are **substantially similar in structure, timing, and economic effect**.

If the IRS determines that the trusts are reciprocal, it may disregard the separate nature of the arrangements and treat each grantor as having retained an interest in the trust they created, resulting in estate inclusion.

⁹⁴ Treas. Reg. §1.166-1(c), and *Kean v. Comm'r*, 91 TC 575 (1988), stating that bona fide debt arises from “a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.”

⁹⁵ *In-Depth Analysis of Slat Planning in Preparation for the End of 2025 and the Scheduled Sunset of the TCJA's Applicable Exclusion Amount*. Katzenstein, Andrew M. and Robbins, Caroline Q. Jul. 2024. National Association of Estate Planners & Councils. [www.naepcjournal.org/issue/44/in-depth-analysis-slat-planning/#_edn10] Accessed on May 3, 2025.

⁹⁶ See, *U.S. v. Grance*, 395 U.S. 316 (1969) and *Estate of Levy v. Comm'r*, TC Memo 1983-453 (Aug. 2, 1983).



Practitioner Planning Tip

To reduce the risk of IRS challenge, practitioners should ensure that the two trusts are **meaningfully different** in one or more of the following ways.

- Different beneficiaries (e.g., one includes children or grandchildren, the other does not)
- Different distribution standards (e.g., Health, Education, Maintenance, and Support (HEMS) versus discretionary)
- Different trustees or trustee powers
- Different funding dates or asset types
- Different retained powers or rights

This approach is often referred to as creating **non-reciprocal SLATs**.

Example 12. Paul and Annie have a net worth of \$25 million. In early 2025, the couple decided it was about time to get serious about estate planning. With the estate and gift tax exclusion for 2025 being \$13.99 million per taxpayer, Paul and Annie have a combined exclusion of \$27.98 million. While they could gift their entire net worth of \$25 million in 2025 to their children to ensure their assets would be protected from estate tax and any potential future decrease in the exclusion, they realize such a tactic would leave them with no assets to live on.

After meeting with their attorney and accountant, Paul and Annie discover they can each set up and fund a SLAT with the other spouse named as the beneficiary of their respective trusts. Paul gifts \$12.5 million to his SLAT naming Annie as a beneficiary, while Annie gifts \$12.5 million to her SLAT naming Paul as a beneficiary. Both gifts are completely sheltered by the 2025 exclusion, resulting in neither of Paul's nor Annie's gifts being taxable. Going forward, Paul and Annie are able to use trust funds to pay their bills and expenses. The terms of the trusts and identity of potential other beneficiaries such as children or grandchildren may be necessary for these trusts to avoid the reciprocal trust doctrine.

CHARITABLE REMAINDER TRUST

A charitable remainder trust (CRT) is a type of irrevocable trust with split-interest ownership of: (1) an income interest paid to the donor during the trust term and (2) a remainder interest paid to a charity at the end of the trust term. A CRT can be structured either as a charitable remainder annuity trust (CRAT) or as charitable remainder unitrust (CRUT).⁹⁷

⁹⁷ *Charitable remainder trusts*. Aug. 26, 2024. IRS. [www.irs.gov/charities-non-profits/charitable-remainder-trusts] Accessed on May 3, 2025.

In a properly structured CRT, a taxpayer transfers assets to the CRT, the CRT then sells the assets and invests the sales proceeds in income-producing assets. The taxpayer receives an annuity or unitrust payment for a specified term or the life of the beneficiaries in accordance with the income interest of the CRT. The creation of a CRT provides further benefits to the taxpayer including the following.

- A limited charitable deduction in the year funded
- Sales of assets by the CRT are not subject to SE and net investment income tax (NIIT) at the time of the sale.
- Deferred income from the annuity or unitrust interest may be taxed at lower rates because it is received over the payout term.
- Estate tax liability may be reduced as a result of the taxpayer transferring appreciating assets to an irrevocable trust.

A charity benefits at the end of the income term by receiving any remaining assets of the CRT.

The CRT must be irrevocable, valid under state law, and organized as either a CRAT or CRUT.⁹⁸ Both the donor and the income beneficiary may include corporations, partnerships, and individuals (individual beneficiaries must be living when the trust is created).⁹⁹ A **CRAT** provides for a **fixed amount** to be paid annually to the income beneficiary. A **CRUT** provides for a **percentage** of the annual market value of the trust assets to be paid to the income beneficiary. The remainder interest of a CRT must be transferred to or used by a charitable organization described in IRC §170(c).

Both the CRAT and CRUT require minimum distributions to the beneficiary of not less than 5% and not more than 50% of the initial value of the CRAT or of the annual market value of the CRUT.¹⁰⁰ Both types of trusts may have a fixed term that does not exceed 20 years or payments that continue for the life of the beneficiary.¹⁰¹ Additionally, the value of the remainder interest **must be at least 10% of the initial net FMV** of all property contributed to the CRAT or the CRUT based on an actuarial calculation performed at funding. The actual remainder value of the assets will likely vary based on market performance over the term of the CRT and the charity may actually receive more than 10% of the original contribution or could also receive nothing.

Variations of the CRUT exist which may provide that distributions for any year may not exceed the trust's accounting income.¹⁰² That limitation may further allow the trust to make-up the distributions in later years.¹⁰³ While a CRUT may accept additional contributions in later years, a CRAT may not.



Practitioner Planning Tip

The IRS has issued sample trust instruments for both CRATs and CRUTs in Rev. Procs. 2003-53 through 2003-60 and 2005-52 through 2005-59, respectively. Practitioners with taxpayers interested in CRT agreements should refer their clients to an attorney familiar with these IRS-approved templates and applicable state law to ensure compliance and streamline the drafting process.

⁹⁸. IRC §664.

⁹⁹. IRC §§664(d)(1)(A) and 664(d)(2)(A).

¹⁰⁰. Ibid. See also Rev. Rul. 70-452, 1970-2 CB 199 and Rev. Proc. 2016-42, 2016-34 IRB 269.

¹⁰¹. Ibid.

¹⁰². IRC §664(d)(3)(A); referred to as a net income charitable remainder trust (NICRUT).

¹⁰³. IRC §664(d)(3)(B); referred to as a net income with make-up charitable remainder trust (NIMCRUT).

Anti-Abuse Barriers

To ensure that CRTs are not used to circumvent tax rules, the IRS imposes several structural requirements and limitations. These rules are designed to preserve the integrity of the charitable deduction and ensure that a meaningful remainder interest ultimately benefits a qualified charity.

10% Minimum Remainder Requirement.¹⁰⁴ The present value of the charitable remainder in any transfer to a qualified CRAT or a CRUT must be at least 10% of the net FMV of the property as of the date it is contributed to the trust.

Note: The actual remainder value at the end of the trust term may be more or less than 10%, but the trust must meet this threshold at inception to qualify as a CRT.

Payout Percentage Limits.¹⁰⁵ Both CRATs and CRUTs must distribute **not less than 5% and not more than 50%** of the trust's value annually.

- For CRATs: based on the initial FMV of the trust assets.
- For CRUTs: based on the annually revalued FMV of the trust assets.

5% Probability of Exhaustion Rule (CRATs Only).¹⁰⁶ The IRS has taken the position that a CRAT will not qualify for a charitable deduction if there is **greater than a 5% actuarial probability** that the trust corpus will be exhausted before the charitable remainder vests.

This rule is based on the principle that a charitable deduction is not allowed if the charitable interest is not certain to **vest** or is subject to a condition that is not “so remote as to be negligible.”¹⁰⁷ Although the 5% probability-of-exhaustion rule is defined in terms of the estate and gift tax charitable deduction, the income tax charitable deduction regulations contain similar language.¹⁰⁸

Note. This rule does **not** apply to CRUTs, which are inherently variable and revalued annually.

Impact of Low Interest Rates. In low-interest rate environments, it may be difficult for lifetime CRATs to satisfy both the 10% remainder requirement and the 5% probability test, especially for younger beneficiaries or longer trust terms. In such cases, a CRUT may be a more valuable alternative.

This is particularly true for CRATs with a fixed annual payback as compared to CRUTs with a variable annual payback. The maximum annual payout percentage may not exceed 50% of the initial net FMV of all property placed in the CRAT and 50% of the net FMV of the assets as annually revalued for a CRUT.¹⁰⁹

Fixed-Term CRTs¹¹⁰

While many CRTs are structured to provide income for the life of one or more beneficiaries, CRTs may also be established for a **fixed term of years**, not to exceed **20 years**. This variation offers unique planning opportunities, particularly when the donor wishes to guarantee a minimum payout period, benefit multiple individuals or entities over a defined timeframe, or avoid the complexities of life expectancy-based calculations.

¹⁰⁴ IRC §§664(d)(1)(D) and (d)(2)(D).

¹⁰⁵ *Charitable remainder trusts*. Jun. 28, 2025. IRS. [www.irs.gov/charities-non-profits/charitable-remainder-trusts] Accessed on Jul. 6, 2025.

¹⁰⁶ Rev. Rul. 77-374, 1977-2 CB 329.

¹⁰⁷ Treas. Regs. §§20.2055-2(b)(1) and 25.2522(c)-3(b)(1).

¹⁰⁸ Treas. Reg. §1.170A-1(e).

¹⁰⁹ IRC §§664(d)(1)(A) and (d)(2)(A).

¹¹⁰ *Charitable remainder trusts*. Jun. 29, 2025. IRS. [www.irs.gov/charities-non-profits/charitable-remainder-trusts] Accessed on Jul. 29, 2025.

The following are key features of a fixed-term CRT.

- **Defined duration.** The trust pays income for a set number of years, regardless of whether the income beneficiary survives the full term.
- **Continuation of payments.** If the donor dies before the term ends, the remaining payments may continue to the donor's estate or designated heirs.
- **Valuation simplicity.** The charitable deduction is calculated using a term-certain factor rather than actuarial life expectancy, which can simplify planning and documentation.

Interest Rate Selection. In calculating the charitable remainder (to test the required 10% charitable remainder minimum or the 5% probability-of-exhaustion rule), the current AFR is used. The §7520 rate used in computing the remainder interest for CRTs can be found in Table 5 of the monthly AFR release.¹¹¹ The taxpayer has the flexibility of selecting the AFR for the month in which the valuation date falls or either of the two preceding months.¹¹² Selecting the largest AFR available will maximize the quarterly or annual income payout to the beneficiary.

For a CRAT or CRUT with a fixed term of years, the payments may be continued to the donor's estate or heirs if the donor dies before the expiration of the income payout term.¹¹³

Establishing a Fixed-Term CRT. The process for establishing a fixed-term CRAT or CRUT is similar to that of a life-income CRT, with a few key distinctions.

- Step 1.** The donor creates an irrevocable CRT. The terms of the trust require an annual income stream paid to one or more living recipients, but the remainder value passes to a charitable organization after the death of the donor/income beneficiary or after a specified term of years.
- Step 2.** The donor transfers assets to the trust and takes a charitable income tax deduction equal to the estimated remainder interest that will pass to charity.¹¹⁴ If the asset is an appreciated long-term capital gain asset,¹¹⁵ a charitable income tax deduction for the market value of the asset is available, which is reduced by the value of the retained income interest. A contribution of other types of assets yields a charitable deduction equal to the lesser of FMV or basis. No charitable deduction applies if a zero-basis ordinary income asset is transferred to the trust.
- Step 3.** After receipt of the asset, the charitable trust may sell the asset or keep them as part of its investment portfolio. The trust reports the sale on its annual Form 5227, *Split-Interest Trust Information Return*, but pays no tax because the trust is tax-exempt under IRC §664(c)(1). The gains and other forms of income that may be earned throughout the term of the trust are then allocated to the income beneficiary over time as the trust makes distributions. Ordinary income passes out to the beneficiary first followed by capital gains.
- Step 4.** The charitable trust usually invests the sale proceeds or other assets to provide a source of income to allow payment of the specified income interest to the income beneficiary.
- Step 5.** At the death of the income beneficiary or at the end of the trust's term, the remaining trust assets pass to the designated charity. The property is not part of the donor's or income beneficiary's taxable estate and thus escapes any estate taxes.

¹¹¹. Current and past rates under IRC §7520 may be accessed at *Applicable federal rates (AFRs) rulings*. Aug. 19, 2024. IRS. [www.irs.gov/applicable-federal-rates] Accessed on May 3, 2025.

¹¹². Treas. Reg. §1.7520-2(a)(2).

¹¹³. Rev. Rul. 74-39, 1974-1 CB 156.

¹¹⁴. IRC §170(f)(2).

¹¹⁵. "Capital gain asset" includes IRC §1231 assets, except to the extent of IRC §§1245 and 1250 ordinary income recapture.

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Funding of a Charitable Trust and Taking the Charitable Deduction

Highly appreciated assets (e.g., corporate stock, real estate) are usually used to fund a CRT, which takes the asset at its carryover basis. Contributions to a CRT are subject to the same charitable limitations as traditional charitable contributions which will vary based on the type of asset contributed.

Note. Beginning in 2026, limitations are placed on total itemized deductions. See the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act for more information.

Ordinary income assets, such as inventory or depreciable equipment, produce a charitable deduction for the donor computed as the lesser of FMV or the basis of the asset. In late 1993, the IRS issued a private letter ruling that approved a cash-method business owner's transfer of ordinary income business assets to a CRUT.¹¹⁶

Observation. Because the transfers of assets in this 1993 ruling all represented ordinary income property with no basis (as opposed to capital gain property), the donor was not allowed to claim a charitable deduction at the time of the transfer of assets to the CRUT. Rather, the objective of the strategy was to convert business assets into tax-free cash at retirement, defer recognition of income, provide a gift to a designated charity, and avoid the highest income tax rates, SE tax, and NIIT liability.

If unmarketable assets are transferred to a CRT, the trust does not qualify for charitable status unless valuation of the property is completed by an independent trustee or determined by a qualified appraisal.¹¹⁷ Additionally, a CRT may have unrelated business taxable income (UBTI), particularly if the CRT attempts to hold an ownership interest in an actively conducted business. A CRT that has UBTI becomes nonexempt and subject to taxation as a complex trust.¹¹⁸

Note. Transfers to a CRT of interests in a general partnership, limited partnership, or limited liability company may expose the CRT to UBTI. Additionally, the transfer of debt-financed assets or the existence of debt within the business entity can trigger UBTI.

The 2-tiered "self-dealing" excise tax of IRC §4941 can apply to a CRT that sells property to a disqualified person or otherwise transacts, leases, or deals with the donor or a related party.¹¹⁹

Note. CRT donations are deductible for both regular tax and alternative minimum tax (AMT) purposes.

Because of the percentage limitations and the order in which charitable contributions are taken into account on the donor's tax return, it is important to plan the utilization of the charitable contribution. Such planning helps to ensure that contributions are fully utilized within the six eligible tax return years (the year of contribution plus the five carryforward years). In some cases, it is necessary to fund a CRUT over several years to assure utilization of the contribution carryovers.

¹¹⁶ Ltr. Rul. 9413020 (Dec. 22, 1993).

¹¹⁷ Treas. Reg. §1.664-1(a)(7)(i).

¹¹⁸ Treas. Reg. §1.664-1(c).

¹¹⁹ IRC §4941(a).

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The amount of the charitable income tax deduction is based on the estimated value that will eventually pass to the charitable beneficiary at the end of the CRT term. The estimate is calculated using **three factors**.¹²⁰

1. The amount or percentage of the retained income interest (the higher the annual income paid to the donor, the smaller the value of the charitable deduction for the remainder portion)
2. The term of years or life expectancy of the retained income interest (the shorter the term of the income interest or the shorter the life expectancies of the beneficiaries, the greater the charitable income tax deduction)

Note. The IRS tables for term and remainder interests and life expectancies are found in two publications. IRS Pub. 1457, *Actuarial Valuations, Version 4A*, is used for income, estate, and gift tax purposes and provides remainder, income, and annuity examples. IRS Pub. 1458, *Actuarial Valuations, Version 4B*, is used for income, estate, and gift tax purposes and provides unitrust remainder examples.

3. The IRS-published 120% annual mid-term AFR,¹²¹ which must be selected from either the current month or 2-month period prior to the charitable transfer (the greater the interest rate, the larger the charitable deduction)

Observation. A donor may desire to provide a benefit for noncharitable beneficiaries (e.g., their children) by replacing the value of the asset that was given to charity. This can be accomplished by purchasing a life insurance contract naming the donor's heirs as beneficiaries using the income stream and tax savings from the deduction to the charitable trust to fund the purchase. If this life insurance contract is acquired within an irrevocable life insurance trust, the death benefit proceeds are not subject to estate taxes for the donor.

Example 13. Rock, age 65, inherited real estate which has appreciated in value to \$500,000 and is debt-free. Rather than pay capital gains tax on the \$350,000 of appreciation, Rock contributes the real estate to a CRUT, and names his alma mater, Hard Place University, as the charitable beneficiary. The trustee of the CRUT sells the real estate and reinvests the proceeds. Assuming the §7520 rate is 3.0%, Rock will receive the following from the CRUT.

- A charitable income tax deduction in Year 1 of approximately \$227,000¹²²
- 5% of the value of the trust annually, or \$25,000 (5% x \$500,000) in Year 1; and
- A Schedule K-1 (Form 1041) annually reporting the character of the \$25,000 distribution which may be ordinary income, capital gain, or principal depending on the available deferred income remaining in the trust.

¹²⁰. Brown, M. (Host). (2019, Sep.). *Charitable Remainder Trusts (CRT) (73)*. ACTEC Trust and Estate Talk. ACTEC Foundation [actecfoundation.org/podcasts/charitable-remainder-trusts-faqs-crt] Accessed on Aug. 7, 2025.

¹²¹. Current and past rates under IRC §7520 may be accessed at *Applicable federal rates (AFRs) rulings*. Aug. 19, 2024. IRS. [www.irs.gov/applicable-federal-rates] Accessed on May 3, 2025.

¹²². IRS Pub. 1458, *Actuarial Valuations*, p.8 (2023).

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Net Investment Income Tax¹²³

A CRT's accumulated net investment income may be subject to the 3.8% NIIT for tax years beginning after 2012. A CRT's NII is categorized and distributed based on the existing §664 income-tier system.¹²⁴ Under this “worst first” system, income is considered distributed in the following order.

1. Ordinary income
2. Capital gains
3. Exempt income

Because NII accumulated in post-2012 years is subject to the additional 3.8% NIIT, it is considered to be the first income distribution from within each of the first two tiers.

Observation. The gain on the post-2012 sale of assets contributed by a business owner presumably is NII, because the CRT does not meet the material participation test. Under the distribution scheme presented above, the NII is considered distributed first. In the past, the breakdown of the CRT distribution between the interest income portion and the ordinary income portion was moot. However, since 2013, any interest and other investment income that is part of the CRT distribution is subject to the 3.8% NIIT.

Filing Requirements¹²⁵

Split-interest trusts,¹²⁶ which include CRTs, are required to file an annual Form 5227 reporting the trust's annual income and balance sheet information. Schedule K-1 (Form 1041) is attached to the Form 5227 to report each beneficiary's share of trust income and distributions. A copy of the charitable trust document must be attached to the Form 5227 for the first year the return is required to be filed, accompanied by a written declaration signed by the trustee indicating that the trust instrument is a true and complete copy.

Form 5227 must be filed for each calendar year and is generally due on April 15. Form 5227 may be filed electronically (mandatory for filers required to file at least 10 returns of any type during the calendar year) or mailed to the IRS Center listed in the instructions.

GRANTOR-RETAINED INTEREST TRUST

Grantor-retained interest trusts are irrevocable trusts to which the grantor transfers assets while retaining the use of the assets or receiving a stream of income from the trust assets over a term of years. At the end of the term, the remainder interest is distributed to the successor beneficiaries. However, if the grantor passes away during the retained interest term, the entire value of the trust assets is included in the grantor's taxable estate.

Note. Typically, assets transferred to the trust comprise of appreciable assets, such as marketable securities, real estate, stock in S corporations or closely held C corporations, and interest in family limited partnerships.

¹²³ IRC §1411.

¹²⁴ Treas. Reg. §1.1411-3(d)(iii)(2).

¹²⁵ Instructions for Form 5227.

¹²⁶ See IRC §4947(a)(2).

There are three primary types of grantor-retained interest trusts.

- Grantor-retained annuity trust (GRAT)
- Grantor-retained unitrust (GRUT)
- Grantor-retained income trust (GRIT)

GRANTOR-RETAINED ANNUITY TRUST

A GRAT is a grantor-retained interest trust where the grantor:

1. Retains an interest of least 5% of the value of the trust at the trust's creation, and
2. Receives the right to a fixed annuity payment for a term of years, usually between two and 10 years.

A **zeroed-out GRAT** eliminates (or minimizes) gift tax by setting the amount of the annuity payment equal to the present value of the assets transferred to the GRAT. If the assets in the GRAT appreciate at a rate **higher than the \$7520 rate**, then the appreciated assets are distributed to the beneficiaries with no gift tax consequences. If the assets in the GRAT appreciate **less than the \$7520 rate**, then the grantor simply receives the value of the property contributed to the GRAT back through the annuity payments.

The fixed payment amount is a percentage of the trust assets' FMV at the time of the initial contribution to the GRAT. There is a flexibility in the structure of the annuity payment, where the payment amount can remain the same each year or it can increase up to 120% annually.¹²⁷ However, once the annuity is established, additional property **cannot** be added to the GRAT.¹²⁸ If a grantor does make additional contributions to the same GRAT, the trust no longer qualifies as a GRAT. Rather, it simply becomes a grantor trust with assets passing to the beneficiaries named in the trust agreement.

Observation. A GRAT can accomplish two important estate planning objectives. The GRAT technique freezes the value of the grantor's highly appreciated assets at their current value and provides the grantor with an annuity payment for a term of years. Thus, the GRAT can deliver benefits without potential transfer tax disadvantages.

Technical Requirements¹²⁹

A GRAT must make at least one annuity payment to an annuitant every 12 months from either the GRAT's income or principal. Each annual payment must be made within 105 days of the anniversary of the date upon which the GRAT was established.¹³⁰ Promissory notes cannot be used to fund annuity payments, and the trustee cannot prepay the annuity amount or make payments to any person other than the annuitant during the qualified interest term.

¹²⁷ Treas. Reg. §25.2702-3(b)(1)(ii)(A).

¹²⁸ Treas. Reg. §25.2702-3(b)(5).

¹²⁹ Treas. Reg. §25.2702-3(b).

¹³⁰ Treas. Reg. §25.2702-3(b)(4). Date of creation is largely a state law issue and could be the date the GRAT instrument was signed or the date of funding. If the required annuity amount is not distributed within the 105-day period, the annuity amount is deemed an additional disqualifying contribution to the GRAT.

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The annuity amounts paid by a GRAT are subject to a fixed-amount requirement. These payments must be a fixed dollar amount of the initial FMV of the property transferred to the trust. There is also a formula adjustment requirement that is tied to the fixed value of the trust assets as finally determined for gift tax purposes. This provision requires adjustment of the annuity amount.¹³¹

Note. From a financial accounting standpoint, the GRAT is a separate legal entity. The GRAT's bank account is established using the grantor's SSN as the identification number. Annual accounting is required, including a balance sheet and an income statement.¹³²

Tax Consequences

For **income tax purposes**, the GRAT is treated as a grantor trust because, by definition, the retained interest exceeds 5% of the value of the trust at the time the trust is created.¹³³ Thus, there is no gain or loss to the grantor on the transfer of property to the GRAT in exchange for the annuity.¹³⁴

Because the trust is a grantor trust, the grantor is taxed on trust income, including interest, dividends, rents, and royalties, as well as pass-through income from business entity ownership.¹³⁵ The grantor also can claim the GRAT's deductions. However, the grantor is not taxed on annuity payments, and transactions between the GRAT and the grantor are ignored for income tax purposes. A significant tax benefit of a zeroed-out GRAT is that the sale of the asset between the grantor and the GRAT does not trigger any taxable gain or loss. The transaction is treated as a tax-free installment sale of the asset.

Note. Because a GRAT is treated as a grantor trust, the GRAT assets can grow without the burden of paying income taxes at trust tax rates. Income taxes are paid by the grantor.

For **gift tax purposes**, the value of the gift equals the value of the property transferred to the GRAT less the value of the grantor's retained annuity interest. In essence, the transferred assets are treated as a gift of the present value of the remainder interest in the property. Thus, asset appreciation can shift (net of the assumed interest rate that is used to compute present value) from the grantor's generation to the next generation.¹³⁶

Note. If the GRAT underperforms (i.e., the GRAT assets fail to appreciate at a higher rate than the interest rate of the annuity payment), the GRAT can sell its assets back to the grantor with no income tax consequences (if the GRAT is a wholly owned grantor trust).¹³⁷ Subsequently, the grantor can place repurchased property in a new GRAT with a lower annuity payment. The original GRAT would then pay out its remaining cash and collapse.

¹³¹. Treas. Reg. §25.2702-3(b)(2), which references the formula in Treas. Reg. §1.664(2)(a)(1)(iii).

¹³². See *The trustee typically provides the grantor with an annual statement detailing the income and deductions attributable to the trust and Essential Records*. Accounting Insights [accountinginsights.org/does-a-grat-file-a-tax-return-filing-rules-and-requirements] Accessed on Jul. 30, 2025.

¹³³. IRC §673. Also, under IRC §674, the grantor is treated as the owner of any portion of the trust over which the grantor controls beneficial enjoyment, corpus, or income, exercisable by the grantor or a nonadverse party or both, without the consent of any adverse party. There are exceptions to this general rule, however, under IRC §674(b).

¹³⁴. There can be issues, however, if there is debt on the property transferred to the GRAT that exceeds the property's basis. Also, there can be an issue with partnership "negative basis" (i.e., the partner's share of partnership liabilities exceeds the partner's share of the tax basis in the partnership assets).

¹³⁵. The GRAT is permitted to hold S corporation stock under IRC §1361(c)(2).

¹³⁶. *Great Time for a GRAT*. Burke, Megan. Oct. 1, 2019. Journal of Accountancy. [www.journalofaccountancy.com/issues/2019/oct/wealth-transfer-grantor-retained-annuity-trusts] Accessed on July 30, 2025.

¹³⁷. Rev. Rul. 85-13, 1985-1 CB 184.

Example 14. Bernard, age 60, transferred \$5 million to a GRAT in January 2025 and would like to retain an annuity for 10 years. At the end of the 10-year term, the remainder will be distributed to Bernard's children. With the §7520 rate for January 2025 equaling 5.2% and using the Table B factor (IRS Pub. 1457) of 7.6473,¹³⁸ the annuity stream is valued at \$3,823,650 (\$500,000 annuity payment × 7.6473 Table B factor), and the remainder interest is valued at \$1,176,350 (\$5 million total property – \$3,823,650 annuity stream value). Consequently, Bernard is deemed to have made a taxable gift to the GRAT of \$1,176,350 in 2025. Bernard prepares and timely files his 2025 Form 709 to report this gift.

If the GRAT assets earn 3% income annually and grow at a rate of 5% totaling an annual appreciation of 8%, Bernard will receive a stream of 10 payments of \$500,000 and Bernard's children will receive \$3,551,344 at the end of the 10-year trust term (the future value of the \$5 million property less the 10 annuity payments of \$500,000 at an appreciation rate of 8% a year).

It is possible to adjust the gift value to zero so there is no taxable gift. The value of the remainder interest is calculated by using an interest rate formula determined by §7520. If the income and appreciation of the trust assets exceed the §7520 rate, the assets that remain at the end of the GRAT term pass to the GRAT beneficiaries.

Note. Some practitioners do not adjust the gift value to zero because this may raise the question of whether there is a valid trust (because of the lack of a valid net transfer of value to the trust). Accordingly, for cases in which a minimal gift value is desired, a nominal gift value is used and reported on a gift tax return to reduce the chance that the validity of the trust arrangement is questioned by the IRS. Such a practice also starts the limitations period with respect to the gift tax by disclosing the nominal gift on the gift tax return.

Example 15. Use the same facts as **Example 14**, except that Bernard had previously made large taxable gifts that utilized his applicable estate and gift tax exclusion, so it is important to him that the gift value of the \$5 million transfer be zeroed out. Accordingly, Bernard needs to receive an annuity payment of \$653,826 (\$5 million ÷ 7.6473 Table B factor). Assuming that the GRAT assets earn 3% income annually and grow at a rate of 5%, the trust will have assets worth \$1,322,934 at the end of the 10-year term (the future value of the \$5 million property less the 10 annuity payments of \$653,826 at an appreciation rate of 8% a year). The assets will pass to the Bernard's children. The value of the gift that Bernard made to the GRAT will be valued at less than \$1 (\$5 million total property – \$5 million annuity stream value).

Observation. Even though the value of the gift was less than \$1, Bernard should report the gift on a timely filed Form 709 to trigger the running of the statute of limitations for gift tax assessment purposes.¹³⁹ A copy of the trust should be attached along with a description of contributed assets, the value of the assets (including appraisals), and a statement describing how the value of the gift was determined.

The grantor's payment of income taxes during the annuity period is not treated as a gift to the trust remainder beneficiaries.¹⁴⁰ Additionally, if the trustee reimburses (or has the power to reimburse) the grantor for the grantor's payment of income tax, the reimbursement (or the discretion to reimburse) may have gift tax consequences depending upon whether the tax reimbursement provision was in the original trust agreement.¹⁴¹

¹³⁸ IRS Pub. 1457 Table B can be downloaded at [www.irs.gov/retirement-plans/actuarial-tables].

¹³⁹ Treas. Reg. §301.6501(c)-1(f)(4) allows the disclosure of a "non-gift" to start the statute of limitations on any claim by the IRS that a transfer had a gift element.

¹⁴⁰ Rev. Rul. 2004-64, 2004-27 IRB 7. If, however, the trust (or local law) requires the trust to reimburse the grantor for income tax the grantor pays that is attributable to trust income, the full value of the trust's assets is includable in the grantor's gross estate under IRC §2036(a)(1).

¹⁴¹ CCA 202352018 (Dec. 29, 2023).

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For **GSTT purposes**, the grantor can only allocate their GSTT exemption to the GRAT's assets after the GRAT term expires, based on the FMV of assets at that time.¹⁴² If the GRAT becomes a GST trust under IRC §2632(c)(3)(B), and the GSTT exemption is not timely allocated, then the automatic allocation rules under §2632(c)(4) apply.

Whether a distribution from the GRAT is subject to GSTT depends on whether the beneficiary is a **skip person** at the time the trust is created, rather than when the trust interest ends.¹⁴³ A skip person is generally defined as an individual who is **two or more generations below** the grantor (e.g., a grandchild or great-grandchild), or a trust in which **all beneficiaries** are skip persons.

A grantor is prohibited from allocating any of their lifetime exemption for GSTT purposes during an estate tax inclusion period (ETIP).¹⁴⁴ An ETIP is the period during which the grantor receives GRAT annuity payments. Accordingly, during the term of a GRAT, the grantor may not make any GSTT allocation. Such an allocation is allowable only after the termination of the grantor's interest in the GRAT.

Example 16. Lilandra contributed \$10 million of assets to a GRAT and retained an annuity payment that essentially zeroed out the gift because it had a present value of \$9,999,999. At the end of the GRAT term, the remaining GRAT assets were worth \$5 million. Consequently, Lilandra transferred \$5 million of assets by making a \$1 gift.

Lilandra established a GRAT remainder trust for the benefit of her grandchildren. At the end of the initial GRAT's term, Lilandra must allocate \$5 million of GSTT exemption to shelter the remainder trust from the GSTT instead of being able to allocate \$1 of GSTT exemption at the establishment of the trust.

Death of Grantor During GRAT Term

If the grantor dies before the end of the GRAT term, a portion (or all) of the GRAT is included in the grantor's gross estate. The amount included in the grantor's estate is the lesser of the FMV of the GRAT's assets as of the grantor's date of death or the amount of principal needed to pay the GRAT annuity into perpetuity (which is determined by dividing the GRAT annuity by the §7520 rate in effect during the month of the grantor's death).¹⁴⁵

Example 17. Roberta died in January 2025 with \$700,000 of assets held in a 10-year GRAT. The GRAT was created in January 2017 with a contribution of \$1.5 million. At that time, the annuity was calculated as \$170,503 per year based on an interest rate of 2.4% and a zeroed-out gift (\$1.5 million ÷ 8.7975 Table B factor for a 10-year 2.4% interest annuity). The amount included in Roberta's gross estate is the lesser of \$700,000 (the FMV of the GRAT assets at the time of death) or \$3,278,904 (the value of the GRAT annuity paid into perpetuity (\$170,503 annuity payment ÷ 5.2% AFR for January 2025)). Therefore, the amount included in Roberta's estate is \$700,000.

Advantages

Some advantages of a GRAT are summarized as follows.

- The gift tax cost is reduced compared to a direct gift.
- The GRAT is a grantor trust.
- The grantor can borrow funds from the GRAT, and the GRAT can borrow money from third parties.¹⁴⁶
- The GRAT term can be as short as two years.
- A properly structured GRAT meets the requirements of §2702. Therefore, many potential IRS challenges to its validity are eliminated because the GRAT conforms to relevant Code provisions (which is not the case with an IDGT).

¹⁴² IRC §2642(f).

¹⁴³ Ltr. Rul. 9047028 (Aug. 27, 1990).

¹⁴⁴ IRC §2642(f).

¹⁴⁵ Rev. Rul. 82-105, 1982-1 CB 133.

¹⁴⁶ When an amount borrowed from third parties is outstanding at the time the GRAT ceases to be a grantor trust, the IRS takes the position that the grantor realizes income of the borrowed amount. TAM 200010010 (Nov. 23, 1999).

Disadvantages

The disadvantages of a GRAT are summarized as follows.

- Upon formation, some of the grantor's applicable exclusion may be utilized.
- The grantor must survive the GRAT term. Otherwise, all or a portion of the GRAT assets becomes part of the grantor's gross estate.
- No GSTT exemption can be allocated to the GRAT during the GRAT term. This makes the GRAT strategy ineffective for avoiding GSTT if a direct gift to GRAT beneficiaries would be subject to the GSTT.
- Notes or other forms of indebtedness cannot be used to satisfy the required annuity payments.
- The grantor continues to pay income taxes on all of the GRAT's income that is earned during the GRAT term.
- A GRAT must use the §7520 rate (120% of the midterm AFR), which is generally higher than the IDGT rate (which, under IRC §1274, is the AFR based on the term of the note).

Note. Although the higher GRAT rate may not be a large disadvantage in a very low-interest rate environment, it may prove to be more disadvantageous if interest rates are higher (because assets transferred to the GRAT need to grow faster than the GRAT rate for the GRAT to be worthwhile). The required §7520 rate for GRATs and the §1274 rate for IDGTs is frequently referred to as the “hurdle rate.”¹⁴⁷ In a higher-interest rate environment, GRATs may not provide the same advantages as an IDGT because of this difference in hurdle rates.

GRANTOR-RETAINED UNITRUST¹⁴⁸

A GRUT is an irrevocable trust which pays a fixed percentage of the net FMV of the trust assets, determined annually, instead of a fixed annuity that would be retained under a GRAT. The percentage must be paid at least annually, and the current year's payment cannot be more than 120% of the preceding year's payment. As such, the annuity payment is variable in nature. Unlike a GRAT, additional amounts can be contributed to a GRUT. However, an income-only or an income-with-make-up provision is not allowed with a GRUT. The ability to shift extra wealth is not as effective with a GRUT; therefore, other entities are used more often.

In comparison to a GRUT, a GRAT may be chosen, due to the following three advantages.

1. A GRAT does not need future revaluations.
2. The property's value is frozen when it is transferred to a GRAT.
3. The value of the retained interest can be made to approximate the value of the transferred property, reducing the remainder's value and potential gift tax.

¹⁴⁷. *Wealth transfer strategies amid shifting interest rates*. Bussert, Brayn W. May 1, 2024. AICPA & CIMA. [www.thetaxadviser.com/issues/2024/may/wealth-transfer-strategies-amid-shifting-interest-rates.html] Accessed on May 3, 2025.

¹⁴⁸. Treas. Reg. §25.2702-3(c).

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GRANTOR-RETAINED INCOME TRUST¹⁴⁹

A GRIT is an irrevocable trust in which the grantor retains the right to **income** for a fixed term of years. Upon termination of the trust, the assets in the trust pass to successor beneficiaries. The main purpose of such a trust is to reduce the gift tax value of the transfer. Therefore, GRITs are similar to GRATs in this objective. GRITs are effective estate planning tools when the value of a promise to transfer an asset in the future is less than the current value of that asset.

GRITs are not as commonly used subsequent to the enactment of the special valuation rules under §2702.¹⁵⁰ As a result of these valuation rules, GRITs with successor beneficiaries consisting of the following family members of the grantor receive a zero value for retained interests of such trust.¹⁵¹

- Spouse
- Ancestor or lineal descendant
- Sibling
- Spouse of any ancestor, lineal descendant, or sibling

Consequently, GRITs are highly restrictive and undesirable for grantors wishing to transfer property to direct family members. However, grantors could utilize a GRIT strategy for beneficiaries consisting of lineal descendants of their siblings (nieces and nephews) and/or friends.

COMPARISON

To help practitioners compare the key features of the three primary types of grantor-retained interest trusts — **GRATs**, **GRUTs**, and **GRITs** — the following table summarizes their core structural differences. These distinctions are important when evaluating which trust structure best aligns with a client's estate planning goals, particularly in terms of valuation, income stream, and tax implications.

Feature	GRAT	GRUT	GRIT
Grantor's retained interest to receive	Fixed annuity payment based on a percentage of the FMV of the trust's assets at time of initial contribution	Variable annuity payment based on a fixed percentage of the FMV of the trust's assets at yearend	Right to income for fixed term (years or grantor's life)
Payment structure	Fixed annuity	Variable annuity	Income only
Revaluation required	No	Yes (annually)	No
Additional contributions allowed	No	Yes	No
Common use case	Estate freeze with minimal gift tax	Asset transfer with growth potential	Gift tax reduction (limited use)
Valuation method	Based on initial FMV	Based on annual FMV	Based on income stream
Family member beneficiaries allowed	Yes	Yes	No (if subject to §2702)

¹⁴⁹. *Wealth transfer strategies amid shifting interest rates*. Bussert, Brayn W. May 1, 2024. AICPA & CIMA. [www.thetaxadviser.com/issues/2024/may/wealth-transfer-strategies-amid-shifting-interest-rates.html] Accessed on May 3, 2025.

¹⁵⁰. Ibid.

¹⁵¹. IRC §§2702(e) and 2704(c)(2).

SPLIT-PURCHASE ANNUITY TRUST¹⁵²

With GRATs, GRUTs, and QPRTs being an exception, the special valuation rules under §2702 restrict estate tax-saving benefits when a grantor's direct family members are named as beneficiaries of a trust. However, another exception to these restrictions is the utilization of a **split-purchase annuity trust (SPLAT)**. A SPLAT is an irrevocable annuity trust consisting of property contributed by the grantor while retaining a term interest to receive annuity payments and a purchase of a remainder interest by the family member or family members. If the contribution and purchase is made in the same transaction or in a series of transactions, the grantor is deemed to have acquired the entire property and transferring the property purchased by the family member(s) to the family member(s).¹⁵³ However, the amount of the grantor's gift to the family member(s) will not exceed the amount the grantor paid during the transaction or sequence of transactions.¹⁵⁴

The trust's value is therefore split into two parts, one being the value of the annuity for the grantor and the value of the remainder interest for the successor beneficiaries. The grantor receives the fixed annuity payments during the trust term and the successor beneficiaries receive the remaining trust assets after the trust term. The grantor's retained annuity is not a completed gift, and the value of such is therefore included in the grantor's taxable estate. However, the value of the remainder interest to the successor beneficiaries is excluded from the grantor's taxable estate.

Example 18. Sarah, age 65, establishes a \$1 million 10-year SPLAT by contributing property with a present value of \$750,000. Sarah's children purchase the remaining interest of property for \$250,000. Sarah is treated as having acquired the entire property and transferring the remaining interest to her children. The amount of Sarah's gift is limited to \$750,000, the amount of consideration Sarah furnished for the SPLAT. Sarah will then receive annuity payments until the end of the trust term after 10 years, whereupon Sarah's children will receive the remaining trust property.

Advantages

Some advantages of a SPLAT are summarized as follows.

- Successor beneficiaries acquire the remainder interest at a lower cost than the full value of the trust assets.
- Because the remainder interest is purchased by the successor beneficiaries, there is no gift tax liability for the remainder interest.
- The trust removes future appreciation on the remainder interest from the grantor's estate.
- The grantor receives a fixed annuity for a specified term.

Disadvantages

Some disadvantages of a SPLAT are summarized as follows.

- If the trust's assets do not grow as expected, the remainder interest may not provide significant value to the beneficiaries.
- The grantor's unexpected early death before the end of the trust term would negate the estate tax benefits of the SPLAT.

¹⁵². *Cutting Edge Estate Planning Techniques: What Have I Learned From My Colleagues?* Zeydel, Diana S.C. 2012. NAEPC. [www.naepcjournal.org/journal/issue13c.pdf] Accessed on May 3, 2025.

¹⁵³. Treas. Reg. §27.2702-4(c).

¹⁵⁴. Ibid.

KEY QUESTIONS WHEN REVIEWING A TRUST

Tax practitioners are often called upon to review existing trust documents, prepare fiduciary income tax returns, or advise clients on the tax implications of proposed trust structures. Whether the trust is revocable or irrevocable, grantor or non-grantor, or designed for estate, income, or charitable planning, a thorough understanding of its terms and funding is essential as described in the previous chapter. The following checklist outlines key questions practitioners should ask when reviewing a trust agreement. These questions are designed to help identify the trust's purpose, tax classification, potential compliance issues, and planning opportunities.

1. What is the purpose of the trust?
 - Wealth transfer (e.g., IDGT, SLAT, GRAT)
 - Asset protection (e.g., ILIT, QPRT)
 - Income deferral or charitable planning (e.g., CRT, CRAT, CRUT)
 - Marital or spousal planning (e.g., QTIP, SLAT)
 - Business succession or valuation freeze
2. How was the trust funded?
 - Was the funding a completed gift?
 - Were contributions reported on Form 709?
 - Was the funding asset cash, life insurance, real estate, or a business interest?
 - Were Crummey notices issued (if applicable)?
 - Was the 3-year rule under §2035 triggered?
3. Who are the trustees and beneficiaries?
 - Identify the trustee and successor trustees.
 - Determine relationships to the grantor (e.g., spouse, child, unrelated party)
 - Identify all beneficiaries and their relationships to the grantor, including the beneficiaries' personal identifying information.
 - Are there potential GST implications?
4. What powers are retained or granted?
 - Powers of appointment (general or limited)?
 - Withdrawal rights (e.g., Crummey powers, 5-and-5 powers)?
 - Trustee discretion over income/principal distributions?
 - Any retained incidents of ownership (e.g., in ILITs)?

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5. Are there any red flags for estate inclusion?
 - Retained control or enjoyment (§2036)
 - Incidents of ownership (§2042)
 - Reciprocal trust doctrine concerns
 - Improperly structured promissory notes (e.g., IDGTs)
6. What is the trust's tax classification?
 - Grantor versus non-grantor trust?
 - Simple versus complex trust?
 - Does it qualify for marital deduction or charitable deduction?
 - Is it eligible for QSST or ESBT treatment (if holding S corporation stock)?
7. What is the status of the grantor's lifetime exclusion?
 - What was the BEA at the time of funding?
 - How much of the exclusion has been used?
 - Are there DSUE amounts available?

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

Note. This chapter contains selected cases, revenue rulings, revenue procedures, Treasury regulations, announcements, and letter rulings issued during the past year, through approximately July 31, 2025. Each appears as a condensed version and should not be relied on as a substitute for the full document. A full citation appears for each item. This chapter is not intended to be a comprehensive coverage of all tax law changes. Rather, it reports the rulings and cases most likely to be of interest to tax professionals.

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SUBSTANTIAL AUTHORITY

If there is substantial authority for a position taken on a tax return, neither the taxpayer nor the tax preparer will be subject to the penalty for underreporting income even if the IRS successfully challenges the position taken on the return. By contrast, if there is no substantial authority for a position taken on a tax return, the underreporting penalties may be imposed unless the position has been adequately disclosed and there is a reasonable basis for the position.

EVALUATION OF AUTHORITIES

There is substantial authority for the tax treatment of an item only if the weight of the authorities that support the treatment is substantial in relation to the weight of the authorities that support a contrary treatment.

- All the authorities relevant to the tax treatment of an item (including the authorities contrary to the treatment) are taken into account in determining whether substantial authority exists.
- The weight of the authorities is determined in light of the pertinent facts and circumstances. There may be substantial authority for more than one position with respect to the same item.
- Because the substantial authority standard is an objective one, the **taxpayer's belief** that there is substantial authority for the tax treatment of an item **is not relevant** in determining whether that is in fact true.

NATURE OF ANALYSIS

The weight accorded to an authority depends on its relevance and persuasiveness, as well as the type of document providing the authority. For example, a case or revenue ruling that has some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts or otherwise inapplicable to the tax treatment. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted (such as a private letter ruling) is diminished to the extent that the deleted information may have affected the authority's conclusions.

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. Private rulings, technical advice memoranda (TAM), general counsel memoranda (GCM), revenue procedures, and/or actions on decisions issued prior to the Internal Revenue Code (IRC) of 1986 generally must be accorded less weight than more recent ones.

There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

AUTHORITY HIERARCHY

The following factors are considered in determining whether there is substantial authority for the tax treatment of an item.¹

- Applicable provisions of the IRC and other statutory provisions
- Temporary and final Treasury regulations construing such statutes

Note. A proposed regulation presents a **tentative** IRS position that may be changed when a temporary and/or final regulation is issued.

- Revenue rulings
- Revenue procedures

¹ Treas. Reg. §1.6662-4(d)(3)(iii).

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- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent, as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation
- Letter rulings and TAM issued after October 31, 1976
- Actions on decisions and GCM issued after March 12, 1981
- IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin (IRB)

Additional information on some of the preceding items follows.

IRC. Except where provisions violate the U.S. Constitution, IRC provisions are binding in all courts.

Treasury Regulations (Income Tax Regulations). The regulations are the Treasury Department's official interpretation and explanation of the IRC. Regulations have the force and effect of law unless they are in conflict with the statute they explain.

Revenue Rulings. The IRS is bound by the position taken in a revenue ruling. Revenue rulings that interpret Treasury regulations are entitled to substantial deference.

Letter Rulings and TAM. Private letter rulings and TAM are IRS rulings directed at particular taxpayers. A private letter ruling is issued for a fee. The IRS is bound to such a ruling only for the particular taxpayer who requested it. A TAM is issued in response to a request for a legal opinion.

Chief Counsel Advice (CCA). A CCA is an IRS ruling issued to IRS field operations by the Office of Chief Counsel. It may be directed at a particular taxpayer or a particular issue. Included in this category are various legal memoranda (e.g., Internal Legal Memoranda (ILM) and Litigation Guideline Memoranda (LGM)).

GCM. GCM detail the legal reasoning behind the issuance of a revenue ruling.

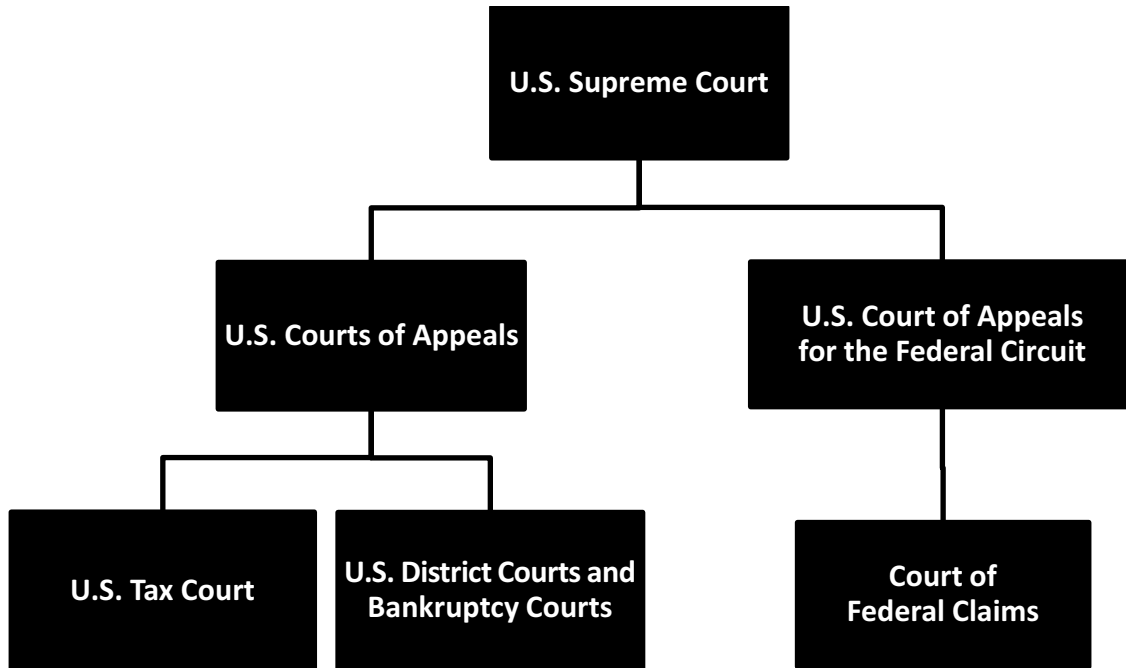
Service Center Advice (SCA). SCAs are issued by the IRS in response to a question coming from an IRS center. There are two types of SCAs: routine and significant. A **routine SCA** is answered by district counsel and not coordinated with the national office. A routine SCA is not issued to the public. A **significant SCA (SSCA)**, on the other hand, is issued only with the approval of the national office. An SSCA is not legal advice and addresses only the interpretation or application of the Internal Revenue laws. SSCAs are made public, but any information identifying taxpayers is deleted.

Tax Court Summary Opinions. A case decided under the small-case procedures cannot be appealed by the taxpayer or the IRS. Without the appeals process, incorrect legal interpretations by the Tax Court cannot be challenged. Therefore, the Tax Court's decision is binding only on that particular case. However, reviewing the cases can still be useful; they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

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JUDICIAL SYSTEM FOR TAX DISPUTES

Three levels of federal courts have jurisdiction to hear tax cases. The following diagram illustrates the three levels. The diagram is followed by a brief description of each court.



Note. Although tax liabilities are addressed by bankruptcy courts, they are generally addressed in a bankruptcy context under the terms of the Bankruptcy Code in a different manner than in the other courts noted in the above diagram.

CASE COMMENCEMENT

A taxpayer in a dispute with the IRS generally has two choices after they receive a statutory notice or notice of final determination (a 90-day letter).

1. File a petition in the Tax Court without paying the tax.
2. Pay the tax and file a claim of refund. If the IRS rejects the claim, the taxpayer can file suit in a U.S. District Court or the Court of Federal Claims.

Note. U.S. District Courts also have jurisdiction to hear federal tax cases. However, these courts are generally used only for very substantial tax disputes because of the high costs and the complexities of using them to resolve tax issues. Consequently, these courts are rarely used by individual taxpayers to resolve tax disputes with the IRS.

THE U.S. TAX COURT

The U.S. Tax Court is a federal court of record that was established in 1942 by Congress under Article I of the Constitution. It replaced the Board of Tax Appeals. Congress created the Tax Court to provide a judicial forum in which taxpayers could dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to the payment of the disputed amounts.

The Tax Court is located at 400 Second Street, NW, Washington, DC 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trials in various designated cities.

As of July 2025, the Tax Court is composed of 19 judges (one seat currently vacant), 12 senior judges, and five special trial judges. The judges generally have expertise in tax law.

This is the only forum in which a taxpayer can contest a tax liability **without** first paying the tax. However, there is a \$60 filing fee that may be paid online at **pay.gov**, or by check or money order made out to “Clerk, United States Tax Court.”² Jury trials are not available in this forum.

The jurisdiction of the Tax Court was greatly expanded by the Internal Revenue Service Restructuring and Reform Act of 1998.³ The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning the following.

- Notices of deficiency
- Notices of transferee liability
- Certain types of declaratory judgments
- Readjustment and adjustment of partnership items
- Review of the failure to abate interest
- Administrative costs
- Worker classification
- Relief from joint and several liability on joint returns
- Review of certain collection actions

The Tax Court also has limited jurisdiction under IRC §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under IRC §7478, the Tax Court can also issue a declaratory judgment for a state or local government that has failed to get a tax exemption for a bond issue.

The IRS issues a statutory notice of deficiency in tax disputes in which the IRS has determined a deficiency. In cases in which a deficiency is not at issue, the IRS issues a notice of final determination. A notice of final determination is issued in the following types of tax disputes.

- Employee versus independent contractor treatments
- Innocent spouse claim determinations
- Collection due process cases

² *How to Pay the Filing Fee*. United States Tax Court. [ustaxcourt.gov/pay_filing_fee.html] Accessed on Aug. 20, 2025.

³ *Internal Revenue Service Restructuring and Reform Act of 1998*, PL 105-206, §§3201, 3401, 3463, and 3464.

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To invoke the jurisdiction of the Tax Court, the taxpayer must file a petition in Tax Court within 90 days after the IRS notice of deficiency (or notice of final determination) is mailed.⁴ **The 90-day date cannot be extended by the IRS.** Similarly, the Tax Court has no statutory authority to extend the 90-day period.⁵ However, the Tax Court does have the discretion to accept a timely but nonconforming document as a petition and allow later amendments to that document that relate to the originally timely filed nonconforming petition.⁶

Observation. Taxpayers and practitioners should not rely on the Tax Court's discretion to extend the 90-day period by filing a nonconforming document that is not a valid Tax Court petition. There is no guarantee that the Tax Court will grant relief from the 90-day deadline.

Who May Practice in the U.S. Tax Court

A taxpayer may represent themselves in Tax Court, or they may be represented by a practitioner admitted to the bar of the Tax Court. Generally, an attorney who is a member of the bar of any state (or the District of Columbia) may be admitted to the bar of the U.S. Tax Court. The attorney must complete the required application for admission to practice (which must be notarized), attach the required proof of good standing in their state bar, and pay the required \$50 fee.

A nonattorney may also be admitted to practice before the U.S. Tax Court. To do so, the nonattorney practitioner must pass a 4-hour examination consisting of the following four parts and pay the \$150 examination fee.

- Tax Court rules of practice and procedure
- Federal taxation
- Federal rules of evidence
- Legal ethics

A score of at least 70% in each of the four parts is necessary to pass the examination. Generally, the examination is conducted every two years. After passing the examination, the nonattorney practitioner must file the required application for admission.

The following resources for attorneys and nonattorneys provide information about admission to practice before the U.S. Tax Court (including the necessary forms, fee information, and mailing addresses).

- **Attorneys: uofi.tax/15b7x1**
[ustaxcourt.gov/files/documents/Admissions_Information_Attorney_12212021.pdf]
- **Nonattorneys: uofi.tax/15b7x2**
[ustaxcourt.gov/files/documents/Nonattorney_Examination_Procedures_050322.pdf]

⁴ IRC §6213(a).

⁵ *R. S. Schoenfeld v. Comm'r*, TC Memo 1993-303 (Jul. 13, 1993); *Schake v. Comm'r*, TC Memo 2002-262 (Oct. 10, 2002).

⁶ *R. M. Crandall v. Comm'r*, 650 F.2d 659 (5th Cir. 1981); *N. E. Carstenson v. Comm'r*, 57 TC 542 (1972).

Tax Court Decisions

The Tax Court hears several types of cases and issues several types of opinions. Specifically, the court hears both regular cases and small tax cases (referred to as S cases).

An S case is generally one that involves less than \$50,000 of unpaid tax. The \$50,000 threshold includes penalties but does not include interest. S cases are heard using less formal procedures and do not provide the right of appeal to a higher court. For a case to be treated as an S case, the taxpayer must choose S case status when petitioning the Tax Court by marking a checkbox and the Tax Court must agree that the case qualifies.

Note. For more information about S cases, see IRC §7463 and **uofi.tax/15b7x3** [www.ustaxcourt.gov/petitioners_start.html].

A Tax Court **summary opinion** is an opinion rendered in an S case. It may **not** be relied on as precedent.

Regular opinions are opinions from cases that are not S cases, and a regular opinion may be a memorandum opinion or a Tax Court opinion. A **Tax Court opinion** is issued if the Tax Court believes the case involves a sufficiently important or novel legal or tax issue. All other regular cases result in **memorandum opinions**. Both memorandum opinions and Tax Court opinions may be appealed and may serve as precedents.

A **bench opinion** can be issued by the Tax Court in any regular or S case. A bench opinion occurs when the judge issues the opinion orally in court during the trial. The taxpayer receives a transcript of the bench opinion a few weeks after the trial. Bench opinions may **not** be relied on as precedents.

Observation. Tax Court opinions may be viewed online. A search engine for finding cases is available at **uofi.tax/15b7x4** [www.dawson.ustaxcourt.gov].

Note. Information about the Tax Court rules of practice and procedure are available at **uofi.tax/15b7x5** [www.ustaxcourt.gov/rules.html].

Tax Court Appeals

A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

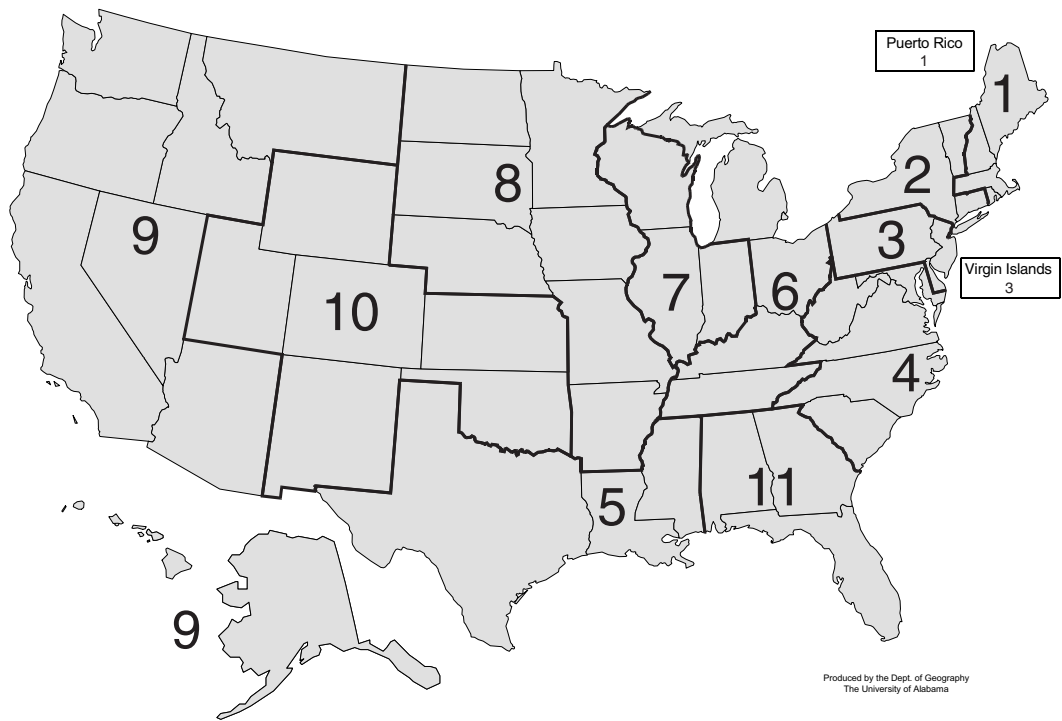
A final appeal can be made to the U.S. Supreme Court; but, because the Court's jurisdiction is discretionary, it hears relatively few tax cases. Many of the court transcripts from these cases can be accessed online at **uofi.tax/15b7x6** [www.uscourts.gov].

The taxpayer can file a refund suit in the Claims Court or the Federal District Court once they have paid the deficiency. In both of these courts, decisions of the Tax Court are not binding as precedents. A jury trial is available only in the Federal District Court. Many federal court opinions can be accessed online at **uofi.tax/15b7x6** [www.uscourts.gov].

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The 13 judicial circuits of the United States are constituted as follows.

Circuits	Hears Appeals from Federal District Courts and U.S. Tax Court Cases Originating in:
D.C.	U.S. Tax Court cases originating in D.C., Federal Administrative agencies, and Federal District Court cases for the District of Columbia
1st	Maine, Massachusetts, New Hampshire, Puerto Rico, Rhode Island
2d	Connecticut, New York, Vermont
3d	Delaware, New Jersey, Pennsylvania, Virgin Islands
4th	Maryland, North Carolina, South Carolina, Virginia, West Virginia
5th	Louisiana, Mississippi, Texas
6th	Kentucky, Michigan, Ohio, Tennessee
7th	Illinois, Indiana, Wisconsin
8th	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
9th	Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam
10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
11th	Alabama, Florida, Georgia
Fed.	Any federal case involving subject matter within its jurisdiction; U.S. Court of Federal Claims; U.S. Court of International Trade



IRS ACTIONS ON DECISION⁷

The IRS has the ability to refuse to accept a court's legal reasoning in a tax case (unless the case was resolved by the U.S. Supreme Court). Generally, the IRS may issue an Action on Decision (AOD) for a case that it did not appeal but that decided issues that were adverse to it.

An AOD is a formal memorandum that alerts IRS officials and the public about the position the IRS will take in future litigation. An AOD is issued at the discretion of the IRS, and the IRS is not bound by it. An AOD does not have the force of a regulation or revenue ruling.

An AOD may take one of the following forms, depending on the position the IRS takes regarding the litigated case.

- **Acquiescence.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling.
- **Acquiescence in result only.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling. However, the IRS has general disagreement or concern with the court's reasoning in the case.
- **Nonacquiescence.** The IRS has decided against appealing the case but does not agree with the holding of the court and will not apply the court's decision in resolving similar cases with other taxpayers.

Observation. An AOD may provide a practitioner with insight on the stance the IRS will take on an issue that has been litigated. In this regard, an AOD may provide a useful source of information about taxpayers in the same or similar circumstances as those involved in the litigation.

The practitioner can view AODs online at **uofi.tax/15b7x7** [irs.gov/actions-on-decisions]. In addition, the Internal Revenue Manual provides information about when the IRS will consider issuing an AOD and the criteria used to determine when doing so is appropriate. This information can be found at **uofi.tax/15b7x8** [www.irs.gov/irm/part36/irm_36-003-001#d0e51].

Note. Although the IRS is bound by a particular Tax Court or federal court ruling with regard to the taxpayer(s) involved in that case, it is not bound to follow that decision in subsequent cases that have the same or similar facts. In addition, the IRS is not obligated to appeal a case from Tax Court or any other court.

⁷. *Actions on Decision (AOD)*. IRS. [irs.gov/actions-on-decisions] Accessed on Jul. 9, 2025; IRM 36.3.1 (2013).

BUSINESS EXPENSES

Business Losses and Theft Deductions

Heather and Stewart Weston v. Comm’r, TC Memo 2025-16 (Feb. 12, 2025)

IRC §§162, 165, 263A, 6651, and 6654

When Bad Investments Aren’t Deductible Losses

Facts. Stewart Weston, a seasoned California commercial real estate agent, became involved in two informal business ventures in Indiana between 2015 and 2017. These ventures were initiated through a personal connection — his barber introduced him to Jeffrey Broughton, a construction manager with experience in property renovations.

Initially, Mr. Weston invested approximately \$75,000 through his wholly owned disregarded entity, ADR Homes, LLC, to acquire 30 tax-delinquent properties in Kokomo, Indiana. These properties were purchased at a county auction and were expected to be renovated and resold for profit. The oral agreement between Mr. Weston and Mr. Broughton provided that Mr. Weston would recoup his investment plus an 8% return, with any additional profits split 50/50. No formal partnership agreement was executed, and Mr. Weston had minimal involvement in day-to-day operations.

In 2016, Mr. Weston also began funding a second venture — a demolition and excavation business operated by Mr. Broughton through Freedom First Excavating and Demo, LLC. This business bid on municipal contracts to demolish blighted properties and remediate contaminated lots. Mr. Weston again provided capital, with an informal understanding that profits would be shared.

Throughout 2016 and 2017, Mr. Weston wired funds — often in response to invoices from Mr. Broughton or his assistant — for property purchases, renovations, and demolition work. Mr. Weston’s operations manager, Laneshia Stamm, helped manage the flow of funds and communications. Despite early optimism, concerns began to mount in 2017. A site visit by Ms. Stamm revealed no visible progress on some properties, and Mr. Broughton became increasingly unresponsive.

By late 2017, Mr. Weston ceased funding new renovation projects but continued supporting the demolition business into 2018. He also negotiated the purchase of Mr. Broughton’s personal and business properties in Kokomo for over \$700,000, which included forgiving \$276,000 in debt. Mr. Broughton vacated the premises shortly thereafter and disappeared from the business scene.

In 2018 and 2019, Mr. Weston began liquidating the Indiana properties. Some were sold at a loss, others were retained or lost to tax foreclosure. Mr. Weston also received title to a property in Culver, Indiana, as partial compensation for unpaid demolition work. Despite these efforts, Mr. Weston testified that the ventures wiped out his retirement savings and left him financially devastated.

The IRS prepared substitutes for returns (SFRs) for 2017 under IRC §6020(b) on September 25, 2019, showing tax due of \$210,500 for Mr. Weston and \$169,362 for Mrs. Weston. The SFRs included Form 13496, §6020(b) *Certification*, Form 4549-A, *Income Tax Examination Changes*, Form 5278, *Statement of Tax Changes*, and Form 886-A, *Explanation of Items*, but not a Form 1040, *U.S. Individual Income Tax Return*, or a transcript of account.

On October 17, 2019, the IRS issued separate notices of deficiency to each spouse, reflecting the SFR amounts and assessing additions to tax for failure to file, failure to pay, and underpayment of estimated tax. The Westons submitted a joint Form 1040 for 2017 on January 8, 2020, reporting a theft loss of \$2,035,914 and tax due of \$36,502. However, the IRS did not process the return, and as of trial, the Westons had made no payments toward their 2017 tax liabilities.

Issues. The issues in this case are the following.

- Whether the Westons were entitled to deduct the approximately \$2.1 million in payments as a theft loss or an ordinary trade or business loss
- Whether the Westons were liable for additions to tax for failure to file under IRC §6651(a)(1), failure to pay under §6651(a)(2), and underpayment of estimated tax under IRC §6654

Analysis. The Westons sought to deduct over \$2.1 million in payments made to two Indiana-based ventures — one focused on home renovations and the other on demolition and excavation. Their legal theories evolved over the course of litigation, ultimately asserting three alternative grounds for deductibility: (1) as ordinary and necessary business expenses under IRC §162, (2) as business losses under IRC §165(c)(1), and (3) as theft losses under §165(c)(3). The Tax Court rejected each theory in turn.

First, the court found that Mr. Weston’s role in the ventures was that of a passive investor, not an active business operator. Although he funded the projects and received invoices, he had no operational control, rarely visited the sites, and **maintained no books or records**. His own testimony emphasized that he was not involved in day-to-day management and expected only a return on capital. These facts were fatal to a §162 deduction, which requires regular and active engagement in a trade or business. The court concluded that Mr. Weston’s activities did not rise to that level.

Next, the court considered whether the payments could be deducted as business losses under §165(c)(1). For the home renovation venture, the court held that the payments were capital expenditures subject to capitalization under IRC §263A. Because none of the properties were sold in 2017, no loss could be recognized in that year. For the demolition business, the court acknowledged that some payments may have been made in 2017, but the record lacked sufficient detail to determine whether they were deductible expenses or capital outlays. Without evidence of gross receipts, completed contracts, or substantiated costs, the court declined to estimate a deductible loss.

Finally, the Westons argued that the payments were lost to theft and thus deductible under §165(c)(3). While there were troubling signs — such as misdirected property titles, uncompleted work, and unresponsiveness from Mr. Broughton — the court found the evidence insufficient to establish theft under Indiana law. Moreover, even if theft had occurred, the Westons failed to show that they discovered the loss in 2017 or that there was no reasonable prospect of recovery at that time. In fact, Mr. Weston continued funding the ventures into 2018 and even purchased additional property from Mr. Broughton, undermining any claim of finality or discovery of loss in 2017.

In sum, the court found that the Westons had not substantiated any basis for deducting the \$2.1 million in payments in 2017. The amounts were treated as capital contributions to ventures that ultimately failed, but not in a manner that triggered a deductible loss in the year at issue.

In addition to disputing the disallowance of their claimed loss deduction, the Westons also challenged the IRS’s imposition of penalties for failing to file their 2017 return on time, failing to pay the tax due, and failing to make estimated tax payments.

The court began by examining the late filing penalty under §6651(a)(1). Although the Westons had requested an extension, they failed to file their return by the extended deadline of October 15, 2018. The IRS had prepared SFRs under §6020(b), which included sufficient documentation to establish the Westons’ liability. The Westons argued that they were unable to file because they lacked information about their Indiana investments due to Mr. Broughton’s misconduct. However, the court was unpersuaded. It emphasized that taxpayers are expected to file using the best information available and amend later if necessary. The Westons could have filed a partial return and supplemented it once more information became available. Their failure to do so was not excused by reasonable cause.

Turning to the failure-to-pay penalty under §6651(a)(2), the court again found that the IRS had met its burden. The Westons had made no payments toward their 2017 tax liability. While they claimed financial hardship, they offered no evidence that paying the tax would have caused undue hardship — such as being forced to sell assets at a loss. The court found no justification for their nonpayment and upheld the penalty.

Finally, the court addressed the underpayment of estimated tax under §6654. The Westons had made no estimated payments for 2017 and did not qualify for any of the statutory exceptions. Although they argued that their investment losses constituted “unusual circumstances” that should excuse the penalty, the court disagreed. It noted that §6654 does not provide a general reasonable cause exception and that the Westons’ situation, while unfortunate, did not rise to the level of a casualty or disaster. As a result, the estimated tax penalty was also sustained. All additions to tax were upheld in full.

Holding. The court held that the Westons were not entitled to deduct any portion of the \$2.1 million in payments for 2017. Furthermore, all additions to tax under §§6651(a)(1), (2), and 6654 were sustained.

Home Office Expense and Gambling Losses

Katherine Kalk v. Comm’r, TC Memo 2024-82 (Sep. 4, 2024)

IRC §§162, 165(d), 274, and 280A

When the House Wins: Kalk’s Business Expenses Fail IRC §162

Facts. Katherine J. Kalk, a software consultant and recreational gambler, was audited by the IRS for tax years 2011 through 2016. The IRS determined deficiencies totaling over \$428,000 across those years, primarily due to unreported income, disallowed deductions, and an early retirement distribution penalty. Ms. Kalk conceded most issues, including the unreported income and penalties, but contested the disallowance of business expense deductions related to her consulting activity and gambling losses beyond those allowed by the IRS.

Ms. Kalk operated her consulting business under the names Katie Kalk Consulting and Arisoft Global US, LLC. She contracted with Performance G2 (PG2) from 2010 through August 2012 to provide IT services. PG2 reimbursed her for travel and other expenses only if they were reasonable and pre-approved in writing. Ms. Kalk also claimed to have continued consulting independently after her PG2 contract ended, though she reported no gross receipts from consulting after 2012.

She also engaged in frequent gambling activity, primarily at casinos in Indiana and Las Vegas. She reported gambling winnings and losses on her returns, but the IRS disallowed a portion of the losses due to lack of substantiation.

Issues. The issues in this case are the following.

- Whether Ms. Kalk was entitled to deduct business expenses related to her consulting activity under IRC §162
- Whether she substantiated gambling losses sufficient to offset her reported gambling winnings under IRC §165(d)

Analysis. Under §162, a taxpayer may deduct ordinary and necessary expenses incurred in carrying on a trade or business. However, the taxpayer bears the burden of substantiating both the existence of the business and the expenses. The Tax Court found that Ms. Kalk failed to demonstrate that she was actively engaged in a consulting business after 2012. She reported no gross receipts from consulting in 2013–2016 and failed to produce credible evidence of ongoing business activity. Her claimed IRC §274 expenses — including travel, meals, and home office deductions — were either unsubstantiated or personal in nature.

The court also rejected her home office deduction, finding that she failed to prove that her home was the principal place of business or that it met the exclusive use requirement under IRC §280A.

In contrast, the court allowed Ms. Kalk to deduct gambling losses to the extent of her gambling winnings. Although her records were incomplete, the court accepted a combination of casino win/loss statements and credible testimony to estimate her losses. Applying the *Cohan* rule,⁸ the court found that her gambling losses exceeded the amount allowed by the IRS and permitted additional deductions accordingly.

Holding. The court held that Ms. Kalk was not entitled to deduct any business expenses related to her consulting activity for the years at issue. However, it held that Ms. Kalk was entitled to deduct additional gambling losses beyond those allowed by the IRS, limited to the amount of her gambling winnings.

Expenses of Starting a Business

Kwaku Eason and Ashley Leisner v. Comm’r, TC Summ. Op. 2024-17 (Aug. 13, 2024)

IRC §§162, 195, and 6662(a)

Taxpayers Must Start Business Before Receiving Deductions

Facts. Kwaku Eason and Ashley Leisner formed Ashley & Makai Homes (Homes) in July 2016. They elected for the company to be taxed as an S corporation. The corporation was formed to provide advice and guidance to real estate owners and investors. Mr. Eason and Ms. Leisner were not required to obtain any type of license before the intended business activity could begin. Mr. Eason and Ms. Leisner enrolled in two courses offered by Advanced Real Estate Education for a total of \$41,934. They also had business cards and business stationery printed. However, Advanced Real Estate Education failed to provide adequate services and went out of business. The Mr. Eason and Ms. Leisner also abandoned their intended business activities through Homes by 2018.

The expenses, including the cost of the courses, were included as deductions on the S corporation tax return and on Schedules C, *Profit or Loss from Business*, filed with each of their tax returns. The deductions on the S corporation’s tax return did not flow through to Mr. Eason and Ms. Leisner’s personal tax returns. They reported no income attributable to the real estate services on any of the tax returns.

Issues. The issues in this case are the following.

- Whether Mr. Eason and Ms. Leisner were engaged in a trade or business during 2016
- Whether they are entitled to the deductions they claimed
- Whether the petitioners are liable for an IRC §6662(a) accuracy-related penalty

Analysis. Taxpayers can deduct ordinary and necessary expenses paid or incurred during the taxable year only while “carrying on any trade or business.”⁹ The business expense deduction is unavailable if paid or incurred **before** the taxpayer is “carrying on” a trade or business.¹⁰ Because no income or activity showed that services were offered or provided to customers during 2016, Mr. Eason and Ms. Leisner are not entitled to the deductions claimed on their separate Schedules C.

⁸. *Cohan v. Comm’r*, 39 F.2d 540, 543-44 (2d Cir. 1930).

⁹. IRC §162(a).

¹⁰. IRC §195(a).

Taxpayers may be subject to a penalty under §6662(a) if they substantially understate their income tax liability. In this case, the underpayment on Mr. Eason's and Ms. Leisner's 2016 return did not meet the threshold for a substantial understatement. However, the court found that they were not liable for the penalty because they acted in good faith and had reasonable cause.¹¹ The expenses were properly documented, and the IRS has not issued regulations clearing defining when a business begins if no licensing is required. Given the lack of guidance and the taxpayers' efforts to start a business, the court concluded that their position was reasonable.

Holding. The court held that Mr. Eason and Ms. Leisner are not allowed to claim business expense deductions because their business had not started by the end of 2016. However, the court also held they are not subject to the §6662(a) accuracy-related penalty because they acted in good faith.

Personal Enjoyment Factor

James William Avery v. Comm'r, No. 23-9004 (10th Cir. Dec. 9, 2024)

IRC §162(a)

Racing Toward Disallowance: Attorney's Car Expenses Not Deductible

Facts. Attorney James William Avery lived in Colorado before moving to Indiana in 2003. Although he was in Indiana, he still practiced law in Colorado. Mr. Avery began attending car shows in Indiana in an effort to generate legal business, eventually transitioning into competitive racing and placing a law firm decal on his vehicle. In 2010, he stopped racing and moved back to Colorado.

On his tax returns for 2008–2011, Mr. Avery claimed amounts spent on his race car as business expenses on his Schedule C, *Profit or Loss From Business*. The IRS rejected all his claimed deductions for business expenses and attempted to collect almost \$1 million in past-due taxes and penalties. The IRS and Mr. Avery could not agree on a settlement, and Mr. Avery appealed to the Tax Court. The case went to trial in 2022, and the court found that the racing expenses were not ordinary and necessary expenses. Consequently, the court disallowed the deduction for racing expenses, but did allow business expenses unrelated to racing. Mr. Avery appealed, arguing the Tax Court considered his enjoyment of car racing, which was **an impermissible factor**.

Issue. The issue in this case is whether the consideration of personal enjoyment is an impermissible factor in determining whether an expense is an ordinary and necessary business expense.

Analysis. To determine whether a claimed deduction is an ordinary and necessary business expense, the taxpayer must demonstrate it was an “ordinary and necessary expense of the particular business in which he was engaged. An expense is ordinary if the transaction ... is of common or frequent occurrence in the type of business involved.”¹²

The Tax Court held that car racing was not a common expense and noted that Mr. Avery enjoyed car racing. The court noted that this was a personal expense, as evidenced by Mr. Avery racing in Indiana while his law practice was in Colorado. The court determined that considering personal enjoyment as one factor — among others — is permissible when evaluating whether an expense is primarily personal or business-related.

Holding. The court held that personal enjoyment can be considered when determining whether an expense was business or personal if the court considers other relevant factors and does not base its decision solely on personal enjoyment. It rejected Mr. Avery's appeal and entered a final order for payment of taxes and penalties.

¹¹ IRC §6664(c).

¹² IRC §162(a).

CORPORATIONS

Claim of Right

Norwich Commercial Group, Inc. v. Comm’r, TC Memo 2025-43 (May 12, 2025)

IRC §§461 and 1341

IRS Interprets the Claim of Right Wrongly

Facts. Norwich Commercial Group, Inc. is a Connecticut mortgage originator that is taxed as an accrual-basis C corporation. In the normal course of its business, it would borrow funds from warehouse lenders, with which it maintained lines of credit (LOCs). The warehouse lender would advance funds to the mortgage originator, which it would provide to the new home buyer in exchange for a promissory note secured by their new residence. The mortgage originator would sell the mortgage receivable to a mortgage loan investor. Norwich, as a mortgage originator, must carefully account for its mortgage receivable balances. The LOC balances were never to exceed the **principal** amount of the mortgage receivables, as this situation would indicate an undercollateralized line of credit.

Due to an accounting error, this happened during the period 2007–13, when one of Norwich’s warehouse lenders, Liberty Bank, provided inaccurate statements. Because the accounting firm believed the warehouse lender’s records were correct, it recorded adjusting journal entries to Norwich’s financial records that reflected the overstated mortgage fee income and receivables. After the end of the year, it provided unqualified opinions indicating that the financial statements fairly presented the financial position of Norwich during the years at issue.

The problem was discovered when Norwich implemented new loan origination software at the request of two states’ banking regulatory agencies. The external consultant implementing the software found that the LOC balance owed Liberty significantly exceeded the mortgage receivables on its books. The external consultant found two smaller errors (identified as “B mortgage loan” and “C mortgage loan”) with another warehouse lender, Farmington Bank.

Norwich’s chief financial officer (CFO) immediately attempted to advise Liberty that there was a significant problem, although it required several attempts to arrange a discussion of the problem with Liberty’s staff. Thus, both parties made honest errors in accounting that they found years after the errors had been made. The accounting errors resulted in Norwich **overstating income** during the years in question.

This discrepancy revealed that the LOC was significantly undercollateralized, prompting Norwich to take corrective action. In November 2014, Norwich and Liberty signed an agreement giving Liberty a “first lien on and security interest in” all of Norwich’s assets, thereby providing the additional collateral needed. In March 2015, Norwich and the mortgage lender agreed to reduce the total unsecured amount by almost \$600,000 of interest that Norwich overpaid to the warehouse lender because it had received erroneously advanced funds. Norwich was liable for the net amount, nearly \$6.7 million, which it completely repaid in 2014 and 2015.

Given that by this time, some of the years were closed for tax purposes, Norwich deducted the payments from its 2014 taxable income, describing the deduction as a “CLAIM OF RIGHT DOCTRINE ADJUSTMENT.”¹³ As this exceeded Norwich’s net taxable income, they created a net operating loss (NOL) that it carried forward to 2015. This adjustment also included two small amounts arising from problems with loans from Farmington.

Issues. The issues in this case are the following.

- Whether Norwich is entitled to deductions for the amounts it paid to warehouse lenders in 2014 and 2015 to correct prior overstatements of income under the claim of right doctrine, or whether those payments were merely nondeductible loan repayments
- If Norwich is entitled to the deductions, in which year those deductions should be claimed

¹³ IRC §1341(a)(1).

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Analysis. The claim of right doctrine applies when a taxpayer realizes that they have recognized taxable income to which they did not have an unrestricted right. Under IRC §1341 and supporting regulations, a taxpayer who included income under a claim of right and later repays it may either deduct the repayment or recompute tax for the year of the income's inclusion if it results in a lower tax.

In its opinion, the Tax Court cited the doctrine's origin in a 1932 case decided by the Supreme Court, which held the following.¹⁴

[i]f a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to [include on his] return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Amplifying this point, the Tax Court quoted further from the same case.¹⁵

*If in a later year "the company had been obliged to refund the profits received in [a prior year], it would have been **entitled to a deduction** [emphasis added] from the profits of [the year of repayment], not from an earlier year."*

This established the foundation of the Tax Court's opinion that Norwich believed that it had an unrestricted right to the funds it had received, and therefore, the funds had been included with their income.

Because neither Norwich nor Liberty believed there was any obligation to repay the funds, the court found that the transfers met the requirement established by the Supreme Court that income received under the claim of right doctrine must be taken without any express or implied agreement to repay.¹⁶ Said another way, if there had been any repayment obligation, even tacit, the claim of right doctrine would not apply.

The IRS argued that the claim of right doctrine did not apply because Norwich and Liberty were both in the business of lending and borrowing funds, and therefore there was an implied obligation to repay the amounts advanced — making them loans rather than income. In this case, however, the Tax Court disagreed with the IRS's focus on the **origin** of the funds, rather than the **substance** of the transaction that caused Norwich to consider the funds as income in the first place. Both Norwich and Liberty assumed that Norwich had adequately collateralized the money it had borrowed from Liberty, leaving no consideration for any repayment. Indeed, the Norwich CFO had repeatedly requested the attention of the financial staff of Liberty to advise them that they were owed money.

Consequently, both parties incorrectly believed that Norwich was entitled to the funds that Liberty had transferred to it in the years at issue. Consequently, Norwich's repayment of the overpayment satisfied the four-prong test in *James v. Comm'r* when the taxpayer:¹⁷

1. Receives the funds,
2. Controls the use and disposition of the funds,
3. Asserts entitlement to the funds by treating them as its own, and
4. Lacks consensual recognition of an obligation to repay the funds.

Because these conditions were met, the court found that Norwich's receipt of funds from Liberty met the requirements for the claim of right doctrine.

¹⁴ *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932).

¹⁵ *Ibid.*

¹⁶ *James v. U.S.*, 366 U.S. 213, 219-220 (1961).

¹⁷ *Ibid.*, quoted by the Tax Court in this case.

Next, the Tax Court addressed the timing of the deduction. The IRS argued that the deduction should take place in the years that the income had been recognized,¹⁸ and that issues of economic performance must be considered.¹⁹ The court noted that most claim of right cases involve cash basis taxpayers; however, Norwich was an accrual basis taxpayer. Norwich argued that the timing of the deduction depended on the timing of the discovery that a liability existed.²⁰ The court determined that this discovery occurred in 2014 with the agreement executed by Norwich and Liberty in November of that year. The court found support for this decision in a regulation that the IRS had written under the claim of right doctrine.²¹

[I]f the taxpayer is on an accrual method of accounting, the provisions of this section shall apply to the year in which the obligation properly accrues for the repayment of the item included under a claim of right.

As Norwich recognized its obligation to repay Liberty in 2014, the claim of right doctrine applied to Norwich that year, when it accrued the obligation to make the payment.

The court also addressed the two errors involving Farmington Bank. It found that the Farmington C mortgage loan was not included in income and therefore not deductible. However, the Farmington B mortgage loan, which had been mistakenly included in income in 2012, was properly deductible in 2014 under the claim of right doctrine. The court adjusted Norwich's 2012 income accordingly to reflect only the Farmington B correction.

Holding. The Tax Court held that Norwich is entitled to deductions totaling \$6,954,117 for the amounts it paid to Liberty in 2014 and 2015, and excludes the amount already repaid to Farmington. Furthermore, the court held that these deductions were properly claimed on Norwich's 2014 return because it properly accrued a repayment obligation in that year.

Termination Fees in Failed Corporate Acquisitions

***AbbVie Inc. & Subsidiaries v. Comm'r*, 164 TC 10 (Jun. 17, 2025)**

IRC §§162, 1211, and 1234A

Breaking Up Is Ordinary: AbbVie's \$1.6B Fee Allowed as Ordinary Deduction

Facts. In July 2014, AbbVie Inc., a C corporation, entered into a merger agreement to acquire Shire PLC, a foreign public limited company, in a \$55 billion proposed merger transaction. To advance the proposed merger, AbbVie and Shire executed a series of agreements detailing their respective obligations. Central among these was a co-operation agreement, which laid out the procedural steps each company would undertake to pursue the transaction. Under this agreement, AbbVie committed to paying Shire a substantial termination fee if it failed to fulfill its responsibilities, resulting in the deal's collapse.

On October 3, 2014, the U.S. Treasury issued IRS Notice 2014-52,²² signaling forthcoming anti-inversion regulations under IRC §7874. In response, AbbVie's board terminated the merger, triggering a \$1.6 billion break fee payable to Shire. The break fee would become payable if AbbVie chose to terminate the transaction based on certain regulatory conditions or if specific regulatory complications arose. Additionally, in scenarios where AbbVie's shareholders failed to approve the merger but the break fee was not triggered, AbbVie remained contractually obligated to reimburse Shire for qualifying transaction-related expenses exceeding \$500 million. This alternative payment obligation was referred to as the "Cost Reimbursement Payment."

¹⁸ IRC §461(a).

¹⁹ IRC §461(h).

²⁰ IRC §461(h)(2).

²¹ Treas. Reg. §1.1341-1(e).

²² IRS Notice 2014-52, 2014-42 IRB 712.

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AbbVie deducted the fee on its timely filed 2015 Form 1120, *U.S. Corporation Income Tax Return*, as an ordinary and necessary business expense under IRC §162. The IRS determined that the break fee was not deductible as an ordinary expense or loss because the break fee should be treated as a capital loss under IRC §1234A. The IRS issued a notice of deficiency for approximately \$572 million from the recharacterization.

Issues. The issues in this case are the following.

- Whether §1234A applies to a termination fee paid in connection with a failed stock acquisition, thereby treating the payment as a capital loss
- Whether AbbVie can alternatively deduct the fee as an ordinary business deduction under §162

Analysis. IRC §162 permits taxpayers to deduct ordinary and necessary business expenses. IRC §165 allows taxpayers to deduct costs associated with abandoned capital transactions. This includes expenses incurred in formulating plans for the organization or reorganization of a corporation when those plans are ultimately abandoned.²³

There are some exceptions to the general rule for losses. IRC §1211 limits corporations to only deduct capital losses to the extent that the corporation has capital gains. Additionally, corporations cannot deduct capital losses against ordinary income. However, ordinary losses can offset both capital gains and ordinary income. Therefore, it is generally more beneficial for a taxpayer to characterize a loss as ordinary rather than capital. Similarly, more favorable outcomes result from ordinary and necessary business expenses.

Gains or losses that qualify under §1234A are treated as gains or losses from the sale of a capital asset. IRC §1234A applies when the following four conditions are satisfied.

1. There is a gain or loss
2. The gain or loss must be attributable to the cancelation, lapse, expiration, or other termination of a right or obligation
3. The terminated right or obligation must be “with respect to” property
4. The underlying property must be (or would be upon acquisition) a capital asset in the hands of the taxpayer

The court found that the **third requirement** — that the right or obligation must be “with respect to property” — was **not satisfied**. The court reasoned that the co-operation agreement between AbbVie and Shire was fundamentally a **services agreement**, not a contract to buy or sell property. AbbVie’s obligations under the agreement included regulatory coordination, shareholder communication, and recommending the merger—not the transfer of property. Furthermore, the break fee was triggered by AbbVie’s board withdrawing its recommendation, not by a failure to transfer property. The court emphasized that neither AbbVie nor Shire owned the shares that would be exchanged in the merger; those were held by public shareholders. Therefore, the agreement did not confer rights or obligations “with respect to property” as required by §1234A. Because the terminated agreement did not involve rights or obligations with respect to property, §1234A did not apply, and the break fee was deductible as an ordinary business expense under §162.

Holding. The court held that AbbVie’s payment of \$1.6 billion break fee to Shire was not subject to §1234A because the payment did not arise from the termination of a right or obligation “with respect to property.” Instead, the payment stemmed from AbbVie’s failure to fulfill service-related obligations under a co-operation agreement. Therefore, the break fee was deductible as an ordinary business expense, and not a capital loss.

²³ *El Paso Co. v. U.S.*, 694 F.2d 703, 712 (Fed. Cir. 1982).

Equitable Tolling

***Belagio Fine Jewelry, Inc. v. Comm’r*, 164 TC 7 (Apr. 15, 2025)**

IRC §§6651, 6656, and 7436

Attorney’s Mailing Mistake Does Not Allow for Equitable Tolling

Facts. Belagio Fine Jewelry, Inc. did not file quarterly employment tax returns during 2016 and 2017. The IRS audited Belagio and determined that it had a common-law employee for tax years 2016 and 2017. Belagio was issued a notice of employment tax determination under IRC §7436 dated August 24, 2021, and the IRS assessed the following.

- Employment tax deficiencies
- Additions to tax for failure to timely file per IRC §6651(a)(1)
- Additions to tax for failure to timely pay under §6651(a)(2)
- Deposit penalties under IRC §6656

Belagio’s attorney mailed a petition for redetermination to the court on November 18, 2021; the court received it on November 23, 2021, one day after the 90-day filing period as specified in §7436.

The IRS filed a motion to dismiss for lack of jurisdiction, arguing that the petition was not filed within the required time frame. On June 25, 2024, the court held that the 90-day deadline was a non-jurisdictional claim-processing rule and denied the IRS’s motion. On August 9, 2024, the IRS filed a motion to dismiss for failure to state a claim upon which relief can be granted. The IRS argued that the 90-day deadline is not subject to equitable tolling because there were no extraordinary circumstances. Belagio filed an objection, arguing that the IRS seeks to relitigate the question of whether Belagio’s case may be dismissed for failure to file on time.

Note. Equitable tolling is a legal doctrine that allows a court to extend a statute of limitation for filing a lawsuit, if a plaintiff, despite using reasonable diligence, was prevented from discovering the injury or filing the lawsuit before the original deadline due to circumstances beyond their control.²⁴

Issues. The issues in this case are the following.

- Whether the 90-day deadline to file a petition for redetermination of an employment tax determination under §7436 is subject to equitable tolling
- If yes, whether equitable tolling is warranted in this case

Analysis. A petition must ordinarily be filed within **90 days** of the determination date under §7436(b)(2). Belagio filed a redetermination request, which arrived one day after the 90-day window. The IRS filed a motion to dismiss the petition for lack of jurisdiction, as the petition was not filed on time. The court denied the motion and held that the filing deadline in §7436(b)(2) was not jurisdictional but reserved the judgment on whether the deadline is subject to equitable tolling.

²⁴ IRM 5.9.13.19.3 (2022).

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The IRS then filed a motion to dismiss for failure to state a claim, arguing that equitable tolling did not apply and therefore the petition was untimely. This prompted the court to examine whether equitable tolling was warranted. For equitable tolling to apply, a taxpayer must establish that it pursued its rights diligently and that extraordinary circumstances beyond the taxpayer's control prevented timely filing. However, the issue in question was due to Belagio's attorney making a mailing error. The attorney's office mailed the redetermination request via FedEx Express Saver, a delivery service not designated by the IRS. The court determined a mailing error was not an extraordinary circumstance outside the taxpayer's control and found that there was no evidence that Belagio pursued its rights diligently because there was no evidence that Belagio contacted their attorney about the mailing. As a result, the court concluded that Belagio failed to meet the requirements for equitable tolling and dismissed the petition as untimely.

Holding. The court ruled that the 90-day deadline for filing a Tax Court petition can be equitably tolled in appropriate circumstances. However, the court held that equitable tolling was not warranted because of the error made by the attorney's office. The court granted the IRS's motion to dismiss the case for failure to state a claim upon which relief can be granted.

CREDITS

Timeliness of Tax Credits and Refunds

Susan and Moses Libitzky v. U.S., No. 23-15614 (9th Cir. 2024)

IRC §6511

Taxpayer's Refund Claim Barred by Look-Back Period

Facts. Moses Libitzky filed joint federal income tax returns with his wife, Susan. Mr. Libitzky owns and operates a commercial property management company. The Libitzskys frequently overpaid their federal income tax to apply overpayment credits to their tax liability for the following year. The Libitzskys hired an accountant, Mr. Albrecht, to prepare and file their tax returns.

The Libitzskys requested a 6-month extension in April 2012 for their 2011 tax return and made a \$310,000 payment towards their 2011 taxes. Mr. Albrecht did not file the 2011 tax return by the extended deadline, and in 2012, the Libitzskys made an additional \$455,000 in tax payments to the IRS. In 2013, the IRS sent two letters to the Libitzskys informing them they never filed a return for 2011 and risked losing their tax refund if they did not promptly file their 2011 return. The Libitzskys did not respond to these notices and also did not file their 2012 return.

The Libitzskys filed a 2013 tax return in October 2014, which triggered another IRS letter informing them they owed an additional \$577,924 for the 2013 tax year. As a result of this notice, the Libitzskys realized that their 2011 and 2012 returns had not been filed and forwarded the IRS notice to Mr. Albrecht. In February 2015, Mr. Albrecht submitted the Libitzskys' 2012 tax return and claimed that \$645,119 of overpaid 2012 income taxes should be applied to the Libitzskys' 2013 tax liability. The refund claimed on the 2012 return assumed that an overpayment from the 2011 return would be applied to the 2012 return, although Mr. Albrecht had not yet filed the Libitzskys' 2011 return.

In August 2015, the IRS issued a notice to Libitzskys informing them of its intent to seize their assets for the balance due of \$616,497. Mr. Albrecht responded to the IRS and promised to file the 2011 tax return by September 23, 2015, but he failed to do so. Mr. Albrecht also informed the IRS that the refund would fully pay the due balance. After an IRS agent visited them on January 20, 2016, to collect on the delinquent 2011 tax return, the Libitzskys finally filed their 2011 tax return along with a formal refund claim the same day. However, the 2011 return showed an overpaid balance of \$692,690. The parties agreed that the overpayment was deemed to have been made on April 17, 2012.

Issues. The issues in this case are the following.

- Whether the Libitzkys' tax refund request was timely under the limitation and look-back periods of IRC §6511
- Whether the informal claim doctrine preserved their right to a refund

Analysis. A taxpayer must file a claim for credit or refund within the **limitation period** and the **look-back period** to receive a tax credit or refund from the IRS.²⁵ The limitation period requirement requires the taxpayer to file a claim within three years from the time the return was filed or two years from the time the tax was paid, or if no return was filed by the taxpayer, within two years from the time the tax was paid.²⁶

The look-back period limits the amount of credit and refund to the amount of the tax paid during the three years plus the extension period prior to filing a refund claim if the taxpayer submitted the refund claim within three years after filing a tax return.²⁷ If the refund claim was not made within three years after filing a return, the amount of the credit or refund is limited to the portion of the tax paid during the two years immediately prior to filing the claim.²⁸

Although the Libitzkys filed their 2011 return and refund claim within the 3-year limitation period (on January 20, 2016), the overpayment was deemed paid on April 17, 2012 — more than three and a half years earlier. **As a result, the refund was barred by the look-back period.**

The Libitzkys argued for an exception known as the **informal claim doctrine**. The informal claim stops the running of the statutes of limitations. The Libitzkys claimed they submitted an informal refund claim by September 2015 because they informed the IRS of their intent to use their tax overpayments, which would make the April 2012 overpayment fall within the three-and-a-half-year look-back period. The Libitzkys' argument fails because the 2011 tax return was not filed by September 2015, and therefore, the limitation period under the informal claim doctrine is limited to two years instead of three years.

The Libitzkys further argued that the later-filed tax return changes the limitation period for their informal claim and merges together so that the 3-year limitation period applies. The court rejected the argument that the later-filed return could retroactively validate the informal claim and extend the look-back period. The court emphasized that the limitation and look-back periods must be satisfied independently and cannot be merged.

Holding. The court held that the Libitzkys cannot sue to recover their overpayments because their April 2012 tax payment was not made within the applicable look-back period. The court's determination was based on the credit claim made when they filed their 2011 tax return in January 2016. In addition, the court affirmed the district court's dismissal of the taxpayer's lawsuit for lack of jurisdiction.

²⁵ *Zeier v. IRS*, 80 F.3d 1360 (9th Cir. 1996).

²⁶ IRC §6511(a).

²⁷ IRC §6511(b)(2)(A).

²⁸ IRC §6511(b)(2)(B).

DEDUCTIONS

Charitable Contributions and Qualified Appraisals

***WT Art Partnership LP v. Comm’r*, TC Memo 2025-30 (Apr. 9, 2025)**

IRC §§170, 6662, 6664, and 6751

Failure to Obtain Qualified Appraisals Excused, But Valuation Still Penalized

Facts. WT Art Partnership LP (WTArt), a partnership controlled by philanthropist Oscar Tang, donated five ancient Chinese paintings to the Metropolitan Museum of Art (the Met) between 2010 and 2012. The paintings were originally acquired in 1997 from collector C.C. Wang for \$5 million. The donations were part of a long-term plan to support the Met’s Asian art collection, with the paintings on loan or display at the museum for years prior to their formal donation.

To substantiate the charitable contribution deductions, WTArt attached appraisals from China Guardian, a major Chinese auction house. The appraisals valued the five paintings at over \$73 million in total, including \$26 million for a single painting, *Palace Banquet*. The IRS disallowed the deductions, asserting that China Guardian was not a qualified appraiser and that the appraisals did not meet the requirements of IRC §170(f)(11). Alternatively, the IRS argued that the paintings were grossly overvalued and imposed penalties under IRC §6662.

The parties later stipulated to the fair market values (FMVs) of four of the five paintings. The FMV of *Palace Banquet* remained in dispute.

Issues. The issues in the case are the following.

- Whether the appraisals were qualified appraisals by a qualified appraiser under §170(f)(11) and if not, whether the failure was due to reasonable cause and not willful neglect
- The FMV of *Palace Banquet* at the time of donation
- Whether a deaccession restriction reduced the painting’s value
- Whether accuracy-related penalties under §6662 apply

Analysis. The court determined that the appraisals were not qualified because China Guardian was not a qualified appraiser. The appraisals were signed by the auction house’s president, who lacked verifiable education and experience in valuing ancient Chinese art. Moreover, China Guardian did not regularly perform appraisals or hold itself out as an appraisal firm.

However, the court excused the failure under the reasonable cause exception in §170(f)(11)(A)(ii)(II). Mr. Tang had relied in good faith on the advice of Wen Fong, a renowned Chinese art scholar, and on prior interactions with the IRS, which had accepted similar appraisals in a 2005 audit. The court found that WTArt had exercised ordinary business care and prudence.

On valuation, the court rejected WTArt’s \$26 million appraisal for *Palace Banquet*, finding it inflated and based on questionable comparables. The court accepted the IRS expert’s valuation of \$10 million and adjusted it slightly upward to \$12 million, based on the painting’s quality and uniqueness.

The court also rejected the IRS’s argument that a deaccession restriction reduced the painting’s value. The gift documents explicitly stated that the donation was unconditional, and the court found no legally binding restriction.

Because the reported value of *Palace Banquet* exceeded 200% of its FMV, the court upheld the 40% gross valuation misstatement penalty under §6662(h) for 2010. However, it declined to impose penalties for 2011 and 2012, finding that WTArt had reasonable cause and acted in good faith.

Holding. The court held that the appraisals were not qualified, but the failure was excused by reasonable cause. Furthermore, the FMV of *Palace Banquet* was \$12 million and no deaccession restriction applied. The court applied a 40% penalty for 2010 due to a gross valuation misstatement, but did not apply any penalties for 2011 or 2012.

Medical Expense Deduction

Ltr. Rul. 202505002 (Jan. 31, 2025)

IRC §§152 and 213

IRS Draws Line Between Personal and Surrogate Medical Expenses

Facts. A heterosexual married couple (Taxpayers A and B) sought a private letter ruling on the deductibility of various expenses related to their use of assisted reproductive technology (ART), including in vitro fertilization (IVF) and gestational surrogacy. Taxpayer A had multiple medical diagnoses requiring medication that was not safe to use during pregnancy, necessitating the use of a surrogate and a donated egg.

The taxpayers requested a ruling under IRC §213 to deduct expenses related to the following.

- Medical care for both spouses
- Egg donor costs
- Sperm donation and freezing
- IVF procedures (embryo creation and storage)
- Surrogate childbirth expenses
- Surrogate medical insurance
- Legal and agency fees related to surrogacy
- Other medical expenses arising from the surrogate pregnancy

Analysis. Under §213(a), a taxpayer may deduct medical expenses for the care of the taxpayer, spouse, or dependent, to the extent they exceed 7.5% of adjusted gross income (AGI). Medical care is defined in §213(d)(1)(A) to include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for affecting any structure or function of the body.

The IRS reiterated that expenses must be directly attributable to the taxpayer, spouse, or dependent to qualify. **Courts have consistently denied deductions for surrogacy-related expenses where the procedures are performed on third parties.** Citing cases such as *Morrissey v. U. S.*²⁹ and *Magdalin v. Comm'r*,³⁰ the IRS emphasized that expenses related to a surrogate's medical care, egg donation, and legal/agency fees do not qualify under §213 because they do not affect the taxpayer's own body or that of a dependent.

However, the IRS ruled that medical expenses directly attributable to the taxpayers — such as sperm donation and related procedures — are deductible, subject to the general limitations of §213.

Holding. Expenses related to the surrogate's medical care, egg donation, IVF procedures, and legal/agency fees are **not deductible** under §213. Medical expenses directly attributable to the taxpayers, such as sperm donation, are **deductible**, subject to the 7.5% AGI threshold.

²⁹ *Morrissey v. U.S.*, 871 F.3d 1260, 1271 (11th Cir. 2017).

³⁰ *Magdalin v. Comm'r*, TC Memo 2008-293 (Dec. 23, 2008).

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Charitable Contribution Deduction

Karl and Fay Leo v. Comm’r, TC Memo 2025-9 (Jan. 29, 2025)

IRC §§170, 6662(h), and 6664

Overstated Value, Underpaid Tax: The IRS Wasn’t Feeling Charitable

Facts. Karl and Fay Leo contributed a 136.4-acre industrial property in Union County, Mississippi — known as the Bankhead Property — to a charity on December 31, 2013. The property included over 1 million square feet of building space, much of it in disrepair. The Leos claimed a charitable contribution deduction of \$15,225,000 based on an appraisal by Harold Campbell valuing the property at \$15.8 million. The property was sold to Mercy Foundation for \$575,000 in a bargain sale.

The Leos carried forward the deduction to tax years 2016 and 2017, claiming \$2,565,256 and \$2,474,461, respectively. The IRS issued a notice of deficiency, asserting that the fair market value (FMV) of the property was only \$4.3 million and disallowing the carryforward deductions. The IRS also imposed a 40% gross valuation misstatement penalty under IRC §6662(h).

Issues. The issues in this case are the following.

- The FMV of the Bankhead Property as of December 31, 2013
- Whether the Leos were entitled to the charitable contribution deductions claimed in 2016 and 2017
- Whether the Leos were liable for the 40% gross valuation misstatement penalty under §6662(h)

Analysis. Under IRC §170, a taxpayer may deduct the difference between the FMV of property and the amount received in a bargain sale to a qualified charity. FMV is determined as the price a willing buyer would pay a willing seller, neither under compulsion and both with reasonable knowledge of the facts.

The Leos relied on an appraisal by Mr. Campbell, who valued the property at \$15.8 million. However, the Tax Court found Mr. Campbell’s report unpersuasive. The court noted that Mr. Campbell appeared to have precommitted to a high valuation, failed to consider extensive photographic evidence of disrepair, and made unsupported assumptions about the condition of the property’s electrical and plumbing systems.

The Leos also presented expert testimony from Mr. Singleton, who valued the property at \$12.425 million using a blended sales-comparison and income approach. Mr. Singleton assumed the property was in average condition and relied heavily on Mr. Campbell’s flawed conclusions. He also used a market rent of \$1.50 per square foot, despite actual leases on the property ranging from \$0.45 to \$1.05 per square foot. The court rejected Mr. Singleton’s valuation as overly optimistic and inconsistent with the record.

The IRS’s expert, Mr. Ladner, valued the property at \$4.05 million using a sales-comparison approach. Mr. Ladner conducted a site inspection, interviewed tenants, and adjusted for the property’s poor condition, low ceilings, and functional obsolescence. The court found Mr. Ladner’s valuation credible and supported by the record, including the property’s actual sale for \$1.13 million just 16 months later.

Because the Leos reported a value of \$15.8 million — more than 200% of the court-determined value of \$4.05 million — the court found a gross valuation misstatement under §6662(h). The court also noted that IRC §6664(c)(3) provides no reasonable cause exception for such misstatements.

Holding. The court held that the FMV of the Bankhead Property as of December 31, 2013, was \$4,050,000. Additionally, the Leos were not entitled to the charitable contribution deductions claimed in 2016 and 2017. Lastly, the Leos were liable for the 40% gross valuation misstatement penalty under §6662(h).



Depreciation Deductions

Sherman Smith v. Comm’r, TC Memo 2025-24 (Mar. 24, 2025)

IRC §§167 and 6651

Guesswork Is Not Good Enough

Facts. On March 11, 2024, Sherman Smith filed his 2018 federal income tax return, which included a depreciation deduction for a property located in Los Angeles, California. The property was originally purchased by Mr. Smith’s brother in 2002 and used as his personal residence. In 2011, Mr. Smith assumed the outstanding mortgage on the property, and at some point, his brother transferred his tenant-in-common interest in the property to Mr. Smith. It is unclear whether Mr. Smith’s brother continued to reside in the property after its alleged conversion to rental use.

The IRS issued a notice of deficiency on November 8, 2021, asserting a deficiency in Mr. Smith’s 2018 federal income tax. The IRS was also imputing IRC §6651(a) additions to tax. The IRS and Mr. Smith resolved other issues raised in the notice, but the depreciation deduction remained disputed.

Issue. The issue in this case is whether Mr. Smith was entitled to the depreciation deduction for the rental property he claimed on his 2018 federal income tax return.

Analysis. Under IRC §167(a), a depreciation deduction is allowed for property used in a trade or business or held for the production of income. When a property is converted from personal to rental use, the depreciable basis is the lesser of the property’s adjusted basis or its fair market value at the time of conversion.³¹

Mr. Smith claimed a depreciation deduction for a property he acquired from his brother and later converted to rental use. However, he failed to substantiate either the adjusted basis or the fair market value of the property at the time of conversion. The Tax Court emphasized that deductions are a matter of legislative grace and must be supported by credible evidence. Mr. Smith relied on real estate valuation tools available in 2024 — several years after the relevant tax year — which the court found speculative and insufficient. As a result, the court concluded that the depreciation deduction was not properly calculated and disallowed the claim.

Holding. The Tax Court held that Smith was not entitled to the depreciation deduction claimed on the 2018 tax return. The deduction was disallowed due to failure to substantiate the property’s depreciable basis and fair market value of the property at the time of conversion to rental use.



Theft Loss Deduction

Michael Shaut v. Comm’r, TC Memo 2024-103 (Nov. 6, 2024)

IRC §§162, 165, 172, and 6662

Casualty and Theft Provisions Cannot be Used to Deduct Bad Business Decisions

Facts. On April 21, 2022, the IRS issued a notice of deficiency to Michael Shaut, a lawyer, regarding his 2019 tax return. The IRS determined a tax deficiency of \$38,149 and an accuracy-related penalty of \$7,630. In response, Mr. Shaut submitted an amended return, claiming a fraud loss deduction of \$1,380,000 and a carryover net operating loss (NOL) of approximately \$570,000.

Mr. Shaut claimed that the fraud loss deduction stemmed from what he called a ‘Ponzi scheme.’ It involved Downing Investment Partners, LLP, a company that claimed to be developing patentable technology. He invested \$250,000 in 2014 and loaned the company over \$100,000 from 2014 to 2016. In March 2014, he became the company’s president, a position he held until September 2014, earning approximately \$100,000. In February 2015, he transitioned to a managing director role, stepping away from an officer position to focus on fundraising. In this capacity, he recruited multiple investors, each contributing \$1 million or more.

³¹ Treas. Reg. §1.167(g)-1.

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However, in 2016, it became clear that the founding members of Downing had been misleading investors and mismanaging funds. The revelation led to numerous lawsuits in which Mr. Shaut was named as a defendant. The lawsuits were resolved by 2018, but two founding members of Downing were sentenced to prison.

On his amended 2019 tax return, Mr. Shaut stated that he was the victim of investment fraud, claiming a \$720,000 loss from an investment in Downing and another \$600,000 in attorney's fees. Yet, the amended return claims a fraud loss of \$1,380,000, even though the two elements of the loss equal only \$1,320,000.

To substantiate these expenses, Mr. Shaut produced various receipts and promissory notes, that added up to less than the amounts claimed. Furthermore, the receipts Mr. Shaut produced were for 2017, 2018, 2019, and 2021, not just 2019.

Mr. Shaut claimed NOL deductions of approximately \$570,000 as carryforward losses from the 2018 tax year. Initially, these losses were attributed to business expenses from Shaut Law Offices. However, on the amended return, they were attributed to Carbon Vision, LLC, a solar company Mr. Shaut founded in 2008.

On his 2017 tax return, Mr. Shaut reported negative taxable income of \$72,399, which he claimed resulted from a 2016 NOL carryforward of \$99,903. He also reported a net loss of \$306,705 for Carbon Vision.

On his 2018 tax return, Mr. Shaut reported no wages or other income, citing business losses totaling approximately \$567,806 across three separate Schedules C, *Profit or Loss From Business*. He reported a loss of \$233,093 for Shaut Law Offices, which also included "Personal losses carry over from 2017" of \$109,547 under Other Expenses. Carbon Vision reported a net loss of \$74,013, which included \$32,500 in legal and professional expenses, but did not list a NOL carryforward. Lastly, Downing Investment Partners, described as a business investment firm, reported no gross receipts and \$260,700 in expenses.

Issues. The issues in this case are the following.

- Whether Mr. Shaut is entitled to claim a theft or casualty loss deduction related to his investment in Downing Investment Partners, LLP
- Whether Mr. Shaut can deduct his legal fees as an ordinary and necessary business expense
- Whether Mr. Shaut is entitled to claim an NOL deduction for 2019
- Whether Mr. Shaut is liable for an accuracy-related penalty

Analysis. The court ruled that Mr. Shaut failed to substantiate his claim for a theft loss deduction for the 2019 tax year. He invested in Downing before 2019 and knew by 2016 of a principal's dishonesty and that his investment was likely lost. The court found his claim that he discovered the loss in 2019 unconvincing.

Additionally, the court found that Mr. Shaut did not establish that he was a victim of theft under applicable law. Despite his claims of limited involvement, he served as Downing's president and later raised millions from investors. Thus, the court concluded that Mr. Shaut had not shown that his losses were anything other than the result of poor business judgment.

Next, the court analyzed whether Mr. Shaut could deduct his legal fees as an ordinary and necessary business expense. Mr. Shaut did not clearly distinguish the legal fees related to Downing, as his amended return did not report these expenses separately from those related to his own legal practice. While he suggested that the fees should be treated as a business expense for Downing, he failed to provide reliable evidence supporting this claim. Many of the legal invoices submitted were for years other than 2019, and he did not establish that the legal fees were directly related to Downing.

Furthermore, Mr. Shaut's claim contradicted his own testimony regarding his role at Downing. While he argued that he was merely an individual who helped raise money and was not involved in Downing's daily operations, he simultaneously asserted that he was engaged in business at Downing and entitled to deduct nearly \$600,000 in legal fees. The court found this position inconsistent and unsupported by credible evidence. As a result, it determined that Mr. Shaut did not meet his burden of proof for the 2019 legal fees as ordinary and necessary business expenses.

The court next considered whether Mr. Shaut was entitled to a deduction for an NOL carryforward. He failed to provide reliable documentation to substantiate an NOL carryforward from 2017 or 2018. Inconsistencies in his tax returns further weakened his claim. His 2017 return reported an NOL carryforward of \$5,894, yet his 2018 return claimed over \$109,000 for an NOL carryforward from 2017. These contradictions undermined his credibility and claim to the deduction. As a result, Mr. Shaut was unable to establish that he had qualifying losses from previous years to apply to 2019, and the court upheld the IRS's denial of the NOL deduction.

Finally, the court considered whether Mr. Shaut was liable for an accuracy-related penalty due to a substantial understatement of income tax.³² The court entered a conditional ruling upholding the penalty contingent on post-trial computations. Ultimately, the post-trial computations sustained the IRS's determination of both the tax deficiency and the penalty.

Holding. The court held that Mr. Shaut is not entitled to a theft or casualty loss deduction because he failed to prove that a criminal theft occurred. He cannot deduct his legal fees as an ordinary and necessary business expense because he failed to prove that the expenses were directly tied to a trade or business for the 2019 tax year. Mr. Shaut is not entitled to an NOL deduction because he failed to provide credible evidence of a valid carryforward loss, and his tax returns contained inconsistencies regarding the NOL amounts. The court upheld the accuracy-related penalty because the final tax calculations confirmed a substantial understatement of income tax, and Mr. Shaut failed to prove that the IRS's determination was incorrect.

Controlled Substance Business Expenses

Patients Mutual Assistance Collective Corp. v. Comm'r, TC Memo 2024-98 (Oct. 21, 2024)

IRC §§162, 167, 170, and 280E

Cannabis Business Deductions Go Up in Smoke

Facts. Patients Mutual Assistance Collective Corporation (PMACC) is a medical cannabis dispensary licensed in California. PMACC reported taxable income of \$1,042,943 and a tax liability of \$354,601 for 2016. It deducted \$13,150,618 in ordinary and necessary business expenses under IRC §162, \$47,008 in charitable contributions under IRC §170, and \$123,204 in depreciation expenses under IRC §167. The IRS audited PMACC's 2016 federal income tax return. The IRS issued a notice of deficiency, contending that PMACC's taxable income was actually \$39,192,237, and its tax liability was \$13,717,283. PMACC filed for a redetermination of the deficiency.

Issue. The issue in this case is whether IRC §280E and the Controlled Substances Act³³ are unconstitutional, permitting PMACC to deduct ordinary and necessary business expenses.

Analysis. IRC §280E provides that no deduction that allowed for any amount paid to traffic in controlled substances in violation of federal law. The IRS contended PMACC was trafficking controlled substances, not in violation of California law, but in violation of federal law. Thus, the IRS concluded that PMACC could not deduct its business, charitable contribution, and depreciation expenses.

³² IRC §§6662(a) and (b)(2).

³³ 21 USC §§801–971.

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PMACC responded that §280E was unconstitutional because it is either an unapportioned direct tax or an excessive fine in violation of the U.S. Constitution's Eighth Amendment. PMACC further argued the Controlled Substances Act is unconstitutional when applied to state legal trafficking of marijuana. However, §280E is constitutional under the Tax Court's precedent,³⁴ and the Controlled Substances Act is constitutional under Supreme Court precedent.³⁵

Holding. The court held that because §280E and the Controlled Substances Act are constitutional, PMACC cannot deduct ordinary and necessary business, charitable contribution, and depreciation expenses from its taxable income.

Properly Substantiated Business Expenses

John Pak v. Comm'r, TC Memo 2024-86 (Sep. 11, 2024)

IRC §§162(a) and 167(a)

Nothing Fishy about Taxpayers' Deductions

Facts. John Pak operated the Mikato Japanese Steak House in Alabama, which commenced operations in 2008. The restaurant was a high-end Japanese hibachi and sushi restaurant operating in a shopping mall. The location was an empty structure that required a custom build-out to install hibachi grills, a sushi bar, and a martini bar. Mr. Pak claimed he paid \$1,150,000 for the build-out, \$400,000 for the hibachi tables, and \$100,000 for other fixtures and equipment.

Mr. and Mrs. Pak hired a paid preparer to prepare their 2008 and 2009 returns. In their joint tax return for the 2008 tax year, Mr. and Mrs. Pak reported 7-year property with a basis of \$285,000 and nonresidential real property with a basis of \$1,380,000 on Form 4562, *Depreciation and Amortization*. The Paks claimed a \$14,605 depreciation deduction on the 2008 return. On their 2009 tax return, the Paks claimed a \$113,903 depreciation deduction but did not include Form 4562.

Mr. and Mrs. Pak filed their joint income tax returns for 2010–12 late, with Mr. Pak preparing the 2010 and 2011 returns and an accountant preparing their 2012 return. The 2010 return claimed a \$2,411 depreciation deduction on their Schedule C, *Profit or Loss From Business*. Mr. and Mrs. Pak did not claim a depreciation deduction in 2011 or 2012.

The Paks did not file tax returns for 2014–2016. The IRS issued notices of deficiency for 2010–2012 and prepared substitute returns for 2014–2016. The deficiencies stemmed from unreported income and disallowed business deductions related to the restaurant. The IRS also assessed additions to tax and penalties, including late-filing and accuracy-related penalties.

In 2018, the Paks hired Kenneth Thacker, CPA, to evaluate their tax liabilities for the years at issue. In August 2018, Mr. Thacker submitted amended returns for 2010–2012, claiming additional depreciation deductions of \$190,106, \$160,679, and \$137,171, respectively. He calculated those amounts by using the figures Mr. and Mrs. Pak reported on their 2008 tax return. In November 2018, Mr. Thacker prepared individual tax returns for the Paks' 2014–2016 tax years, claiming depreciation deductions of \$121,173, \$106,866, and \$155,265, respectively. The 2015 and 2016 returns also claimed wage expense of \$135,825 and contract labor expense of \$136,516. The IRS did not accept any amended returns submitted after the notices of deficiency.

³⁴ *N. Cal. Small Bus. Assistants Inc. v. Comm'r*, 153 TC 4 (2019). See also *Today's Health Care II LLC v. Comm'r*, TC Memo 2021-96 (Aug. 2, 2021).

³⁵ *Gonzales v. Raich*, 545 U.S. 1 (2005).

Issues. The issues in this case are the following.

- Whether Mr. Pak is entitled to additional trade or business depreciation deductions for each of the years at issue
- Whether he is entitled to additional trade or business expense deductions for contract labor expenses for 2015 and 2016.

Analysis. The taxpayer generally bears the burden of proving that the determinations in a notice of deficiency are incorrect.³⁶ The taxpayer must show that the deduction is allowed under a statutory provision and substantiate the expense for the deduction.³⁷ IRC §167(a) allows deductions for depreciation of property used in a trade or business. The taxpayer must establish a property's depreciable basis by showing its cost. The *Cohan* rule states that if a taxpayer demonstrates that they have incurred a trade or business expense but cannot adequately substantiate the amount, the court should estimate the amount and allow a deduction to that extent.³⁸ The taxpayer must prove a reasonable evidentiary basis for the court to estimate a taxpayer's basis in property. In this case, the Tax Court concluded that Mr. and Mrs. Pak had adequately shown they incurred depreciable expenditures, and they were entitled to some deduction as they acquired property used for the operation of the restaurant.

Mr. Pak's testimony on the amounts he paid for the hibachi tables, sushi bar, and the build-out work is substantially consistent with the basis figures reported on the 2008 return. The IRS also accepted the 2008 return as filed, which the court accepted as corroborating evidence to establish a basis estimate under the *Cohan* rule.³⁹ A paid tax professional prepared the 2008 return, which reported amounts that appeared reasonable. Thus, Mr. and Mrs. Pak established that they are entitled to depreciation deductions for the years at issue consistent with a 2008 basis in nonresidential real property and 7-year property of \$690,000 and \$142,500.

The parties agreed that Mr. Pak was entitled to deduct wage expenses of \$134,826 and \$102,051 for 2015 and 2016. Mr. Pak claimed he had additional contract labor expenses of \$136,516 and \$155,265 for 2015 and 2016. These deductions reflect the principle that deductions are allowed for "ordinary and necessary expenses paid or incurred ... in carrying on any trade or business."⁴⁰

Mr. Pak testified that he made cash payments to retain chefs in addition to their wages. Mr. Thacker reviewed Mr. Pak's records to see which checks were made out to cash with a memo line stating "payroll," "salaries," or "cooks." Mr. Thacker also testified that the labor cost was roughly the average labor cost in the restaurant industry. The IRS objected to this testimony as expert testimony in its brief and argued Mr. Thacker testified only as a fact witness. Although Mr. Thacker was not listed as an expert before trial, the court had considered expert testimony when the opposing party had not timely objected.⁴¹ As Mr. Thacker had 30 years' experience in accounting, Mr. Pak had satisfied his burden to justify the deduction for his additional contract labor expenses.

Holding. The court held that Mr. Pak is entitled to additional business depreciation deductions and additional contract labor expense deductions.

Caution. Paying employees with cash is likely to raise significant employment tax issues and possibly trust fund penalties when introduced in court.

³⁶ Tax Court Rule 142(a)(1); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

³⁷ IRC §6001; *Hradesky v. Comm'r*, 65 TC 87, 89-90 (1975), *aff'd per curiam*, 540 F.2d 821 (5th Cir. 1976).

³⁸ *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930).

³⁹ *Wheeler v. Comm'r*, TC Memo 2014-204 (Oct. 6, 2014).

⁴⁰ IRC §162(a).

⁴¹ See *Schmidt v. Comm'r*, TC Memo 2014-159 (Aug. 6, 2014).

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Liability and Equipment Expenses

***Morning Star Packing Company v. Comm’r*, No. 21-71191 (9th Cir. Dec. 19, 2024)**

IRC §461

The Taxpayer Says “Tomato,” the IRS Says “To-mah-to”

Facts. Morning Star Packing Company (Morning Star) is a large seasonal tomato processor that uses the **accrual method of accounting**. The company was audited by the IRS for its 2014 tax return, during which the IRS disallowed a deduction for between \$16.7 million and \$21 million in **anticipated** equipment reconditioning expenses. Morning Star argued that its financing agreements required it to recondition the equipment to maintain it in good working order. However, the Tax Court found that the financing agreements did not create a fixed liability to recondition the equipment. The Tax Court concluded that the anticipated expenses failed to satisfy the fact of liability provision of the all events test. Morning Star appealed the decision to the Ninth Circuit.

Issue. The issue in this case is whether Morning Star satisfied the all events test and could deduct the anticipated equipment expenses in the year they were incurred.

Analysis. A taxpayer’s liability can be recognized when “all events have occurred which determine the fact of liability and . . . such liability can be determined with reasonable accuracy.”⁴² **The fact of liability prong requires “the liability [to be] fixed, absolute, and unconditional.”**⁴³ The liability is not fixed if it is not “based on events that have not occurred by the close of the taxable year.”⁴⁴

Morning Star claimed the final production run of the harvest season created a fixed liability to recondition its equipment. Morning Star relied on its financing agreements as creating the obligation to recondition the equipment. However, the financing agreements did not expressly require Morning Star to recondition its equipment. The agreements required the equipment to be kept in “good working order and condition, ordinary wear and tear excepted” but did not require reconditioning. Morning Star conceded that its equipment’s deterioration was due to ordinary wear and tear.

Morning Star also argued its equipment “required between \$16.7 million and \$21 million in reconditioning costs,” and so it must be “in a state of disrepair beyond mere ‘ordinary wear and tear.’” However, a high cost does not necessarily indicate that more than wear and tear has occurred. Morning Star conceded it could still process another truckload of tomatoes before reconditioning, indicating the reconditioning was not to fix equipment that was inoperative.

Holding. The court held that Morning Star cannot deduct the reconditioning expenses because it did not satisfy the fact of liability prong.

Observation. One of the judges on the case dissented sharply. He observed that Morning Star’s reconditioning expenses were “fixed, absolute, and unconditional” because the loan agreements required it to keep the equipment in good working order, except for reasonable wear and tear. Morning Star has to recondition its equipment at the end of the season to keep it in good working order. Because \$21 million worth of repairs were required, this amounted to more than just wear and tear.

⁴² IRC §461(h)(4); Treas. Reg. §1.461-1(a)(2).

⁴³ *Gold Coast Hotel & Casino v. U.S.*, 158 F.3d 484, 487 (9th Cir. 1998).

⁴⁴ *U.S. v. Gen. Dynamics Corp.*, 481 U.S. 239, 243-44 (1987).

Tax Deficiencies and Penalties

***Leslie and Leon Greenblatt v. Comm’r*, TC Memo 2024-109 (Dec. 16, 2024)**

IRC §§48, 172, 351, 6651(a), and 6662

A Landmark Decision on NOL Deductions and Penalties

Facts. Leslie and Leon E. Greenblatt III filed joint federal income tax returns for 2008 and 2009. Mr. Greenblatt owns several S corporations, C corporations, IRC §351 spinoff transactions, and a qualified subchapter S corporate subsidiary (Qsub). For these years, the Greenblatts claimed net operating loss (NOL) carryforward deductions of \$18.3 million and \$17.7 million, respectively, under IRC §172. Mr. Greenblatt claimed the NOL deductions without providing documentation to establish his basis in the entities that generated the losses.

Some of their corporations paid for the Greenblatts’ legal bills, which the IRS considered constructive dividends that should have been included in their income for the years in question. The Greenblatts claimed to have reimbursed the corporation for these personal expenses by making deposits, even though nothing tied the personal deposits to the personal expenditures. Furthermore, the Greenblatts claimed general business credits under IRC §48 for their investments that generated electricity from landfill gas. They claimed the business entity was a valid Qsub of an S corporation they controlled, even though the entity failed to make a Qsub election.

The IRS determined deficiencies in the Greenblatts’ federal income tax of \$93,013 for 2008 and \$24,608 for 2009. Additionally, the IRS assessed additions to tax under IRC §6651(a) of \$22,172 for 2008 and \$6,835 for 2009, along with accuracy-related penalties under IRC §6662(a) of \$18,603 for 2008 and \$4,922 for 2009. The IRS conceded that Mr. and Mrs. Greenblatt are entitled to deduct the \$66,015 charitable contribution carryover claimed for 2008. Various other adjustments reflected in the notice of deficiency are computational and must be resolved under Rule 155.

Issues. The issues in this case are the following.

- Whether Mr. and Mrs. Greenblatt are entitled to NOL carryforward deductions for 2008 and 2009
- Whether they failed to report income associated with constructive dividends for 2008
- Whether they are entitled to general business credits for 2008 and 2009
- Whether they are liable for additions to tax under §6651(a) for failure to timely file their tax returns
- Whether they are liable for accuracy-related penalties under §6662(a) for the years 2008 and 2009

Analysis. The Greenblatts claimed substantial NOL carryforward deductions for 2008 and 2009. The court found that they failed to elect to waive the carryback period and therefore must carryback any NOLs before carrying those NOLs into 2008 and 2009, the years in question.

Compounding this issue, the court noted that a taxpayer must have basis in their S corporations to realize an NOL for the years involved. Without credible substantiation of basis, a zero basis must be assumed. Although Mr. Greenblatt claimed to have made equity contributions, his lack of documentation undermined his claim. Therefore, the Greenblatts must carry back the NOLs before applying them to 2008 and 2009, and must also account for the lack of basis substantiation.

In this case, the IRS determined that the Greenblatts failed to report certain income for 2008. The court found that the alleged reimbursements do not identify Mr. Greenblatt as the source of the funds and that no link was established between the reimbursements and the payments made. The court stated that the alleged reimbursements could have been loans extended to the corporation. Thus, the court affirmed the IRS’s contention that the payments by the corporation were constructive dividends.

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The court took issue with the Greenblatts' claimed general business credits for 2008 and 2009. The court decided that the corporate entity was a separate corporation, rather than a disregarded Qsub entity that could pass the credits through to the Greenblatts. Consequently, the Greenblatts were not entitled to the business credits for the energy property placed in service for 2008, although the corporation that made the investment could.

The IRS imposed additions to tax under §6651(a) for the Greenblatts' failure to timely file tax returns for 2008 and 2009. Finding no reasonable cause for the late filings, the court sustained the additions to tax.

The IRS imposed accuracy-related penalties under §6662(a) for 2008 and 2009. The Greenblatts fared better here because the court found that they reasonably relied on their accountant's advice. It acknowledged the complexity and changes in NOL rules and concluded that they had no reason to question their accountant's positions.

Holding. The court held that Mr. and Mrs. Greenblatt are entitled to the claimed NOL carryforward deductions for both 2008 and 2009, but only after carrying them back to the years prior to incurring them. The court also held that they failed to report constructive dividend income for 2008 and are liable for the resulting tax due. Additionally, the court held that the Greenblatts are not entitled to the general business credits claimed for both 2008 and 2009, even though their corporation is.

Lastly, the court held that the Greenblatts did not have reasonable cause for late filing and are liable for additions to tax under §6651(a). However, the court determined that they are not liable for accuracy-related penalties under §6662(a) for 2008 and 2009.

Estimated Expenses

***Patricia and Anthony Anderson v. Comm'r*, TC Memo 2024-95 (Oct. 17, 2024)**

IRC §§6001, 6651, and 6654

Cohan Doctrine Rejected: When Estimation Is Not an Option

Facts. Anthony and Patricia Anderson, a married couple, operated seven business entities. They utilized the cash method of accounting. For the five years, 2010 through 2013 and 2015, the Andersons did not file income tax returns.

The IRS prepared substitutes for tax returns and determined deficiencies in federal income tax. Moreover, the IRS determined the Andersons were liable for additions to tax in accordance with IRC §6651(a)(1) for failure to timely file tax returns, §6651(a)(2) for failure to pay the tax shown on a return, and §6654 for failure to pay estimated tax.

The Andersons petitioned the Tax Court for review. They sought a review of the additions to tax and claimed deductions based on deductible expenses listed on Schedules C, *Profit or Loss from Business*, and E, *Supplemental Income and Loss*. Furthermore, the Andersons claimed a net operating loss (NOL) carried over from a 2005 NOL, as well as NOLs from the years between 2006 to 2009 and 2014.

To substantiate many of their deductions claimed, the Andersons submitted cash disbursements journals and account registers for each of the seven business entities. A cash disbursements journal lists expenditures day by day, while an account register lists expenditures by vendor.

The Andersons submitted bank statements substantiating a limited number of claimed deductions, which the court accepted. However, the majority of claimed expenses lacked corroborating source documents such as invoices or receipts. The court did not consider the cash disbursements journals and account registers as proper documentary evidence to substantiate the majority of the deductions claimed. When asked for documentary evidence, Mr. Anderson explained that the relevant documents were in “so many boxes” that he would not be able to bring them into the courtroom and that he had “no access to them [I]t’s the subject of another pending legal matter.” Because the Andersons were unable to provide the source documents, the court, citing *Barrios v. Comm’r*, treated the accounting summaries as ‘argument — not evidence,’ due to the absence of underlying source documentation.⁴⁵

Issues. The issues in this case are the following.

- Whether the Andersons were entitled to the deductions they claimed on Schedules C and E
- Whether they could deduct carryover NOLs from 2006 to 2009 and 2014
- Whether the Andersons were liable for the additions to tax

Analysis. IRC §6001 and Treas. Reg. §1.6001-1(a) require taxpayers to maintain records to support any deductions claimed. To claim deductions on Schedules C and E, a taxpayer must prove “the fact” of the expenditures.⁴⁶ “When a taxpayer’s records have been destroyed or lost due to circumstances beyond his control, he is generally allowed to substantiate his deductions through secondary evidence.”⁴⁷ When a taxpayer fails to maintain adequate records, the court may, under the *Cohan* doctrine, use its discretion to estimate deductible expenses.⁴⁸

The cash disbursements journals and the account registers do not evidence actual payment. Similar documents “merely containing lists of categories and amounts of expenses without the introduction of any source documents underlying the figures” are treated “as argument — not evidence.”⁴⁹

Applying these rules, the Tax Court evaluated the Andersons’ explanations for failing to provide documents verifying payment of the deductible expenses. The court found the first excuse — that the documents are stored in many boxes — did not constitute a circumstance beyond the Andersons’ control and, therefore, no secondary evidence would be permitted. The second excuse — that the records are unavailable due to their involvement in another legal matter — was also unconvincing because the Andersons failed to provide specific details explaining why the records could not be accessed.

Under the *Cohan* doctrine, the court may estimate expenses when a taxpayer cannot fully substantiate them. The court declined to apply the *Cohan* doctrine, emphasizing that estimation is inappropriate where the taxpayer could have, and in fact did, maintain adequate records but failed to produce them. The Tax Court found that the Andersons could have maintained records and, in fact, did maintain some records. As a result, the court refused to estimate expenses on the Anderson’s behalf. Consequently, only a small portion of expenses substantiated by bank records were deductible, while the majority remained disallowed.

The Tax Court next examined whether the Andersons were entitled to an NOL carryover from prior years. Generally, a taxpayer can deduct an NOL for a taxable year by including the total NOL carryovers and providing all relevant supporting details with their tax return.⁵⁰ Taxpayers must also prove both the existence of an NOL from prior years and the amount eligible for carryover.⁵¹

In this case, the Andersons failed to provide evidence showing that they had not already used their 2005 NOL. Additionally, they did not substantiate the existence or amount of NOLs for 2006–2009 or 2014 with any contemporaneous documentation. Furthermore, the court had no reasonable basis to estimate these amounts. As a result, the Tax Court disallowed the NOL deductions.

Holding. The Tax Court held that, other than a few deductions substantiated by bank records, the Andersons were not entitled to the deductions listed on Schedules C and E because the cash disbursements journals and the account registers do not evidence actual payments. The Tax Court held that no NOL could be carried over from 2006 through 2009 or from 2014 to the years in question. The court upheld the additions to tax because the Andersons did not address the additions to tax in their brief, claim any error, or provide facts regarding the additions to tax.

⁴⁵ *Barrios v. Comm’r*, TC Memo 2023-32 (Mar. 14, 2023), quoting *Rodriguez v. Comm’r*, TC Memo 2009-22 (Jan. 29, 2009).

⁴⁶ *Anderson v. Comm’r*, TC Memo 2023-42 (Mar. 28, 2023), *aff’d*, No. 23-9002, 2024 WL 2239160 (10th Cir. May 17, 2024). The Andersons in this citation are not the same individuals petitioning in the instant case.

⁴⁷ *Boyd v. Comm’r*, 122 TC 305, 320 (2004); accord *Barrios v. Comm’r*, TC Memo 2023-32 (Mar. 14, 2023).

⁴⁸ *Cohan v. Comm’r*, 39 F.2d 540, 543-44 (2d Cir. 1930).

⁴⁹ See *Barrios v. Comm’r*, TC Memo 2023-32 (Mar. 14, 2023).

⁵⁰ IRC §172(a); Treas. Reg. §1.172-1(c).

⁵¹ U.S. Tax Court Rule 142(a); *Keith v. Comm’r*, 115 TC 605, 621 (2000).

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Falsified Documents

Ishveen K. Chopra v. Comm’r, TC Memo 2025-2 (Jan. 8, 2025)

IRC §§162, 274, 6662, 6663, and 7454

Fabricated Records Are Insufficient to Prove Expenses

Facts. Ishveen Chopra, a healthcare consultant, filed an individual tax return for 2019 that the IRS selected for examination. On her Form 1040, *U.S. Individual Income Tax Return*, Ms. Chopra reported wage income of \$188,015. She claimed itemized deductions of \$71,924, which included various personal and business-related expenses. Additionally, she reported a \$4,388 loss from Manticore Consultancy, a partnership in which she claimed a 50% interest. She filed a Schedule C, *Profit or Loss from Business*, with no revenue, and \$89,828 of expenses. After accounting for these deduction and losses, her tax return reflected a taxable income of \$22,116. Based on this figure, she calculated a tax liability of \$2,461. She claimed a \$27,849 refund, suggesting significant withholding or credits applied during the year.

Her examination was assigned to Revenue Agent Gary Libbin, who requested documentation from Ms. Chopra to substantiate her deductions. She submitted American Express and Discover Bank statements, as well as invoices from her health insurer, a law firm, and a hotel. Mr. Libbin observed that several submitted documents — including bank statements and hotel invoices — appeared to be fabricated, containing misspellings and formatting inconsistencies. He asked his supervisor, Ashley Gunn, to approve a civil fraud penalty under IRC §6663 or, alternatively, an accuracy-related penalty under IRC §6662(d). On June 9, 2022, Ms. Gunn signed the approval form for a civil fraud penalty.

The IRS issued a notice of deficiency to Ms. Chopra for 2019. The notice disallowed the claimed medical, legal, and business expenses. Ms. Chopra petitioned the Tax Court but was uncooperative with the IRS attorneys and provided no additional documentation. She claimed additional documentation was irrelevant.

The IRS filed a motion to compel production of documents, which the court granted and with which Ms. Chopra did not comply. Accordingly, the IRS filed a motion to impose sanctions, and Ms. Chopra’s relevancy objections were overruled. The judge ruled that, at trial, she would be prohibited from introducing any documents she had not made available, and the court might draw “negative inferences” from her refusal to produce the documents that the IRS had requested.

Issues. The issues in this case are the following.

- Whether Ms. Chopra’s claimed deductions were fraudulent, making her liable for civil fraud penalties
- Whether Ms. Chopra was entitled to the itemized deductions and business deductions she claimed on her return

Analysis. IRC §162(a) allows deductions of ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business. Whether an expense is necessary is a question of fact. Taxpayers must prove they are entitled to any deductions claimed.⁵²

Ms. Chopra’s claim for a medical expense deduction was denied as the court determined the associated invoice was fake. The hospital that supposedly issued the invoice had no record of treating her. Ms. Chopra had also claimed a \$89,828 deduction for business expenses associated with work she performed for Manticore. However, a partner can only deduct partnership expenses if the partnership agreement specifically requires the partner to pay it out of their own pocket.⁵³ Ms. Chopra failed to provide a copy of the partnership agreement or a copy of the entity’s tax return.

⁵² *In-DOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1992).

⁵³ *Cropland Chem. Corp. v. Comm’r*, 75 TC 288, 295 (1980).

Ms. Chopra claimed a \$1,479 deduction for advertising expenses under §162 but could not prove she paid for any advertising expenses. She also claimed a deduction of \$29,941 for various office equipment and furniture under IRC §179 but could not prove she actually bought and paid for any equipment. Ms. Chopra claimed a \$31,196 deduction for attorney's fees, but the law firm stated they did not provide any services for her during 2019. Ms. Chopra also claimed \$8,688 for hotel expenses and \$13,309 for vehicle expenses under IRC §274, but she did not provide documentation meeting the statute's strict requirements.

If tax is underpaid due to fraud, the IRS can assess a penalty for 75% of the underpayment.⁵⁴ The IRS must prove the fraud by clear and convincing evidence under IRC §7454(a). If the IRS proves at least some of the underpayment was due to fraud, it will all be treated as fraudulent unless the taxpayer shows the underpayment was not due to fraud.⁵⁵ In this case, the IRS proved Ms. Chopra understated and underpaid income tax in 2019 and proved that at least a significant portion of it was due to fraud. The IRS showed several indications, or "badges of fraud," were present. Ms. Chopra understated her income, kept inadequate records, gave implausible explanations, failed to cooperate with tax authorities, provided testimony that was not credible, and filed false documents.

Holding. The Tax Court held that the IRS had proven, by clear and convincing evidence, that Ms. Chopra's 2019 tax underpayment was attributable to fraud. Her substantiation for the itemized and business deductions she claimed was missing, inadequate, or obviously falsified, so she lost the ability to claim those deductions. Ms. Chopra failed to establish that any of the underpayment was not attributable to fraud. Thus, the IRS's imposition of a civil fraud penalty of \$22,890 was upheld.

ESTATE

Estate Valuation

Estate of Anne Milner Fields v. Comm'r, TC Memo 2024-90 (Sep. 26, 2024)

IRC §§2033, 2036(a), 2043, and 6662

Estate Runs Dry on Illiquidity Discount

Facts. Anne Milner Fields inherited an oil business from her late husband and became a successful businesswoman. She mentored her great-nephew, Bryan Milner, and named him as the primary beneficiary of her wealth. In her later years, she entrusted Mr. Milner with a durable power of attorney.

In May 2016, approximately a month before Ms. Fields's death, Mr. Milner created AM Fields Management, LLC, and AM Fields, LP ("AM Fields"), transferring nearly all of Ms. Fields's \$17 million personal assets into the partnership under his control. Ms. Fields received a 99.9941% limited partnership interest, while AM Fields Management, controlled solely by Mr. Milner, held a 0.0059% general partner interest.

After Ms. Fields passed away in June 2016, an appraisal valued her limited partnership interest at approximately \$10.8 million, reflecting discounts for lack of control (15%) and lack of marketability (25%). The Estate of Anne Milner Fields (Estate) reported this discounted value for federal estate tax purposes. The IRS audited the Estate and challenged the valuation, arguing that under IRC §2036(a), the full date-of-death value of the transferred assets should be included in the gross estate, as the transfer was not a bona fide sale for adequate and full consideration.

⁵⁴ IRC §6663(a).

⁵⁵ IRC §6663(b).

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Issues. The issues in this case are the following.

- Whether the full date-of-death value of the assets transferred to AM Fields should be included in the gross estate under §2036(a)
- The correct date-of-death fair market value (FMV) of Ms. Fields's limited partnership interest if the court decides that the full date-of-death value of assets should not be included in the gross estate
- Whether the Estate is liable for an accuracy-related penalty under IRC §§6662(a) and (b)(1) for a substantial understatement of tax

Analysis. Under §2036(a), if a decedent makes an inter vivos transfer of property but retains the possession, enjoyment, or control of that property until death, the property is included in the gross estate for estate tax purposes. The purpose of this section is to prevent individuals from artificially reducing their taxable estate by transferring assets while still retaining control over them.⁵⁶

There is a 3-part test for property to be included in the gross estate under §2036(a). First, the decedent must have transferred property during their lifetime. Second, the decedent must have retained the right to income, possession, or enjoyment of the transferred property until death. Third, the transfer must not have been a bona fide sale for adequate and full consideration.⁵⁷

Because these transfers were made while Ms. Fields was alive, the first requirement under §2036(a) was met.

Second, the court analyzed whether Ms. Fields retained an interest in the transferred property. Because Ms. Fields retained possession and control of the transferred assets, the court found that the second requirement under §2036(a) was met.

Third, the court considered whether the transfers qualified as a bona fide sale for adequate and full consideration. Here, the date-of-death value of Ms. Fields's limited partnership interest was the same as the value of the partnership interest at the time of transfer only 27 days before her death. Thus, only the FMV of the transferred assets at death was to be included in the estate.

The next issue in the case was determining the correct date-of-death FMV of Ms. Fields's limited partnership interest in AM Fields. The Estate and the IRS disagreed on the appropriate illiquidity discount to apply. The Estate's expert, David Katzen, applied a 10% illiquidity discount, but he did not provide detailed calculations or comparable transactions to justify this discount.

The IRS's expert, David Fuller, agreed that an illiquidity discount was appropriate but conducted a more detailed analysis. His analysis yielded a 5.7% illiquidity discount. Given the lack of supporting evidence for Mr. Katzen's 10% discount, the court adopted Mr. Fuller's 5.7% discount, resulting in the total date-of-death FMV of the assets transferred to AM Fields as \$17,297,329. However, because the notice of deficiency determined an inclusion of only \$17,062,631, and the IRS did not plead for an increase in this amount, the court accepted this amount as the value of the Estate.

The final issue of the case is whether the Estate is liable for a 20% accuracy-related penalty under §§6662(a) and (b)(1) for a substantial understatement of tax. The IRS argued that the Estate acted negligently or with reckless disregard of tax rules.

⁵⁶ *Estate of Bongard v. Comm'r*, 124 TC 95 (2005); *U.S. v. Estate of Grace*, 395 U.S. 316 (1969).

⁵⁷ *Estate of Bongard v. Comm'r*, 124 TC 95 (2005).

The Estate argued that Mr. Milner, as executor, made substantial efforts to determine the proper tax liability and relied on professional advice in good faith. However, the court found that Mr. Milner did not personally research or understand the implications of §2036, nor did he verify whether the Estate's \$6.2 million reduction in reported assets was legally justified. A reasonable person in Mr. Milner's position would have recognized such a large discount as questionable, undermining his claim of good faith.

Furthermore, there was no evidence that the Estate's accountant or its attorney specifically advised Mr. Milner that the Estate could both discount the value of Ms. Fields's partnership interest and exclude the full value of the transferred assets. Because the Estate failed to prove that it actually relied on competent professional advice, it did not establish reasonable cause for the underpayment.

Therefore, the court rejected the Estate's defense and held that it failed to meet its burden of proving reasonable cause or good faith reliance. As a result, the Estate is liable for the 20% accuracy-related penalty under §§6662(a) and (b)(1) for a substantial understatement of tax.

Holding. The court ruled in favor of the IRS, holding that the full date-of-death FMV of the assets transferred to AM Fields must be included in the gross estate under §2036(a) because the transfer lacked a bona fide non-tax business purpose and was primarily intended to reduce estate tax liability. Additionally, the court held that the total date-of-death FMV of the assets transferred to AM Fields was limited to \$17,062,631 because the IRS's notice of deficiency determined an inclusion of only that lower amount. Lastly, the court held that the Estate was liable for the 20% accuracy-related penalty due to negligence in reporting the estate's tax liability.

EXEMPT ORGANIZATIONS

First Amendment Issues

***Catholic Charities Bureau, Inc. v. Wisconsin Labor and Industry Review Commission*, 605 U.S. 238 (2025)**

Wis. Stat. §108.02(15)(h)(2)

First Amendment Impacts State Tax Classifications of Religious Organizations

Facts. Catholic Charities Bureau and four diocesan affiliates provide social service programs for the elderly, disabled, and poor under the Diocese of Superior, Wisconsin. In 2016, they sought a determination from the Wisconsin Department of Workforce Development that they qualified for the religious-employer exemption outlined in Wis. Stat. §108.02(15)(h). This unemployment compensation statute allows an exemption for religious employers provided they meet both of the following requirements.

1. **The employee is employed by a church, convention, or association of churches**, or by a minister or member of a religious order in the exercise of their ministry.
2. **The organization is operated primarily for religious purposes** and is operated, supervised, controlled, or principally supported by a church, convention, or association of churches.

The Catholic Charities Bureau and its affiliates argued that they qualified for Wisconsin's religious employer exemption from unemployment taxes because they operated primarily for religious purposes and are supervised, controlled, and supported by a church. The Wisconsin Department of Workforce Development disagreed, acknowledging that the organizations met the structural control requirement but concluding they did not operate for religious purposes. The Wisconsin Supreme Court affirmed that conclusion, reasoning that the organizations' lack of proselytization and their provision of services to people of all faiths rendered their activities to be secular in nature, not religious. As a result, the court held that they did not meet the exemption's requirement that the organization be operated primarily for religious purposes.

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Following the Wisconsin Supreme Court's ruling, Catholic Charities Bureau and its affiliates petitioned the U.S. Supreme Court for review, arguing that the state's interpretation of the exemption statute violated the First Amendment. The petition contended that Wisconsin's denial of the exemption imposed an unconstitutional denominational preference by favoring religious organizations that proselytize or serve only co-religionists. The Supreme Court granted certiorari to address whether the state's criteria for religious purpose improperly discriminated among religious organizations.

Issue. The issue in this case is whether a state may condition a religious exemption from unemployment tax on the presence of overtly religious activities, such as proselytization, without violating the First Amendment.

Analysis. Wisconsin, like many states, exempts specific religious organizations from contributing to its unemployment compensation fund. The Catholic Charities Bureau brought the case before the Supreme Court, arguing that this action violated their rights under the First Amendment's religious clauses. In its ruling, the Court examined parts of the interpretation and the statute. They found the First Amendment guarantees religious institutions broad autonomy to conduct their internal affairs and govern themselves. Additionally, the First Amendment protects a religious organization's right to establish voluntary religious associations and allow them to decide for themselves, free from state interference, matters of church governance, as well as faith and doctrine.

Holding. The Court held that the Wisconsin State Supreme Court violated the First Amendment's Religious Clauses, distinguishing between secular and religious, when they ruled in favor of the Wisconsin Department of Workforce Development. The Court held that Wisconsin's Supreme Court's interpretation of its exemption created a denominational preference, favoring religions that proselytize or serve only those within their faith, and discriminating against faiths whose doctrines forbid attempting to convert someone while engaging in charitable work. The Court ruled that the interpretation violated the Catholic Charities Bureau's First Amendment rights and could not stand.

Note. Although states may offer exemptions to religious organizations, laws or regulatory exemptions that single out certain denominations or require religious-specific activity as a condition for an exemption will likely face strict scrutiny.

FINCEN ISSUES

FBAR Penalties Jurisdiction

Stephen and Judy Jenner v. Comm'r, 164 TC 7 (2024)

IRC §§6320 and 6330

No Collection Due Process Hearings for FBAR Penalties

Facts. Stephen and Judy Jenner failed to timely file foreign bank account reports (FBAR) for 2005 to 2009 and were assessed FBAR penalties. In November 2022, the Department of Treasury informed the Jenners that it would withhold funds from their monthly social security benefits. The Jenners submitted forms to request collection due process (CDP) hearings. In May 2023, the IRS notified the Jenners through a letter that they did not qualify for a hearing because FBAR penalties are not taxes and are not subject to the requirements of IRC §6330.

The Jenners filed a petition with the Tax Court in June 2023 claiming they were denied CDP rights pursuant to §6330. The IRS filed a motion to dismiss the case for lack of jurisdiction because the collection of FBAR penalties is not subject to the requirements of §6330, which relates to notices and opportunities for hearing before a levy is imposed.

Issue. The issue in this case is whether FBAR penalties are subject to the requirements of §§6320 and 6330.

Analysis. FBAR penalties are authorized under Title 31 of the United States Code, whereas the Internal Revenue Code is found in Title 26. Under Title 31, each U.S. person who maintains a relationship with a foreign financial agency is required to keep certain records and file an annual report.⁵⁸ This report, known as Form 114, *Report of Foreign Bank and Financial Accounts*, must be submitted to the Financial Crimes Enforcement Network (FinCEN). The Secretary of the Treasury (Secretary) can impose a civil penalty on any person who fails to file Form 114.⁵⁹

The Secretary delegated to FinCEN the authority to enforce the provisions and impose civil penalties for anyone who fails to file the form. FinCEN further delegated this authority to the IRS. FBAR penalties are considered a nontax debt to the United States because it is not a debt or claim pursuant to the Code. Title 31 USC §3716 governs collection, which provides agencies with requirements and the authority to collect outstanding debts through administrative offsets.

The Tax Court has limited jurisdiction allowed only to the extent authorized by Congress. A taxpayer can petition the Tax Court for review of a valid notice of determination that falls under §6330(d)(1). The administrative determination must concern a tax over which the Tax Court generally has jurisdiction. The Jenners argue that the letter notifying them of their disqualification for a CDP hearing is a valid notice of determination under §6330. The Jenners also contend that the CDP procedures in §6330 apply to any type of liability if the Secretary files a lien or levy. However, §6330 covers only determinations relating to unpaid taxes governed under the Code.⁶⁰ FBAR penalties are not imposed by the Code and are not taxes covered by either §§6320 or 6330. FBAR penalties cannot be collected through liens or levies; instead, the collection is a civil action to recover a civil penalty. Therefore, the IRS has no obligation to provide petitioners with a CDP hearing.

Holding. The Tax Court held that because FBAR penalties are imposed under Title 31 — not the Internal Revenue Code — they are not “taxes” and thus not subject to the CDP procedures in §§6320 and 6330. The case was dismissed for lack of jurisdiction.

GROSS INCOME

Embezzled Funds

Matthew Hutcheson v. Comm’r, TC Memo 2025-1 (Jan. 2, 2025)

IRC §§61(a), 72(t), 975 6651(a)(1), 6662, 6663, 6751, and 7454

Retirement Plans and Renovation Scams

Facts. Matthew Hutcheson was a fiduciary of two retirement plans covered by the Employee Retirement Income Security Act of 1974 (ERISA). During 2010, he diverted over \$5.3 million in plan assets for personal use. Mr. Hutcheson used these funds to purchase and renovate a personal residence, pay personal and professional expenses, and finance an attempted acquisition of a resort and golf course through Green Valley Holdings, LLC (GVH), an entity he controlled. Mr. Hutcheson was later convicted of wire fraud and sentenced to over 17 years in prison.

The IRS issued a notice of deficiency for 2010, asserting that the diverted funds constituted unreported income. The IRS also assessed a fraud penalty under IRC §6663, an addition to tax for failure to file under IRC §6651(a)(1), and a 10% additional tax on an early individual retirement arrangement (IRA) distribution under IRC §72(t).

⁵⁸ 31 USC §5314(a).

⁵⁹ 31 USC §5321(a)(5)(A).

⁶⁰ IRC §6320(a)(3)(A).

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Issues. The issues in this case are the following.

- Whether Mr. Hutcheson had unreported income of \$5,307,688 from diverted retirement plan assets and \$10,825 from other sources
- Whether he was liable for the 10% additional tax on an early IRA distribution under §72(t)
- Whether he was liable for an addition to tax for failure to file under §6651(a)(1)
- Whether Mr. Hutcheson was liable for the civil fraud penalty under §6663

Analysis. Under IRC §61(a), gross income includes all income from whatever source derived, including embezzled funds. The court reaffirmed that misappropriated funds are includible in income in the year received. As an ERISA fiduciary, Mr. Hutcheson was required to act solely in the interest of plan participants. His diversion of plan assets for personal benefit constituted a breach of fiduciary duty and resulted in taxable income. The court found that Mr. Hutcheson exercised complete dominion and control over the diverted funds and used them for personal enrichment. The court rejected his claims that the funds were invested in a nonpublic company or used for community development. Supporting documents, including irrevocable trust receipts, were found to be falsified.

Regarding the early IRA distribution, the court held that Mr. Hutcheson failed to show that any statutory exception applied, making him liable for the 10% additional tax under §72(t). The court also upheld the addition to tax under §6651(a)(1) for failure to timely file his 2010 return.

Finally, the court found clear and convincing evidence of fraud under §6663. Mr. Hutcheson underreported income, provided false and inconsistent explanations, concealed assets, failed to cooperate with tax authorities, and engaged in illegal conduct. He created and used falsified documents and forged signatures. His conduct demonstrated a willful intent to evade tax, and the entire underpayment was deemed attributable to fraud.

Holding. The Tax Court held that Mr. Hutcheson had unreported income of \$5,307,688 from embezzled plan assets and \$10,825 from other sources. The court also held that he was liable for the 10% additional tax on an early IRA distribution under §72(t). Additionally, the court held that Mr. Hutcheson was liable for the addition to tax for failure to file under §6651(a)(1) and for the 75% civil fraud penalty under §6663.

Updated Mileage Rates

Rev. Rul. 2025-9, 2025-16 IRB 1415 (Apr. 14, 2025)

IRC §61

Personal Use of Company Aircraft

Purpose. Rev. Rul. 2025-9 provides updated Standard Industry Fare Level (SIFL) rates and terminal charges for valuing noncommercial flights on employer-provided aircraft. Just as employees are imputed income for personal use of company automobiles, Treas. Reg. §1.61-21(g) imputes income based on personal use of company aircraft. These valuations are used to determine the fringe benefit income to be included under IRC §61 when employees or other service recipients use such aircraft for personal purposes.

Analysis. The ruling continues the semi-annual update practice by incorporating the latest Department of Transportation SIFL rates and terminal charges, which are necessary for applying the base aircraft valuation formula under Treas. Reg. §1.61-21(g)(5). For the first half of 2025, the SIFL mileage rates are tiered as follows:

- **Tier 1: Up to 500 miles:** \$0.2869 per mile
- **Tier 2: 501 to 1,500 miles:** \$0.2187 per mile
- **Tier 3: Over 1,500 miles:** \$0.2103 per mile

Once the total mileage is determined, the corresponding mileage charge is calculated, and then this amount is multiplied by an aircraft-use percentage. The percentage varies based on whether the individual is classified as a **control employee**, such as a director or elected officer.⁶¹ The percentage also varies with the aircraft's maximum certified take-off weight.⁶² For example, for an aircraft with a maximum certified take-off weight between 6,001 and 10,000 pounds, the applicable multiplier is 125% for a control employee and 23.4% for a non-control employee.

These figures are critical inputs when calculating the value of personal flights, in combination with the aircraft multiples specified in Treas. Reg. §1.61-21(g)(7). Tax professionals advising clients on executive compensation and fringe benefits should ensure that payroll and reporting systems are updated with these new figures to ensure compliance and accurate reporting on Form W-2, *Wage and Tax Statement*. As with prior rulings, no substantive changes have been made to the valuation methodology; the ruling functions strictly to update the rate inputs for the applicable period.

Effective Date. The associated rates are valid from January 1, 2025, through June 30, 2025.

Extensive Business Losses

Mohamad Aboui and Mahyar Mizani v. Comm'r, TC Memo 2024-106 (Dec. 9, 2024)

IRC §§161, 162, 166, 172, 469, 1366, 1368, and 6662(a)

Revving Up Tax Law

Facts. Mohamad Nasser Aboui and Mahyar Mizani filed joint federal income tax returns for 2013 through 2016. Mr. Aboui was the sole shareholder of HPPO Corp., an S corporation that operated several used car dealerships in California. HPPO specialized in selling vehicles to customers with poor credit, offering in-house financing for the vast majority of its sales. The business model involved recognizing the full sale price of vehicles at the time of sale, even when customers paid in installments. However, HPPO frequently faced defaults, with many vehicles repossessed — often in poor condition — and over 250 vehicles never recovered.

During the years at issue (2013–2016), HPPO began winding down operations due to financial losses and family health issues. Mr. Aboui used HPPO's bank accounts to pay personal and unrelated business expenses, including those related to his real estate ventures. The IRS identified deficiencies in their filings and assessed accuracy-related penalties under IRC §6662(a) as shown in the following table.

Year	Identified Deficiency	Accuracy-Related Penalty
2013	\$ 805,149	\$161,030
2014	1,145,104	229,021
2015	1,161,864	232,373
2016	831,771	166,354

The audit was complicated by the death of Mr. Aboui and Ms. Mizani's original accountant and miscommunications from a subsequent representative, which led the IRS to reconstruct income using a bank deposit analysis and to treat HPPO as a cash-basis taxpayer — contrary to its actual hybrid accounting method.

⁶¹ Treas. Reg. §1.61-21(g)(8).

⁶² Treas. Reg. §1.61-21(g)(7).

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The IRS later adjusted the deficiencies and accuracy-related penalties as follows.

Year	Adjusted Deficiency	Adjusted Accuracy-Related Penalty
2013	\$ 970,872	\$194,174
2014	1,374,515	274,903
2015	1,181,074	237,015
2016	756,519	151,304

Issues. The issues in this case are the following.

- Whether HPPO had any unreported income for 2016
- Whether HPPO can claim deductions for the cost of goods sold (COGS), business expenses, and bad debts each year
- Whether Mr. Aboui and Ms. Mizani may deduct net operating losses (NOL) for 2013 through 2016
- Whether their real estate losses can be deducted
- Whether the distributions made by HPPO to the couple should be considered taxable
- Whether the accuracy-related penalties under §6662(a) are dismissible

Analysis. The couple and HPPO Corp. claimed significant NOL and business deductions, including COGS, bad debts, real estate losses, and distributions from HPPO, for the years 2013 through 2016.

The Revenue Agent (RA) for the IRS reconstructed the car dealer's gross income but used the cash method when, in fact, HPPO used a **hybrid method** of accounting, with gross receipts accounted for using the accrual method. HPPO recognized income when it sold a car on credit, which made individual payments the repayment of debt with interest. The court found that the RA's use of the cash method led to distortions in income, including overreporting for 2013–2015 and an incorrect underreporting adjustment for 2016. The court ultimately rejected the RA's reconstruction and accepted HPPO's reported income.

The court concluded that Mr. Aboui provided extensive documentation of his corporation's COGS and business expenses that substantiated all except the meals and entertainment expense. In contrast, the IRS's use of the bank deposits method introduced inaccuracies into the computation of gross income because it was an incorrect method of accounting to apply in this case. Thus, Mr. Aboui was entitled to adjust gross income using the business's COGS as he calculated.

Bad debt deductions are authorized by IRC §166 when a taxpayer can prove that a debt exists and has become worthless or uncollectible. Because the court recognized that Mr. Aboui had consistently recognized income from HPPO's car sales and could document his inability to repossess all cars associated with uncollectible debt, Mr. Aboui was entitled to deduct bad debt expenses.

The court found that Mr. Aboui and Ms. Mizani were not entitled to the claimed NOL deductions. Although the court disallowed the claimed NOL deductions due to a lack of substantiating evidence, the petitioners were still entitled to deduct passthrough losses from HPPO to the extent they were properly reported and supported. The court sustained the real estate losses. Because the Abouis had a deduction of \$43,629 in 2014 and did not carry forward any unused passive losses to the other properties, the court allowed them to deduct the real estate loss for 2014.

The court sustained the real estate losses because Mr. Aboui and Ms. Mizani did not carry forward any of the other losses for the other six properties. However, the court forbade the IRS from raising the active participation requirement as a new issue subsequent litigation.

The IRS correctly assessed some taxable shareholder distributions for 2013 through 2016. The couple did not challenge the treatment of these distributions. However, they provided records showing basis for the distributions, making them not taxable for 2013 or 2014.

The IRS's assessment of accuracy-related penalties was not sustained, because the underpayment was not due to negligence, and the couple acted with reasonable cause and in good faith. They kept substantial records for HPPO's business and provided them to their accountant, relying on the accountant to prepare the returns for the business and personal filings.

Holding. The court found that HPPO did not have unreported income for 2016. The court also found that HPPO was entitled to adjust its gross income with COGS expense and to deduct allowed business expenses, including bad debt deductions. However, the court determined that HPPO could not support the NOLs it claimed; accordingly, the court disallowed these deductions.

The court found that the Mr. Aboui and Ms. Mizani could deduct real estate losses, subject to limitations, and could carry forward unused passive losses. The court found that some, but not all, of the distributions that the couple received were taxable. Finally, the court determined that Mr. Aboui and Ms. Mizani were not liable for the accuracy-related penalties under IRC §6662(a) for 2013 through 2016.

INNOCENT SPOUSE

Innocent Spouse Relief

Joanne Salvi and Michael Vanover v. Comm'r, TC Memo 2025-37 (Apr. 22, 2025)
IRC §6015

Knowledge, Compliance, and Credibility Prevent Innocent Spouse Relief

Facts. Joanne Salvi Vanover (Ms. Salvi), a human resources professional with a master's degree, was married to Michael Vanover from 2015 until their divorce in 2023. During the years at issue (2017 and 2018), the couple lived in a home solely owned by Ms. Salvi in Ohio, along with her two children from a prior relationship. The couple maintained separate finances but shared a joint account for household expenses. Ms. Salvi managed the household bills and tax filings, while Mr. Vanover contributed a portion of his income to shared expenses.

Mr. Vanover had a long history of financial and tax problems, including unpaid federal and state taxes, delinquent child support, and failure to file tax returns from 2004 to 2014. Ms. Salvi testified that she became aware of his financial issues around 2017, when she noticed frequent collection calls and his inability to obtain credit. In 2017, the couple entered into an IRS installment agreement for unpaid 2015 taxes, which Ms. Salvi helped arrange.

The couple filed joint returns for 2017 and 2018, both prepared by Ms. Salvi's cousin, a CPA. The 2017 return was filed late and showed a balance due, which was not paid. The 2018 return was also filed late and initially omitted some of Mr. Vanover's income. A corrected return was later filed, showing a tax due of over \$21,000, which also went unpaid.

In 2020, the couple's relationship deteriorated following a physical altercation that led to Ms. Salvi's arrest and conviction for domestic violence. They separated shortly thereafter and finalized their divorce in 2023. The divorce decree ordered an equal division of IRS liabilities for the years 2015 through 2019, subject to modification by the Tax Court.

Ms. Salvi filed Form 8857, *Request for Innocent Spouse Relief*, claiming she was unaware of Mr. Vanover's tax issues and that he withheld financial information. She also alleged abuse and financial control. The IRS granted partial relief under IRC §6015(c) for items attributable solely to Mr. Vanover but denied relief for the remainder. Ms. Salvi petitioned the Tax Court.

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Issue. The issue in this case is whether Ms. Salvi was entitled to full or additional relief from joint and several liability under §6015(b), (c), or (f) for tax years 2017 and 2018.

Analysis. Under § 6015(b), the court found that Ms. Salvi had reason to know of the understatement on the 2018 return. She was aware of Mr. Vanover’s financial issues, had access to the tax documents, and played a central role in preparing the returns. Her failure to inquire further about the accuracy of the returns precluded relief.

Under §6015(c), the court granted proportional relief for the portion of the 2018 deficiency attributable solely to Mr. Vanover — specifically, unreported self-employment income and a retirement distribution subject to the IRC §72(t) penalty. The court found no evidence that Ms. Salvi had actual knowledge of these items.

Under §6015(f), the court conducted a full equitable relief analysis using the factors outlined in Rev. Proc. 2013-34. While Ms. Salvi was divorced and did not significantly benefit from the unpaid taxes, several factors weighed against relief.

- She had reason to know the tax would not be paid.
- She failed to demonstrate economic hardship.
- Her post-separation tax compliance was inconsistent.
- Her claims of abuse and financial control were either unsupported or contradicted by the record.

The court found her testimony lacking in credibility, particularly regarding her knowledge of the returns and her claims of abuse. In contrast, Mr. Vanover’s testimony was found to be credible.

Holding. The Tax Court granted partial relief under §6015(c) for the portion of the 2018 deficiency attributable to Mr. Vanover but denied all other relief under §§6015(b), (c), and (f).

Innocent Spouse Relief

***Monique Franco v. Comm’r*, TC Summ. Op. 2024-21 (Oct. 8, 2024)**

IRC §§6015(f), 6663, and 7463(b)

Constructive Knowledge Critical Despite 3-Step Framework for Equitable Relief

Facts. Monique Franco and her husband, Charles Bolgiani, filed a joint federal income tax return for 2018 that failed to report \$97,174 in income. The omitted income was earned by both spouses. Of the omitted income, \$16,326 in gambling winnings was attributable specifically to Ms. Franco. The IRS issued a notice of deficiency for \$22,248 and a civil fraud penalty of \$17,069 under IRC §6663. Ms. Franco conceded the deficiency but contested the penalty and sought innocent spouse relief under IRC §6015(f). The IRS conceded the fraud penalty but denied relief.

The couple had a turbulent marriage, including alleged affairs, abuse, and financial control by Mr. Bolgiani. He was solely responsible for preparing their tax returns, and Ms. Franco signed the returns without review. The refund was deposited into Mr. Bolgiani’s separate bank account. At trial, Ms. Franco alleged she had been threatened or abused when asking to review the returns.

With a high school education, Ms. Franco participated in the household’s finances but had a history of prior tax audits and denied innocent spouse claims. She was still married to Mr. Bolgiani at the time of trial and resided in a home valued at \$313,000. She alone held the title to this residence. Her monthly income was estimated at \$3,500 plus \$550 in rent, but she failed to substantiate her income and expenses adequately.

Issues. The issue in this case is whether Ms. Franco is entitled to innocent spouse relief under §6015(f) for 2018.

Analysis. Innocent spouse relief under §6015 provides relief from joint and several liability for spouses who file joint tax returns. To qualify, the spouse requesting relief must prove that they did not know or have reason to know of the understatement of tax. It would be inequitable to hold them liable for the deficiency.

In this case, Ms. Franco did not significantly benefit from the understatement of income. While the tax refund was deposited solely into Mr. Bolgiani's account, suggesting Ms. Franco did not directly benefit from **his** unreported income, the situation is complicated by the fact that Ms. Franco herself had unreported gambling earnings.

Regardless of whether she directly received the refund related to Mr. Bolgiani's income, her election to file a joint return with him under IRC §6013(a) carries significant legal consequences. This election subjects both spouses to **joint and several liability** for the accuracy of the entire return, including all items of income — both hers (the gambling winnings) and his (the other unreported income) — and the total tax liability, as outlined in §6013(d)(3). Ms. Franco is equally responsible for any tax deficiency arising from **both** her unreported gambling income and Mr. Bolgiani's unreported income, even if she was unaware of the specifics of his earnings. The principle of joint and several liability, as affirmed in cases like *Butler v. Comm'r*,⁶³ holds both spouses accountable for all tax obligations on a jointly filed return.

Ms. Franco signed the joint tax return without reviewing it due to fear of physical abuse or of Mr. Bolgiani withholding money to buy food. She claimed that her turbulent relationship with Mr. Bolgiani supports the inequity of holding her liable for the deficiency.

The IRS and Ms. Franco agreed that she was ineligible for either **general relief** under §6015(b) or **separate liability relief** under §6015(c) but left open the possibility that she might qualify for **equitable relief** under §6015(f). In considering this alternative, the Tax Court analyzed Ms. Franco's claim using the 3-step framework in Rev. Proc. 2013-34, §§401–403.⁶⁴

1. **Threshold requirements** (§4.01) must be satisfied if any further consideration of the request is to be made. Ms. Franco satisfied all the threshold requirements.
 - ♦ Marital status
 - ♦ Economic hardship
 - ♦ Knowledge or reason to know of the item giving rise to the deficiency
 - ♦ Legal obligation
 - ♦ Significant benefit
 - ♦ Compliance with income tax laws
 - ♦ Mental or physical health
2. **Streamlined relief** (§4.02) is considered next after it has been determined that the threshold requirements have been satisfied. This alternative is not available to Ms. Franco because she was still married to Mr. Bolgiani during the tax year in question.
3. **Facts and circumstances** (§4.03) can be considered by the IRS if streamlined relief is unavailable. In Ms. Franco's case, the seven factors yielded mixed results.

⁶³ *Butler v. Comm'r*, 114 TC 276, 282 (2000).

⁶⁴ Rev. Rul. 2013-34, 2013-43 IRB 397.

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The court judged three factors to be **neutral** in Ms. Franco's case: her marital status, her joint legal obligation for the tax liability, and her compliance with federal income tax law in subsequent years because neither she nor the IRS could establish whether she had filed subsequent tax returns using the married filing jointly or married filing separately filing status.

The court decided that two factors weighed **in her favor**. She received no significant benefit from the income understatement, and she suffered from poor physical and mental health.

Two important factors weighed **against** equitable relief in her case. First, Ms. Franco had significant equity in her home, so she failed to prove she had financial hardship. Second, the court decided she had reason to know that income items had been omitted from the return. Although Ms. Franco signed the return without reviewing it due to fear of physical assault or of being denied money to purchase food, she should have known that the return omitted her gambling winnings. Her involvement in the household financial decisions and prior history of filing inaccurate tax returns indicate she had reason to know, and therefore constructive knowledge, of the items giving rise to the deficiency.

The court noted inconsistencies and lack of reliability in Ms. Franco's testimony, including conflicting statements regarding living expenses and prior tax history. Ms. Franco's testimony regarding Mr. Bolgiani's abuse was not backed by additional evidence, and the court found her testimony unreliable on this issue. Therefore, the abuse exception does not apply.

Holding. The Tax Court denied innocent spouse relief under §6015(f). Ms. Franco failed to demonstrate economic hardship and was found to have had reason to know of the understatement on the 2018 return. The court found no credible evidence of abuse sufficient to override her constructive knowledge.

Note. For more information about innocent spouse relief, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 8: Divorce.



IRS PROCEDURES — MISCELLANEOUS

Power of Attorney

Vensure HR, Inc. v. Comm'r, No 1:20-cv-00728-PEC (Oct. 4, 2024)

Treas. Reg. §301.6402-2(e)

IRS Waives Goodbye to a Power of Attorney Attachment Requirement

Facts. Vensure HR, Inc., provides tax reporting services to businesses as a professional employer organization. Vensure believed it overpaid the IRS more than \$3.7 million in the spring of 2014 and filed for a refund. Vensure claimed it was unable to pay taxes for later periods due to this overpayment, but the IRS assessed late-payment penalties of more than \$1.5 million, which Vensure paid. In 2016, Vensure filed six Forms 843, *Claim for Refund and Request for Abatement*, seeking a refund. The forms were signed by an attorney representing Vensure, but no Forms 2848, *Power of Attorney, and Declaration of Representative*, were attached, which the instructions for Form 843 require when a legal representative signs the form. Nevertheless, the IRS refunded approximately \$750,000 of the refund that Vensure sought.

However, either Vensure or its attorneys sent at least three powers of attorney (POAs) to the IRS separately in 2015 and 2017. In 2018, the IRS denied the penalty-refund claims because Vensure had not shown “reasonable cause.” Perhaps inadvertently, the IRS acknowledged that it had the POA on file when it sent the denial of the refund claim to Vensure's attorney.

Vensure filed a complaint in the Court of Federal Claims in 2020 seeking a penalty refund. The IRS moved to dismiss the complaint for lack of subject-matter jurisdiction, arguing that the complaint had not been properly filed. Vensure argued it substantially complied. The IRS won at trial and on Vensure's appeal to the Court of Federal Claims. Vensure appealed to the Court of Appeals for the Federal Circuit.

Issues. The issues in this case are the following.

- Whether Treas. Reg. §301.6402-2(e) requires a POA to be physically attached to the refund claim
- Whether the requirement to attach a POA is a statutory non-waivable requirement or one that the IRS can waive
- Whether the IRS waived the requirement for the POA to accompany Form 843

Analysis. Treas. Reg. §301.6402-2(e) provides that a POA must “accompany” the tax refund filing. According to the regulation, and the instructions for Form 1040, *U.S. Individual Income Tax Return*, attaching a POA is necessary, although neither the regulation nor the instructions specify how to attach it. There are no statutory provisions that provide the method of filing a POA with the IRS; thus, the “accompany” requirement is regulatory in nature and, therefore, waivable. Further, the court noted that the IRS accepts a POA recorded in the centralized authorization file (CAF) system for Form 1040, *U.S. Individual Income Tax Return*, even though the regulations governing the use of POAs with that form were similar to the regulations governing their use with Form 843. The court concluded that the IRS derived its procedures from the IRS's own instructions and publications instead of the language of the Code or its authorized regulations.

Whether the IRS had waived the POA requirement by investigating the claim's merits is a fact-based question that the appellate court left to the Court of Federal Claims to decide on remand. However, the fact that the IRS had refunded some portion of the claim makes it clear that it had investigated the merits of Vensure's claim. If the IRS investigates a claim, it has effectively “dispensed with the formal requirements” when “it took action upon the claim.”⁶⁵

Holding. The court held that the requirement that a POA be attached to a refund claim is waived if the IRS decides to investigate the claim without an attached POA. Because the IRS did investigate the merits, the case was remanded for a factual determination on whether the IRS waived the POA requirement.

Obsolete Guidance

IRS Notice 2025-22 (May 5, 2025)

IRC §§409A, 864, 965, 4191, and 4980I

Obsolete Guidance No Longer Enforced

Purpose. Under Executive Order 14219, the current administration is identifying regulations and other guidance documents for elimination. These documents no longer serve a purpose due to legislative repeal, expiration, or policy shifts.

Analysis. The IRS begins by withdrawing its support for IRS Notice 2015-73,⁶⁶ indicating it will no longer litigate the matter it addressed. In its final month, the Biden administration announced it would no longer defend any listed transaction notices that it issues under basket market options. This 10-year-old notice classified certain structured transactions as **listed transactions** because taxpayers used them to attempt to convert ordinary or short-term capital gains into long-term capital gains.

⁶⁵ *Angelus Milling Co. v. Comm'r*, 325 U.S. 293 (1945).

⁶⁶ IRS Notice 2015-73, 2015-46 IRB 660, *invalidated by* AOD 202401 (Dec. 24, 2024).

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Additionally, IRS Notice 2009-49⁶⁷ has been terminated based on the winding down of all troubled asset relief programs (TARP) at the end of the federal government's fiscal year 2023.⁶⁸ IRS Notice 2009-49 was issued in the wake of the Emergency Economic Stabilization Act of 2008⁶⁹ and incorporated into IRC §409A(a)(2)(A)(v). Under the terms of IRS Notice 2009-49, if the Treasury Department acquired the equity or warrants to purchase the equity of a financial institution, this action would not be considered a change in control. Because the TARP provisions ceased in 2023, this notice can be made obsolete with no practical impact.

Repealed provisions in the Code justified the withdrawal of the following notices or announcements.

- **Medical device excise tax deposit penalty relief.** Under IRS Notice 2018-10, manufacturers of medical devices were subject to excise taxes under IRC §4191⁷⁰. This notice granted relief from penalties for the first three calendar quarters of 2018. Because the Further Consolidated Appropriations Act of 2020⁷¹ repealed the penalties, IRS Notice 2018-10 is no longer enforceable.
- **Taxable medical devices: correction #1.** IRS Ann. 2013-23 contained corrections to the final regulations on the excise tax applied to medical device sales.⁷² Because the underlying tax law was repealed, the announcement is no longer needed. The original corrections appeared in TD 9604.⁷³
- **Taxable medical devices: correction #2.** IRS Ann. 2013-19 contained additional corrections to the final regulations providing guidance on the excise tax on medical device sales.⁷⁴ Because the excise tax is no longer in effect, the IRS is rescinding this announcement.
- **Excise tax on high-cost employer-sponsored health coverage #1.** IRS Notice 2015-16 was issued to initiate the regulatory process for implementing the excise tax on high-cost employer-sponsored health coverage, added by the Affordable Care Act.⁷⁵ Congress repealed this provision in the Further Consolidated Appropriations Act of 2020, rendering this notice obsolete.
- **Excise tax on high-cost employer-sponsored health coverage #2.** IRS Notice 2015-52 provided further guidance on the excise tax, which is now moot due to the repeal.⁷⁶

Before the enactment of the Tax Cuts and Jobs Act (TCJA),⁷⁷ IRC §965 allowed domestic corporations a temporary dividends-received deduction for dividends from their controlled foreign corporations. IRS Notice 2005-64 provided guidance for the treatment of foreign taxes under this provision.⁷⁸ TCJA rewrote §965, making the notice obsolete.

Finally, TCJA also rendered Rev. Rul. 91-32 unnecessary.⁷⁹ This ruling addressed the tax consequences of a foreign partner disposing of an interest in a partnership, either domestic or foreign. TCJA codified the relevant principles, eliminating the need for separate guidance.

⁶⁷ IRS Notice 2009-49, 2009-25 IRB 1093.

⁶⁸ *TARP Reports*. Dec. 7, 2023. U.S. Department of the Treasury. [home.treasury.gov/data/troubled-assets-relief-program/reports] Accessed on May 6, 2025.

⁶⁹ *Emergency Economic Stabilization Act of 2008*, PL 110-343.

⁷⁰ IRS Notice 2018-10, 2018-08 IRB 359.

⁷¹ *Further Consolidated Appropriations Act of 2020*, PL 116-94.

⁷² IRS Ann. 2013-23, 2013-16 IRB 940.

⁷³ TD 9604, 2012-52 IRB 730.

⁷⁴ IRS Ann. 2013-19, 2013-14 IRB 760.

⁷⁵ IRS Notice 2015-16, 2015-10 IRB 732; *Patient Protection and Affordable Care Act*, PL 111-148.

⁷⁶ IRS Notice 2015-52, 2015-35 IRB 227.

⁷⁷ *Tax Cuts and Jobs Act*, PL 115-97, §14103(a).

⁷⁸ IRS Notice 2005-64, 2005-36 IRB 471.

⁷⁹ *Tax Cuts and Jobs Act*, PL 115-97, §13501; Rev. Rul. 91-32, 1991-20 IRB 20.

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The following table summarizes the affected notices, announcements, and revenue rulings.

Guidance	Code Section or Regulation Affected	Action
IRS Notice 2015-73	IRC §§6111, 6112; Treas. Reg. §1.6011-4(b)	Obsoleted
IRS Notice 2009-49	IRC §409A	Obsoleted
IRS Notice 2018-10	IRC §§4191, 6656	Obsoleted
IRS Announcement 2013-23	IRC §4191	Obsoleted
IRS Announcement 2013-19	IRC §4191	Obsoleted
IRS Notice 2015-16	IRC §4980I	Obsoleted
IRS Notice 2015-52	IRC §4980I	Obsoleted
IRS Notice 2005-64	IRC §965	Obsoleted
Rev. Rul. 91-32	IRC §§701, 702, 704, 741, 865, 875; Treas. Reg. §1.864-4	Obsoleted

Prompt Response to IRS Communications

Rosa Marcano v. Comm’r, TC Summ. Op. 2024-26 (Dec. 23, 2024)

IRC §§6213 and 7422

An Expensive Vacation

Facts. On October 2, 2023, the IRS mailed a notice of deficiency to Rosa Marcano. Ms. Marcano received the notice on October 5, 2023. Ms. Marcano traveled to Cabo San Lucas, Mexico, from October 23 to 30, 2023, and Bogota, Colombia, from December 15, 2023, to January 28, 2024. She signed and dated her petition on January 10, 2024. It was filed on January 17, 2024, 107 days after the IRS mailed the notice.

Issue. The issue in this case is whether Ms. Marcano was entitled to the extended 150-day period to file a Tax Court petition, rather than the standard 90 days, based on her international travel during the filing window.

Analysis. The Tax Court’s jurisdiction in a deficiency case hinges on two requirements: the issuance of a valid notice of deficiency and the taxpayer’s timely filing of a petition — within 90 days of the notice’s mailing, or 150 days if certain conditions are met. The petition must be filed within 90 days of the IRS’s mailing of the petition or within 150 days if it is addressed to someone outside the United States.⁸⁰

Ms. Marcano argues that because she was out of the country when the 90-day period expired, she should be entitled to the 150-day filing period. However, the petitioner’s absence must result in a **delayed receipt** of the notice.⁸¹ In this case, Ms. Marcano received the notice when it was first delivered on October 5, 2023. She then spent another three weeks in the United States.

Holding. The court held that neither of Ms. Marcano’s trips entitled her to the 150 days because she received the notice in the United States when it was delivered; thus, there was no delayed receipt. Consequently, the Tax Court has no jurisdiction because the petition was not filed within the applicable 90-day period. Ms. Marcano may pay the amount in dispute and file a claim for a refund.⁸²

⁸⁰ IRC §6213(a).

⁸¹ *Levy v. Comm’r*, 76 TC 228, 231 (1981), quoting *Mindell v. Comm’r*, 200 F.2d 38, 39 (2d Cir. 1952).

⁸² IRC §7422(a).

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Foreign Income/Bankruptcy Procedures

U.S. v. Brian Miller, 604 U.S. ____ (2025)

11 USC §§106(a) and 544(b)

Sovereign Immunity Limits Trustee's Power to Avoid Fraudulent Transfers

Facts. Brian Miller, served as the bankruptcy trustee for a failed Utah-based business. During the course of the bankruptcy proceedings, Mr. Miller discovered that the company's shareholders had misappropriated approximately \$145,000 in corporate funds to pay their personal federal tax debts.

Mr. Miller filed an avoidance action under 11 USC §544(b), which allows a trustee to avoid transfers that an actual unsecured creditor could void under applicable law. He relied on Utah's fraudulent-transfer statute as the applicable law and named the United States as the transferee, seeking to claw back the tax payments made to the IRS.

The federal government moved to dismiss the claim, asserting that **sovereign immunity** barred the action. It argued that no actual unsecured creditor could sue the United States under Utah law, and therefore, Mr. Miller could not either. The lower courts disagreed, holding that 11 USC §106(a) waived the government's sovereign immunity for the entire §544(b) claim, including the underlying state-law fraudulent transfer claim.

Issue. The issue in this case is whether Mr. Miller can recover federal tax payments made by a debtor to the IRS under a state fraudulent transfer law when the IRS would normally be protected by sovereign immunity.

Analysis. Mr. Miller argued that these payments were fraudulent transfers under Utah's Uniform Fraudulent Transfer Act (UFTA) because they used company funds to satisfy personal tax debts, thereby depleting the bankruptcy estate to the detriment of creditors. Under §544(b), a trustee may "step into the shoes" of an actual unsecured creditor and assert any claim that creditor could bring under applicable non-bankruptcy law. Mr. Miller identified such a creditor and invoked Utah's fraudulent transfer statute to challenge the payments to the IRS.

The legal conflict arose because the United States, as the recipient of the funds, claimed sovereign immunity — a doctrine that generally protects the federal government from being sued unless Congress has clearly waived that immunity. Mr. Miller countered that 11 USC §106(a) waived sovereign immunity for all claims brought under §544(b), including those based on state law.

The Supreme Court disagreed. It emphasized that while §106(a) does waive sovereign immunity for certain **federal** Bankruptcy Code provisions (including §544), it does **not** extend that waiver to **state-law causes of action** embedded within those provisions. The Court reasoned that allowing such a broad interpretation would effectively let state law dictate the federal government's liability, which Congress did not clearly authorize.

The Court also highlighted a key limitation of §544(b): the trustee can only bring claims that an actual unsecured creditor could bring outside of bankruptcy. Because no private creditor could sue the United States under Utah's UFTA due to sovereign immunity, Mr. Miller likewise lacked standing to do so.

Holding. The Supreme Court held that §106(a) waives sovereign immunity only for the **federal causes of action** listed in that section, such as §544 itself — not for **state-law claims** that a trustee may invoke under §544(b). The Court reversed the Tenth Circuit, holding that §106(a) does not waive sovereign immunity for state-law claims embedded in §544(b) actions. The trustee could not proceed against the United States under Utah's fraudulent-transfer law.



Partnerships

***Alan Hamel and Estate of Suzanne Hamel v. Comm’r*, TC Memo 2025-19 (Feb. 25, 2025)**

IRC §6229

No More *Chevron*, No Problem... Maybe

Facts. In a prior decision,⁸³ the Tax Court held that Alan and Suzanne Hamel were unidentified partners under IRC §6229 and upheld the IRS’s notices of deficiency issued to the Hamels in March 2021. The court relied in part on *Chevron, U.S.A. v. Natural Resources Defense Council*⁸⁴ to uphold the validity of Temp. Treas. Reg. §301.6229(e)-1T, which interprets how partner-identifying information must be furnished. A partner is unidentified if “the name, address, and taxpayer identification number of a partner are not furnished on the partnership return for a partnership taxable year.”⁸⁵ Temp. Treas. Reg. §301.6229(e)-1T interprets “furnished” in §6229(e) to mean that a partner is unidentified until identifying information is provided by a method prescribed in Temp. Treas. Reg. §301.6223(c)-1T.⁸⁶

After the Supreme Court overruled *Chevron* in *Loper Bright Enterprises v. Raimondo*,⁸⁷ the Hamels filed a motion for reconsideration, arguing that the Tax Court’s reliance on *Chevron* was no longer valid and that the regulation exceeded the scope of §6229(e).

Issue. The issue in this case is whether the court impermissibly relied on *Chevron* when interpreting Temp. Treas. Reg. §301.6229(e)-1T in its prior decision.

Analysis. In its prior decision, the Tax Court found §6229(e) to be ambiguous where Congress used the word “furnish,” and deferred to the IRS’s interpretation of how partner-identifying information must be provided. Although the Supreme Court has overruled *Chevron*, the Court noted that *Chevron* did not mandate overruling prior cases simply because they relied on *Chevron*. Thus, the mere fact that *Chevron* was overruled did not undermine the Tax Court’s previous decision in this matter.

Furthermore, the court acknowledged it relied on *Chevron* when it deferred to the IRS’s interpretation of §6229(e). However, the Tax Court held that it would no longer provide a deferential and permissible interpretation of the statute simply because an administrative agency, such as the Treasury, offered it. Instead, the court stated that it will now use every tool of statutory interpretation needed to resolve ambiguity. Yet, the court noted that Congress delegated authority to the Treasury Department to write regulations regarding the partnership information required by §6229(e). Thus, the court concluded that even though *Chevron* has been overruled, the best reading of §6229(e) is consistent with Temp. Treas. Reg. §301.6223(c)-1T.

Holding. The Tax Court reaffirmed its prior decision, finding that even though *Chevron* was overruled, the IRS’s reading of §6229(e) was the best interpretation.

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⁸³ *Hamel v. Comm’r*, TC Memo 2024-62 (Jun. 3, 2024).

⁸⁴ *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.* 467 U.S. 837 (1984).

⁸⁵ Treas. Reg. §301.6223(c)-1(b)(3)(i).

⁸⁶ This regulation is now final regulation Treas. Reg. §301.6223(c)-1.

⁸⁷ *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024).

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Tax Court Jurisdiction

Comm'r v. Zuch, 605 U.S. 422 (Jun. 5, 2025)

IRC §6330

Supreme Court: Tax Court Cannot Rule on Liability After Levy Is Lifted

Facts. In 2012, Jennifer Zuch and her then-husband, Patrick Gennardo, each filed untimely 2010 married filing separately tax returns. For tax year 2010, the couple paid \$50,000 in estimated taxes to their account. Ultimately, both taxpayers had balances due. Mr. Gennardo, who owed a significant balance, filed an offer in compromise, which the IRS accepted. As part of the resolution, the IRS applied the entire \$50,000 in estimated payments to his account. Subsequently, Ms. Zuch amended her 2010 return to report additional income, resulting in an additional \$28,000 in tax liability. She claimed entitlement to the full \$50,000 in estimated payments and requested a \$22,000 refund.

The IRS disagreed and sought to collect Ms. Zuch's unpaid taxes by placing a levy on her property. Ms. Zuch requested a collections due process (CDP) hearing and contested the levy. The appeals officer (AO) did not consider Ms. Zuch's argument about the misapplied \$50,000 tax payment and issued a notice of determination sustaining the levy action under IRC §6330(c)(3).

Ms. Zuch appealed to the Tax Court under §6330(d)(1). During the prolonged litigation, Ms. Zuch's subsequent tax filings generated refunds. The IRS offset the refunds until the liability for 2010 was zero, and then the IRS moved to dismiss the Tax Court proceeding. The IRS argued that the Tax Court lacked jurisdiction because the IRS no longer had a basis to levy Ms. Zuch's property.

The Tax Court ruled in favor of the IRS and dismissed the case. Ms. Zuch appealed to the Third Circuit Court. The Third Circuit Court vacated the dismissal, holding that the IRS's abandonment of the levy did not render the Tax Court proceedings moot. The IRS filed an appeal to the Supreme Court.

Issue. The issue in this case is whether the Tax Court retains jurisdiction under §6330 to resolve disputes about underlying tax liability once the IRS releases a levy.

Analysis. The scope of the CDP hearing was limited to the levy; therefore, this prevented the AO from considering any additional disputes regarding the liability. It could be argued that a taxpayer may raise any relevant disputes relating to §6330(c)(3), but not all disputes are required to be considered when they are outside the scope.

IRC §6330(e)(1) authorizes the Tax Court to enjoin any action or proceeding of the unpaid tax or proposed levy; however, that power does not extend to ordering refunds or declaratory judgments once there is no pending levy. Under the default rule of IRC §7421(a), taxpayers ordinarily must pay the disputed tax first and then sue for refund. The CDP process is a narrow exception triggered by a threat of levy. Therefore, if a levy is released, the default rule requiring the payment of taxes first reasserts itself.⁸⁸

Holding. The Court held that the Tax Court lacks jurisdiction under §6330 once the levy is no longer at issue; therefore, Ms. Zuch must seek relief through refund litigation instead. This reinforces the limited scope of CDP proceedings and the importance of timely refund claims.

⁸⁸ IRC §7421(a).

Importance of Timely Response

Blake Adams v. Comm’r, No. 23-1063 (D.C. Cir. Dec. 6, 2024)

IRC §§6213, 6320, 6321, and 7345

Ignoring Notices Does Not Invalidate Tax Debt

Facts. Blake Adams failed to file federal income tax returns for 2007 and 2009–2015. The IRS mailed Mr. Adams various notices of deficiency, but Mr. Adams claimed he never received them.

The IRS proceeded to assess the deficiencies because Mr. Adams did not challenge them within the required 90-day period under IRC §6213. Mr. Adams claimed he never received notice of the assessments, either.

The IRS proceeded to file various notices of lien and intent to levy from 2015–2019, pursuant to IRC §§6320 and 6321. Mr. Adams did not dispute that the notices of lien and intent to levy informed him of his right to a collection due process (CDP) hearing.

The IRS levied approximately \$26,700 from 2017 to 2020. Mr. Adams still had \$1.1 million in outstanding federal liabilities. In 2018, 2019, and 2020, the IRS certified Mr. Adams’s tax debt as seriously delinquent to the State Department, which revoked Mr. Adams’s passport. Mr. Adams argued that the passport revocation violated his constitutional right to international travel, but he did not raise this claim through the administrative channels available to challenge the IRS certifications. Mr. Adams never challenged the IRS’s 2018 and 2019 certifications of his tax debt as seriously delinquent — the certifications that led to the revocation of his passport — before filing his 2020 Tax Court petition. On December 3, 2020, Mr. Adams filed a petition in the Tax Court challenging the 2020 certification under IRC §7345, arguing he never received notice of the deficiencies or of his right to challenge them.

The Tax Court granted the IRS’s motion for summary judgment, concluding that Mr. Adams’s liabilities constituted a seriously delinquent tax debt. Mr. Adams appealed to the D.C. Circuit Court.

Issue. The issue in this case is whether the IRS’s certification of Mr. Adams’s tax debt as seriously delinquent was erroneous.

Analysis. Under §7345, the IRS can certify a taxpayer’s debt as seriously delinquent if it exceeds a threshold amount (adjusted annually; \$53,000 during the years at issue) and a notice of federal tax lien has been filed. Taxpayers can seek to reverse that certification if the IRS made a mistake or if one of two statutory exceptions applies — such as being in an active installment agreement or having a pending due process hearing. In Mr. Adams’s case, the IRS had assessed over \$1.1 million in liabilities and filed liens. Mr. Adams had missed his opportunity to request a CDP hearing. He also did not claim that any of the exceptions applied. Mr. Adams contended that the IRS failed to serve notice of each deficiency, and so the assessments were illegal. However, assessment merely refers to the “official recording of liability that triggers levy and collection efforts,”⁸⁹ which the IRS fulfilled. Mr. Adams also did not timely assert any lack of notice of the tax deficiencies. He conceded that he received the notices of lien and intent to levy. Those notices would have advised Mr. Adams of his right to request a CDP hearing. But he still failed to attend a CDP hearing at which he could have challenged any missing notices of deficiencies.

Holding. The court held that the IRS met the requirements for certifying a seriously delinquent tax debt under §7345. Mr. Adams failed to timely challenge the underlying tax assessments or the IRS’s lien filings, and he did not qualify for any statutory exceptions. Therefore, the IRS’s certifications of the seriously delinquent tax debt were not erroneous.

⁸⁹ *Hibbs v. Winn*, 542 U.S. 88, 101 (2004).

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Collection Due Process

***Peoplease, LLC v. Comm’r*, TC Memo 2025-14 (Feb. 6, 2025)**

IRC §6330

Tax Court Upholds Levy in Collection Due Process Case

Facts. Peoplease, LLC is a professional employer organization based in South Carolina. On February 28, 2023, Peoplease received a final notice of intent to levy for the payroll tax period ending December 31, 2021. Peoplease timely filed Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, to request a collection due process (CDP) hearing as per IRC §6330(d)(1).

During the hearing, Peoplease’s representative informed the appeals officer (AO) that Peoplease submitted a Form 941-X, *Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund*, for the same quarter, which included an employer retention credit (ERC) claim. They stated the ERC claim would offset the entire liability. Peoplease expressed no interest in pursuing a collection alternative.

The AO contacted the IRS unit responsible for ERC claims. On December 6, 2023, the unit responded that additional documentation was required to complete the ERC claim. On December 20, 2023, the AO faxed Peoplease and their representative a request for additional information. However, neither Peoplease nor their representative responded to the request. After no response was received by the AO, the AO informed Peoplease’s representative that the AO would issue a notice of determination and sustain the proposed levy.

Issues. The issues in this case are the following.

- Whether the AO abused her discretion by issuing a notice of determination and sustaining the proposed levy
- Whether the Tax Court had jurisdiction to consider ERC claims for other payroll tax periods unrelated to the levy

Analysis. Peoplease conceded the underlying liability for the quarter ending December 31, 2021. Peoplease later asserted that ERC claims for other quarters, if processed, would satisfy the liability. However, in a CDP case, the court lacks jurisdiction to determine whether there is an overpayment related to a separate, unrelated tax liability.

The court determined that the AO did not abuse her discretion. She verified compliance with legal procedures, considered Peoplease’s claim, and followed up appropriately. Additionally, she balanced collection needs with taxpayer concerns, and acted reasonably when the taxpayer failed to provide requested documentation.

Holding. The court upheld the AO’s determination, finding that the AO did not abuse her discretion in sustaining the proposed levy. Additionally, Peoplease conceded to the tax liability and thus, the court did not address this claim. Furthermore, the court held it lacked jurisdiction to determine whether an ERC claim from other quarters, outside the scope of the current case, could be applied to offset Peoplease’s liability for the quarter ending December 31, 2021.

Employer Retention Credit

***Stenson Tamaddon, LLC v. IRS et al.*, No. CV-24-01123-PHX-SPL (D. Ariz. 2024)**

IRC §§3134, 6402, 6413, and 7803

IRS ERC Guidance Found Interpretive, Not Legislative

Facts. Stenson Tamaddon, LLC, is a tax advisory and technology firm that assists businesses with tax credits and financial solutions, particularly with filing employee retention credit (ERC) claims. The firm is compensated only from the proceeds of credits refunded to clients and is not otherwise paid. It devotes significant resources to complying with IRS policy positions on the ERC and adjusts its business practices accordingly.

Stenson claimed it was injured by IRS positions that allegedly “unlawfully narrow or limit the availability of ERC for businesses.” Specifically, it challenged IRS Notice 2021-20⁹⁰ — a 102-page Q&A document providing guidance on the ERC — as improper lawmaking in violation of the Administrative Procedure Act (APA), exceeding the IRS’s statutory authority, and being arbitrary and capricious. Stenson also sought a preliminary injunction enjoining the IRS from placing a moratorium on ERC claim processing.

Issue. The issue in this case is whether IRS Notice 2021-20 constituted improper legislative rulemaking under the APA, exceeded the IRS’s statutory authority, or was arbitrary and capricious.

Analysis. The court held that Stenson had standing to challenge the notice. It reasoned that Congress created the ERC under the Coronavirus Aid, Relief, and Economic Security Act for the benefit of Stenson’s clients, and that tax preparation services like Stenson are essential in carrying out Congress’s intent.

The court also rejected the government’s sovereign immunity argument, concluding that the notice constituted final agency action for which there was no other adequate remedy in court.

On the APA claim, the court distinguished between legislative rules (which require notice-and-comment under APA §553) and interpretive rules (which do not). It found the challenged portions of the notice to be interpretive.

- **FAQ No. 6**, which specified that household employers are not considered to be operating a trade or business and are not eligible for the ERC, was an interpretation of statutory language — not new law — and thus not subject to APA rulemaking requirements.
- **FAQ No. 10**, which limited “orders from an appropriate governmental authority” to federal, state, or local governments with jurisdiction over the employer’s operations, was a “natural interpretation” of the statute.
- **FAQ No. 11**, which defined a “nominal portion” of business operations as 10% of gross receipts or employee hours, was a safe harbor-not a binding threshold and therefore not a legislative rule.
- **FAQs Nos. 14–16**, which clarified that voluntary suspensions would not qualify as suspensions due to a governmental order, were also found to be interpretive.
- **FAQs Nos. 70–71**, which required employers to substantiate eligibility and retain employment tax records for at least four years, were consistent with IRC §6001 and its regulations.

The court rejected Stenson’s assertion that the notice effectively amended the ERC statute without following APA procedures. It also found the notice was not arbitrary or capricious, distinguishing the case from *CIC Services, LLC v. Comm’r*,⁹¹ noting that here the notice interpreted the statute itself — not a regulation — and that policy disagreements do not render agency action arbitrary.

Finally, the court addressed the issue of agency deference. It held that the Supreme Court’s decision in *Loper Bright Enterprises v. Raimondo*,⁹² which repealed the Chevron doctrine, did not apply. The IRS was not asking the court to defer to its interpretation, and the notice carried no force of law and was not entitled to deference in any event.

Holding. The court upheld IRS Notice 2021-20 as a valid interpretive rule under the APA. The IRS’s guidance did not exceed its statutory authority, was not arbitrary or capricious, and did not require notice-and-comment rulemaking. The request for a preliminary injunction was denied.

⁹⁰ IRS Notice 2021-20, 2021-11 IRB 922.

⁹¹ *CIC Services, LLC v. Comm’r*, 593 U.S. 313 (2021).

⁹² *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024).

Penalty Abatement

Beyoncé Knowles-Carter v. Comm’r, No. 5695-23 (Dec. 11, 2024)

IRC §6662

Beyoncé’s Tax Penalties “Disappear”

Facts. The IRS sent Beyoncé Knowles-Carter, a famous entertainer, a notice of deficiency stating she owed \$2,698,316 in tax deficiencies and underpayment penalties for 2018 and 2019.⁹³ For 2018, the IRS disallowed legal and professional fees, other expenses on her Schedule C, *Profit or Loss from Business*, an \$869,000 deduction for a charitable contribution carryover, and stated she owed tax on unreported royalty income. The IRS also disallowed various expenses Mrs. Knowles-Carter claimed on her Schedule E, *Supplemental Income and Loss*, for 2019 that included utilities, insurance, management fees, taxes, and depreciation expenses. The 2019 expenses were disallowed for alleged failure to substantiate.

In April 2023, Mrs. Knowles-Carter petitioned the Tax Court to resolve the matter. The chief counsel of the IRS referred the controversy to the Independent Office of Appeals (Appeals) for settlement talks. Twice during 2024, the attorneys for both parties advised the Tax Court that they were reviewing additional information Mrs. Knowles-Carter had provided.

Issues. The issue in the case is whether Mrs. Knowles-Carter failed to report income and substantiate expenses.

Analysis. Rev. Proc. 2016-22 sets rules for the administrative appeals process for Tax Court cases.⁹⁴ Mrs. Knowles-Carter submitted additional documentation, which Appeals reviewed. Eventually, Mrs. Knowles-Carter and the IRS reached an agreement wherein she owed a tax deficiency of only \$591 and an accuracy-related penalty of \$118 for 2018, pursuant to IRC §6662(a). Mrs. Knowles-Carter and the IRS agreed that she owed nothing for 2019.

Holding. The court held that Mrs. Knowles-Carter’s assessment should be drastically reduced from the initial amount of \$2,698,316, to \$709 as a result of the settlement discussions with Appeals.



IRS PROCEDURES — PENALTIES

Appeal Procedural Requirements

Grand Marina Investors, LLC v. IRS et al., No. 23-cv-1676-RCL (Sep. 20, 2024)

5 USC §522

The Importance of Following Through on FOIA Appeals

Facts. In 2016, the IRS selected Grand Marina Investors’s (Grand Marina) 2014 federal income tax return for examination. In May 2017, the IRS notified Grand Marina that it would adjust the return. In 2018, Grand Marina sent a Freedom of Information Act (FOIA) request to the IRS, asking for documents relating to the examination of the 2014 tax return. The IRS sent a response stating that it had located 2,086 pages of documents but was withholding 328 pages and redacting 43 pages, as it noted in its response letter in February 2018. In March 2020, Grand Marina submitted a second FOIA request, divided into Parts 1a and 1b. In July 2021, the IRS responded to the second FOIA request but only responded to Part 1a, noting that its response was not a final agency action and partially redacted some of the documents. However, the IRS failed to advise Grand Marina of its right to appeal. The IRS stated the response to Part 1b was still to come. Grand Marina appealed the Part 1a decision in October 2021. The IRS upheld the decision on Part 1a one month later.

⁹³ *Beyoncé vs. the IRS: The Surprising Details About Queen Bey’s \$2.9 Million Tax Dispute*. Oct. 14, 2024. JD Supra. [www.jdsupra.com/legalnews/beyonce-vs-the-irs-the-surprising-5481839] Accessed on Mar. 28, 2025.

⁹⁴ Rev. Proc. 2016-222, 2016-15 IRB 577.

The IRS responded to Part 1b of the second FOIA request in October 2022 with additional documents but again withheld some. The IRS also notified Grand Marina of its right to appeal within 90 days. Grand Marina did not appeal but instead filed a complaint in June 2023, alleging the IRS claimed FOIA exemptions to which it was not entitled. The IRS moved to dismiss for failure to state a claim, arguing Grand Marina failed to exhaust its administrative remedies before suing.

Issue. The issue in this case is whether Grand Marina exhausted its administrative remedies under the FOIA before bringing suit.

Analysis. The FOIA requires taxpayers seeking government documents to exhaust administrative remedies before suing in federal court.⁹⁵ The taxpayer must file an administrative appeal with the agency, and if the agency still declines to provide the requested documents, they can sue in federal court.⁹⁶ Grand Marina never appealed the IRS's determination of its first FOIA request, and so the court dismissed Grand Marina's claims related to the first request.

Grand Marina failed to exhaust its administrative remedies for Part 1a of the second request. The IRS never sent Grand Marina a final determination, only an interim determination, and it failed to inform Grand Marina that it could appeal. Nevertheless, the IRS processed Grand Marina's appeal of the adverse response to Part 1a and upheld the original response. Thus, the purposes of administrative exhaustion were fulfilled, and so Grand Marina's FOIA lawsuit regarding Part 1a could proceed.

Grand Marina did not appeal the IRS's determination on Part 1b of the second FOIA request, and so Grand Marina failed to exhaust its administrative remedies with respect to Part 1b. The court would not have a full administrative record to review; therefore, Grand Marina's claims with respect to Part 1b could not proceed.

Holding. Even though the IRS never made a final determination as to Part 1a of the second FOIA request, Grand Marina appealed, and the IRS processed the appeal. Therefore, the purposes of administrative exhaustion were fulfilled, and the IRS's motion to dismiss was denied. But Grand Marina never appealed the IRS's determination of its first FOIA request or Part 1b of its second request. Consequently, those claims were dismissed as Grand Marina failed to exhaust its administrative remedies before filing suit.

Reliance on Computer Software

***Dealers Auto Auction of Southwest LLC v. Comm'r*, TC Memo 2025-38 (Apr. 28, 2025)**

IRC §§6050I, 6330, 6721, 6722, and 6724

Cash Is Not King Without Notifying the IRS

Facts. Dealers Auto Auction of Southwest LLC, (Dealers Auto), an Arizona LLC, received cash payments exceeding \$10,000 in the conduct of business, which triggered the requirement to file the Form 8300, *Report of Cash Payments Over \$10,000 Received in a Trade or Business*, under IRC §6050I. Although Dealers Auto implemented AuctionMaster software to assist with compliance, it failed to file and furnish the required Forms 8300 for tax year 2016. The IRS assessed penalties totaling \$118,140 under IRC §§6721 and 6722 for the following infractions.

- 264 Forms 8300 filed more than 30 days late
- Two Forms 8300 filed less than 30 days late
- 63 delinquent dealer notifications
- 127 delinquent runner notifications

⁹⁵ *Freedom Watch, Inc. v. NSA*, 134 F.Supp.3d 437, 439 (D.D.C. 2015).

⁹⁶ 5 USC §522(a)(6)(A)(i)(III)(aa); *Jud. Watch, Inc. v. FBI*, 190 F.Supp.2d 29, 32-33 (D.D.C. 2002).

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Dealers Auto challenged the penalties in a collection due process hearing, asserting reasonable cause due to software malfunction.

Issues. The issues in this case are the following.

- Whether Dealers Auto had reasonable cause under IRC §6724 for failing to file and furnish Forms 8300 for 2016
- Whether the reliance on software is a valid basis for a reasonable cause defense when it malfunctions

Analysis. The Tax Court has jurisdiction under IRC §6330(d)(1). Because Dealers Auto did not have a prior opportunity to dispute the penalties, the court reviewed Dealers Auto's underlying liability on a de novo basis. This means that the Tax Court considers the legal aspects of the case without deference to the IRS's determinations. As a non-individual entity, Dealers Auto had the burden for production and persuasion regarding reasonable cause for the case. Under Treas. Reg. §301.6724-1, reasonable cause requires either significant mitigating factors or events beyond the taxpayer's control, along with responsible behavior before and after the failure. The court acknowledged that software malfunctions **could** constitute events beyond the taxpayer's control. The court distinguished this case from the *Boyle* case,⁹⁷ noting that Dealers Auto did not argue that it delegated its filing duty, but claimed they had a failure within the notifications in the software. However, Dealers Auto failed to prove the following.

- The software malfunctioned
- They used the software correctly
- They had internal controls to help detect noncompliance

Therefore, the court found insufficient evidence to sustain Dealers Auto's reasonable cause claim.

Holding. Because Dealers Auto failed to establish reasonable cause for its failure to file and furnish the required Forms 8300 for 2016, the court sustained the penalties assessed by the IRS. Although the court agreed that a software failure could constitute a reasonable cause, Dealers Auto failed to prove that the software failed to function properly, that it used the software correctly, and that it had controls in place to detect noncompliance. Therefore, its reasonable cause claim failed.



PARTNERSHIPS

Statute of Limitations

***Surk, LLC v. Comm'r*, TC Memo 2024-99 (Oct. 29, 2024)**

IRC §§704(d), 743, and 754

One Mistake Does Not Enable Another

Facts. Surk, LLC, taxed as a partnership, had a majority ownership interest in Outerknown, LLC from 2014 to 2017. Outerknown was also taxed as a partnership. Surk deducted passthrough losses from Outerknown on its 2014 and 2015 returns that exceeded its outside basis in Outerknown. The IRS did not disallow those deductions at the time and did not issue a notice of final partnership administrative adjustment (FPAA) for those years, which were closed under the statute of limitations by the time of the court's review.

⁹⁷ *U.S. v. Boyle*, 469 U.S. 241 (1985).

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In 2021, the IRS issued an FPAA for tax year 2017, asserting that Surk must reduce its outside basis in Outerknown to reflect the excess losses improperly deducted in 2014 and 2015. This reduction led to a partial disallowance of Surk's 2017 passthrough loss deduction from Outerknown. The parties agreed that Surk was entitled to increase its outside basis in 2017 due to a previously unaccounted for 2016 cash distribution and corresponding IRC §743 adjustment. This adjustment restored sufficient basis to support the full 2017 loss deduction.

Issue. The issue in this case is whether Surk must reduce its basis in Outerknown even though the statute of limitations has closed for the years involved.

Analysis. The court acknowledged that Surk improperly deducted excess losses in 2014 and 2015. However, because those years are closed to assessment, the IRS did not seek to disallow those deductions retroactively. Instead, they required Surk to adjust its 2017 outside basis to reflect those prior year excess losses. The court accepted the stipulation that Surk's 2016 distribution triggered a gain that reflected a §743 basis increase. This adjustment alongside the IRC §754 election, increased Surk's outside basis in Outerknown for 2017.

With the basis increase accounted for, Surk had sufficient outside basis to deduct the full 2017 loss from Outerknown. The IRS conceded this point during litigation. Although the court allowed the 2017 loss deduction, it determined that Surk must reduce its 2017 yearend outside basis by the total of excess losses deducted in 2014 and 2015, which is consistent with the FPAA.

Holding. The court held that Surk is entitled to deduct the full passthrough loss from Outerknown for 2017. However, Surk must reduce the 2017 year-end outside basis in Outerknown to reflect excess losses that were deducted in 2014 and 2015.

Unsubstantiated Expenses

Thomas Langlois v. Comm'r, TC Memo 2025-12 (Feb. 3, 2025)

IRC §§162, 704, and 6662

Disallowed Deductions, Basis Shortfalls, and Penalty Enforcement

Facts. Thomas Langlois, a power line worker and a member of Local 42 of the International Brotherhood of Electrical Workers, was employed by Asplundh Construction Corp. in Connecticut during 2015. In addition to his employment, Mr. Langlois held an interest in two limited liability companies (LLCs) taxed as partnerships and owned one rental property located in Oak Lawn, Illinois.

On Mr. Langlois's 2015 tax return, he claimed employee-related expenses for meals, tools, appropriate clothing, and boots. However, for the same period, Mr. Langlois's pay stubs reflected reimbursements for meals and miscellaneous expenses exceeding \$2,500. He claimed \$41,341 in itemized deductions, which included \$21,576 in unreimbursed employee expenses for business purposes. These expenses consisted of \$175 for parking, tolls, and transportation, \$13,031 for travel, and \$8,370 for other business expenses. The \$13,031 reported travel expenses included a June 2015 trip to Phoenix, Arizona, where Mr. Langlois claimed he was seeking higher-paid employment.

In 2008, Mr. Langlois started Forbearance, a Connecticut LLC, with Denise Dudek. Forbearance began as a storm response company, and both members contributed funds at the outset, which were used to purchase trucks, tools, and other necessary equipment. For several years, Mr. Langlois and Ms. Dudek covered most expenses using personal funds, and although the expenditures were accounted for, these expenditures were not tracked as partner capital contributions. On his 2015 tax return, Mr. Langlois claimed his 49% ownership share, which totaled an ordinary business loss of \$119,144.

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In 2012, Mr. Langlois and Sandra Bedell formed Hair Station, an Illinois LLC. At its inception, Mr. Langlois agreed to lend Hair Station a total of \$200,000, including up to \$60,000 during the first year. In an agreement between Mr. Langlois and Ms. Bedell, Hair Station would allocate 90% of any profits or losses to Mr. Langlois. Mr. Langlois did not reside near Hair Station's location, and he had no cosmetology-related licenses in the State of Illinois. On his 2015 tax return, Mr. Langlois claimed an ordinary business loss of \$29,537.

Following an audit of his 2015 tax return, the IRS issued a notice of deficiency, disallowing various deductions Mr. Langlois had claimed, including unreimbursed employee expenses, job search expenses, and partnership losses. The IRS also imposed a 20% accuracy-related penalty under IRC §6662. Mr. Langlois petitioned the Tax Court to challenge the IRS's determinations.

Issues. The issues in this case are the following.

- Whether unreimbursed employee business expenses, including tools, clothing, parking, and travel expenses, were deductible under IRC §162
- Whether out-of-state job-search expenses were deductible
- Whether partnership losses for Langlois's distributed shares were deductible under IRC §704(d)
- Whether the IRC §6662(a) 20% accuracy-related penalty should be sustained

Analysis. To deduct unreimbursed employee business expenses, a taxpayer must demonstrate either that their employer did not offer reimbursement or that any reimbursement provided was insufficient to cover the full cost of the expenses. Mr. Langlois showed expenses for tools and clothing items he claimed were necessary for his employment. For the tools expenses he claimed, Mr. Langlois could not provide proof that any of the tools purchased were required for his 2015 employment or evidence that he used these tools in connection with his employment. Regarding Mr. Langlois's clothing expenses, the receipts showed purchases of sweatshirts, boots, and socks — items classified as ordinary street wear. Such clothing is not deductible, even if worn while performing work duties.⁹⁸ Mr. Langlois could not demonstrate that he was not entitled to reimbursement for any expenses incurred or that he did not receive any reimbursement under Asplundh's reimbursement policies. Mr. Langlois testified that some of the travel included in the employee business expense deduction was travel from Connecticut to Chicago to check on his businesses and rental property. The travel was not related to his employment with Asplundh and was not a qualified deduction under the employee business expense deduction.

IRC §162 generally allows taxpayers to deduct all ordinary and necessary expenses paid or incurred during the operation of a trade or business, and Mr. Langlois argued that his job search expenses are deductible and are related to Asplundh. These job search expenses were incurred when he flew to Phoenix, where he claimed to scout the Arizona and California job markets for higher-paying positions. The only documentation Mr. Langlois provided regarding mileage for the job search expenses was his notes, which were recreated two years after the trip, reflecting driving distances from "Dad's house" to various locations. Mr. Langlois failed to provide any documentation that he visited any locations related to his job search, nor could he provide that he was driving his personally owned or leased vehicle. Regarding the claimed air travel expense, Mr. Langlois established that he purchased a round-trip ticket to Phoenix, but could not, once again, corroborate the purpose of the job search. Mr. Langlois failed to satisfy the strict substantiation requirements to deduct the expenses of his job search, and thus, the court deemed these expenses nondeductible.

⁹⁸ *Ayria v. Comm'r*, TC Memo 2022-123 (Dec. 19, 2022).

The court then moved on to the question of Mr. Langlois's partnership basis. If a partner cannot establish their adjusted basis in the partnership, then they cannot deduct any partnership loss under §704(d). Mr. Langlois could not prove his initial contribution for either partnership; however, he did contend that he contributed at least \$259,099 to Forbearance and \$178,099 to Hair Station. To support his contribution to Forbearance, Mr. Langlois introduced digital receipts for all expenses, including cash payments and many credit card purchases across multiple states. However, Mr. Langlois failed to connect those receipts to any of the business expenditures. The court stated that although it accepted Mr. Langlois's and Ms. Dudek's testimony that they paid some expenses related to Forbearance's storm response work, Mr. Langlois's failure to connect the receipts to the expenses rendered them nondeductible, as items such as meals and fuel could be considered personal expenses.

Mr. Langlois's responded that the receipts reflect cash payments that he made for Forbearance's expenses or reimbursed contractor expenses that were paid on behalf of Forbearance. However, Mr. Langlois failed to introduce any bank statements that could support his claim that he spent more than \$250,000 on Forbearance's behalf from 2008 to 2014 or work schedules that may prove he was reimbursing others. In the absence of any support documentation or expense matching, Mr. Langlois failed to show his adjusted basis in Forbearance and cannot deduct any partnership losses for Forbearance.

For Hair Station, Mr. Langlois was unable to establish that he had a sufficient adjusted basis in 2015 to deduct the partnership losses. Unlike Forbearance, however, Mr. Langlois introduced tally sheets related to his 2012-2014 capital contributions, which included expenses in categories such as Forms 1099-MISC, *Miscellaneous Information*, deposits, transfers, and check recipients. Mr. Langlois was able to provide some documentation to support the amounts reported for each category. However, Mr. Langlois failed to demonstrate that he had paid these expenses, as the payment records indicated that the funds originated from Hair Station itself, not Mr. Langlois. Because there was insufficient proof that Mr. Langlois made the payments, he cannot claim them as his capital contribution and thus cannot claim the deduction.

The IRS imposed a 20% accuracy-related penalty under §6662(d)(2), which defines the term "understatement" as the excess of the tax required to be shown on the return over the amount shown on the return that exceeds the greater of \$5,000 or 10% of the necessary tax to be shown on the return. Mr. Langlois reported on his return a tax of \$12,706, but his corrected return now shows he owed \$40,526 in tax, reflecting an understatement of \$27,820 (\$40,526 – \$12,706). Mr. Langlois did not provide any evidence to contest the determination, and thus, he is liable for the 20% accuracy-related penalty.

Holding. The Tax Court held that Mr. Langlois failed to substantiate his claimed employee business expenses, job search expenses, and partnership losses. Therefore, the notice of deficiency was upheld, and the 20% accuracy-related penalty under §6662(a) was upheld.

RETIREMENT

Early Distributions

Charlie Campana v. Comm’r, TC Memo 2025-23 (Mar. 19, 2025)

IRC §§61, 72(t), and 6662

Unreported Retirement Income and a Misunderstood Withholding: No Relief for Taxpayer

Facts. Charlie Campana, a Florida resident, experienced financial hardship during the COVID-19 pandemic and withdrew \$56,673 from his Fidelity retirement account in 2021. At the time, he was under age 59½. He also received \$99 in interest income from the IRS that year.

Mr. Campana timely filed his 2021 Form 1040, *U.S. Individual Income Tax Return*, reporting \$37,964 in taxable income. However, he failed to report both the retirement distribution and the interest income. He also did not report the 10% additional tax on early distributions under IRC §72(t), nor did he account for the \$1,874 in tax withheld by Fidelity.

The IRS issued a notice of deficiency in August 2023, determining a tax deficiency of \$18,064 and an accuracy-related penalty of \$3,238 under IRC §6662(a). Mr. Campana challenged the deficiency, arguing that a refund he was owed from tax year 2017 should offset his 2021 liability. However, he did not provide any documentation or IRS determination for 2017 that would give the Tax Court jurisdiction over that year.

Issues. The issues in this case are the following.

- Whether Mr. Campana failed to report \$99 in interest income and \$56,673 in retirement distributions
- Whether Mr. Campana is liable for the 10% additional tax on early retirement distributions under §72(t)
- Whether Mr. Campana is liable for the accuracy-related penalty under §6662(a)

Analysis. The Tax Court upheld the IRS’s determinations on all issues. First, the court found that Mr. Campana had conceded receipt of both the interest income and the retirement distribution. Under §61(a), both are includible in gross income. The court rejected Mr. Campana’s argument that a refund from 2017 should offset his 2021 liability, noting that it lacked jurisdiction over the 2017 tax year because no notice of deficiency had been issued for that year.

Next, the court addressed the 10% additional tax under §72(t) for early distributions from a qualified retirement plan. Mr. Campana did not argue that any statutory exceptions applied, and the court found none. Accordingly, the additional tax was sustained.

Finally, the court considered the accuracy-related penalty under §6662(a). The understatement exceeded both 10% of the tax required to be shown and \$5,000, satisfying the threshold for a substantial understatement. The IRS met its burden.

Mr. Campana argued that he believed Fidelity would withhold the necessary tax and that he did not understand the reporting requirements. However, he did not consult a tax professional or review the Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, issued by Fidelity. The court found that his misunderstanding did not constitute reasonable cause under Treas. Reg. §1.6664-4(b)(1), and it sustained the penalty.

Holding. The Tax Court held that Mr. Campana failed to report taxable income, was liable for the 10% additional tax on early distributions, and did not qualify for relief from the accuracy-related penalty.



Taxation of Criminal Forfeiture

Lonnie Hubbard v. Comm’r, No. 24-1450 (6th Cir. 2025)

IRC §§62, 63, 219, and 408

Forfeited IRA Not Taxable to Criminal Defendant

Facts. Lonnie Hubbard was a pharmacist who was convicted of selling oxycodone to drug addicts and supplying pseudoephedrine to methamphetamine manufacturers. The government confiscated his homes, cars, and other personal property. In 2017, the IRS confiscated Mr. Hubbard’s individual retirement arrangement (IRA), which contained \$427,518. Mr. Hubbard was in prison at the time and did not file a return for 2017. In 2020, the IRS sent Mr. Hubbard a notice of deficiency stating he owed \$274,930. This amount comprised taxes on the 2017 IRA withdrawal and penalties for failure to pay the taxes.

Mr. Hubbard filed a complaint in the Tax Court challenging the notice, arguing he should not have to pay because the money was forfeited to the IRS during his criminal case. However, the court found in favor of the IRS, explaining that its precedent established that funds withdrawn from an IRA qualify as income even when the withdrawal was an “involuntary distribution” to a third party. Mr. Hubbard appealed to the Sixth Circuit Court of Appeals.

Issue. The issue in this case is whether Mr. Hubbard owed tax on the involuntary forfeiture of his IRA.

Analysis. Forfeiture laws allow the government to seize specific property used in the commission of crimes, ensuring that individuals do not profit from crimes.⁹⁹ Here, the Tax Court issued an order that the IRA funds were to be seized, and the IRS became the IRA’s owner at that time.

Taxpayers must pay tax on gross income minus deductions.¹⁰⁰ Employees can deposit money into an IRA and deduct the amount they deposited in some circumstances.¹⁰¹ Although the money is not taxable when deposited, the employee must pay tax on the money when it is withdrawn from the account.¹⁰² Thus, Mr. Hubbard would have had to pay taxes on the money in the IRA if he withdrew it, but he never did. The IRS was the one that took control of the account and transferred the money to another account. Because the transferring of the money did not reduce any indebtedness for Mr. Hubbard and was not an economic gain, it was not “income” for him.

The IRS argued that sometimes taxpayers do need to pay tax on involuntary withdrawals, such as in domestic child support cases. But the Sixth Circuit held that this analogy overlooks the forfeiture aspect of this case. The IRS did not withdraw the funds to satisfy a debt owed by Mr. Hubbard.

Holding. The court held that Mr. Hubbard did not owe tax on the amount the IRS withdrew from his IRA account.

⁹⁹ *Kaley v. U.S.*, 571 U.S. 320, 323 (2014).

¹⁰⁰ IRC §63(a).

¹⁰¹ IRC §§62(a)(7) and 219(a).

¹⁰² IRC §408(d)(1).

S CORPORATIONS

Shareholder Debt and Loans

***Arland and Ima Jean Keeton v. Comm’r*, No. 23-3750 (9th Cir. Oct. 30, 2024)**

IRC §§6694(a)(3) and 7482(a)(1)

Bad Debt or Bad Bet?

Facts. Arland and Ima Jean Keeton, along with Robert and Lorene Riemenschneider, formed Keeton-Riemenschneider, LLC (KRLLC), with each couple owning 50%. From 1994 to 2007, KRLLC made sporadic payments to Idaho Waste Systems, Inc. (IWS), a company in which both couples each owned 34.5%.

In 2012, all IWS shareholders signed a Unanimous Consent agreement converting their debt to equity, and IWS removed all notes payable to KRLLC from its balance sheet. In 2018, after IWS went into foreclosure, KRLLC recorded the outstanding balance due from IWS as a bad debt expense. The Keetons reported their share of this bad debt as a loss on their 2017 and 2018 tax returns.

The IRS disallowed the loss, asserting that the advances were equity infusions, not loans. The IRS also imposed accuracy-related penalties, which the Keetons challenged, citing reliance on their CPA’s advice.

Issues. The issues in this case are the following.

- Whether the Tax Court erred in finding that KRLLC’s advances to IWS were equity contributions rather than bona fide debt
- Whether the Tax Court erred in sustaining accuracy-related penalties against the Keetons despite their reliance on professional tax advice

Analysis. In determining whether an advance to a corporation constitutes debt or equity, courts apply a factual analysis reviewed for clear error. The Ninth Circuit has long held that the classification depends on the substance of the transaction, not its form. The multifactor test from *Hardman v. U.S.*,¹⁰³ is used to evaluate such transactions, especially when shareholders advance funds to their own corporation. Key factors include the presence or absence of a fixed maturity date, enforceability of repayment, subordination to other creditors, the corporation’s capitalization, and its ability to obtain outside financing.

Applying these principles, the Tax Court found that the advances from KRLLC to IWS were equity contributions. The court emphasized that KRLLC was not a third-party creditor but a vehicle through which the Keetons and Riemenschneiders — each owning 34.5% of IWS — funneled funds into their struggling corporation. The 2012 Unanimous Consent agreement, which converted shareholder debt to equity and removed KRLLC’s notes from IWS’s books, was found to apply to these advances. Although Mr. Keeton testified otherwise, the Tax Court was not required to credit testimony it found lacking in credibility.

The *Hardman* factors overwhelmingly supported the equity characterization: there was no fixed maturity date, repayment was not contingent on earnings, KRLLC had no enforcement rights and was subordinate to other creditors, IWS was thinly capitalized, and it lacked access to alternative financing. The Ninth Circuit concluded that the Tax Court did not clearly err in sustaining the disallowance of the claimed bad debt deduction.

¹⁰³. *Hardman v. U.S.*, 827 F.2d 1409 (9th Cir. 1987).

As for the accuracy-related penalties, the court reiterated that taxpayers **cannot rely on professional advice** when the advisor lacks full knowledge of the relevant facts. The Keetons' CPA, Jennifer Werner, testified that she was unaware of the 2012 Unanimous Consent agreement and the removal of KRLLC's note from IWS's books — facts she acknowledged would have been relevant to her advice. The court noted that the Keetons did not provide their advisor with all material information. The court found no clear error in the Tax Court's conclusion that the Keetons lacked reasonable cause and good faith.

Holding. The Ninth Circuit affirmed the Tax Court's decision. It held that the advances from KRLLC to IWS were equity contributions, not loans, and that the Keetons were not entitled to deduct the resulting loss. The court also upheld the accuracy-related penalties, finding no clear error in the Tax Court's determination that the Keetons lacked reasonable cause and good faith.

Shareholder Status

Karen Veeraswamy v. Comm'r, TC Memo 2024-83 (Sep. 4, 2024)

IRC §§1366(a) and 6651(a)

Deceived Taxpayer Liable for Share of Corporation's Income

Facts. In 2000, Karen Veeraswamy and her husband, Velappan, started Ashand Enterprises, Inc. Ashand was incorporated as an S corporation, and the Veeraswamys each owned 100 shares of the corporation's common stock. Ashand's primary asset was a building on Ward Avenue that generated rental income. Mr. Veeraswamy ran the company and served as Ashand's president while Mrs. Veeraswamy was Ashand's secretary and treasurer.

In 2011, Mrs. Veeraswamy filed for divorce and Mr. Veeraswamy restricted her from accessing Ashand's bank accounts and office. Mr. Veeraswamy argued that Ashand was not a marital asset because Mrs. Veeraswamy was no longer involved with the company. Mrs. Veeraswamy began filing her tax returns using married filing separately filing status because she interpreted Mr. Veeraswamy's words to mean she was no longer an Ashand shareholder.

In 2013, Mr. Veeraswamy filed for chapter 11 bankruptcy protection for Ashand. In the bankruptcy proceedings, he claimed he was Ashand's president and sole owner. Mrs. Veeraswamy won a child support order from the divorce court and filed a proof of claim in Ashand's bankruptcy. The Ward Avenue property was sold for \$7.6 million in 2014, which left nearly \$2 million after paying off Ashand's debts and expenses. Mrs. Veeraswamy did not assert she was Ashand's co-owner at any part of the process, but the bankruptcy court ordered the surplus to be put into escrow until the divorce proceedings finished.

Mr. Veeraswamy filed a chapter 13 bankruptcy in 2018, which was converted to a chapter 7 bankruptcy. In 2019, he died, and Mrs. Veeraswamy discovered corporate documents that showed Mr. Veeraswamy had lied, and she had remained a 50% shareholder in Ashand. Mrs. Veeraswamy sought \$950,000 as an equity distribution from Ashand's sale of the Ward Avenue building. She asserted her part ownership as a 50% shareholder in Ashand and also moved to reopen Ashand's bankruptcy.

The Department of Justice (DOJ) intervened in Ashand's bankruptcy and wanted to keep Mr. Veeraswamy as Ashand's sole shareholder to ensure somebody recognized capital gain from the sale of the property. The trustee in Mr. Veeraswamy's bankruptcy negotiated a settlement with Mrs. Veeraswamy in the interest of the estate. The court reclassified her claims for domestic support and equity disbursement as secured claims, and the trustee distributed those funds. She did not report either figure in her 2022 tax return and did not file a return for the 2014 tax year.

The IRS reopened the 2014 audit for Ashand in February 2022 after the agent learned about Mrs. Veeraswamy's claim as a 50% shareholder. Ashand did not file a tax return for 2014, and the IRS determined Ashand realized a \$1.9 million capital gain from the sale of the building and roughly \$80,000 in net rental income in 2014. The IRS also looked into Mrs. Veeraswamy's tax liabilities and assigned half of Ashand's net rental income and half of its capital gain to her.

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Issue. The issue in this case is whether Mrs. Veeraswamy was a 50% shareholder in Ashand in 2014.

Analysis. A taxpayer remains a shareholder in an S corporation despite having a poor relationship with other shareholders.¹⁰⁴ A shareholder can abandon their interest in an entity, but there needs to be a relinquishment of the asset and any future claims to it.¹⁰⁵ Mrs. Veeraswamy did not abandon her interest in Ashand because she did not make an affirmative act of abandonment and actively pursued her ownership interest in the bankruptcy proceedings. Therefore, the court concluded that it is more likely than not that Mrs. Veeraswamy was a 50% shareholder of Ashand in 2014.

Mrs. Veeraswamy argued for equitable estoppel, which is when one party relies on another party's representation to their detriment. The DOJ had previously argued in Mr. Veeraswamy's bankruptcy proceedings that Mrs. Veeraswamy was not an owner of Ashand to prevent the distribution of the corporation's surplus to her. To assert equitable estoppel against the United States, Mrs. Veeraswamy must first show that it participated in affirmative misconduct, that its wrongful acts would cause a serious injustice, and that there would not be undue damage to the public interest if a court estops the United States. In its arguments, however, the court determined that the DOJ had not acted in bad faith or engaged in misconduct because it acted on information available at that time. When the IRS contested Mrs. Veeraswamy's amended proof of claim, she had already known about her ownership interest in Ashand. Mrs. Veeraswamy also did not incur a detriment because the bankruptcy court ruled against the DOJ, and she received her surplus share. Therefore, the IRS is not equitably estopped from asserting Mrs. Veeraswamy's ownership interest.

Mrs. Veeraswamy also argued for collateral estoppel, which limits a party from trying the same issue that a court has already determined. There are five elements to establish collateral estoppel.

1. The ownership issue must be identical to the issue decided in bankruptcy court.
2. The bankruptcy court must be of competent jurisdiction and have rendered a final judgment on the issue.
3. The IRS was a party in the previous case or in privity with a party there.
4. The parties actually litigated the issue and resolution was essential to the bankruptcy court decision.
5. The controlling facts and legal principles have not changed.

The ownership issue was the same. However, the bankruptcy court did not issue a final judgment on the ownership issue in either the chapter 11 case or in Mr. Veeraswamy's bankruptcy case. Therefore, the IRS is not estopped from arguing that Mrs. Veeraswamy owned half of Ashand in 2014 in this case.

As an S corporation shareholder, Mrs. Veeraswamy must include in her income the pro rata share of the corporation's income, losses, deductions, and credits.¹⁰⁶ She is required to include half of Ashand's income even if she did not receive that share as a distribution back in 2014. She can also deduct half of the corporation's expenses as an S corporation shareholder. Mrs. Veeraswamy must also pay a penalty for failing to timely file a return and for failing to timely pay the amount shown on a return, as she did not argue for reasonable cause.¹⁰⁷

Holding. The court held Mrs. Veeraswamy was a 50% shareholder in Ashand in 2014. The court further held she must recognize her share of Ashand's net income in her taxable income for 2014.

¹⁰⁴. *Hightower v. Comm'r*, TC Memo 2005-274 (Nov. 28, 2005), *aff'd* 266 Fed.Appx. 646 (9th Cir. 2008).

¹⁰⁵. *Tsakopoulos v. Comm'r*, TC Memo 2002-8 (Jan. 9, 2002), *aff'd* 63 Fed.Appx. 400 (9th Cir. 2003).

¹⁰⁶. IRC §1366(a)(1).

¹⁰⁷. IRC §§6651(a)(1) and (a)(2).

S Corporation Status

James Maggard and Szu-Yi Chang v. Comm’r, TC Memo 2024-77 (Aug. 7, 2024)

IRC §§1361, 1363, and 1366

Napkin Accounting Gets Messy

Facts. James Maggard and his wife, Szu-Yi Chang, resided in Silicon Valley. Mr. Maggard co-founded an engineering consulting partnership with his friend, Todd Schricker, and incorporated Schricker Engineering Group (Schricker) in 2002 as an S corporation. Mr. Maggard and Mr. Schricker each owned half of the 10,000 common shares of stock. Mr. Schricker sold his interest in the company to Mr. Maggard in July 2003. Mr. Maggard then sold a 60% interest to two unidentified individuals, LL and WJ. The two individuals joined Schricker’s board and also served as employees in the company. Although each owner was entitled to a pro rata share of the dividends, LL and WJ began making disproportionate distributions to themselves at the expense of Mr. Maggard. Even though he had an accounting background, LL, acting as Schricker’s CEO and CFO, stopped filing Form 1120-S, *U.S. Income Tax Return for an S Corporation*, from 2011–2016.

Although he was a shareholder of the corporation, Mr. Maggard received no report of his share of the corporation’s income and expenses until his attorney requested one. In response to this request, Mr. Maggard received a single number, \$300,000, written on a napkin, representing his share of Stricker’s 2014 loss. A year later, he was informed that his share of the 2015 loss was \$50,000 in a similarly informal manner. On their 2016 tax return, Mr. Maggard and Ms. Chang, reported no income or loss from Schricker on their individual income tax returns.

After hiring a CPA to investigate, Mr. Maggard discovered the disproportionate distributions in 2012 and accused LL and WJ of embezzling more than \$1 million from Schricker. LL denied the accusations, and LL and WJ prevented Mr. Maggard from fully participating as a director and shareholder of Schricker. LL and WJ also voted to increase their salaries, vacation time, and other employee benefits.

LL and WJ sued Mr. Maggard for breach of contract and fraud, and Mr. Maggard filed a countersuit in 2013 to rescind the share sale agreement based on fraud, their failure of consideration, breach of contract, and embezzlement. The court found that Schricker overdistributed to LL and underdistributed to Mr. Maggard. The court also ordered Schricker to make a corrective distribution of \$164,783 to Mr. Maggard. LL and WJ refused this order and, in October 2018, bought Mr. Maggard’s entire stake in the company for \$1,262,500.

Mr. Maggard wanted to submit a whistleblower claim, and the IRS responded that the claim could cause the termination of Schricker’s S corporation status, at which point Schricker would be taxed as a C corporation and owe corporate taxes. Mr. Maggard completed and submitted the whistleblower form to the IRS, but the IRS did not act on it.

In late 2018, Mr. Maggard finally received his Schedules K-1 (Form 1120-S), *Shareholder’s Share of Income, Deductions, Credits, etc.*, for 2011–2016. These forms showed Mr. Maggard’s proportionate share of Schricker’s earnings were, in fact, profits and not losses. The IRS audited Mr. Maggard and Ms. Chang’s tax returns and determined the couple did not correctly report income or losses from Schricker. At trial, Mr. Maggard and his wife conceded they did not incur the losses in 2014 and 2015 as reported.

Issues. The issues in this case are the following.

- Whether disproportionate distributions terminated Schricker’s status as an S corporation
- Whether Mr. Maggard and Ms. Chang correctly reported their income or losses from Schricker on their individual tax returns for 2014-2016

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Analysis. S corporations generally are not taxed on income at the corporate level but, instead, pass income and deductions through to their shareholders in proportion to their ownership of shares.¹⁰⁸ To be designated an S corporation, the corporation must choose to be taxed as an S corporation, have 100 shareholders or fewer, have only shareholders who are individuals, particular trusts, or nonprofits, and have only one class of stock.¹⁰⁹ A corporation is treated as having one class of stock if all shares of the stock confer equal rights to distributions and liquidation proceeds.¹¹⁰ The IRS focuses on shareholder **rights** under the corporation's governing documents, not what the shareholders actually do.

Disproportionate distributions by themselves do not change a company's S corporation status.¹¹¹ The unauthorized distributions were not formally memorialized in Schricker's governing documents, and therefore, the court cannot revoke Schricker's election to be an S corporation. Schricker did not authorize or create a second class of shares through formal corporate action. Therefore, Schricker maintained its S corporation status for the years at issue.

In addition to the S corporation status issue, the court addressed whether Mr. Maggard and Ms. Chang properly reported their share of Schricker's income. The couple claimed losses of \$300,000 in 2014 and \$50,000 in 2015 based on informal estimates provided by Schricker's CFO. However, the Schedules K-1 issued in 2018 showed that Schricker had earned profits during those years. Mr. Maggard and Ms. Chang conceded at trial that they had not incurred the reported losses. As a result, the court upheld the IRS's adjustments to their income for 2014–2016.

Holding. The court held that Schricker's S corporation election was not terminated by its disproportionate distributions. The court further held the Mr. Maggard and Ms. Chang must include his proportionate share of Schricker's income in his tax return as reflected on the Schedules K-1.

Observation. The court's opinion expressed sympathy for Mr. Maggard's situation. He was responsible for paying tax on his share of the corporation's income, but the corporation did not distribute his share of its cash to Mr. Maggard, with which he could have paid taxes. This situation was compounded by the corporation's failure to provide Mr. Maggard with information that would enable him to report his income accurately. Nevertheless, the court followed treasury regulations and precedents in deciding against Mr. Maggard.

SELF-EMPLOYMENT

Employment Tax

James Clark v. Comm'r, TC Memo 2025-13 (Feb. 2, 2025)

IRC §§1401 and 6662

Schedule C Left on the Cutting Room Floor

Facts. James Clark earned two primary income streams during 2019: freelance movie review writing, which brought in \$8,250 of revenue, and movie-related memorabilia sales, which yielded \$41,972. He sold the memorabilia on eBay and received payment via a PayPal account in his name. PayPal subsequently issued a Form 1099-K, *Payment Card and Third Party Network Transactions*, to Mr. Clark, reporting the \$41,972 in gross payment.

Although Mr. Clark prepared his 2019 return with assistance from an H&R Block representative, he did not report this combined \$50,222 income on Schedule C, *Profit or Loss from Business*. Instead, he reported the entire amount on line 7a, *Other Income*, of his Form 1040, *U.S. Individual Income Tax Return*, thereby excluding it from self-employment (SE) tax.

¹⁰⁸. IRC §§1363 and 1366.

¹⁰⁹. IRC §1361(b)(1).

¹¹⁰. Treas. Reg. §1.1361-1(l)(1).

¹¹¹. See *Minton v. Comm'r*, TC Memo 2007-372 (Dec. 26, 2007), *aff'd* 562 F.3d 730 (5th Cir. 2009); *Mowry v. Comm'r*, 116 TCM (CCH) 55 (2008); *Schulz v. Comm'r*, 294 F.2d 52, 55 (9th Cir. 1961).

In June 2021, the IRS's Automated Underreporter (AUR) Program sent Mr. Clark a CP2000, *Notice of Unreported Income*, indicating discrepancies between the income the IRS had on record from PayPal and what Mr. Clark reported on his 2019 tax return. Mr. Clark did not respond to the notice. In November 2021, the IRS issued a notice of deficiency, determining that the \$50,222 Mr. Clark had reported as "other income" was subject to SE tax and that he owed a penalty for a substantial understatement of tax.

Mr. Clark mailed a petition to challenge the IRS's notice of deficiency on February 5, 2022, as substantiated by the U.S. Postal Service's postmark. However, the Postal Service did not deliver the petition to the Tax Court until July 19. The court sent it to the IRS on August 3. Because the envelope containing Mr. Clark's petition bore a postmark within 90 days of the IRS issuing the notice, it was timely filed, even though the IRS did not receive it for almost six months.

Lacking knowledge of Mr. Clark's petition, the IRS failed to place a litigation hold on his account and, in March 2022, assessed the deficiency and penalties set out in the notice.

Before the trial, two significant events occurred. First, the Social Security Administration (SSA) informed Mr. Clark in March 2023 that it would reduce his recorded 2019 SE earnings from \$46,380 to \$0, based on revised data it received from the IRS. Second, the IRS refunded Mr. Clark the deficiency and penalties he had paid, as it determined that the assessment was premature considering the upcoming litigation.

Issues. The issues in this case are the following.

- Whether the \$50,222 that Mr. Clark reported as 'other income' should have been recognized as SE income subject to SE tax
- Whether Mr. Clark's reporting of income on Line 7a of Form 1040 instead of Schedule C led to a substantial understatement of tax, thereby subjecting him to an accuracy-related penalty

Analysis. The taxpayer bears the burden of proving the IRS's determinations erroneous.¹¹² A tax applies on net earnings from SE activities.¹¹³ SE income refers to the net earnings from SE activities that an individual derives during a taxable year.¹¹⁴ Net earnings from SE activities include the gross income from any trade or business.¹¹⁵

Mr. Clark argued that he was not liable for SE tax for 2019 because the IRS conceded he was not liable, as witnessed by the refund it issued and by the SSA document that stated his 2019 SE income was \$0.

However, the court found this argument unpersuasive. It explained that the IRS's refund and the SSA's reduction of his earnings record reflected the IRS's reversal of a premature assessment. As such, the refund and SSA document did not amount to an admission that Mr. Clark's freelance writing and memorabilia-sales income were exempt from SE tax.

Furthermore, Mr. Clark already stipulated that he earned \$8,250 from writing movie reviews and \$41,972 from selling memorabilia. As such, his argument conflicted with the stipulated facts and had no merit.

The court next addressed whether Mr. Clark's underpayment was subject to a 20% accuracy-related penalty for a substantial understatement of income tax.¹¹⁶ An underpayment is a substantial understatement of income tax when it exceeds 10% of the tax required to be shown.¹¹⁷ The IRS must prove that an accuracy-related penalty is appropriate.¹¹⁸ An IRS supervisor must approve the penalty unless it is automatically calculated through electronic means.¹¹⁹

¹¹² *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

¹¹³ IRC §1401; Treas. Reg. §1.1401-1(a).

¹¹⁴ IRC §1402(b).

¹¹⁵ IRC §1402(a).

¹¹⁶ IRC §§6662(a) and (b)(2).

¹¹⁷ IRC §6662(d)(1)(A).

¹¹⁸ IRC §7491(c); *Higbee v. Comm'r*, 116 TC 438, 446 (2001).

¹¹⁹ IRC §§6751(b)(1) and (2).

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A taxpayer may avoid the penalty if they had reasonable cause and acted in good faith.¹²⁰ Good faith is determined based on the specific facts and circumstances of each case.¹²¹ A court may consider the taxpayer's efforts to determine the correct tax liability, as well as their experience, education, and sophistication. It may also evaluate whether the taxpayer had an honest misunderstanding of fact or law or relied on professional advice.¹²²

Mr. Clark's understatement of 2019 income tax exceeded 10% of the tax that was required to be shown on the return. Additionally, the penalty was automatically calculated by the IRS's AUR Program, and thus, the usual written supervisory approval requirement of IRC §6751(b)(1) did not apply.

The court also concluded that Mr. Clark failed to show reasonable cause or good faith as he did not demonstrate actual reliance on professional tax advice or any specific misunderstanding of tax law that would excuse the reporting error. The court recognized that Mr. Clark had limited knowledge of federal income tax matters during the trial. However, given his more than 30 years of experience as an SE individual, the court concluded that he did not make a reasonable effort to determine his correct tax liability or establish a valid justification for the underpayment.

Holding. The court held that the \$50,222 Mr. Clark reported as other income should have been recognized as SE income subject to SE tax. Additionally, Mr. Clark's reporting of income on Form 1040, line 7a, instead of Schedule C, led to a substantial understatement of tax, subjecting him to the accuracy-related penalty.



¹²⁰. IRC §6664(c)(1).

¹²¹. Treas. Reg. §1.6664-4(b)(1).

¹²². *Higbee v. Comm'r*, 116 TC 438, 448-449 (2001).

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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YEAREND TAX PLANNING

When a tax year draws to a close, farmers face a unique set of tax planning opportunities and challenges. Unlike many other businesses, agricultural producers can take advantage of unique IRS rules that, when strategically applied, can significantly reduce tax liabilities.

CASH ACCOUNTING

Farmers are the only business that maintains an inventory that may utilize the **cash method of accounting**, which offers significant flexibility in managing taxable income.¹ Under this method, income is recognized when cash is received and expenses to be deducted when cash is paid out. This contrasts with the **accrual method**, which recognizes income when earned and expenses when incurred, regardless of cash flow.²

The flexibility of the cash method allows farmers to actively manage the timing of income and expenses, which can be especially valuable in years with volatile commodity prices or unexpected weather events. By thoughtfully applying certain techniques, producers can shift income into lower-tax years or accelerate deductions to reduce current-year liabilities. The following are key strategies that leverage the benefits of the cash method.

- **Income deferral.** A farmer with a high-income year can defer sales of crops or livestock until the following tax year to push income into a period where they anticipate lower earnings or lower tax rates. This can be particularly beneficial for smoothing out income fluctuations common in agriculture.

Observation. A properly drafted deferred sales contract should be used to defer income from grain and livestock sales. A valid deferred sales contract requires the farmer-seller be on the cash method of accounting and have a legitimate business purpose for deferring the income.³

- **Prepaid expenses.** Farmers can accelerate deductions by prepaying for certain expenses for the upcoming year. This includes items like feed, seed, fertilizer, and other supplies. However, there are limitations.⁴
 - ♦ The payment must be for the actual purchase of supplies and not merely a deposit.
 - ♦ The prepayment must have a legitimate business purpose (e.g., securing prices, ensuring supply) and cannot be made solely for tax avoidance.
 - ♦ The deduction for prepaid farm supplies and feed is generally limited to 50% of other deductible farm expenses (all deductions on Schedule F (Form 1040), *Profit or Loss From Farming*, excluding prepaid items) for the year.⁵ This 50% limitation can be waived under certain qualified farm-related taxpayer conditions, such as a change in business operations due to extraordinary circumstances or if prepaid expenses were consistently below the 50% threshold in prior years. Specifically, if total prepaid expenses for the preceding three tax years is less than 50% of the total other deductible farm expenses for those three tax years, the exception is met and the limit on the deduction for prepaid expenses does not apply.

Note. Advance payments of rent can be deducted only in the year to which they apply. However, for cash basis taxpayers, the 12-month rule may allow them to deduct the cost of advance rental or leasing payments in year one, even though a portion of that benefit is received in the following year.⁶

¹. IRC §448(b)(1).

². Treas. Reg. §1.446-1(c).

³. See IRS Pub. 225, *Farmer's Tax Guide*.

⁴. Ibid.

⁵. IRC §464(d).

⁶. Treas. Reg. §1.263(a)-4(f).

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Example 1. John Cushing operates a cash-basis grain farm. It is late December 2025, and he has had an exceptionally profitable year due to favorable commodity prices and good yields. He anticipates 2026 to be less profitable due to projected lower prices. John wants to reduce his 2025 taxable income. The following are selections from his financial situation in 2025.

- Projected 2025 Gross Farm Income: \$500,000
- Projected 2025 Deductible Farm Expenses (excluding prepaid items): \$200,000
- Current Net Farm Income (before considering prepayments): \$300,000

John knows he will need a significant amount of fertilizer, seed, and chemicals for his 2026 planting season. His usual supplier is offering a price discount for orders placed and paid for by yearend. John takes the following steps as part of his yearend tax planning.

1. Calculate the 50% limitation

John's other deductible farm expenses for 2025 are \$200,000. However, the maximum he can deduct for prepaid farm supplies is 50% of this amount, or \$100,000 ($\$200,000 \times 50\%$).

2. Make prepaid purchases

On December 28, 2025, John enters into an agreement with his supplier to purchase the following.

- Fertilizer for \$70,000
- Seed for \$20,000
- Chemicals for \$15,000

He pays the full amount of \$105,000 to the supplier in December 2025. The supplier confirms the discounted price and commits to delivering the supplies in early 2026.

3. Calculate the deduction in 2025

Even though John paid \$105,000, he can only deduct up to the 50% limit. Therefore, John can deduct \$100,000 calculated in step 1 of his prepaid expenses on his 2025 tax return.

Note. John could also analyze prior-year tax returns to determine if he meets the 3-year test to avoid the application of the 50% prepaid limitation.

By strategically prepaying \$105,000 for 2026 supplies, John successfully reduces his 2025 taxable income by \$100,000. This lowers both his income tax and self-employment (SE) tax for 2025.

The remaining \$5,000 (\$105,000 paid – \$100,000 deducted) that exceeds the 50% limitation for 2025 is deductible in 2026 when the supplies are actually consumed or used, along with any other expenses incurred in 2026.

MAXIMIZING DEPRECIATION DEDUCTIONS

To effectively manage taxable income, farmers often rely on depreciation strategies that allow for accelerated cost recovery of capital investments. The Code provides several options for expensing or depreciating assets, each with its own eligibility rules, limitations, and planning opportunities. The most powerful tools available are the expense method depreciation under IRC §179, which allows for immediate deduction of qualifying property, and bonus depreciation.

Expense Method Depreciation⁷

For tangible depreciable personal property, all or part of the income tax basis can be deducted currently in the year in which the property is placed in service (defined as when property is in a state of readiness for its intended use in the taxpayer's trade or business),⁸ regardless of the time of year the asset was placed in service. This is an off-the-top depreciation allowance that may be taken each year at the taxpayer's election.⁹ For property placed in service in tax years beginning after December 31, 2024, the aggregate basis amount (annual dollar limit) eligible for the deduction is \$2,500,000.¹⁰

The expense method depreciation amount is limited to the taxpayer's aggregate business taxable income that is derived from businesses that the taxpayer **actively conducts** during the tax year with any disallowed amounts carried over to the next year (i.e., §179 cannot be used to create or increase a loss.)¹¹ Active conduct is defined as a facts and circumstances test that is used to determine if the taxpayer "meaningfully participates in the management or operations of the trade or business."¹² Wages and salaries that the taxpayer receives as an employee are included in the aggregate amount of active business taxable income of the taxpayer. The limitation applies at the entity level for pass-through entities in addition to also applying at the individual taxpayer level.

Note. The annual dollar limitation applies to partnerships and S corporations as well as to each individual owner.¹³ It is common for family members of agricultural operations to share ownership of equipment. If a co-ownership arrangement rises to the level of a trade or business (requiring a partnership return), a single §179 limitation applies to the equipment purchases. But, if the co-ownership does not constitute a partnership, each individual is entitled to use their respective share of equipment purchases in calculating the §179 limitation.

The annual dollar limit for expense method depreciation is for **all eligible property** placed in service during the year, not for each item. Property that is eligible for expense method depreciation is tangible, depreciable personal property.¹⁴ Also, qualified leasehold improvement property and qualified retail improvement property are eligible for expense method depreciation, as are air conditioning and heating units.

However, certain items of tangible depreciable personal property are **not eligible** for expense method depreciation. In general, any property that would be ineligible for investment tax credit (when the investment tax credit was available) is ineligible for expense method depreciation. In most cases, property with a class life greater than 15 years, or real property that is, by definition, reclassified as 15-year property, is not eligible.¹⁵ Also, property acquired by gift or inheritance, property received from an estates or trusts, and property acquired from a spouse, ancestor, or lineal descendant is not eligible for expense method depreciation.

Caution. Practitioners should ensure they understand how their tax preparation software program handles newly acquired property, as many programs do not differentiate between methods of acquisition.

⁷ IRC §179.

⁸ See, e.g., *Brown v. Comm'r*, TC Summ. Op. 2009-171 (Nov. 23, 2009).

⁹ Estates and trusts are not eligible for IRC §179 per IRC §179(d)(4).

¹⁰ For 2025, the maximum amount eligible for the deduction is \$31,300 for heavy sport utility vehicles (SUVs). An SUV is considered heavy if it has a gross vehicle weight rating of more than 6,000 pounds but less than 14,000 pounds. Such vehicles are also eligible for first-year bonus depreciation.

¹¹ This definition includes IRC §1231 gains and losses as well as interest from the working capital of the business. Treas. Reg. §1.179-2(c).

¹² Treas. Reg. §1.179-2(c)(6)(ii).

¹³ Treas. Reg. §1.179-2(b)(3)(i).

¹⁴ This includes costs to prepare and plant a vineyard, including labor costs per CCA 201234024 (May 9, 2012). Expense method depreciation is tied to the beginning of the taxpayer's tax year.

¹⁵ IRC §§168(k)(2)(A)-(F).

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For **real** property traded in, only the cash boot that is paid to acquire replacement property is eligible for expense method depreciation. For **personal** property traded in, the full purchase price is eligible for expense method depreciation.

For the farmer or rancher, however, expense method depreciation is potentially available for a wide array of assets at the taxpayer's election. For example, expense method depreciation may be claimed not only on machinery and equipment, purchased breeding stock, pickup trucks, and business automobiles, but also on tile lines, fences, feeding floors, grain bins, and silos. These assets qualify because they were eligible for the investment tax credit when it was available and are classified as 'other property' under IRC §1245.

Taxpayers can select those assets to which they would like to have expense method depreciation apply and select a specific amount to expense. If expense method depreciation is selected for a particular asset, regular depreciation cannot be claimed on that portion of the asset's basis, and the basis of the qualifying property must be reduced by the amount of the expensing deduction.

For tax year 2025, expense method depreciation begins to phase out when the total cost of qualifying property placed in service exceeds \$2,500,000, and is fully phased out at \$6,500,000.¹⁶ For each dollar of investment in excess of \$4 million for the year, the allowable expense amount is reduced by \$1. Thus, for 2025, at \$2,500,000 of purchases, the full deduction is available, and at \$6,500,000 of purchases, no expense method depreciation is available.

Expense method depreciation can be claimed only to the extent of taxable income from an active trade or business.¹⁷ Within the last decade, the IRS has conceded the idea that wage income from a Form W-2, *Wage and Tax Statement*, is considered income from a trade or business. Moreover, a spouse's Form W-2 wage income is considered income from an active trade or business for this purpose if they file a joint income tax return.

The maximum allowable deduction per year is reduced by one-half per year for married individuals filing a separate return. For a partnership, the limitation applies to both the partnership and each of the partners. Members of a controlled group of corporations divide the expensed amount. For expense method depreciation assets disposed of by installment sale, all payments received under the contract are deemed to have been received in the year of sale to the extent of expense method depreciation claimed on the property.

The expense method election for eligible property must be made on the first return (or on a timely filed amended return) for the year the elected property is placed in service. However, an expense method depreciation election can be made or revoked on an amended return for an open tax year (generally the most recent three years).

Note. Upon disposition of property on which an expense method depreciation election has been made, special income tax recapture rules may apply.

¹⁶ This amount is indexed for inflation for tax years beginning after 2015.

¹⁷ The definition includes IRC §1231 gains and losses as well as interest from the working capital of the business per Treas. Reg. §1.179-2(c). A taxpayer is deemed to be actively participating in a trade or business based on a fact-based determination concerning whether the taxpayer "meaningfully participates" in the management or operations of the trade or business per Treas. Reg. §1.179-2(c)(6)(ii). The limitation for an S corporation is determined by increasing business net income for those deductions claimed for compensation to shareholder-employees and the taxable income limitation for partnerships is determined after adding back deductions for guaranteed payments paid to partners. Any disallowed amounts due to the limitation are carried over to the next tax year per IRC §179(b)(3)(B).

Bonus Depreciation.¹⁸ Bonus depreciation allows for an immediate deduction of 100% (for property placed in service after January 19, 2025) of the cost of new and used qualifying property in the year the property is placed in service. The One Big Beautiful Bill Act (OBBBA), enacted on July 4, 2025, reinstates 100% bonus depreciation for qualifying property placed in service on or after January 1, 2025. This provision overrides the phase-down schedule established under the Tax Cuts and Jobs Act (TCJA), which had reduced bonus depreciation to 40% for 2025.

Unlike §179, bonus depreciation generally has no investment or income limits. Bonus depreciation applies to a property's adjusted income tax basis for both regular income tax and alternative minimum tax (AMT) purposes. Eligible property is property with a recovery period of 20 years or less, computer software, and water utility property. As noted previously, eligible property need not be “new property” defined as the original use of the property commencing with the taxpayer. So, used machinery and equipment, breeding or dairy animals and buildings, fences, tile lines and other improvements on the purchase of a farm are eligible.

Note. When claiming bonus depreciation, any expense method depreciation should be claimed first, then the bonus depreciation, followed by regular depreciation.

While expense method depreciation is an election and claimed first, bonus depreciation is automatic. An election out of bonus depreciation can be made which will allow the taxpayer to elect the precise amount of expense method depreciation desired (so as to not created a net operating loss (NOL) and/or “soak up” a tax bracket). The election out of bonus depreciation applies to all assets within a particular class life, as defined under the modified accelerated cost recovery system (MACRS) — the primary system used to determine depreciation periods for most tangible property.

Note. IRC §168(k) provides for an election that allows first year bonus depreciation for certain plants that are planted or grafted after 2015. Under the provision, a specified plant is any tree or vine which bears fruit or nuts, and any other plant which will have more than a single yield of fruits or nuts, and which generally has a pre-productive period of more than two years from the time of planting or grafting to the time at which the plant begins bearing fruits or nuts.

Example 2. Sarah Sota operates a corn and soybean farm. It is December 2025, and she anticipates a strong taxable income for the year. To reduce her tax burden, she decides to invest in the following depreciable property placed in service in December.

New tractor cost	\$350,000	(5-year MACRS property)
Used grain bin cost	<u>100,000</u>	(7-year MACRS property)
Total qualifying purchases	\$450,000	

Sarah should consider the following options.

Option A: Maximize First-Year Deduction

Sarah expects her net farm income (before new equipment deductions) to be \$500,000. She wants to maximize her first-year deduction to reduce this income.

Following the ordering rules, Sarah first elects §179. Sarah can elect §179 for both the tractor and the grain bin, totaling \$450,000. This deduction directly reduces her taxable income. An advantage is that Sarah receives a 100% immediate deduction for these assets, significantly lowering her \$500,000 income to \$50,000 (\$500,000 income – \$450,000 §179 deduction.) However, §179 cannot create a net loss that is **deductible** in the current year. It is limited to taxable business income. Sarah can carry forward any §179 deduction not used due to the business income limitation to future years.

¹⁸ IRC §168(k); *One Big Beautiful Bill Act*, PL 119-21, §70301.

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Next, Sarah evaluates her bonus depreciation options. If Sarah's purchases were much higher, she might hit the §179 limit. Any remaining qualified cost would then be eligible for bonus depreciation. The 100% bonus depreciation provision allows Sarah to immediately deduct the entire \$450,000 cost of the assets in 2025. The advantage of bonus depreciation is that it **can** create or increase an NOL that can be carried forward, and can offer greater flexibility if Sarah has a very high capital expenditure year and minimal income. It also applies to all qualified property, not asset-by-asset like §179. However, if Sarah disposes of the property, depreciation recapture is triggered under §1245 at ordinary income rates.

Observation. Sarah could choose either §179 or bonus depreciation for the entire \$450,000. This provides a full deduction in the current high-income year, reducing her taxable income from \$500,000 to zero (or lower if she has other deductions). However, using §179 is often the simplest and most effective strategy when a farmer has sufficient taxable income to absorb the full deduction, and it can also be used to select a specific amount to optimize a tax bracket.

Option B: Manage Income and Future Planning

Sarah expects her net farm income to be \$150,000 this year, but she anticipates even lower income in 2025 due to market changes.

Under this option, if Sarah elects §179 expense method depreciation for the full \$450,000 cost of assets, and her income is \$150,000, she could only deduct \$150,000 in 2025 due to the taxable income limitation. The remaining \$300,000 (\$450,000 §179 deduction – \$150,000 income) is carried forward to 2026. Carrying forward a large §179 deduction might not be ideal if she anticipates very low or no income in 2026, as it might take many years to fully utilize.

Rather than electing any §179 amount, Sarah could claim 100% bonus depreciation on the \$450,000. This \$450,000 bonus depreciation **would** create an NOL for 2025 of \$300,000 (\$150,000 income – \$450,000 bonus). The NOL of \$300,000 can be carried forward indefinitely to offset future taxable income. As a farm loss, it can also be carried back for two years. This can be a more efficient use of the deduction if current year income is insufficient to absorb the full §179 amount.

Note. Sarah could also choose to use a smaller amount of §179, perhaps just enough to zero out her 2025 income, and then use bonus depreciation on the remaining basis. This combines the immediate benefit with the flexibility of bonus depreciation.

Observation. Sarah would likely prefer bonus depreciation (or a combination with §179) to generate an NOL. This allows her to use the immediate deduction power of bonus depreciation even if her current income is low and then carry forward (or back) the resulting loss to offset future income (or prior income in the previous two years) when she might need the deductions more. If she used §179 alone, the unused portion might sit as a carryforward for a long time.



Practitioner Planning Tip

Practitioners should consider the following pointers when making bonus and §179 deductions.

- **Income level is crucial.** For taxpayers with high taxable income who want to reduce it significantly, §179 is often preferred for its 100% immediate expensing (subject to limits).
- **NOL potential.** If the taxpayer's income is low or a loss is anticipated, bonus depreciation may be preferred because it **can** create or increase an NOL that can be carried forward (or back for a farming NOL), unlike §179 which is limited by taxable income in the current year.
- **Flexibility.** IRC §179 can be elected on an asset-by-asset basis, allowing the taxpayer to pick and choose which assets to expense. Bonus depreciation, once elected for a class of property, generally applies to all qualified property within that class. An election **out** of bonus depreciation for certain classes of property can be made.

Repairs Versus Capitalization. Farmers must carefully distinguish between repairs, which are fully deductible in the year paid, and capital improvements, which must be capitalized and depreciated over time. The distinction between a deductible repair and a capital improvement that must be depreciated has long lacked a clear, objective standard, making it difficult to determine the proper tax treatment of certain expenses. The basic issue is distinguishing between expenses that qualify as ordinary and necessary business costs under IRC §162(a) — which are currently deductible, including incidental repairs — and those that fall under IRC §263(a), which must be capitalized. The latter includes costs for acquiring new property, making permanent improvements or betterments that increase a property's value, adapting property to a new use, or restoring it to its original condition.

Note. As for materials and supplies, the treatment of materials and supplies for farmers is guided by Treas. Reg. §1.162-12(a) which allows for full deductibility for all amounts actually expended in carrying on the business of farming.

INCOME AVERAGING¹⁹

Another technique that is available to a farmer is the ability to average income. Individuals engaged in a farming (or fishing) business can elect to spread whatever portion of current income is desired (termed **elected farm income** (EFI)) evenly over the three prior taxable years. The current year's income tax liability is calculated by determining the current year's tax (without the amount of EFI) plus the increases in income tax for each of the three prior taxable years by taking into account the allocable share of EFI for each of those years. Any adjustment for any taxable year is taken into account for income averaging purposes in subsequent tax years.

Note. For each base year, a recomputed tax is calculated as if a third of the current year's electing farm income had been included in that year's taxable income. A prior year's actual tax return is not revised or amended — it is only a hypothetical recomputation.

¹⁹ IRC §1301.

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Requirements

Only individuals with farm income are eligible to utilize income averaging. Estates and trusts are not eligible, and C corporations are not considered to be individuals. For entities taxed as partnerships that pass through income items to the partners or members, the partners or members, if they are individuals, should be able to elect income averaging. For S corporations engaged in farming, the character of income from the corporation continues in the hands of the shareholders and will allow shareholders to utilize income averaging.²⁰ Likewise, income attributable to a farming business carried on by a partnership can be averaged without regard to the partner's level of participation in the partnership or the size of the ownership interest.²¹

An individual electing income averaging must be engaged in a farming business in the year for which the election is made. However, they do not need to have been necessarily engaged in a farming business in the three prior carryback years.²²

Observation. This flexibility is particularly beneficial for individuals who may have had a significant increase in farm income in the current year but had little or no farm income in the previous three years. By averaging the current year's income over the base years, taxpayers may reduce their overall tax liability by applying it to years with lower income and potentially lower tax rates.

A **farming business** means a trade or business involving the cultivation of the land or the raising and harvesting of any agricultural or horticultural commodities but does not include the processing of commodities or products "beyond those activities which are normally incident to the growing, raising or harvesting of such products."²³

An individual's relationship to the farming business is critical in determining eligibility. Farmers who actively manage their operations and assume the financial risks associated with production and market fluctuations are clearly eligible to elect income averaging. The final regulations make it clear that a landlord is not considered to be engaged in a farming business if the rental is either a fixed rent (cash rent) or even share rents based on a share of a tenant's production determined after the tenant has begun significant activities on the land.²⁴ Whether the landlord materially participates in the tenant's farming business is irrelevant for income averaging purposes. Thus, non-materially participating landlords are eligible for income averaging if the landlord's share of a tenant's production is **set in a written rental agreement before the tenant begins significant activities on the land**. That places a premium on written leases.

It is likely that individuals who have ceased farming operations with the only activity in the year in question being the sale of inventory and the sale of machinery are not engaged in a farming business in that year.²⁵ However, gains or losses from property regularly used in a farming business after cessation of the farming business are treated as attributable to a farming business if the property is sold within a reasonable time after cessation of the farming business. If the sale or other disposition of such assets occurs within one year of the cessation of farming, it is presumed to be within a reasonable time. After that, it is a facts and circumstances test.²⁶

²⁰ As stated in IRC § 1366(b), "the character of any item included in a shareholder's pro rata share...shall be determined as if such item were realized directly from the source from which realized by the corporation or incurred in the same manner as incurred by the corporation."

²¹ Summary to TD 8972 (Jan. 7, 2002).

²² Instructions for Schedule J. See also Treas. Reg. §1.1301-1(d)(1).

²³ Temp. Treas. Reg. § 1.263A-4T(c)(4)(i)(C). The regulations also provide the definition of a qualified fishing business.

²⁴ Treas. Reg. §1.1301-1(b)(2).

²⁵ Income from the sale of farm machinery is typically treated as IRC §1231 gain, not ordinary farm income. Income from the sale of inventory (such as crops harvested in a prior year) may be considered farm income, but only if the taxpayer is still engaged in the farming business in that year. If farming operations have permanently ended, even if sales of leftover inventory occur, the IRS is likely to view the taxpayer as no longer engaged in a farming business.

²⁶ Prop. Treas. Reg. §1.1301-1.

Eligible Income

Gains from the “sale or other disposition of property (other than land) regularly used by the taxpayer in such a farming business for a substantial period” are eligible for averaging.²⁷ Clearly, gains from the sale or exchange of land do not qualify. Although not entirely clear, it would appear that gain from land sales is ineligible for averaging whether that gain is taxed as capital gain, ordinary income, recaptured depreciation, or unrecaptured IRC §1250 gain and where that gain is attributable to the soil. The IRS’s position is that gains from assets considered to be part of the land (e.g., buildings, fences, and tile lines) are eligible for income averaging.²⁸

Losses in the Base Years

The IRS allows losses in the three carry back or “base years” to be utilized, and the instructions to Schedule J (Form 1040), *Income Averaging for Individuals With Income from Farming or Fishing*, contain guidance on how the calculations are to be handled.²⁹ However, negative EFI figures in the year of election cannot be used to reduce tax liability as calculated with reference to the three carryback years. In other words, when elected farm income is spread across the three prior base years, it cannot cause an NOL in any of those years. If a base year already has an NOL, it cannot be offset further by allocating more electing farm income to it.

Note. If the EFI allocated to a base year would fall into a tax bracket that was not used due to losses (i.e., no tax was owed), there is no refund or negative tax rate for that portion. Thus, income averaging only reduces the current year tax to the extent that it would have increased tax in the base years.

Other Points

An individual is not prohibited from making an income averaging election solely because their filing status is not the same as in the base years.³⁰ In terms of how the remaining bracket amounts are to be divided between the spouses if both spouses have elected income averaging in a year following divorce, the allocation depends on whether the farm income is considered community income or separate income. The allocation is reported on Form 8958, *Allocation of Tax Amounts Between Certain Individuals in Community Property States*.

An income averaging election can be made on a late or amended return if the period of limitations on filing a claim for credit or refund has not expired. Also, a previous election can be changed or revoked if the period of limitations has not expired.

To elect income averaging, a taxpayer must complete and attach Schedule J to their federal income tax return for the year of the election. There is no separate checkbox or standalone election form — filing Schedule J itself constitutes the election. This can be done on an original return or on an amended return, provided the statute of limitations for claiming a refund has not expired. The IRS treats the inclusion of a properly completed Schedule J as a valid and binding election for that tax year.³¹ A draft copy of the 2025 version of Schedule J follows.

²⁷ IRC §1301(b)(1)(B). The meaning of “substantial period” is unclear. In proposed regulations, “substantial period” remains undefined with resolution of the issue subject to a facts and circumstances test. Prop. Treas. Reg. §1.1301-1. Presumably, sales reported on Form 4797 count.

²⁸ The IRS has taken the position in Prop. Treas. Reg. §1.1301-1 that income from gains or losses from structures on land is not ineligible.

²⁹ Final Treas. Reg. §1.1301-1(d)(2)(i) takes the same position.

³⁰ Treas. Reg. §1.1301-1(f)(2).

³¹ Instructions for Schedule J.

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TREASURY/IRS AND OMB USE ONLY DRAFT

SCHEDULE J (Form 1040)

Department of the Treasury
Internal Revenue Service

Income Averaging for Individuals With Income From Farming or Fishing

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to www.irs.gov/ScheduleJ for instructions and the latest information.

OMB No. 1545-0074

2025
Attachment
Sequence No. **20**

Name(s) shown on return

Social security number (SSN)

DRAFT — DO NOT FILE

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1	Enter the taxable income from your 2025 Form 1040, 1040-SR, or 1040-NR, line 15	1	
2a	Enter your elected farm income . See instructions. Do not enter more than the amount on line 1 . . .	2a	
Capital gain included on line 2a:			
b	Excess, if any, of net long-term capital gain over net short-term capital loss	2b	
c	Unrecaptured section 1250 gain	2c	
3	Subtract line 2a from line 1	3	
4	Figure the tax on the amount on line 3 using the 2025 tax rates. See instructions	4	
5	If you used Schedule J to figure your tax for: • 2024, enter the amount from your 2024 Schedule J, line 11. • 2023 but not 2024, enter the amount from your 2023 Schedule J, line 15. • 2022 but not 2023 or 2024, enter the amount from your 2022 Schedule J, line 3. Otherwise, enter the taxable income from your 2022 Form 1040, 1040-SR, or 1040-NR, line 15. If zero or less, see instructions.	5	
6	Divide the amount on line 2a by 3.0	6	
7	Combine lines 5 and 6. If zero or less, enter -0-	7	
8	Figure the tax on the amount on line 7 using the 2022 tax rates. See instructions	8	
9	If you used Schedule J to figure your tax for: • 2024, enter the amount from your 2024 Schedule J, line 15. • 2023 but not 2024, enter the amount from your 2023 Schedule J, line 3. Otherwise, enter the taxable income from your 2023 Form 1040, 1040-SR, or 1040-NR, line 15. If zero or less, see instructions.	9	
10	Enter the amount from line 6	10	
11	Combine lines 9 and 10. If less than zero, enter as a negative amount	11	
12	Figure the tax on the amount on line 11 using the 2023 tax rates. See instructions	12	
13	If you used Schedule J to figure your tax for 2024, enter the amount from your 2024 Schedule J, line 3. Otherwise, enter the taxable income from your 2024 Form 1040, 1040-SR, or 1040-NR, line 15. If zero or less, see instructions	13	
14	Enter the amount from line 6	14	
15	Combine lines 13 and 14. If less than zero, enter as a negative amount	15	
16	Figure the tax on the amount on line 15 using the 2024 tax rates. See instructions	16	
17	Add lines 4, 8, 12, and 16	17	

For Paperwork Reduction Act Notice, see your tax return instructions.

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Schedule J (Form 1040) 2025

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18	Amount from line 17	18	
19	If you used Schedule J to figure your tax for: • 2024, enter the amount from your 2024 Schedule J, line 12. • 2023 but not 2024, enter the amount from your 2023 Schedule J, line 16. • 2022 but not 2023 or 2024, enter the amount from your 2022 Schedule J, line 4. Otherwise, enter the tax from your 2022 Form 1040, 1040-SR, or 1040-NR, line 16.	19	
20	If you used Schedule J to figure your tax for: • 2024, enter the amount from your 2024 Schedule J, line 16. • 2023 but not 2024, enter the amount from your 2023 Schedule J, line 4. Otherwise, enter the tax from your 2023 Form 1040, 1040-SR, or 1040-NR, line 16.	20	
21	If you used Schedule J to figure your tax for 2024, enter the amount from your 2024 Schedule J, line 4. Otherwise, enter the tax from your 2024 Form 1040, 1040-SR, or 1040-NR, line 16* * Only include tax reported on this line that is imposed by section 1 of the Internal Revenue Code. See instructions.	21	
22	Add lines 19 through 21	22	
23	Tax. Subtract line 22 from line 18. Also include this amount on Form 1040, 1040-SR, or 1040-NR, line 16 Caution: Your tax may be less if you figure it using the 2025 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.	23	

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Schedule J (Form 1040) 2025

In computing AMT (when it applies), the regular tax liability for farmers and fishermen is determined without regard to income averaging. That means that a farmer or fisherman receives the full benefit of income averaging.³²

Example 3. Rachel Nade operates a grain farm. Her income can fluctuate significantly year-to-year due to weather conditions, commodity prices, and input costs. Her taxable income for her base years following.

- Year 1 (2022): Taxable Income = \$20,000 (a tough year due to drought)
- Year 2 (2023): Taxable Income = \$45,000 (better yields, moderate prices)
- Year 3 (2024): Taxable Income = \$30,000 (good yields, but lower prices)

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In the current year (2025), Rachel is having an exceptionally good year. Excellent weather and strong commodity prices mean her projected taxable income from farming for 2025 is \$150,000. If Rachel simply reports the \$150,000 taxable income from farming in 2025, a large portion of that income will be pushed into higher federal income tax brackets. This means she will pay a significantly higher average tax rate on her 2025 farm income compared to her previous, lower-income years.

As Rachel approaches the end of 2025, her tax advisor suggests considering the Schedule J farm income averaging election. Rachel and her advisor decide how much of her current year's farm income she wants to average. This is the EFI. It can be all or part of her current year's taxable farm income. They decide to average \$90,000 of her \$150,000 farm income. The remaining \$60,000 (\$150,000 – \$90,000) will be taxed normally in 2025.

³² Treas. Reg. §1.1301-1(g).

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The \$90,000 EFI is then notionally spread equally over the three preceding tax years (the base years). Rachel's tax liability for each of the base years (2022, 2023, and 2024) is recalculated as if an additional \$30,000 of farm income had been earned in each of those years.

Year	Original Taxable Income	From EFI	Recalculated Taxable Income
2022	\$20,000	\$30,000	\$50,000
2023	45,000	30,000	75,000
2024	30,000	30,000	60,000

For each base year, the tax advisor calculates how much additional tax would have been owed if \$30,000 of the current year's farm income had been included in that year's taxable income. Because these base years had lower income levels, this additional \$30,000 in each year will likely be taxed at lower marginal rates than if the full \$90,000 was taxed in the high-income current year (2025).

The tax on Rachel's non-averaged income for 2025 (the \$60,000) is calculated using the 2025 tax rates. The sum of the additional taxes calculated for the three base years is added to the tax on her non-averaged 2025 income.

By notionally shifting \$90,000 of her high 2025 income back to the lower-income base years, Rachel effectively gets to have that portion of her income taxed at the potentially lower marginal tax rates that applied to her in 2022, 2023, and 2024, rather than the higher marginal rates she faces in 2025 with \$150,000 of income. If in each of the three base years, her tax rate was 12% and in 2025, her tax rate would be 22% without averaging, the income averaging savings is \$9,000 ($\$90,000 \times (22\% - 12\%)$). This results in a lower overall federal income tax liability for 2025 than if she had not used income averaging.

In summary, Rachel's ability to effectively use income averaging relies on good record-keeping and the ability to project her current year's income with reasonable accuracy towards the end of the year. As part of her yearend tax planning meetings (e.g., in November or December), her advisor can run these calculations to see if Schedule J provides a benefit. This decision is often made in conjunction with other yearend strategies, such as timing of expense payments (pre-paying inputs, if advantageous) or deferring sales (if using valid deferred payment contracts). Rachel can choose any amount of the current year's farm income to elect for averaging to optimize the tax benefit.

Observation. Income averaging only applies to income from a farming or fishing business. It does not apply to wages, investment income, etc. If a base year had negative taxable income, the practitioner must manually calculate that negative amount before entering it on Schedule J.³³ Recalculating tax for base years can sometimes affect other tax items from those years, though often the impact is primarily on the tax rates applied to the averaged income. Some states allow income averaging, while others do not. This needs to be considered separately. While beneficial, it adds complexity to the tax return, making professional advice even more valuable.

³³ IRS Pub. 225, *Farmer's Tax Guide*.

MANAGING SE TAXES

Another key concept for yearend tax planning involves SE tax planning. A sole proprietor farmer is considered self-employed and engaged in the trade or business of farming. This means that the farm income is subject to SE tax, which generates liability for social security and Medicare taxes.³⁴

Strategies to manage SE tax include the following.

- **Maximizing deductions.** Every deductible farm expense reduces net farm income, which in turn lowers the amount subject to SE tax. Therefore, diligently tracking and claiming all ordinary and necessary business expenses is critical.
- **Trade-in equipment.** Under TCJA, the fair market value (FMV) of equipment traded in must be reported as a disposition on Form 4797, *Sales of Business Property*. The full purchase price of the acquired equipment is eligible for the §179 deduction which reduces income on Schedule F. Even if the net trade difference is zero, SE tax may be reduced.
- **Entity structure.** While most farmers operate as sole proprietors (reporting on Schedule F), exploring other entity structures like an S corporation or a manager-managed limited liability company (LLC) can sometimes reduce SE tax by allowing a portion of income to be treated as allocable earnings not subject to SE tax, provided a reasonable salary (or guaranteed payment) is paid.

HANDLING NOLs

Losses incurred in the operation of farms and ranches as business enterprises as well as losses resulting from transactions entered into for profit are deductible from gross income. An NOL may be claimed as a deduction for individuals that is entered as a negative figure on Form 1040, *U.S. Individual Income Tax Return*. Farm losses can be carried forward indefinitely to offset future taxable income or can be carried back up to two years.³⁵

Procedurally, the NOL is calculated on the current year's tax return and for purposes of utilizing the carryback rule, the NOL is subtracted from the income in the carryback year(s) using Form 1045, *Application for Tentative Refund*, or Form 1040-X, *Amended U.S. Individual Income Tax Return*. If the farm taxpayer prefers to carry the loss forward instead of back, an election must be made by attaching a statement to the original return. The election must be made by the due date (including extensions) of the return for the NOL year.

Example 4. In 2025, Cornelius Cobb has a \$50,000 NOL. He had \$40,000 taxable income in 2023 and \$30,000 in 2024. If Cornelius carries the NOL back, it is first applied to 2023 where it will offset his entire \$40,000 of taxable income that year, leaving \$10,000 to carry to 2024. This could lead to tax refunds for both years.

CONCLUSION

Yearend tax planning is an ongoing process for farmers, not a last-minute scramble. By understanding and strategically utilizing the unique tax rules applicable to agriculture, farmers can significantly impact their financial well-being. Proactive engagement with a qualified tax professional specializing in agricultural taxation is highly recommended to develop a personalized plan that addresses the specific circumstances of each farm operation. This partnership can help ensure compliance, maximize deductions, and optimize overall tax efficiency for years to come.

³⁴ See IRC §1402(a) and Treas. Reg. §1.1402(c)-1.

³⁵ IRC §172(b)(1)(B)(i). The NOL is carried back to the two prior tax years, starting with the earliest year first.

INVOLUNTARY CONVERSIONS UNDER IRC §1033

An involuntary conversion is the compulsory transformation of property into similar property, dissimilar property, or money due to the property's destruction, theft, seizure, requisition or condemnation (actual or threatened).³⁶ IRC §1033 provides an exception to the general rule that gain realized from the sale or exchange of property is recognized for tax purposes.

Involuntarily converted means that property is destroyed, stolen, seized, requisitioned, or condemned (or sold or exchanged under threat or imminence of such actions). Common examples of involuntary conversions include property destroyed by natural disasters (such as floods, hurricanes, or wildfires) and property taken by governmental entities under eminent domain.

The primary benefit of §1033 is that if the taxpayer reinvests the proceeds from the involuntary conversion into qualifying replacement property within a specified time period, any gain realized on the conversion is not recognized, it is only deferred.³⁷ However, gain is recognized in the year of conversion to the extent that the amount realized exceeds the cost of the replacement property.

QUALIFYING REPLACEMENT PROPERTY

In the context of an involuntary conversion, **qualified replacement property** is the property a taxpayer acquires to replace property that was involuntarily converted, allowing for the non-recognition of any gain realized from the conversion. The specific requirements for what constitutes a qualified replacement property depend on the type of converted property and the nature of the involuntary conversion.³⁸

Note. Some property does not qualify as replacement property. This includes acquiring stock in a corporation (unless it is the acquisition of control of a corporation owning similar property), and personal-use property to replace business or investment property, and vice versa (unless under the “like-kind” rule for condemned business/investment real property).

Similar or Related in Service or Use

For most involuntary conversions, the replacement property must be “similar or related in service or use” to the converted property. This is a stricter standard than the like-kind standard used in IRC §1031 exchanges. The IRS interprets this standard narrowly, focusing on the functional similarity and end use of the properties.³⁹ Key considerations include the following.

- **Physical characteristics and end uses.** The replacement property should have closely similar physical characteristics and perform substantially the same function as the converted property. For example, a manufacturing plant would generally need to be replaced with another manufacturing plant. Farmland taken by eminent domain would generally be replaced by other farmland.⁴⁰
- **Service to the owner.** For owner-users, the service or use of the replacement property must be similar to the service or use of the converted property.
- **Relationship to tenants (for lessors).** For lessors, the focus is on the business risks, management responsibilities, and the nature of the relationship with tenants.

³⁶ IRC §§1033(a)(1) and (2).

³⁷ Ibid.

³⁸ Ibid.

³⁹ The replacement property must be similar in service or use to the involuntarily converted property. This is a functional use test. This means that the end use of the replacement property must be substantially similar to the end use of the replaced property. See, e.g., *Lynchburg National Bank & Trust Co. v. Comm'r*, 20 TC 670 (1953), *aff'd* 208 F.2d 757 (4th Cir. 1953).

⁴⁰ If the real estate meets the definition of like-kind real estate for purposes of IRC §1031 it is considered as property that is similar or related in service or use to the converted property. Rev. Rul. 83-39; 1983-1 CB 190.

Exception for Condemned Business or Investment Real Property⁴¹

A more lenient rule applies to the involuntary conversion of real property held for productive use in a trade or business or for investment when the conversion is due to its seizure, requisition, or condemnation (or threat thereof). In these specific cases, the replacement property only needs to be “like-kind” to the converted property.

Note. The like-kind standard, as used in §1031 exchanges, is broader. It generally means property of the same nature or character, even if it differs in grade or quality. For example, one apartment building can be exchanged for another apartment building, or a commercial building can be exchanged for vacant land held for investment.

Other Considerations

Beyond the general requirement that replacement property be similar or related in service or use (or like-kind in certain cases), several additional factors influence whether gain can be deferred under §1033. These include the applicable replacement period, the method of making the election, basis adjustments, and distinctions based on the nature of the involuntary conversion — such as whether it resulted from destruction, theft, or condemnation.

Replacement Period. The taxpayer generally has a specific period to acquire the replacement property to qualify for non-recognition of gain. This period usually ends two years after the close of the first taxable year in which any part of the gain is realized.⁴² However, for condemned real property used in a trade or business or held for investment, the replacement period is generally three years.⁴³ Special rules may apply in the case of presidentially declared disasters.

Note. The IRS has the discretion to extend the replacement period if the taxpayer applies before the original 2-year (or 3-year) deadline.⁴⁴ If the application is submitted after the deadline, the IRS may still approve it if the taxpayer can demonstrate both reasonable cause for failing to file the application within that period and that the late application was filed within a reasonable time after the expiration of that period.⁴⁵

Election. The election to defer the gain is generally made on the tax return for the year the gain is realized. Form 4797 is used to report an involuntary conversion (other than a casualty or theft) of property used in a trade or business, or of capital assets held in connection with a trade or business or transaction entered into for profit.⁴⁶ Form 8949, *Sales and Other Dispositions of Capital Assets*, is used to report gain from involuntary conversions (other than casualty and theft) of capital assets **not** held for business or profit.⁴⁷ Schedule D (Form 1040), *Capital Gains and Losses*, is then used to figure the overall gain or loss from transactions reported on Form 8949.⁴⁸

Note. For an involuntary conversion due to casualty or theft, taxpayers complete Form 4684, *Casualties and Thefts*.⁴⁹ For business property, gains and losses are reported on Form 4797. For personal use property, gains are reported on Schedule D and losses are reported on Schedule A (Form 1040), *Itemized Deductions*.⁵⁰

⁴¹ IRC §1033(g)(1).

⁴² IRC §1033(a)(2)(B)(i).

⁴³ IRC §1033(g)(4).

⁴⁴ IRC §1033(a)(2)(B)(ii).

⁴⁵ Treas. Reg. §§1.1033(a)-2(c)(3)(i) and (ii).

⁴⁶ Instructions for Form 4797.

⁴⁷ Instructions for Schedule D (Form 1040).

⁴⁸ Ibid.

⁴⁹ IRS Pub. 547, *Casualties, Disasters, and Thefts*.

⁵⁰ Instruction for Schedule D (Form 1040).

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If the replacement property is purchased after the taxpayer filed the return on which the election was made to postpone reporting the gain, a statement must be attached to the return for the year in which the replacement property is bought. The statement should contain detailed information on the replacement property.⁵¹

If the taxpayer has different interests in a single piece of property, separate elections can be made as to each separate interest. An example would be where an individual owns an undivided half interest in a piece of real property and a life estate in the other half of the property.⁵²

Note. If the property owner dies after receiving the involuntary conversion proceeds but before either making the election or acquiring the replacement property, it is unclear whether a successor can complete these steps to avoid recognition of gain.⁵³

Basis.⁵⁴ If gain is not recognized, the basis of the replacement property is generally the same as the basis of the converted property, decreased by any money received that was not reinvested, and increased by any gain recognized.

Note. All the details of an involuntary conversion resulting in gain (including facts relating to replacement of the converted property, a decision not to replace, or expiration of the replacement period) must be reported on the return for each tax year in which gain is realized.⁵⁵

Nature of Conversion. The rules governing qualifying replacement property also vary depending on the nature of the involuntary conversion. Specifically, different standards apply depending on whether the conversion resulted from destruction, theft, or seizure, versus a condemnation or a sale under threat of condemnation.

Conversions Due to Destruction, Theft, or Seizure. The replacement property must be “similar or related in service or use” to the converted property. This is a strict test. For example, if an apartment building is destroyed by fire, the replacement property must also be an apartment building (or at least property providing similar rental services). Land generally cannot be replaced with a building, and vice versa, under this strict interpretation.

Conversions Due to Condemnation or Sale Under Threat of Condemnation. The replacement property must be “property similar or related in service or use” or “property which is related in service or use to the property so converted.” This provides more flexibility. For business or investment real property, the “like-kind” standard of §1031 (relating to tax-free exchanges) is applied. This means the replacement property must be of a like kind to the converted property. **Like kind** refers to the nature or character of the property, not its grade or quality. For example, commercial real estate can generally be replaced with other commercial real estate.

⁵¹ IRS Pub. 544, *Sales and Other Dispositions of Assets*.

⁵² Rev Rul 74-273, 1974-1 CB 201.

⁵³ *In re Goodman's Estate*, *Goodman v. Comm'r*, 199 F.2d 895 (3rd Cir. 1952); but see Rev Rul 64-161, 1964-1 CB 298, *revoking* Rev Rul 58-407, 1958-2 CB 404. See also *In re Estate of John M. Morris v. Comm'r*, 454 F.2d 208 (4th Cir. 1972), *aff'g* 55 TC 636 (1971); *Estate of Gregg v. Comm'r*, 69 TC 468 (1977); *Chichester v. U.S.*, No. 77-L-0185-S, 1978 U.S. Dist. LEXIS 18024 (N.D. Ala. May 1, 1978). FSA 200117005 (Jan. 12, 2001); *Estate of Jayne v. Comm'r*, 61 TC 744 (1974).

⁵⁴ Treas. Reg. §1.1033(b)-1.

⁵⁵ Treas. Reg. §1.1033(a)-2(c)(2).

Specific Considerations for Disaster-Related Conversions⁵⁶

There are often specific provisions and extensions related to the replacement period for involuntary conversions resulting from federally declared disasters. These can provide taxpayers with more time to find and acquire suitable replacement property.

Note. For more information on federally declared disasters, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 6: Individual Taxpayer Issues.

Special Rule for Livestock

When a farmer sells livestock (other than poultry) held for draft, dairy, or breeding purposes in excess of the number that would normally be sold during the time period, the sale or exchange of the excess number may be treated as a nontaxable involuntary conversion if the sale occurs because of drought, flood, or other weather-related condition. The livestock sold or exchanged must be replaced within two years after the year in which proceeds were received with livestock similar or related in service or use (dairy cows for dairy cows, for example), and be held for the same purpose that the animals given up were held. Thus, dairy cows can be replaced with dairy cows, but they cannot be replaced with market heifers.⁵⁷

The tax on the sale is triggered when the replacement animals are sold. If it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property used for farming purposes (except real estate). Similarly, if it is not feasible to reinvest the proceeds from involuntarily converted livestock into other like-kind livestock due to soil or other environmental contamination, the proceeds can be invested into property that is not like-kind or real estate used for farming purposes.⁵⁸

If the replacement property is livestock, the new livestock must be held for the same purpose as the animals disposed of because of the weather-related condition.⁵⁹ The 2-year replacement period is extended to four years in areas designated as eligible for assistance by the federal government (i.e., by the President or any agency or department of the federal government).⁶⁰ Presumably, livestock sales occurring **before** the designation of an area as eligible for federal assistance would also qualify for the extended replacement period if the drought, flood, or other weather-related conditions that caused the sale also caused the area to be so designated. Additionally, the Treasury Secretary has the authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years.⁶¹

The election to defer the gain is made by attaching a statement to the return providing evidence of the weather-related condition that caused the early sale, the computation of the gain realized, the number and kind of livestock sold, and the number and kind of livestock that would have been sold under normal business practices. The election can be made at any time within the normal statute of limitations for the period in which the gain is recognized, assuming that it is before the expiration of the period within which the converted property must be replaced.

⁵⁶ See IRC §1033.

⁵⁷ IRC §1033(e).

⁵⁸ IRC §1033(f).

⁵⁹ Treas. Reg. §1.1033(e)-1(d).

⁶⁰ IRC §1033(e)(2)(A).

⁶¹ IRC §1033(e)(2)(B).

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If the election is filed and eligible replacement property is **not** acquired within the applicable replacement period (usually four years), an amended return for the year in which the gain was originally realized must be filed to report the gain. But, if the animals are replaced, for the tax year in which the livestock are replaced, the taxpayer should include information with the return that shows the purchase date of the replacement livestock, the cost of the replacement livestock, and the number and kind of the replacement livestock. The election must be made on the return for the first tax year in which any part of the gain from the sale is realized. It is also important for a taxpayer to maintain sufficient records to support the nonrecognition of gain.

Note. For livestock that are partnership property and are sold by the partnership, the election is the responsibility of the partnership. The partners do not individually make the election to defer recognizing the gain.⁶²

GAIN RECOGNITION

Gain from an involuntary conversion is recognized when the taxpayer fails to meet all the requirements of §1033, which include the following.

1. The nature of the involuntary conversion
2. The qualified replacement property
3. The replacement period
4. Replacement by the taxpayer
5. Replacement by purchase

If a taxpayer receives cash or dissimilar property and elects §1033, gain is recognized only to the extent that the cash and value of dissimilar property received on conversion exceeds the cost of the replacement property. If the taxpayer does not make the election, the entire gain is recognized. These rules apply regardless of whether the conversion proceeds are received in one or more tax years.⁶³

If a taxpayer receives only similar property, no part of the gain is recognized. In that case, non-recognition of gain is mandatory and not subject to the taxpayer's election.⁶⁴ The fact that some or all of the proceeds from the involuntary conversion are received after the replacement does not prevent the gain from qualifying under the non-recognition rule.⁶⁵

Example 5. Bob owns a machine shed that was built for \$250,000 on land that cost \$20,000. The property was taken by condemnation when the depreciated value of the machine shed was \$225,000. The condemnation award was \$300,000. Bob has a gain \$55,000 (\$300,000 condemnation award – \$225,000 shed – \$20,000 land).

If Bob buys similar property costing \$300,000 within the prescribed period and elects §1033, no part of the \$55,000 gain is recognized. If Bob does not make the election, the \$55,000 gain is recognized.

If Bob fails to make a replacement within the specified time period, the entire gain of \$55,000 is recognized. If Bob pays only \$240,000 for similar property, the excess of the award of \$300,000 over the cost of \$240,000 (\$60,000) results in the entire gain of \$55,000 being recognized.

If Bob spends \$250,000 for the replacement property, the excess of the award over the cost of the new property is \$50,000, and if Bob makes the election, gain is recognized only to the extent of \$50,000. If no election is made, the \$55,000 gain is recognized in full. If the award had been \$200,000, the \$45,000 loss would have been recognized regardless of replacement.

⁶² See *Rosefsky v. Comm'r*, 599 F.2d 515 (2d Cir. 1979).

⁶³ Treas. Reg. §1.1033(a)-(2)(c)(1).

⁶⁴ IRC §1033(a)(1); Treas. Reg. §1.1033(a)-2(c)(1).

⁶⁵ Ltr. Rul. 9028046 (Apr. 10, 1990).

Even if a taxpayer is entitled to non-recognition on an involuntary conversion, gain is recognized when the taxpayer fails to allocate the purchase price and basis of an improved parcel of land between an old residence in the remaining condemned land and improvement. Without the bases and the sale price of the replaced residence, gain or loss on the sale could not be determined.⁶⁶ Gain is also recognized when the taxpayer fails to show exactly the replacement property acquired, and shows only the approximate date of acquisition and the approximate cost.⁶⁷

When a taxpayer's apartment building was condemned but not replaced with property of like kind, the taxpayer was not exempt under §1033 from recognizing the amount realized from the involuntary conversion.⁶⁸ The taxpayer resided in one room of the apartment building, thus the gain attributable to that portion of the building was excluded.

WHEN NOT TO USE §1033

While §1033 offers a valuable tax deferral mechanism, there are situations where it might not be the most advantageous option.

Utilizing Loss Amounts on Disposition

If the converted property has a basis higher than the amount realized from the involuntary conversion, a loss occurs. IRC §1033 does not apply to losses; they are generally recognized (subject to other limitations). In this case, not using §1033 is not really a choice, as it is not applicable. However, consider a scenario where a taxpayer has capital loss carryforwards. Recognizing a capital gain on the involuntary conversion (by not reinvesting or not reinvesting the full amount) could allow the taxpayer to offset those capital loss carryforwards, which might otherwise expire unused. This could be more beneficial than deferring the gain under §1033.

Example 6. Prairie Valley Ag Services owns IRC §1231 equipment with an original cost of \$100,000 that is destroyed in a flood. Prairie received insurance proceeds of \$150,000. This results in a \$50,000 capital gain. If Prairie has \$60,000 in capital loss carryforwards, recognizing the \$50,000 gain would allow them to use \$50,000 of those losses, potentially saving on taxes compared to deferring the gain and letting the losses expire.

Greater Offset from Ordinary Income Deduction

In some cases, the basis of the converted property might be such that if it were sold in a voluntary transaction, it would generate ordinary income under depreciation recapture rules (e.g., §1245 for personal property or §1250 for real property). An involuntary conversion can still trigger this recapture. If a taxpayer reinvests in replacement property under §1033, the basis of the replacement property is generally reduced by the amount of gain not recognized. This means the potential for future depreciation deductions on the replacement property might be lower. For instance, if business equipment is involuntarily converted, resulting in a gain that would be treated as ordinary income due to depreciation recapture, the gain can be deferred by reinvesting the proceeds. If the taxpayer does not reinvest and recognizes the income, they might have other deductions available in the current year (like depreciation on other assets) that can offset this ordinary income. Deferring the gain under §1033 would reduce the basis of the new equipment, potentially leading to lower depreciation deductions in future years, which are also ordinary income offsets.

⁶⁶ *Hale v. Comm'r*, 12 TC Memo (CCH 1182).

⁶⁷ *Bliss v. Comm'r*, 27 BTA 803 (1933).

⁶⁸ *Curtis v. Comm'r*, TC Memo 2014-19 (Jan. 28, 2014).



Practitioner Planning Tip

When the disposition results in a capital gain and the replacement property is depreciable — thereby reducing ordinary income and potentially SE tax — a better tax outcome may be achieved by not applying the rules of §1033.

Example 7. Summit Ridge Equipment Co. has machinery with an original cost of \$150,000 and an adjusted basis of \$50,000. The machinery is destroyed by fire and Summit receives insurance proceeds of \$90,000. The \$40,000 gain (\$90,000 proceeds – \$50,000 adjusted basis) is subject to ordinary income recapture under §1245. If Summit reinvests the full \$90,000 in new machinery, the basis of the new machinery is reduced to \$50,000. If Summit had instead recognized the \$40,000 ordinary income in the current year, they might have had other ordinary income deductions (e.g., from operating expenses or other depreciation) to offset it. The trade-off is between an immediate offset versus potentially larger depreciation deductions on a higher basis asset over its useful life.

OPEN TRANSACTION DOCTRINE

The open transaction doctrine, established by the U.S. Supreme Court in *Burnet v. Logan*,⁶⁹ allows taxpayers to defer recognizing income from a transaction until the FMV of the consideration received can be reasonably ascertained. In essence, the taxpayer treats amounts received as a return of capital until the taxpayer's basis has been entirely recovered. This principle is particularly relevant in situations involving contingent payments, where the total amount to be received is uncertain at the time of the transaction.⁷⁰

In the context of farming, the open transaction doctrine can apply to sales involving contingent consideration, such as agreements where the sale price depends on future events like crop yields or market prices. For example, if a farmer sells a portion of their land with the agreement to receive additional payments contingent on the land's future productivity, the total sale price is indeterminate at the time of sale. Applying the open transaction doctrine in such cases allows the farmer to defer recognizing income until the amount becomes fixed or determinable. The same is true when an owner of farmland sells an option for an easement over the land that represents a potential future interest.⁷¹

Note. In general, the open transaction doctrine allows for the proper deferral of tax recognition until the transaction is fully completed, enabling a more accurate reflection of economic realities. For farm taxpayers, the doctrine holds particular importance because the agricultural sector often deals with extended production cycles, variable market conditions, and multifaceted financial arrangements. By applying the open transaction doctrine, farm taxpayers can better align their tax obligations with their actual income and expenses, mitigating potential cash flow challenges. Ultimately, understanding and effectively leveraging the open transaction doctrine can lead to significant benefits for the taxpayer in the specific (and unique) situations where the doctrine may apply.

⁶⁹ *Burnet v. Logan*, 283 U.S. 404 (1931).

⁷⁰ See, e.g., *Estate of Wiggins v. Comm'r*, 72 TC 701 (1979). (citing *Burnet v. Logan*, 283 U.S. 404, and *McShain v. Comm'r*, 71 TC 998 (1979)). Most cases involving the application of the open transaction doctrine involve property other than cash or interests in property that are highly speculative. See *Weigl v. Comm'r*, 84 TC 1192 (1985); *McShain v. Comm'r*, 71 TC 998 (1979); *Westphal v. Comm'r*, TC Memo 1984-363 (Jul. 16, 1984).

⁷¹ *Royser v. Comm'r*, TC Memo 1985-258 (May 29, 1985). The court's opinion stated that the "[a]pplication of the open transaction doctrine is limited to rare and extraordinary circumstances."

COMPARISON TO INSTALLMENT SALE RULES

The IRS generally prefers the installment method under IRC §453 for reporting income from sales involving payments received in future tax years. The installment method requires recognizing a portion of the gain as payments are received, even if the total amount is uncertain. The IRS may challenge the application of the open transaction doctrine, favoring the installment method to ensure income is reported in a timely manner.⁷²

It is important to note that the open transaction doctrine is applied sparingly and typically only in cases where the FMV of the consideration cannot be reasonably determined.

GRANT OF AN OPTION FOR AN EASEMENT

When a landowner grants an option for an easement on farmland, the option represents a potential future interest. The buyer of the option typically pays a premium (option price) for the right to later decide whether to exercise the option and acquire the easement.⁷³

Income Recognition Under Normal Tax Rules⁷⁴

The option price received by the landowner is generally treated as income when received unless the open transaction doctrine applies. If the option is exercised, the income is then adjusted to reflect the nature of the final transaction (e.g., sale of a partial interest in the property through the easement).

Application of the Open Transaction Doctrine

The open transaction doctrine may apply if the total proceeds of the transaction are uncertain or contingent, for example, if the easement's value depends on future events or conditions (e.g., changes in zoning laws or development approvals). The doctrine may apply when the landowner's total income from the transaction cannot be accurately determined until the option is exercised or expires. Under the doctrine, the option premium may not be recognized as income until the transaction is fully closed (either through exercise of the option or expiration). If the option expires unexercised, the premium is recognized as ordinary income in that year.⁷⁵

Easements typically involve partial interests in property, and their treatment depends on whether the transaction constitutes a sale or another type of transfer.⁷⁶ The doctrine might also impact the characterization of the income (capital gain vs. ordinary income) based on the nature of the underlying property and the transaction.⁷⁷

If the payment would be ordinary income whether the option lapsed or was exercised, receipt of the payment must be reported in the tax year received.⁷⁸

⁷² See, e.g., *Estate of Wiggins v. Comm'r*, 72 TC 701 (1979) and *McShain v. Comm'r*, 71 TC 998 (1979).

⁷³ See, e.g., *Estate of Wiggins v. Comm'r*, 72 TC 701 (1979). (citing *Burnet v. Logan*, 283 U.S. 404, and *McShain v. Comm'r*, 71 TC 998 (1979); *Weigl v. Comm'r*, 84 TC 1192 (1985); *McShain v. Comm'r*, 71 TC 998 (1979); *Westphal v. Comm'r*, TC Memo 1984-363 (Jul. 16, 1984).

⁷⁴ IRC §1234.

⁷⁵ Treas. Reg. §1.1234-1(b).

⁷⁶ *Burnet v. Logan*, 283 U.S. 404 (1931). See, Treas. Reg. §1.61-6(a).

⁷⁷ *Foster v. Comm'r*, 80 TC 34 (1983).

⁷⁸ *Comm'r v. Pickard*, 401 F.2d 615 (10th Cir. 1968). A corollary exists in the oil and gas arena with a bonus payment or a delayed rental payment — both of which are reported as ordinary income. If the easement grant is for a period of time and the grantor is retaining an economic interest, the payment ordinary income to be reported in the year received.



Practitioner Planning Tip

Taxpayers seeking to apply the open transaction doctrine bear the burden of proof to demonstrate uncertainty or contingencies. The IRS generally scrutinizes the application of this doctrine, so practitioners should ensure their clients have clear documentation and proper legal advice.

Example 8. Bill (the grantor) receives a lump sum payment from Gloria in exchange for granting her an option to acquire a mineral rights easement on his property. The tax treatment of this payment depends on what happens with the option.

- **If the option lapses** (i.e., Gloria does not exercise it), the payment is treated as **ordinary income** to Bill in the year the option expires.
- **If the option is exercised**, the payment takes on the **same character** as the underlying transaction. For example, if the easement sale would result in capital gain, the option payment is treated as capital gain.
- **If the option is still outstanding** at yearend (i.e., neither exercised nor lapsed), Bill generally **defers reporting** the payment until the tax character becomes clear — either upon lapse or exercise.

Exception: If the payment would be ordinary income regardless of whether the option is exercised or lapses, then Bill must **report the income in the year received**.

Example 9. Jasper owns a large piece of agricultural land and sells an easement right to a conservation organization that wants to preserve the land for agricultural use. The easement restricts the land from being developed for non-agricultural purposes. Jasper and the conservation organization agree on a sale price of \$500,000 for the easement. However, they also include a contingent consideration clause in the agreement. This clause states that if the land's value increases significantly due to future changes in zoning laws or other factors, Jasper will receive an additional payment based on the increased value.

Under the open transaction doctrine, Jasper does not recognize the entire gain from the sale of the easement immediately. Instead, he defers recognizing the gain from additional payments until the contingent consideration is resolved. This means that Jasper will only recognize the initial \$500,000 as income at the time of the sale, and any additional payments will be recognized as income in the future when the contingency is resolved.

HEDGING/SPECULATIVE TRANSACTIONS

Farmers and ranchers frequently participate in commodity markets, both as a means of managing risk and, at times, to pursue speculative opportunities. They may enter into futures and options contracts to hedge against price volatility in the commodities they produce or consume — for example, locking in a price for corn before harvest or securing feed costs in advance. These hedging strategies are typically part of the normal course of business and are designed to stabilize income.

However, not all transactions are hedges. Some producers also engage in speculative trades, aiming to profit from anticipated price movements unrelated to their actual production. In these cases, the transactions are not tied to a specific business risk but are instead treated as investment activity.

These transactions can vary in complexity and timing, and in some cases, the tax consequences are not immediately clear. When the terms of a transaction are uncertain or contingent — such as when the final price or delivery conditions are not fixed at the time of agreement — the open transaction doctrine may apply.

Identifying Hedging and Speculative Transactions

A **hedging transaction** is defined as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business, primarily to reduce (as opposed to simply managing) the risk of price changes or currency fluctuations with respect to ordinary property, or to reduce the risk of interest rate or price changes, or currency fluctuations with respect to borrowing or ordinary obligations.⁷⁹ A taxpayer uses a hedge to lock in a position in a particular commodity.⁸⁰ Once locked in, if the physical commodity increases in value, the taxpayer's value of the futures position should go down — one should offset the other with the net result that the hedge maintains the taxpayer's position.⁸¹

To receive tax treatment as a hedge, the transaction must be identified by the taxpayer as a hedging transaction before the close of the day the hedge is entered into.⁸² The item being hedged must be identified no more than 35 days after the hedging transaction.⁸³ If the transaction is not timely identified as a hedge, the straddle rules and mark-to-market rules may apply.⁸⁴

Speculation refers to entering into commodity transactions that are not directly connected to the taxpayer's farming or ranching operations. For example, a farmer who harvests and sells their corn, then uses the proceeds to buy futures contracts in hopes that corn prices will rise, is engaging in speculation. In this case, the farmer is not using the futures market to hedge a production risk, but rather to profit from anticipated price movements — essentially treating the market as an investment opportunity rather than a risk management tool. This is speculation and is subject to the mark-to-market rules of IRC §1256.⁸⁵

Options as Hedging or Speculation. Farmers and ranchers often buy options. When a **put** option is purchased by the producer of a commodity, the producer acquires the right to sell the commodity at a specific price at a future point in time. If the sale occurs just before the crop is planted or while the crop is growing, the transaction is a hedge. If the right to sell is triggered after the crop is sold, the transaction is speculative.

A farmer or rancher may also buy a **call** option. A call option gives the producer the right to buy the commodity at a specific price at some future point in time. Transactions involving the purchase of a call option for the purchase of a commodity by a crop producer are speculative regardless of when the option is exercised. However, a livestock farmer may enter into a call option for feed, or a crop farmer may enter into a call option for crop inputs. The question of whether a transaction is a hedge or is speculation turns on whether it was entered into in the normal course of the taxpayer's business to reduce risk.⁸⁶

Tax Treatment

Gain and loss from **hedging** transactions generate ordinary income and loss and are not subject to the loss deferral rules and the mark-to-market rules that apply to speculative transactions.⁸⁷ Because a hedge is entered into in the normal course of the taxpayer's business (such as to lock-in a position in a particular commodity), any resulting gain or loss is treated as ordinary and flows through to Schedule F. As a result, the income is subject to SE tax, just like other farm income. This means that a successful hedge that generates a gain increases both income tax and SE tax liability, while a hedge that results in a loss can reduce both.

⁷⁹ IRC §1221; Treas. Reg. §1.1221-2(b).

⁸⁰ Treas. Reg. §1.1221-2(a)(1).

⁸¹ IRS Pub. 550, *Investment Income and Expenses*.

⁸² IRC §1221(a)(7); Treas. Reg. §1.1221-2(f)(1).

⁸³ Treas. Reg. §1.1221-2(f)(2)(ii).

⁸⁴ IRC §§1092, 263(g), and 1256.

⁸⁵ IRC §§1256(a) and (e).

⁸⁶ Treas. Reg. §1.1221-2(a)(2).

⁸⁷ IRC §1221(j) and Treas. Reg. §1.1221-2.

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However, if the transaction involves **speculation**, resulting gains and losses are treated as capital gains and losses. Capital gains can offset capital losses, but capital losses deductible against ordinary income are capped at \$3,000 per year. Corporations are not eligible for the \$3,000 deduction against ordinary income. Speculative transactions are subject to the loss deferral and mark-to-market rules. Speculative transactions do not impact SE tax.⁸⁸

Mark-to-Market Rules. The **mark-to-market rules** require taxpayers to report gains and losses from regulated futures contracts and other §1256 contracts annually on Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*. These rules close out speculative transactions as of December 31. They are marked to market by treating each contract held by the taxpayer as if it were sold for FMV on the last business day of the tax year, thereby requiring profit or loss to be reported on the taxpayer's income tax return. The net gain or loss is allocated 40% to short-term capital gain (or loss) and 60% to long-term capital gain (or loss).⁸⁹

Tax Accounting

Any income, deduction, gain or loss from a hedging transaction is matched with the income, deduction, gain or loss on the item being hedged. Also, in some situations, the hedge timing rules apply irrespective of whether the transaction has been identified as a hedge.⁹⁰ In essence, the tax rules for hedging transactions address both character and timing and are designed to match the character and timing of a hedging transaction with the character and timing of the item being hedged. Farmers participating in true hedging programs likely have multiple transactions for a single crop and may combine option purchases and sales to minimize the cost of these programs or to create both a ceiling and a floor for prices.

Note. Properly identifying and reporting these many transactions is a challenge for the taxpayer and tax preparer. IRS Pub. 550, *Investment Income and Expenses*, is a helpful resource for more information.

Just as important as the matching principle with commodity transactions is what constitutes “property.”⁹¹ IRC §1001 governs the computation of gain or loss on the sale or exchange of **property**, with gain being the excess of the amount realized over the adjusted basis of the property, and the loss is the excess of the adjusted basis of the property over the amount realized. Thus, for gain or loss to be computed on a transaction, the taxpayer must know the identity and amount of property that will be delivered. That is not known until the contract is settled which is where the open transaction doctrine can come into play.

Example 10. Jack is a corn farmer. He is concerned about the potential decline in corn prices during the 2025 growing season. To protect himself against this risk, he hedges his position by entering into a futures contract. Jack sells a futures contract for March 2026 corn, thereby taking a short position in the futures market. As the growing season progresses, the price of corn declines, and at harvest the market price is lower than what he had anticipated. However, because he sold the futures contract at a higher price, he is able to offset the loss in the physical market with the gain in the futures market.

The hedge triggers the application of the open transaction doctrine. Jack treats the gain from the futures contract as ordinary income and the gain is reported as Schedule F income in the year the hedge is closed.

Example 11. Use the same facts as **Example 10**. Jack sells his harvested corn and then buys futures contracts in anticipation of prices rising. This transaction is speculative and is subject to the mark-to-market rules, which require Jack to report gains and losses from regulated futures contracts on an annual basis. The open transaction doctrine does not apply.

⁸⁸. *Benaglia v. Comm’r*, 36 BTA 838 (1937).

⁸⁹. IRC §1256(a)(3).

⁹⁰. Rev. Rul. 2003-127, 2003-2 CB 1245.

⁹¹. IRC §1001.

Observation. Many commodity transactions in which farmers engage are “open” transactions, with the producer holding merely a contractual obligation at the time of contract execution. An option, for example, is a type of “open transaction.”⁹² Forward grain contracting, hedge-to-arrive contracts, and other types of commodity transactions may also delay tax consequences until the contract requirements are fulfilled.

RECENT CASES

Recent court decisions provide insight into how the IRS and the Tax Court apply the open transaction doctrine and related tax principles in complex or uncertain transactions. The following cases illustrate the doctrine’s limited scope and the importance of clear documentation and valuation.

*Friedman v. Comm’r*⁹³

In *Friedman v. Comm’r*, the Tax Court addressed whether the open transaction doctrine could be applied to defer the recognition of interest income. The petitioners loaned money to their daughter’s S corporation (referred to in the opinion as “Distinct”). They made over \$4.8 million in two loans, one in 2003 and the other in 2007 and took promissory notes in return. The notes called for interest-only payments. The 2003 loan bore interest at an 8% rate and the rate for the 2007 loan was 9%.

Distinct wrote a \$3,335 check to the petitioners every month during 2010 (the year at issue) for a total amount of \$40,021. All the checks were deposited into the petitioners’ joint checking account. Distinct also wrote a check for \$13,125 each month during 2010 which was also deposited into the petitioners’ joint account (total of \$157,500).

Distinct recorded all the payments as “interest expense payments” and claimed an interest expense deduction for the amount paid to the petitioners. Distinct made approximately \$2 million in payments to the petitioners in 2013 and then dissolved in 2014.

The petitioners did not provide any evidence that they tried to enforce collection of either the 2003 or 2007 loan and did not show that such attempts would have been futile during 2010. The petitioners claimed that Distinct was defrauded by insurance agents from 2008 to 2011 and that, as a result of the fraud, they were certain that they would never recover the full amounts of their loans. But they did not provide any corroborating evidence of the fraud.

Of the \$197,521 they received in 2010, the petitioners only reported \$73,371 as interest income. They also claimed a capital loss deduction of \$3,000 on their 2010 return. The IRS claimed that the taxpayers should have recognized interest income annually, based on the applicable federal rate, regardless of the payment contingency.

The Tax Court sided with the IRS, determining that the open transaction doctrine was inapplicable in this scenario, noting that the doctrine is reserved for “rare and extraordinary circumstances” where the property’s FMV is indeterminable. In this case, the Tax Court found that the contingency of interest payments did not render the FMV of the notes unascertainable. Therefore, the doctrine did not apply, and the taxpayers were required to recognize interest income annually, despite the payment contingencies.

Note. The Tax Court’s decision underscores the limited applicability of the open transaction doctrine, particularly in cases involving contingent interest payments. Taxpayers cannot rely on this doctrine to defer income recognition merely because of uncertainties in payment timing or amounts.

⁹² See, e.g., Rev. Rul. 78-182, 1978-1 CB 256.

⁹³ *Friedman v. Comm’r*; TC Memo 2015-177 (Sep. 10, 2015).

*Estate of McKelvey v. Comm’r*⁹⁴

In *Estate of McKelvey v. Comm’r*, the decedent was the founder of Monster Worldwide, Inc., which owned Monster.com, a successful employment website. He died on November 27, 2008. About six weeks before he died, he entered into contracts to sell corporate stock to Bank of America and Morgan Stanley & Co., International. These were “variable prepaid forward contracts” (VPFC) with Bank of America covering stock he owned in Monster. At this time, Monster stock was trading at \$33.47.

Under the contract terms, he received an up-front cash prepayment (over \$50 million) secured by a pledge of the shares for security, in exchange for a promise to deliver up to 1.76 million shares (or a cash equivalent) over ten subsequent settlement dates in September 2008. The number of Monster shares he was obligated to deliver depended on the closing price for Monster shares on each of the settlement dates. If the closing price was less than or equal to \$30.46 per share, one tenth of the total covered shares would be delivered. Thus, Bank of America bore some risk of loss if the stock price declined. If the stock price closed between \$30.46 and \$40.58, the number of shares would be reduced, thus sharing some of the appreciation between Bank of America and the decedent. If the closing price was greater than \$40.58, then the number of shares would be further reduced. At any time, the decedent could have also elected to pay cash instead of deliver stock.

On July 24, 2008, when the Monster stock was trading at \$18.24, the decedent paid the bank nearly \$3.5 million to extend the VPFC settlement dates until corresponding periods in 2010. After he died, his estate settled the contract with Bank of America by delivering the full number of 1.76 million shares. This early settlement was apparently permitted under the terms of the contract. The decedent had also engaged in a similar VPFC with Morgan Stanley, which covered 4.762 million shares. The prepayment amount was \$142 million, and the settlement dates were the same as the Bank of America deal, although the prices were slightly different. The decedent also paid consideration to extend the Morgan Stanley VPFC in 2008. It was also settled early in 2009, after the decedent’s death and in advance of the extended settlement dates.

For tax purposes, the decedent treated the original transactions as “open” transactions in accordance with Rev. Rul. 2003-7,⁹⁵ and did not report any gain or loss for 2007 related to the contracts. In addition, the decedent did not report any gain or loss related to the contract extensions that were executed in 2008 on the basis that the extensions also involved “open” transactions.

In the summer of 2009, following the decedent’s death the previous fall, the decedent’s estate transferred shares of stock to settle the Morgan Stanley & Co. contracts. The estate filed a Form 1040 for the decedent’s taxable year 2008. The IRS issued a deficiency notice in 2014 for over \$41 million claiming that when the decedent executed the extensions in 2008, he triggered a realized capital gain of slightly over \$200 million. The capital gain comprised of a short-term capital gain of \$88 million and \$112 million of long-term capital gain from the constructive sale of shares pledged under the contracts. The IRS claimed that the decedent had no tax basis in the stock pledged as collateral.

The Tax Court disagreed with the IRS on the basis that the “open transaction” doctrine applied because of the impossibility of computing gain or loss with any reasonable accuracy at the time the contracts were entered into. In addition, the court rejected the IRS’s argument that the extensions of the original contracts closed the contracts which triggered gain or loss at the time the extensions were executed. The Tax Court specifically noted that, in accordance with Rev. Rul. 2003-7, VPFCs are open transactions at the time of execution and do not trigger gain or loss until the time of delivery because the taxpayer does not know the identity or amount of property to be delivered until the future settlement date arrives and delivery is made. Until delivery, the only thing that the decedent had was an obligation to deliver; this was not property that could be exchanged under §1001. The Tax Court also noted that the open transaction doctrine applied because the identity and adjusted basis of the property sold, disposed of, or exchanged was not known until settlement occurred. The Tax Court also stated that an option is a “‘familiar’ type of open transaction from which we can distill applicable principles.”

⁹⁴ *Estate of McKelvey v. Comm’r*, 148 TC 13 (2017).

⁹⁵ Rev. Rul. 2003-7, 2003-1 CB 363.

On appeal, the appellate court reversed, holding that the extension of the contracts resulted in an exchange of derivative obligations.⁹⁶ In effect, the old contract was exchanged for a new one. The IRS claimed that this exchange caused a termination, which would trigger a short-term capital gain recognition under IRC §1234A. The appellate court remanded the case to the Tax Court for a determination of whether the exchange satisfied §1234A(1) for a termination of obligations that gave rise to capital gain and, if so, the amount thereof. The appellate court also pointed out that the decedent's estate did not challenge the data and calculations of the IRS expert showing that the amount of shares to be delivered at settlement was "substantially fixed" on the dates each contract was amended resulting in constructive sales of the collateral shares had resulted.⁹⁷

On remand,⁹⁸ the Tax Court looked to case law and rulings addressing the treatment of option contracts. The appellate court had explicitly ruled that the contracts were not debt instruments, but that each option contract had its own holding period existing independently from the underlying asset. Based on the appellate court's holding that an exchange had occurred, the Tax Court determined that there had been a disposition of the original agreement, because the obligations under that agreement had terminated. Although entering a VPFC is not a taxable event, termination and replacement can give rise to the application of §1234A, which requires that gain or loss from cancellation, lapse, expiration, or other termination of rights or obligations concerning a capital asset in the taxpayer's hands to be treated as gain or loss from the sale of a capital asset.

The Tax Court noted that the options had changed significantly in value at the time they negotiated a replacement with the Monster stock having fallen below the minimum contract price. As noted previously, the open transaction doctrine applies when it is impossible to determine the value of either asset exchanged. Here, the decedent had given cash and a future promise in exchange for the new VPFCs. Those new VPFCs could not yet be valued, and the decedent could settle those with either cash or shares, whichever was more advantageous to him. But the gain on termination involved the original VPFCs, which did not require the court to value the new VPFCs.

IRC §1001(a) requires realization of gain from the sale or other disposition of **property** based on the excess of the amount realized over adjusted basis. While the Second Circuit had determined that the exchange involved obligations, not property rights, the Tax Court held that even if the derivative that the decedent held was not technically property, it would be subject to §1001(a), because the underlying shares that gave value to the derivatives were property. Ultimately, the Tax Court determined that the amount realized was less than the amount the IRS has determined which was based on the total contract value received as a prepayment. However, the Tax Court noted that the decedent had to pay for the continuing obligation, which was deducted from the total. In addition, the decedent had to perform his remaining obligations, which Tax Court used expert testimony to value at a total of \$110 million. As a result, the decedent realized \$71.6 million in short-term capital gains.

REAP GRANTS⁹⁹

The Rural Energy for America Program (REAP) grant is a federal program administered by the United States Department of Agriculture (USDA) that provides financial assistance to agricultural producers and rural small businesses. Its primary goal is to promote energy independence, reduce energy costs, and support economic development in rural areas by funding renewable energy systems and energy efficiency improvements.

According to the USDA, the REAP is intended to help agricultural producers and rural small businesses lower their utility bills by investing in more efficient equipment or generating their own renewable energy.

⁹⁶ *Estate of McKelvey v. Comm'r*, 906 F.3d 26 (2nd Cir. 2018).

⁹⁷ The U.S. Supreme Court declined to hear the case. *Estate of McKelvey v. Comm'r*, 906 F.3d 26 (2nd Cir. 2018), *cert. den. sub. nom.*, *Peters v. Comm'r*, 139 S. Ct. 2715 (2019).

⁹⁸ *Estate of McKelvey v. Comm'r*, 161 TC 130 (2023).

⁹⁹ *Rural Energy for America Program Renewable Energy Systems & Energy Efficiency Improvement Guaranteed Loans & Grants*. U.S. Department of Agriculture. [www.rd.usda.gov/programs-services/energy-programs/rural-energy-america-program-renewable-energy-systems-energy-efficiency-improvement-guaranteed-loans] Accessed on Jul. 8, 2025.

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REAP offers two main types of financial assistance — grants and loan guarantees. Grants are direct funding that do not need to be repaid. **Loan guarantees** involve the USDA guaranteeing a portion of a loan made by a commercial lender. Under the REAP, combined grant and loan guarantee funding is also available.

ELIGIBLE APPLICANTS

Eligible applicants are farmers and ranchers who derive at least 50% of their gross income from direct agricultural production. These operations can be located in rural or non-rural areas. Business that satisfy the Small Business Administration (SBA) definition of a small business and are located in an area with a population of 50,000 people or less are also eligible. In addition, certain private electric utilities serving rural customers and tribal corporations may also be eligible.

ELIGIBLE PROJECTS

REAP funding can be used for a wide range of projects, including the following.

- **Renewable Energy Systems (RES)**
 - ♦ Solar (photovoltaic, thermal, irrigation, electric fencing)
 - ♦ Wind (small and large generation)
 - ♦ Biomass (biodiesel, ethanol, anaerobic digesters, solid fuels)
 - ♦ Geothermal (for electricity generation or direct use)
 - ♦ Hydropower (below 30 megawatts)
 - ♦ Hydrogen (derived from biomass or water using wind, solar, or geothermal)
 - ♦ Ocean (tidal, current, thermal) generation
- **Energy Efficiency Improvements (EEI)**
 - ♦ Upgrades to heating, ventilation, and air conditioning systems
 - ♦ Insulation
 - ♦ Lighting upgrades
 - ♦ Cooling or refrigeration units
 - ♦ Doors and windows
 - ♦ Electric, solar, or gravity pumps for sprinkler pivots
 - ♦ Switching from diesel to electric irrigation motors
 - ♦ Replacement of energy-inefficient equipment
 - ♦ Smart thermostats and other energy management systems
- **Energy Audits and Renewable Energy Development Assistance (REDA) Grants.** These grants are provided to service providers (e.g., units of government, higher education institutions, rural electric cooperatives) to help agricultural producers and rural small businesses assess their energy usage and develop renewable energy projects.¹⁰⁰
- **Technical Assistance Grants (TAG).** Funds provided to qualified entities to assist REAP applicants with the application process, including technical, financial, and environmental requirements, as well as System for Award Management (SAM) registration.¹⁰¹

¹⁰⁰. Ibid.

¹⁰¹. *Farm Labor Housing Technical Assistance Grants*. U.S. Department of Agriculture. [www.rd.usda.gov/programs-services/multifamily-housing-programs/farm-labor-housing-technical-assistance-grants] Accessed on Jul. 28, 2025.

FUNDING LEVELS

The REAP program offers a range of funding levels depending on the type and scope of the project.

- Grant amounts for a RES typically range from \$2,500 to \$1 million (though current maximums can be up to 50% of project costs, up to \$500,000 for RES, and \$250,000 for EEI).
- Grant amounts for an EEI typically range from \$1,500 to \$500,000 (up to 50% of project costs).

Loan guarantees can cover up to 75% of eligible project costs. The combined grant and loan guarantee can cover up to 75% of total eligible project costs.

APPLICATION PROCESS

The REAP application process generally involves the following steps.

1. **Preparation.** Determine project design and cost, obtain quotes, contact utilities, compile permits, and contact a local Rural Development State Energy Coordinator.
2. **Registration.** Obtain a unique entity identifier by registering at **SAM.gov**.
3. **Application Assembly.** Gather and complete required forms (e.g., SF-424, *Application for Federal Assistance*, project-specific forms based on cost) and supporting documents (e.g., proof of eligibility, technical requirements, environmental checklist, financial statements, tax returns, energy audit).
4. **Submission.** Submit the completed application package to the local USDA Rural Development State Energy Coordinator.
5. **Review and Scoring.** Applications are scored based on criteria such as energy savings, project cost-effectiveness, readiness, financial feasibility, and environmental benefits.
6. **Award and Disbursement.** If approved, the applicant will be notified of their grant award. Grants are typically disbursed as reimbursements after project completion, payment, and verification.

TAX REPORTING

When a REAP grant is received, it can affect both the **taxable income** of the recipient and the **basis used for calculating depreciation and tax credits**. Understanding how to properly report the grant and related project costs is essential for maximizing tax benefits and avoiding errors. The following are the key concepts for calculating taxable income, the investment tax credit (ITC), and depreciation.¹⁰²

- **Taxable Income.** The REAP grant is generally included in gross income unless specifically excluded. This means the grant amount may increase the taxpayer's income tax liability in the year received.
- **ITC.** The ITC is a federal tax credit that allows taxpayers to reduce their tax liability based on a percentage of the cost of qualifying renewable energy property. For most REAP-eligible projects, the ITC is **30% of the total project cost**, regardless of how much was paid by the taxpayer versus covered by the grant.
- **Depreciation Basis.** The depreciable basis of the equipment is typically the total project cost, reduced by **half of the ITC**. The REAP grant is included in the basis, which increases the total amount eligible for depreciation.

¹⁰². *Rural Energy for America Program Renewable Energy Systems & Energy Efficiency Improvement Guaranteed Loans & Grants*. U.S. Department of Agriculture. [www.rd.usda.gov/programs-services/energy-programs/rural-energy-america-program-renewable-energy-systems-energy-efficiency-improvement-guaranteed-loans] Accessed on Jul. 8, 2025.

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Example 12. Maggie Ray operates a diversified farm in central Illinois, producing corn, soybeans, and raising a small herd of beef cattle. In 2025, she decides to invest in a solar energy system to reduce her long-term electricity costs and improve the sustainability of her operation. After consulting with her local USDA Rural Development office, Maggie applies for and receives a REAP grant to help fund the project.

The total cost of the solar installation is \$125,000. Maggie pays \$100,000 out of pocket, and the remaining \$25,000 is covered by the REAP grant. Because the project qualifies for the ITC, she is also eligible to claim a 30% credit based on the full project cost. Additionally, she is able to deduct depreciation on her solar equipment using 5-MACRS. Maggie calculates the ITC, depreciation, and income using the following steps.

Step 1. Calculate ITC.

$$\begin{aligned}\text{ITC} &= \text{Total Project Cost} \times \text{ITC Percentage} \\ &= \$125,000 \times 30\% \\ &= \$37,500\end{aligned}$$

Step 2. Calculate adjusted depreciation basis.

$$\begin{aligned}\text{Adjusted Depreciation Basis} &= \text{Total Project Cost} - (\text{ITC} \times 50\%) \\ &= \$125,000 - (\$37,500 \times 50\%) \\ &= \$125,000 - \$18,750 \\ &= \$106,250\end{aligned}$$

Step 3. Calculate depreciation.

Using MACRS, depreciation is spread over 5 years, and the annual depreciation amount is determined by the applicable depreciation percentage for each year. The depreciation percentage is 20% for the first year.

$$\begin{aligned}\text{First-Year Depreciation} &= \text{Adjusted Depreciation Basis} \times \text{Depreciation Percentage} \\ &= \$106,250 \times 20\% \\ &= \$21,250\end{aligned}$$

Step 4. Calculate net income tax effect in the first year.

If Maggie is in a 30% overall tax bracket, the net income tax effect in the first year is as follows.

- Tax **due** on REAP Grant included as income = \$7,500 (\$25,000 × 30%)
- Tax **savings** from ITC = \$37,500
- Tax savings from depreciation = \$6,375 (\$21,250 × 30%)
- Overall net tax savings = \$36,375

This reduces Maggie's net cost for the solar project to \$63,625 (\$100,000 out-of-pocket cost – \$36,375 tax savings) in the first year. Tax savings in future years will equal \$25,500 (\$85,000 × assumed 30% tax bracket), reducing the final after-tax cost to \$38,125 (\$63,625 – \$25,500).

CORPORATE-PROVIDED MEALS AND LODGING

Providing meals and lodging to employees can be a valuable perk and sometimes a business necessity. The value of meals and lodging furnished on the business premises for the employer's convenience and as a condition of employment is not taxable income to the employee (and the employee's spouse and dependents) and is deductible by the employer if they are provided in-kind.¹⁰³ Likewise, the value of meals and lodging furnished on the business premises for the convenience of the employer are not wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes.

As an employer-provided fringe benefit, the meals and lodging arrangement is available only to an individual who is an employee of a C corporation. Owners of other entities cannot take advantage of this fringe benefit. For instance, sole proprietors and partners in a partnership do not have the necessary employee status to qualify for the fringe benefit. Also, IRC §1372 bars S corporation employees who own, directly or indirectly, more than 2% of the outstanding stock from receiving tax-free fringe benefits, including the IRC §119 meals and lodging fringe benefit. In addition, with respect to S corporations, the IRC §318 attribution rules apply in determining who considered to be an S corporation shareholder.¹⁰⁴

From a tax perspective, the ideal scenario is for the employee to exclude the value of these benefits from their gross income, while the corporation can still deduct the cost as a business expense.¹⁰⁵ IRC §119 is the cornerstone of this analysis. For a C corporation (and for non-shareholder employees of an S corporation), the value of meals and lodging furnished to an employee, their spouse, or their dependents by or on behalf of the employer can be excluded from the employee's gross income if certain conditions are met. The employer can generally deduct the full cost of these qualifying meals and lodging as an ordinary and necessary business expense under §162, even when the employee must include the benefits in their gross income.

¹⁰³. IRC §119. This tax treatment is available only for meals and lodging furnished to **employees**, not **tenants**. See *Weeldreyer v. Comm'r*, TC Memo 2003-324 (Nov. 25, 2003); *Schmidt v. Comm'r*, TC Memo 2003-325 (Nov. 25, 2003); *Tschetter v. Comm'r*, TC Memo 2003-326 (Nov. 25, 2003); *Waterfall Farms, Inc. v. Comm'r*, TC Memo 2003-327 (Nov. 25, 2003).

¹⁰⁴. The IRS will not issue rulings on whether the value of meals or lodging is excludible from gross income by an employee who is a controlling shareholder of the corporate employer per Rev. Proc. 2013-3, 2013-1 IRB 113.

¹⁰⁵. For IRC §119 purposes (when exclusion is possible) and for inclusion in income (for more-than-2% S corporation shareholders), the amount involved is the FMV of the meals or lodging. For lodging, the FMV is generally the amount the employee would have to pay for comparable lodging in that particular geographic area. Factors include size, condition, furnishings (if any), and location. Determining the FMV of lodging, especially unique lodging, can be challenging. Appraisals or comparisons to local rental markets might be necessary. For meals, the FMV is what a person would pay for the meal in a restaurant or from a caterer. If the employer has a set charge for non-employees, that might be evidence of FMV.

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MEALS EXCLUSION¹⁰⁶

The value of meals furnished to an employee by the employer is excludable from the employee's gross income if the meals are provided to employees for the convenience of the employer on the employer's business premises.

Employer's Convenience

The meals must be furnished for a substantial non-compensatory business reason of the employer. This means the meal is not primarily provided to remunerate the employee. Examples that satisfy this test include the following.

- To have the employee available for emergency calls during the meal period¹⁰⁷
- When the nature of the employer's business requires short meal periods (e.g., a hospital cafeteria for medical staff who need to be on call)¹⁰⁸
- When there are insufficient eating facilities in the vicinity of the employer's premises¹⁰⁹
- Meals furnished to restaurant or food service employees during, immediately before, or immediately after their working hours¹¹⁰

For amounts paid or incurred after December 31, 2017, and before January 1, 2026, if more than half of the employees to whom meals are furnished on the employer's business premises are furnished such meals for the convenience of the employer, then **all** meals furnished to employees on the business premises are treated as furnished for the convenience of the employer.¹¹¹ This provision helps employers with large cafeterias meet the "convenience of the employer" test more easily for all on-premises meals.

Note. The OBBBA retains this rule but also specifies that meal costs are deductible if the expenses relate to (a) goods or services for which the employer receives adequate consideration in a bona fide transaction or (b) food or beverages provided on or at certain commercial vessels, oil or gas platforms, and fishing vessels or fish processing facilities.¹¹²

Cash Meal Allowances

A cash meal allowance does not satisfy the test. For example, in *Comm'r v. Kowalski*,¹¹³ the U.S. Supreme Court established that cash meal allowances are generally **not** excludable under §119, even if intended for meals on duty. IRC §119 applies to meals furnished "in kind." The Court reasoned that §119 "was intended to allow employees to exclude from gross income the value of meals furnished in kind by their employers, on the employer's business premises, for the convenience of the employer — not to allow employees to exclude cash meal allowances."

In Rev. Rul. 71-411,¹¹⁴ the IRS discussed situations where meals provided without charge to employees at company cafeterias or dining rooms qualify under §119. The IRS position in the Rev. Rul. is that if a significant portion of the meals meet the convenience of the employer test, then all meals furnished on the premises to employees may be considered for the convenience of the employer.

^{106.} IRC §119(a)(1).

^{107.} Treas. Reg. §1.119-1(a)(2)(ii)(a).

^{108.} Treas. Reg. §1.119-1(a)(2)(ii)(b).

^{109.} Treas. Reg. §1.119-1(a)(2)(ii)(c).

^{110.} Treas. Reg. §1.119-1(a)(2)(ii)(d).

^{111.} IRC §119(b)(4).

^{112.} *One Big Beautiful Bill Act*, PL 119-21, §70305. This provision is effective for amounts paid or incurred after December 31, 2025.

^{113.} *Comm'r v. Kowalski*, 434 U.S. 77 (1977).

^{114.} Rev. Rul. 71-411, 1971-2 CB 103.

In-Kind Meals Versus Reimbursed Grocery Costs

The employer meal deduction under §162 is available for on-premises meals (e.g., furnishing in-kind meals) not the reimbursement of grocery costs.¹¹⁵ However, groceries that are prepared into meals and consumed on the business premises should be excludible from employee income. While the IRS disagrees on this point,¹¹⁶ the courts have ruled that either the employer or the employee may prepare the groceries into meals, as long as the arrangement otherwise meets the requirements of §119.¹¹⁷

Note. To be eligible for the deduction, an employee of the corporation should have defined duties that include preparation of on-premises corporate-provided meals. The employee should also be compensated for those duties as part of their employment agreement with the corporation.

The definition of groceries includes non-food items such as napkins, toilet tissue, soap, etc. because these items are an integral part of the furnishing of meals and lodging.¹¹⁸

Also, the courts apparently are not concerned whether groceries are purchased directly using the corporate checking account. It is permissible for corporate employees (including spouses on the farm) to purchase groceries and be later reimbursed by the corporation.¹¹⁹

On the Business Premises

The meals must be furnished on the employer's business premises. **Business premises** generally means the employee's place of employment. This can include the employer's factory, office, or other locations where the employee performs significant duties.

There have been several key cases and IRS rulings that provide guidance on the business premises issue. For example, in *Comm'r v. Anderson*,¹²⁰ the court defined business premises as either living quarters that constitute an integral part of the business property or premises on which the company carries on some of its business activities. A rented house across the street from a motel owned by the employer for the motel manager was held **not** to be on the business premises. In *Boyd Gaming Corp. v. Comm'r*,¹²¹ the Ninth Circuit broadened the interpretation of business premises for employer-operated eating facilities. The court found that a cafeteria located in an adjacent building but an "integral part" of the employer's operations (a casino) could be considered "on the business premises." The employees were required to stay on-site due to security concerns and short meal breaks. The court looked at the "functional rather than spatial" link. The IRS specifically discussed hospital employees.¹²² Meals provided in the hospital cafeteria to medical staff who were required to be available for emergencies qualified.

¹¹⁵. *Dobbe Holland America Bulb Farms, Inc. v. Comm'r*, TC Memo 2000-330 (Oct. 25, 2000). In *Tougher v. Comm'r*, 51 TC 737 (1969), *aff'd* 441 F.2d 1148 (9th Cir. 1971), *cert. denied* 404 U.S. 1015 (1972), the court held that "meals" under IRC §119 means ready-to-eat food, not groceries that the employee prepares themselves.

¹¹⁶. Rev. Rul. 77-806, 1977-2 CB 280.

¹¹⁷. *Harrison v. Comm'r*, TC Memo 1981-211 (Apr. 28, 1981) (corporate employees (farm spouses) bought the groceries and converted them into meals which were then furnished to the corporate employees and their families on the farm premises; the employees were paid a small annual salary with their duties defined as including the preparation of meals for corporate employees).

¹¹⁸. *Jacobs v. Comm'r*, 493 F.2d 1294 (3d Cir. 1974).

¹¹⁹. *Harrison v. Comm'r*, TC Memo 1981-211 (Apr. 28, 1981).

¹²⁰. *Comm'r v. Anderson*, 371 F.2d 59 (6th Cir. 1966), *cert. denied* 387 U.S. 906 (1967).

¹²¹. *Boyd Gaming Corp. v. Comm'r*, 177 F.3d 1096 (9th Cir. 1999).

¹²². Ltr. Rul. 9602001 (Sep. 15, 1995).

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LODGING EXCLUSION¹²³

The value of lodging furnished in-kind¹²⁴ to an employee by the employer is excludable from the employee's gross income if three tests are met.¹²⁵ Two of the tests are the same as for meals – the lodging must be provided for the **convenience of the employer**, and the lodging must be provided **on the employer's premises**. An additional requirement for employer-provided lodging is that the **employee must be required to accept the lodging as a condition of employment** (such as for security reasons, livestock observation, or periodic chores). This means the employee **must** accept the lodging to properly perform the duties of their employment (e.g., they need to be available for duty at all times or cannot perform services without residing on the premises).¹²⁶

Note. The corporation must either own or lease the residence in which the corporate-provided lodging is being furnished.¹²⁷ If the corporation does not own the residence, there should be a written lease and a specific rental payment by the corporation to give it access to the residence.

The regulations specify that the condition of employment test is satisfied if an employee is required to accept the lodging to enable the employee to properly perform the duties of the employee's employment.¹²⁸ Lodging will be regarded as furnished to enable the employee properly to perform the duties of employment when, for example, the lodging is furnished because the employee is required to be available for duty at all times **or** because the employee could not perform the services required unless lodging is furnished.¹²⁹

Note. The condition of employment test is often the most scrutinized for lodging. It requires that the employee **must** accept the lodging to properly perform the duties of their employment. It is not enough for the lodging to be convenient or helpful; it must be indispensable.

The litigated cases on this issue date back to the 1930s. The first pair of cases involved individuals working for the Dole Corporation in Hawaii. These individuals were plantation managers in pineapple fields, and they argued that they were required to remain on the premises and, as such, the value of meals and lodging provided to them by the corporation should not be included in their income. They prevailed in court.¹³⁰

In a 1948 case, the rental value of a corporate-owned farmhouse occupied by the sole shareholder of the farm corporation was included in the shareholder's taxable income.¹³¹

¹²³. IRC §119(a)(2).

¹²⁴. Cash allowances for lodging (and meals) are includible in gross income to the extent the allowance constitutes compensation. See, e.g., Ltr. Rul. 9801023 (Sep. 30, 1997).

¹²⁵. Employer-provided lodging can include household utilities per Rev. Rul. 68-579, 1968-2 CB 61, and *Harrison v. Comm'r*, TC Memo 1981-211 (Apr. 28, 1981). It can also include household furnishings (*Turner v. Comm'r*, 68 TC 48 (1977)), and telephone services (*Hatt v. Comm'r*, TC Memo 1969-229 (Oct. 28, 1969)).

¹²⁶. Treas. Reg. §1.119-1(b).

¹²⁷. The corporation should also own the residence if that is where corporate-provided meals are taken.

¹²⁸. Treas. Reg. §1.119-1(b). The nature of the work requires the employee to live on-site (e.g., remote locations, security personnel, property caretakers).

¹²⁹. *Ibid.* For example, there are no adequate alternative housing options nearby that would allow the employee to perform their duties effectively.

¹³⁰. *Dole v. Comm'r*, 43 TC 697 (1965), *aff'd* 351 F.2d 308 (1st Cir. 1965).

¹³¹. *Frederick Smith Enterprises Co. v. Comm'r*, 167 F.2d 356 (6th Cir. 1948).

In a 1966 Wyoming case, *Wilhelm v. U.S.*,¹³² the taxpayers owned a ranch in a remote location several miles from the nearest town. The taxpayers transferred the ranch, ranch house, and all the equipment to the corporation and attempted to live in the house tax-free. The corporation also bought the food and treated it as a deductible expense. The IRS challenged the practice. The Federal District Court for the District of Wyoming ruled against the IRS and noted that the ranch was a grass ranch that put up very little hay and required constant attention by persons experienced in grass ranch requirements to keep cattle alive. The court also noted that during snowstorms the cattle needed to be fed daily, needed to be moved, waterholes had to be kept open, and the cattle had to be protected against the hazards of being trapped or falling into ravines. The court felt that the employees had no other choice but to accept the facilities furnished by the corporate employer, and that the food and lodging were furnished to the employees not only for the convenience of the employer, but that they were indispensable to have the employees on the job at all times.

The *Wilhelm* case was a very important decision, but it also raised the question of how a court would view the situation if the corporation were located in a less remote area. In 1971, the United States Court of Appeals for the 9th Circuit addressed this issue in the context of a grape and crop farming operation in *Caratan v. Comm'r*.¹³³ In *Caratan*, the corporation was located within a 10-minute drive from a residential area of a nearby town. Company policy required supervisory and management personnel to reside on the farm. Company-owned lodging was supplied free of charge for this purpose. The court, in ruling against the IRS, held that the issue was not the remoteness of the corporation, but whether there was a good business reason to require the employees to remain on the premises. The court indicated that the nature of the farming enterprise would determine the reasonableness of requiring employees to reside on the premises rather than the location of the corporation from the nearest town. Whether corporate business required around the clock work such as is the case with a grain drying operation, a farrow-to-finish operation, a dairy or a cattle ranch with characteristics similar to the ranch involved in the *Wilhelm* case was the real issue.

Historically, cash grain operations have had the greatest difficulty in successfully excluding the cost of lodging and meals provided by the corporation to employees. The IRS has difficulty in accepting the fact that grain farmers simply cannot lock up their machinery after the fall harvest, return the next spring and expect it to still be there. The IRS does not put much weight on security, and they think there is no reason why a grain farmer cannot live in town if all that occurs is the planting, cultivating, and harvesting of a crop. On the other hand, livestock ventures or those that are irrigating or drying grain typically have had better success against an IRS challenge. For example, taxpayers were successful in one case involving only a grain operation with the emphasis on grain drying as a reason to be on the premises on a continuing basis.¹³⁴

A 1994 decision from the same court (but a different judge) that decided *Wilhelm* in 1966 declared that the reasoning in *Wilhelm* “is no longer persuasive.” In *Dilts v. U.S.*,¹³⁵ the court disallowed the deductibility of the value of the shareholder’s food and lodging from their income tax. The case involved an unusual set of facts in that the taxpayers, to get around the limits applicable to S corporations, argued that the operation was really a partnership and cited a 1968 case treating partners as employees (one of the few cases to do so). The court in *Dilts* rejected that argument. Although not part of the holding, the court then proceeded to criticize the tax code provision allowing meals and lodging to be excluded from shareholders’ incomes. The court cited public policy concerns and congressional intent to treat similarly situated people as similar for tax purposes to achieve “horizontal equity.” The court reasoned that it would be inequitable to allow corporate shareholders to receive benefits in the form of exclusions that are unavailable to sole proprietors. The *Dilts* case is out of step with the IRS, Tax Court, and the Circuit Courts of Appeal that have decided cases in this area.

¹³². *Wilhelm v. U.S.*, 257 F. Supp 16 (D. Wyo. 1966).

¹³³. *Caratan v. Comm'r*, 442 F.2d 606 (9th Cir. 1971).

¹³⁴. *Johnson v. Comm'r*, TC Memo 1985-175 (Apr. 8, 1985); compare with *J. Grant Farms, Inc. v. Comm'r*, TC Memo 1985-174 (Apr. 8, 1985) (swine raising and grain drying operation); *Caratan v. Comm'r*, 442 F.2d 606 (9th Cir. 1971).

¹³⁵. *Dilts v. U.S.*, 845 F. Supp. 1505 (D. Wyo. 1994).

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In *Benninghoff v. Comm'r*,¹³⁶ a manager of a condominium complex in Florida who lived in one of the units was not allowed to exclude the lodging value because, while convenient, it was not an indispensable requirement for the job. He could have lived nearby and still performed his duties. However, in *Vanicek v. Comm'r*,¹³⁷ caretakers of a large residential property were required to live on-site for security and maintenance. The lodging was excludable because their continuous presence was essential for the job.

In *Caratan v. Comm'r*,¹³⁸ the Ninth Circuit reversed the Tax Court, finding that lodging provided to farm supervisors was excludable. The court held that if the employer provides evidence that the lodging is necessary for the employee to perform their duties, the burden shifts to the IRS to show that the duties could be performed without living on the premises. The remote location and need for constant supervision were key.

Observation. This case is important for demonstrating that if an employer presents a sound business reason why an employee must live on the premises to perform their duties (e.g., constant availability in a remote farming operation), the burden can shift to the IRS to prove otherwise.

In *McDonald v. Comm'r*,¹³⁹ lodging provided to an executive in Japan by his multinational employer was not excludable. While convenient and perhaps customary, the court found he could have performed his duties adequately while living in other available housing. The condition of employment test was not met.

Rev. Ruls. 58-280¹⁴⁰ and 69-499¹⁴¹ suggest that lodging furnished to house parents at a home for mentally challenged individuals was excludable because their continuous presence and availability were integral to their duties.

Adolph Coors Co. v. Comm'r,¹⁴² involved company-owned houses provided to key executives near the brewery. While the executives were on call 24/7, the court found the lodging was not a condition of employment because they could have performed their duties adequately living elsewhere in the community. The houses were more for the executives' convenience and status than an indispensable requirement for their roles. This highlights that simply being on call is not always sufficient.

EMPLOYEE CHARGES FOR MEALS OR LODGING

If an employee is charged a fixed amount for meals or lodging, regardless of whether the meals or lodging are accepted, the amount is includible in the employee's gross income. However, if the employee has the option to accept the meals/lodging and is charged for them, and the conditions of §119 are otherwise met, then the tax result is different.

If an employee is required to pay a fixed charge for meals, and such meals are furnished for the convenience of the employer, the amount paid is excludable from the employee's gross income if the employee is required to make the payment whether they accept the meals or not.¹⁴³ However, if an employee can choose to receive cash instead of the in-kind benefit, the value of the benefit is taxable, even if they choose the meal or lodging.¹⁴⁴

Note. Even if meals do not meet the stringent convenience of the employer test under §119, occasional meals provided to employees may be excludable as a de minimis fringe benefit if their value is so small as to make accounting for them unreasonable or administratively impracticable.¹⁴⁵ Examples include occasional coffee, donuts, or group meals for special circumstances like working late. The employer can fully deduct these costs.

¹³⁶ *Benninghoff v. Comm'r*, 71 TC 216 (1978), *aff'd* 614 F.2d 398 (5th Cir. 1980).

¹³⁷ *Vanicek v. Comm'r*, 85 TC 731 (1985).

¹³⁸ *Caratan v. Comm'r*, 442 F.2d 606 (9th Cir. 1971).

¹³⁹ *McDonald v. Comm'r*, 66 TC 223 (1976).

¹⁴⁰ Rev. Rul. 58-280, 1958-1 CB 157.

¹⁴¹ Rev. Rul. 69-499, 1969-2 CB 39.

¹⁴² *Adolph Coors Co. v. Comm'r*, TC Memo 1968-256 (Nov. 7, 1968).

¹⁴³ IRC §119(b)(2).

¹⁴⁴ The Supreme Court in *Kowalski* made it clear that IRC §119 applies to meals furnished "in kind." However, §119(b)(3) specifies that if an employer provides meals and charges for them, and an employee can elect not to take the meals and not be charged, then amounts charged for meals are not part of the employee's compensation if the meals themselves would be excludable under §119(a).

¹⁴⁵ IRC §§132(a)(4) and (e).

PAYROLL TAX IMPLICATIONS¹⁴⁶

If the value of meals and lodging is properly excluded from an employee's gross income under §119, it is also excluded from wages for purposes of federal income tax withholding, social security and Medicare taxes (FICA), and FUTA.

EMPLOYER'S DEDUCTION (C CORPORATION)

Generally, a C corporation can deduct the full cost of meals and lodging provided to employees if they qualify as ordinary and necessary business expenses under §162. This has been historically true. However, the TCJA initially made employer-provided meals (even for the convenience of the employer) only 50% deductible from 2018 through 2025, after which they were slated to become non-deductible.¹⁴⁷ However, the Consolidated Appropriations Act of 2021, provided a temporary exception for 2021 and 2022, allowing a 100% deduction for food or beverages provided by a restaurant.¹⁴⁸ For meals provided **not** by a restaurant (i.e., an in-house cafeteria not operated as a de minimis fringe), the 50% limitation generally applies for C corporations for expenses incurred after December 31, 2017, and before January 1, 2026.¹⁴⁹

Note. If meals are provided at an employer-operated eating facility and qualify as a de minimis fringe benefit under IRC §132(e)(2) (i.e., revenue from the facility equals or exceeds direct operating costs), the employer can deduct 100% of the cost, and the value is excludable by the employee.

The cost of lodging that qualifies under §119 is generally 100% deductible by the C corporation as a §162 business expense.

S CORPORATIONS

S corporations, with their flow-through tax nature, present a more complicated tax landscape, especially for shareholder-employees.

Non-Shareholder Employees of an S Corporation

For employees of an S corporation who are **not** shareholders, or who are shareholders owning 2% or less of the S corporation's stock, the rules under §119 for excluding the value of meals and lodging are identical to those for C corporation employees. If the tests are met, the value is excludable from their income, and it is not subject to federal income tax withholding, FICA, or FUTA. The S corporation deducts the expense, which then flows through to all shareholders via their Schedules K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*¹⁵⁰

Shareholder-Employees Owning More Than 2% of S Corporation Stock

Under §1372, if a shareholder owns more than 2% of the S corporation's stock (either directly or indirectly through family or entity attribution), they are treated like a partner in a partnership — not like a regular employee — for fringe benefit purposes.

¹⁴⁶. IRC §3121(a)(19) and IRC §3306(b)(14) for FUTA.

¹⁴⁷. IRC §274(o)(1).

¹⁴⁸. This applied to IRC §119 meals if purchased from a restaurant and provided to employees on business premises for the employer's convenience.

¹⁴⁹. IRC §§274(n)(1) and (o).

¹⁵⁰. IRC §1372(a).

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IRC §1372(b) defines a **2% shareholder** as any person who owns (directly or by attribution under §318) on any day during the taxable year of the S corporation more than 2% of the outstanding stock or more than 2% of the total combined voting power of all stock of the corporation. This is an important point. IRC §119 provides an exclusion from **gross income** for **employees**. Because a more-than-2% shareholder-employee is treated as a **partner** for fringe benefit purposes, such a shareholder generally is **not eligible** for the income exclusion under §119. Partners are self-employed individuals, not employees, for this purpose, and §119 does not apply to partners. Therefore, the FMV of meals and lodging furnished to a more-than-2% shareholder-employee, even if all the conditions of §119 (convenience of the employer, on business premises, condition of employment for lodging) are met, must generally be included in the shareholder-employee's gross income as compensation.

As a result, the FMV of meals and lodging provided to a more-than-2% shareholder must generally be included in their taxable income as compensation.

IRS Guidance. In Rev. Rul. 91-26,¹⁵¹ while the ruling specifically addresses accident and health insurance premiums paid by an S corporation for its more-than-2% shareholder-employees, its rationale is foundational for understanding the treatment of other fringe benefits. The ruling confirms that because the S corporation is treated as a partnership and the more-than-2% shareholder as a partner, the premiums are not excludable under IRC §106 (which applies to employees). Instead, the premiums are treated like guaranteed payments under IRC §707(c) if paid for services rendered. The S corporation deducts the cost, and the shareholder-employee includes the amount in gross income. The same logic applies to other statutory fringe benefits normally excludable by common-law employees, such as meals and lodging under §119.

IRS Ann. 92-16,¹⁵² provided further clarification confirming that these amounts are included in wages for income tax withholding purposes on the shareholder-employee's Form W-2. However, when it comes to health insurance — and by extension, other fringe benefits that partners can exclude from income (though meals and lodging under §119 generally do not qualify) — the value of the benefit is **not subject to FICA or FUTA** as long as it is provided under a plan that covers employees and their dependents generally, or a defined class of employees. This FICA/FUTA exception, however, does NOT typically apply to the value of §119-type meals and lodging for a more-than-2% shareholder because the underlying benefit itself is not excludable by a partner.

Tax Reporting Implications. For a more-than-2% shareholder-employee, the FMV of the meals and lodging provided must be included in the gross income with the amount reported as wages on Form W-2. The amount is subject to FICA and FUTA taxes because the value is considered wages and is not excludable under a specific provision for partners. The amount is also subject to federal income tax withholding. However, the shareholder-employee does not pay SE tax on this Form W-2 wage income.¹⁵³

De Minimis Meals for S Corporation More-Than-2% Shareholders. For common-law employees (including non-shareholder S corporation employees), occasional, low-value meals (e.g., coffee and donuts, occasional pizza for a late working night) can be excluded as de minimis fringe benefits under §132(e). For more-than-2% S corporation shareholders, the IRS's position is generally that they are not eligible for the de minimis fringe benefit exclusion because §1372 treats them as partners, and partners are not employees for purposes of §132.¹⁵⁴

Observation. While technically even de minimis benefits might be includible for more-than-2% shareholders, the administrative burden of tracking and taxing every cup of coffee can be significant. Some practitioners take a practical view for truly nominal items, though this carries some audit risk. For more substantial or regular de minimis meals, inclusion as compensation is the safer route. The S corporation can still deduct the cost.

¹⁵¹. Rev. Rul. 91-26, 1991-1 CB 184.

¹⁵². IRS Ann. 92-16, 1992-5 IRB 53.

¹⁵³. The individual is treated as an employee for wage reporting purposes, even though §1372 analogizes them to a partner for benefit eligibility.

¹⁵⁴. See, e.g., CCA 200025045 (Mar. 28, 2000).

Strategy. Given that the §119 exclusion is unavailable, a strategy is for the S corporation to treat the FMV of meals and lodging provided to a more-than-2% shareholder as compensation. In that event, the S corporation deducts its cost (subject to meal limitations), and the shareholder includes the FMV in income. The primary “cost” is the payroll taxes (FICA/FUTA) on this compensation. This approach is often cleaner than attempting to argue for an exclusion that is statutorily unavailable.

Observation. As the FUTA wage base is \$7,000 per employee with a potential net tax rate of 0.6%, the payroll tax cost for this portion is often not a large amount.¹⁵⁵ However, the amount of state unemployment cost can be much higher.

Tax Treatment for the S Corporation.¹⁵⁶ The S corporation can deduct the **cost** of providing the meals and lodging as compensation expense (a business expense under §162), provided it is reasonable in amount. For meals, the S corporation would generally be subject to the 50% limitation under IRC §274(n) unless a specific exception applies.¹⁵⁷

Note. If they are deemed compensation to the more-than-2% shareholder, one might argue the 50% limit under §274(n) does not apply because §274(e)(2) exempts expenses treated as compensation. However, the IRS has taken a stricter view in some contexts for S corporation shareholder meals. Prudence often dictates applying the 50% limit for meals unless clear guidance states otherwise for this specific S corporation shareholder compensation scenario.

For lodging, the S corporation can deduct 100% of the actual costs incurred (e.g., rent, utilities, depreciation if owned by the S corporation).

The deduction reduces the S corporation’s ordinary business income, which then flows through to all shareholders (including the more-than-2% shareholder-employee who received the benefit) on their Schedules K-1 (Form 1120-S), on a pro rata basis according to their stock ownership.

Net Effect for the More-Than-2% Shareholder-Employee. The shareholder-employee includes the FMV of the meals and lodging in their income with the S corporation deducting the same amount. The shareholder-employee’s Schedule K-1 (Form 1120-S) income is reduced by their pro-rata share of that deduction. If they are a 100% shareholder, their Schedule K-1 (Form 1120-S) income is reduced by the full amount. For income tax purposes, this can result in a “wash” — the Form W-2 income inclusion is offset by the reduction in Schedule K-1 (Form 1120-S) income. However, there is no wash for payroll taxes (FICA/FUTA). The S corporation pays the employer’s share, and the employee pays the employee’s share on the value of the benefit. This is a real, additional tax cost.

Lodging Issues. If the shareholder personally owns the home they live in for work purposes, the S corporation could potentially rent the portion of the home used exclusively and regularly for business (e.g., a home office that also serves as the required on-site lodging location if structured very carefully). This would be rental income to the shareholder and rental expense to the S corporation. However, self-rental rules and passive activity rules can be complex. This is distinct from the §119 employer-provided lodging scenario and needs careful planning. It also does not make the living quarters portion excludable if the shareholder is simply living there.

¹⁵⁵. Employers pay FUTA tax only on the first \$7,000 of each employee’s wages during the calendar year. Any wages above \$7,000 for an employee are not subject to FUTA tax. The FUTA tax rate is 6% but employers can receive a credit of up to 5.4% for paying state unemployment tax.

¹⁵⁶. IRC §1372.

¹⁵⁷. Such as the temporary 100% deduction for restaurant-provided meals in 2021-2022, or if the meals qualify as de minimis fringe benefits (although this is harder to argue if they are regular and substantial enough to consider under §119 principles).

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If the lodging is the shareholder's home, IRC §280A limitations are severe. For an S corporation to deduct expenses related to an employee's (even shareholder-employee's) home that they live in, the use must be for the **convenience of the employer**. If the employee rents part of their home to the employer, specific rules apply. If the S corporation **provides** the lodging (owns or rents it from a third party), §280A is less directly applicable to the S corporation's deduction for providing the lodging itself, but the shareholder-employee still faces the §1372 income inclusion.

Example 13. Lydia Hartman is the operations manager for Prairie Crest Ag, Inc., a family-owned grain and livestock corporation in western Iowa. As part of her employment, the company provides Lydia with on-site lodging to ensure she is available for emergency equipment repairs and livestock care during peak seasons. The FMV and cost of the lodging are \$12,000 per year. The lodging meets all three tests of §119 (convenience of the employer, on business premises, and condition of employment).

Prairie Crest is a C corporation and Lydia is an employee. The \$12,000 value of lodging is **excluded** from Lydia's gross income under §119. There is no income tax, FICA, or FUTA on this \$12,000.

Prairie Crest deducts the \$12,000 cost of lodging as a business expense under §162.

Example 14. Use the same facts as **Example 13**, except that Prairie Crest is an S corporation and Lydia is an employee (non-shareholder or a less than or equal to a 2% shareholder). Just like when Lydia was an employee in the C corporation, the \$12,000 value of lodging is **excluded** from her gross income under §119. There is no income tax, FICA, or FUTA on this \$12,000.

As an S corporation, Prairie Crest deducts the \$12,000 cost. This deduction reduces their taxable income, which flows through to all shareholders on their Schedules K-1 (Form 1120-S).

Example 15. Use the same facts as **Example 14**, except that Lydia is an S corporation employee (more-than-2% shareholder/employee). As a shareholder-employee, the \$12,000 FMV of the lodging is included in Lydia's gross income as wages on Form W-2. This \$12,000 is subject to FICA taxes (employee and employer portions) and federal income tax withholding. If Lydia is a 100% owner, her Schedule K-1 (Form 1120-S) income is reduced by the \$12,000 deduction taken by Prairie Crest. For income tax purposes, the \$12,000 Form W-2 income is offset by a \$12,000 reduction in flow-through income. The net income tax effect is \$0 (ignoring phase-outs or limitations potentially affected by adjusted gross income changes).

The FICA tax liability is \$1,836¹⁵⁸ of which \$918 is the employer portion ($\$12,000 \times 7.65\%$) and \$918 is the employee portion ($\$12,000 \times 7.65\%$). The FUTA tax liability is \$42 ($\$7,000 \times 0.6\%$).

Prairie Crest deducts the \$12,000 cost of the lodging as compensation expense. The FICA and FUTA tax payments are also deductible business expenses for the S corporation.

¹⁵⁸. FICA taxes (approximately $\$12,000 \times 15.3\% = \$1,836$, split between employer and employee share, assuming under the social security wage base) are paid and are not "washed out."

KEY CONSIDERATIONS AND PLANNING

For any business relying on §119 to exclude the value of meals provided to non-owner employees (or C corporation owners), it is essential to clearly document the business reasons that justify the convenience of the employer standard. This includes policies or operational needs such as requiring employees to stay on-site during meal periods, being available for emergency calls, having limited time for breaks, or lacking nearby dining options.

It should also be documented that the meals/lodging are furnished **on the business premises**. For lodging, the condition of employment requirement (why the employee **must** accept the lodging to perform their duties) should be carefully denoted with employment agreements reflecting this.

For S corporations providing benefits to more-than-2% shareholders, it is critical to document the FMV of the benefits provided. Also, care should be taken to ensure proper Form W-2 reporting and payroll tax remittance, and records should be maintained of the actual costs for deduction purposes.

Employment agreements must clearly state the requirements for accepting lodging if it is intended to be a condition of employment. Even if it becomes taxable for a more-than-2% S corporation shareholder, the business necessity might still be relevant for other purposes or for non-shareholder employees.

Note. Policies contained in employment agreements should be applied consistently among similarly situated employees.

For farming and ranching corporations attempting to exclude the cost of meals and lodging from employees' income, there should be a resolution by the board of directors clearly setting forth the requirement that employees are required to live on the premises.¹⁵⁹ Sometimes this resolution is questioned because the same people who make the decision as members of the board of directors are the same people who are also employees living in the corporation's house and eating the corporation's food. Thus, while it is not necessarily an arm's length determination, such a resolution should be adopted.

The following is an example resolution for corporate-provided meals and lodging for a grain farming operation.

WHEREAS, the corporation's employees are required to perform duties which include extended working hours during the crop production cycle, and said duties include a requirement to reside on corporate farm premises to supervise and secure grain inventory and machinery/equipment of the corporation; and

WHEREAS, in consideration for those extended hours and on-site duties, the corporation has provided on-premises meals and lodging as a condition of employment within the definitions of IRC §119;

NOW, THEREFORE, IT IS RESOLVED that effective immediately the corporation shall make its on-premises eating facility available to all its employees, in order to allow those employees to attend to their extended duties and on-site supervision requirements.

¹⁵⁹ When a corporate resolution authorizes the construction of a residence on the farm for a controlling shareholder, the stated purpose matters. If the justification focuses on entertaining business guests rather than the operational need for the shareholder to live on-site (such as overseeing poultry breeding or other essential farm activities), it weakens the argument that the lodging is required as a condition of employment. This can result in the loss of the §119 exclusion for employer-provided lodging. See, *Peterson v. Comm'r*, TC Memo 1966-196 (Sep. 2, 1966) in which the controlling shareholder had also resided in nearby community for about the prior 10 years while managing the farming business.

HOBBY LOSSES

For a business expense to be deductible, it generally must be ordinary and necessary or be an investment expense.¹⁶⁰ Investment-related deductions under IRC §212 have largely been eliminated by the TCJA. That puts the emphasis on deductions to be tied to a trade or business activity so that they can be deducted under §162. The trade or business must be conducted with a profit intent. If not, the activity is deemed to be a hobby, and associated losses are **nondeductible hobby losses**. In general, a hobby is any activity that is not engaged in primarily for profit (i.e., any activity that is not a business). However, simply incurring net losses does not mean an activity is conducted without a profit intent.¹⁶¹

Note. In the loss area, agricultural cases have been very visible.¹⁶² The reason for this visibility tends to be that there exists a proportion of the population who are tempted to move out five miles from town, purchase a tract of real estate, buy some livestock, and build a big barbecue pit and a large swimming pool, and claim a deduction for the costs involved. These often are the first or second generation of off-farm people who have a certain fond attachment to rural living.

The IRS targets these types of operations as hobbies. If they are, in fact, a hobby, the costs generally are not deductible. The key distinction, therefore, is determining the line between a hobby and a business.

PRESUMPTION

Until 1969, it was possible to deduct up to \$50,000 per year in losses. In 1969, Congress created a presumption (i.e., safe harbor) that still exists today. The presumption was modified in 1986, but presently, if a taxpayer has gross income in excess of deductions for three or more of the last five years, they are presumed not to be a hobby. **In other words, an activity is presumed to be a business if there are profits for three or more of the last five years.** This requirement has been increased from two or more of the last five years as the rule from 1969 through 1986. For activities consisting of **breeding, training, showing or racing horses, the presumption arises if there is a profit in any two out of the last seven years.**

The IRS can rebut the presumption by carrying the burden of proof and establishing a lack of profit motive. Thus, for farms or ranches operated for pleasure or recreation and not as commercial enterprises, the deduction of expenses is permitted if a profit occurs over a long enough period.¹⁶³

Postponing the Presumption

It is possible to postpone the application of the safe harbor until the close of the fourth tax year (or sixth, for horse activities) after the tax year the activity begins.¹⁶⁴ This is accomplished by making an election via Form 5213, *Election to Postpone Determination as To Whether the Presumption Applies That an Activity is Engaged in for Profit*, to allow losses incurred during the 5-year period to be reported on Schedule C, *Profit or Loss From Business*. Thus, if the activity shows a profit for three or more of the five years, the activity is presumed to not be a hobby for the full 5-year period.

The downside risk of the election occurs if the taxpayer fails to show a profit for at least three of the five years. If that happens, a major tax deficiency could occur for all the years involved. Thus, filing Form 5213 should not be made without thoughtful consideration. For example, while the election provides more time to establish that an activity is conducted with a profit intent, it will also put the IRS on notice that an activity may be conducted without a profit intent. It also extends the statute of limitations for a tax deficiency (and refund claims) associated with the activity.¹⁶⁵

¹⁶⁰. IRC §§162 and 212.

¹⁶¹. See, e.g., *Welch, et al. v. Comm'r*, TC Memo 2017-229 (Nov. 20, 2017).

¹⁶². See, e.g., *Hastings v. Comm'r*, TC Memo 2002-310 (Dec. 23, 2002).

¹⁶³. IRC §183(d); Treas. Reg. §1.183-2(b).

¹⁶⁴. IRC §183(e).

¹⁶⁵. See, e.g., *Wadlow v. Comm'r*, 112 TC 247 (May 11, 1999).

Example 16. Eleanor, a successful software engineer, has a passion for breeding and showing cattle. In 2024, she turned her passion into a potential business, Prestige Beef, with the goal of eventually making a profit. She invested significant capital in high-quality breeding stock, professional training, specialized equipment, and marketing.

- **Year 1 (2024).** Eleanor incurs substantial start-up expenses (veterinary care, stud fees, feed, training classes, website development, advertising) totaling \$25,000. Her income from selling a few animals is only \$5,000. She has a net loss of \$20,000.
- **Year 2 (2025).** Eleanor continues to invest and expand. Expenses are \$30,000, and income is \$10,000. The net loss is \$20,000.
- **Year 3 (2026).** Eleanor's expenses are \$28,000, and income is \$15,000. The net loss is \$13,000.

Because Eleanor has incurred losses for three consecutive years (2024, 2025, and 2026), the IRS might begin to question her profit motive and classify Prestige Beef as a hobby, disallowing her accumulated losses from offsetting her software engineering income.

To prevent the IRS from immediately challenging her activity as a hobby, Eleanor should file Form 5213 within three years of the due date of the return for the first tax year in which she engaged in the activity (2024) and incurred a net loss. This means she generally has until April 15, 2028 (assuming no extensions) to file the form for her 2024 activity.

By filing Form 5213, Eleanor is electing to postpone the IRS's determination of whether the presumption of profit applies. The determination will be postponed until the close of the fourth tax year after the tax year she first engaged in the activity. In Eleanor's case, this would postpone the determination until after the close of the 2028 tax year (four years after 2024).

During the postponement period (2024–2028), the IRS will generally not automatically disallow her losses solely based on the “three-of-five-year” profit presumption. This gives Eleanor more time to demonstrate a profit motive through her actions and ultimately, through achieving profitability. She can continue to deduct ordinary and necessary business expenses on her Schedule F in anticipation of the activity eventually becoming profitable.

Example 17. Use the same facts as **Example 16**, except that in Year 4 (2027), Eleanor implements new marketing strategies and sells more animals. For 2027, her expenses are \$25,000 and her income is \$20,000, resulting in a net loss of \$5,000. In Year 5 (2028) Eleanor's efforts pay off. For 2028, her expenses are \$22,000, and her income is \$30,000, generating a net profit of \$8,000.

Because Eleanor's activity, Prestige Beef, generated a profit in Year 5 (2028), she now has one profitable year within the 5-year test period (2024–2028). She would need to show two more profitable years within this period (or in future periods if the activity continues) to meet the “three-of-five-year” presumption. However, even if she does not meet the presumption within the initial period, the IRS will then look at other factors to determine if the activity is engaged in for profit (e.g., how she conducts the activity, her expertise, time and effort, success in similar activities, etc.).

Observation. By filing Form 5213, Eleanor bought herself critical time to establish her profit motive and pursue profitability without immediate IRS scrutiny on the hobby loss rules, allowing her to claim business losses during the initial development phase of her activity.

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Form 5213 Considerations

The following are some considerations taxpayers should weigh when deciding whether to file a Form 5213 to postpone the determination of a hobby loss.

- **Timeliness.** Form 5213 must be filed by the specified deadline (generally within three years of the due date of the return for the first loss year).
- **Waiver of statute of limitations.** Filing Form 5213 extends the statute of limitations for assessment related to the activity.
- **Not a guarantee.** Filing Form 5213 does not guarantee that the activity will ultimately be deemed a for-profit business. It merely postpones the determination based on the profit presumption rule. It remains necessary to demonstrate a genuine profit motive through actions and intent.
- **IRS scrutiny.** While filing Form 5213 postpones the presumption, it can also alert the IRS to a potential hobby loss issue, which might lead to a future audit if the activity does not ultimately become profitable or exhibit other business-like characteristics.

Alternatively, both receipts and expenses may be ignored if expenses exceed receipts, and the farm is an activity not engaged in for profit. Even for activities not engaged in for profit, deductions are allowed for interest, taxes, and casualty losses, under the usual rules, and for other expenses up to the remaining amount of gross income from the activity. The TCJA eliminated these itemized deductions for most taxpayers, and the OBBBA continues the disallowance.¹⁶⁶

9-FACTOR TEST

If the presumption does not resolve the issue of whether a farm is being operated for pleasure or recreation and not as a commercial enterprise, a determination must be made as to whether the taxpayer was conducting the activity with the primary purpose and intention of realizing a profit. The expectation of profit need not be reasonable, but there must be an actual and honest profit objective. Whether the requisite intention to make a profit is present is determined by the **facts and circumstances** of each case with the burden of proof on the farmer or rancher attempting to deduct the losses.¹⁶⁷ To assist in making this determination, the IRS has developed nine factors to determine whether the requisite profit motive exists.¹⁶⁸

1. **How the activity is conducted.** The first IRS factor is concerned with the manner in which the activity is conducted. Is the activity being conducted in a manner that demonstrates that the taxpayer had a business purpose in mind, or is the taxpayer really conducting the activity as would be expected of someone engaged in a hobby? For instance, do the taxpayers keep adequate records and act like they are trying to make money, or are they just having fun?¹⁶⁹ If the activity is conducted in a business-like manner, with accurate and complete records and books of account, the hiring of experienced supervisors or managers, or the seeking of expert advice, a profit motive is more likely to be found.¹⁷⁰ In a 1994 case, one of the factors the court referenced in denying loss deductions for the taxpayer was the lack of a ready market for the taxpayer's product.¹⁷¹

^{166.} *One Big Beautiful Bill Act*, PL 119-21, §70110.

^{167.} See, e.g., *Ryberg v. Comm'r*, TC Summ. Op. 2012-24 (Mar. 12, 2012).

^{168.} Treas. Reg. §1.183-2(b); see also *Wicks v. U.S.*, 304 F.Supp.3d 1079 (N.D. Okla. 2018).

^{169.} While recordkeeping is important to help establish that the business has been conducted in a business-like manner, the records must be utilized in a manner designed to aid the profitability of the business. See, e.g., *Knudsen v. Comm'r*, TC Memo 2007-340 (Nov. 15, 2007) in which business records maintained, but were not used to review and reduce expenses or to enhance possibility of generating income.

^{170.} See, e.g., *Giles v. Comm'r*, TC Memo 2005-28 (Feb. 17, 2005). Activity not conducted in business-like manner and other factors weighed against taxpayer; deductibility of losses denied.

^{171.} *Lombard v. Comm'r*, TC Memo 1994-154 (May 24, 1994), *aff'd* No. 94-2145, 1995 U.S. App. LEXIS 14609 (4th Cir. Jun. 14, 1995).

2. **Taxpayer's expertise.** The second factor analyzes the degree of expertise the taxpayer has. If the taxpayer or an advisor has expertise in the particular agricultural area involved, a profit intent is shown. If, for example, the taxpayer has a small beef herd, the IRS would look at the taxpayer's knowledge about beef breeding or nutrition.
3. **Time expended.** The third factor looks at the amount of time the taxpayer puts into the activity. There is a noted difference between 10 minutes on a weekend versus the taxpayer committing significant time to the operation. Published court opinions span a wide range of taxpayer involvement—from just a few minutes per week to nearly full-time engagement. In instances where a bona fide farmer has been involved, losses are generally deductible unless the taxpayer had made no apparent effort to reduce or eliminate successive losses. Also, sufficient manual labor by the taxpayer may overcome an IRS argument that the taxpayer was engaged in a hobby operation.
4. **Appreciation in value.** The fourth factor reflects the taxpayer's expectation that the assets associated with the operation will increase in value. Expectation of asset appreciation is recognized as an intent to profit overall, even though the farming operation may itself not produce a profit.¹⁷²
5. **Past activities.** The fifth factor examines if the taxpayer has been involved in a loss venture in the past that they turned around into a profitable venture. With respect to this factor, it is appropriate to examine the history of income on all sides of the activity. However, the presence of occasional profits—especially if they are small or infrequent—may not be sufficient to demonstrate a genuine profit motive. The IRS and courts will consider not just whether profits occurred, but also their size, consistency, and whether they reflect a realistic potential for sustained profitability.
6. **History of income or loss.** The sixth factor involves an examination of the history of income or loss from the activity. One famous farm case revealed 30 years of unbroken losses without a single year of profit.¹⁷³ Over time, losses did not become smaller, and income did not increase. While gain on the sale of the real estate was possible, the regulations require sufficient farming income to offset farming and land carrying expenses. Sufficient income was not present in this case and the IRS ruled against the taxpayer. While start-up losses are to be expected in many ventures, continuing losses beyond the period usually required to achieve profitability may indicate a lack of a profit motive. There must be a prospect, not only for earning future profits, but for profits sufficient to offset losses sustained during the early years of operation. A taxpayer's subjective intent must be demonstrated with objective facts, such as comparing the taxpayer's income and loss numbers to comparable neighboring operations.
7. **Amount of profit.** The seventh factor examines the amount of profits earned from the activity. Activities generating large losses that occasionally produce a profit are not necessarily indicative of a profit intent.

¹⁷². See, e.g., *Stromatt v. Comm'r*, TC Summ. Op. 2011-42 (Apr. 6, 2011) in which taxpayers found to be engaged in cattle ranching on 15 acres with actual and honest profit objective such that claimed losses not limited by IRC §183; taxpayers cleared land for use as pasture which bore “economic relationship” with later cattle operation; taxpayers sold hay until property fully ready for cattle grazing; advice of experienced farmer utilized in preparing cattle operation; no recreational aspect to activity present; taxpayers’ activity added value to the property; no lengthy period of time with history of losses present.

¹⁷³. *Tarutis v. Comm'r*, TC Memo 1982-313 (Jun. 7, 1982).

8. **Socioeconomic factors.** The eighth and ninth factors are related. The IRS tries to make a determination as to whether the taxpayers are high income, wealthy individuals (the eighth factor). In general, the higher the outside income, the greater likelihood that a profit motive will not be found. If the taxpayer has sufficient non-farm income to maintain a comfortable standard of living even with the losses from the “farming” activity, the IRS will often deny the losses. If the taxpayers are not only high income and wealthy, but also enjoy what they are doing (the ninth factor), that is near fatal. If a taxpayer derives pleasure or recreational benefits from the activity this factor may not be sufficient to cause the activity to be classified as a hobby, but it might be a significant factor. For example, a physician who has a horse operation that they operate on the weekends for enjoyment will find it extremely difficult to deduct any expenses unless adequate records are kept, and the operation is conducted in a businesslike manner and the activity is stopped when unprofitability becomes clear. However, if the physician hates taking care of the horses, and can show that the activity is not pleasurable, then even in spite of their wealth the physician may be successful in deducting losses. Courts tend to look through the surface of the activity to see whether elements of recreation or pleasure are present. The eighth and ninth factors are important for low-income taxpayers. The IRS will overlook elements of pleasure if the taxpayer is lower income, but if the taxpayer is wealthy, whether they enjoy the activity or not is critical.¹⁷⁴

HOBBY LOSS REGULATIONS AND *CHEVRON* DEFERENCE

In June 2024, the U.S. Supreme Court reversed its decision in 1984 that created what became known as the *Chevron* doctrine. The Court’s decision in *Chevron v. Natural Resources Defense Council*¹⁷⁵ established a principle of judicial deference governing how courts review administrative agency interpretations of statutes that the agency administers.

The *Chevron* doctrine was applied using a 2-step framework. First, a court was to examine whether the statute in question is clear and unambiguous regarding the issue at hand. If Congress’s intent is clear, that intent must be followed, and the court does not need to defer to the agency’s interpretation. This was based on the principle that Congress’s explicit intent takes precedence.

Second, if the statute is ambiguous or silent on the specific issue, the court evaluated whether the agency’s interpretation is reasonable or permissible. If the interpretation is reasonable, courts deferred to the agency’s expertise and judgment. The rationale was that agencies are better equipped to make decisions on complex, technical, or policy-driven matters within their jurisdiction.

Note. The rationale for the doctrine was that agencies often have specialized knowledge and expertise in their respective fields. The doctrine reflected the idea that Congress implicitly delegates decision-making authority to agencies when statutes are ambiguous, and that courts recognized that agencies are more adaptable to changing circumstances and better suited for detailed regulatory policymaking.

For years, the *Chevron* doctrine has been the subject of debate, with arguments both for and against its continued use. Proponents argue that it respects the separation of powers by allowing agencies, rather than courts, to make policy decisions within their expertise. Conversely, critics contend that it gives too much power to unelected administrative agencies, undermining accountability and potentially leading to overreach or arbitrary decision-making. Indeed, statistics show that farmers caught up in the USDA’s administrative process rarely prevail once the matter gets to a court.

¹⁷⁴. See, e.g., *Vallette v. Comm’r*, TC Memo 1996-285 (Jun. 20, 1986) in which losses attributable to cattle breeding activity not deductible; 15 consecutive years of losses coupled with substantial income from non-farm activities over the same period; *Zarins v. Comm’r*, TC Memo 2001-68 (Mar. 21, 2001) in which losses attributable to tree farm not deductible.

¹⁷⁵. *Chevron USA, Inc. v. NRDC*, 467 U.S. 837 (1984).

The Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*,¹⁷⁶ marks a pivotal shift in administrative law by overturning *Chevron* deference. With the *Loper Bright* ruling, courts are now required to independently interpret statutory provisions without defaulting to agency interpretations. The Court ruled that the Administrative Procedure Act (APA) requires courts to review regulations independently, rather than to defer to the agency's interpretation if it is a permissible construction of the statute. However, the Supreme Court did not overturn all deference. It only disregarded the high deference that *Chevron* granted. As a result of the Court's *Loper Bright* decision, the deferential standard that applies to federal administrative agencies reverts to what is known as the *Skidmore* deference which uses the lower standard of granting "respect" to agency decisions.¹⁷⁷ When courts use *Skidmore*'s lower threshold, agencies prevail in cases at a much lower percentage. *Skidmore*'s lower deferential standard allows courts to utilize judicial review to protect afflicted parties' due process rights by weighing an affected parties' due process interest against the government's interest in technocratic independence from the political and legal processes.

Presently, there are several court cases involving the IRS and tax regulations that are being challenged under the lower deferential standard. One of those involves the hobby loss rules.

Schwarz v. Comm'r,¹⁷⁸ involved a challenge to the hobby loss regulations under IRC §183. At issue is Treas. Reg. §1.183-1(d)(1) and Treas. Reg. §1.183-2(b). The Tax Court had previously upheld the IRS's position that the petitioner's farming activities were not conducted with a profit intent. The Tax Court is reconsidering its decision and is determining whether the regulations at issue are valid under the lower deferential standard.

Under the facts of the case, the petitioners had a history of conducting real estate-related activities involving ranchland. Through their controlled entities, the petitioners bought 15,070 acres in 2005 with the intent to improve it and sell it. However, they later decided to establish an ecotourism activity on a portion of the land involving fee-based fishing and hunting and other outdoor events. That activity was conducted by a partnership that they owned which leased the land from their other controlled entities. The partnership also conducted farming and construction operations on the land and other properties that they owned. The partnership filed a Schedule F for every year from 2005 to 2020, reporting income from both the ecotourism activity and the farming/construction operations. The Schedule F income reported for those years exceeded \$14 million, but a loss resulted every year. The losses flowed through to the petitioners which offset significant taxable income.

The IRS issued a notice of deficiency for tax years 2015–2017, determining that the partnership's activity was not engaged in with the requisite profit intent under §183. The IRS also applied a 20% accuracy-related penalty for each year. The petitioners claimed that they were engaged in the Schedule F activity with a profit intent and that the real estate and the partnership's (and related entities) were engaged in a single activity.

The Tax Court determined that the Schedule F activity and the real estate activities were separate and that the Schedule F activity was not engaged in with the intent to make a profit. On whether the activities were separate or should be combined, the Tax Court noted that the factors of Treas. Reg. §1.183-1(d)(1) (which establishes a test for treating farming and the holding of land on which farming occurs as one activity) were relevant and that neither party "came even remotely close to adequately addressing the issue." The Tax Court rejected the petitioners' argument that the regulation was inapplicable because the petitioners' farming expenses contributed to the appreciation of the real estate. The Tax Court determined that no such exception applied and that the factors set forth in the regulation and caselaw favored the IRS.

On the profit intent issue, the Tax Court went through the factors of Treas. Reg. §1.183-2(b) and concluded that most of the factors favored the IRS, particularly noting the long history of losses and lack of profit only permissible by the petitioners' high non-farm income, particularly when the real estate market was strong. Accordingly, the Tax Court determined that the petitioners were not engaged in the farming activity with the intent to make a profit.

¹⁷⁶. *Loper Bright Enterprises v. Raimondo*, 144 U.S. 2244 (2024).

¹⁷⁷. *Skidmore* deference refers to the Supreme Court's opinion in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

¹⁷⁸. *Gary M. and Marlee Schwarz v. Comm'r*, TC Memo 2024-55 (May 13, 2024).

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As for the accuracy-related penalties, the Tax Court noted that the petitioners' CPA did advise them during the tax years in issue and the petitioners relied in good faith on him as an experienced CPA. As such, the Tax Court held that the accuracy-related penalties did not apply for the tax years at issue.

Note. This case involved large-scale revenues and losses associated with activities that involved the petitioners' personal interests and who also had high income derived from other sources. The petitioners' books and records were inadequate, and their business plans were not well developed. The lawyering in the case was also deficient. Indeed, the Tax Court stated, "Many facts stipulated, alleged, argued, testified about, and otherwise presented to the Court in this case are, or appear to be, incorrect or misleading. The parties' work occasionally reflected an uninspired attitude toward developing, trying, and briefing this case. As a result, many potentially relevant facts and arguments were undeveloped, ignored, misrepresented, and/or missed." The Tax Court was also critical of the credibility of expert witness reports offered in the case, as well of the credibility of the petitioners.

Observation. The case is a poignant illustration that tax professionals must provide an honest assessment to the client of the client's credibility as well as the credibility of experts that the client will utilize.

On August 7, 2024, the IRS entered its computation for entry of decision to which the Tax Court ordered the petitioners to file a response by September 11, 2024. Instead, on September 11, the petitioners filed an objection to the computation for entry of decision to which the Tax Court ordered the IRS to respond by September 26. On September 16, the petitioners filed a motion for reconsideration of the Tax Court's findings which the Tax Court granted on September 17 and ordered the IRS to respond by October 1, which was later changed to November 1. On September 26, the IRS filed its response to the petitioner's objection to the computation for entry of decision. In an order entered on November 5 in the *Schwarz* case, the Tax Court granted the taxpayers' motion for reconsideration of the factual findings in the case. The Tax Court ordered the parties to file responses by February 14, 2025, to the order arguing whether Treas. Reg. §§1.183-1(d)(1) and 1.183-2(b) are valid or not in light of the Supreme Court's opinion in *Loper Bright Enterprises, et al. v. Raimondo* which repealed the *Chevron* doctrine.

CORPORATE REDEMPTIONS

The redemption of C corporation stock can result in favorable capital gains tax treatment for shareholders, rather than being taxed as ordinary dividend income. However, navigating the complex rules of the Code is crucial for proper planning to achieve this outcome. Missteps can lead to significantly higher tax liabilities.

GENERAL RULES

At its core, a stock redemption occurs when a corporation acquires its own shares from a shareholder in exchange for cash or other property. The tax treatment to the shareholder depends critically on whether the redemption is treated as a sale or exchange of the stock (resulting in capital gain or loss)¹⁷⁹ or as a distribution.¹⁸⁰

¹⁷⁹ IRC §302. A redemption will be treated as a sale or exchange under IRC §302 if it meets one of the following tests: (1) not essentially equivalent to a dividend (§302(b)(1)); (2) substantially disproportionate redemption (§302(b)(2)); (3) complete termination of interest (§302(b)(3)); or (4) redemption from non-corporate shareholders in partial liquidations (§302(b)(4)).

¹⁸⁰ IRC §301.

Generally, a C corporation's distribution to a shareholder is treated as a dividend to the extent of its earnings and profits (E&P).¹⁸¹ Only after E&P is exhausted does the distribution first reduce the shareholder's stock basis and then generate capital gain. The key advantage of capital gains treatment is the ability to offset the redemption proceeds with the shareholder's basis in the redeemed stock, effectively taxing only the **gain**, not the entire distribution. Capital losses from other sources can offset capital gains, and additionally up to \$3,000 per year for individuals against ordinary income. While qualified dividends and long-term capital gains often share similar federal tax rates for high-income taxpayers (currently up to 23.8%, including the net investment income tax (NIIT¹⁸²)), **the ability to recover basis and utilize capital losses makes sale or exchange treatment generally more favorable.**

The Code provides specific exceptions under IRC §302(b) that allow a redemption to be treated as a sale or exchange.

1. **Redemption not essentially equivalent to a dividend.**¹⁸³ This is a facts-and-circumstances test requiring a meaningful reduction in the shareholder's proportionate interest in the corporation. It is often the most subjective and difficult to prove.
2. **Substantially disproportionate redemption.**¹⁸⁴ This is a bright-line test and often the preferred method for planning. To qualify under this exception the following must be satisfied.
 - ♦ Immediately after the redemption, the shareholder must own less than 50% of the total combined voting power of all classes of stock entitled to vote.
 - ♦ The shareholder's percentage of voting stock after the redemption must be less than 50% of their percentage of voting stock owned immediately before the redemption.
 - ♦ The shareholder's percentage of common stock (whether voting or non-voting) after the redemption must be less than 80% of their percentage of common stock owned immediately before the redemption.
3. **Complete termination of a shareholder's interest.**¹⁸⁵ This is the clearest path to sale or exchange treatment. The shareholder must completely divest themselves of all stock in the corporation, both directly and constructively. A crucial exception to the family attribution rules¹⁸⁶ (known as the **waiver of attribution**)¹⁸⁷ allows family members' ownership to be disregarded if certain conditions are met, including the redeemed shareholder having no interest in the corporation (other than as a creditor) immediately after the redemption and not acquiring any such interest (except by bequest or inheritance) within 10 years from the date of the redemption.
4. **Partial liquidation.**¹⁸⁸ This applies to non-corporate shareholders where the distribution is part of a genuine contraction of the corporation's business. This is determined at the corporate level, not the shareholder level, and does not require a proportionate reduction in ownership.

Generally, a corporation does not recognize gain or loss on the redemption of its own stock. However, if the corporation uses appreciated property (e.g., a piece of farm equipment or land that has increased in value) to redeem the stock, the corporation would recognize gain as if it sold the property at FMV.¹⁸⁹

¹⁸¹. See, e.g., *Zenz v. Quinlivan*, 150 F.2d 493 (6th Cir. 1954).

¹⁸². IRC §1411.

¹⁸³. IRC §302(b)(1).

¹⁸⁴. IRC §302(b)(2).

¹⁸⁵. IRC §302(b)(3).

¹⁸⁶. IRC §318(a).

¹⁸⁷. IRC §302(c)(2).

¹⁸⁸. IRC §302(b)(4).

¹⁸⁹. IRC §311(b)(1).

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Example 18. Greenfield Farms, Inc. is a family-owned farm corporation. Alan owns 40% of the stock and his daughter, Teresa, owns 60% of the stock. Alan wants to retire and sell all his stock in the corporation back to Greenfield Farms, Inc. in a redemption. Greenfield redeems all of John's 40% interest.

Even after the redemption, under §318(a)(1), Alan is still deemed to own Teresa's 60% because she is his daughter. As such, he is deemed to still own stock, which means it is not a complete termination unless the attribution is waived.

Alan may waive the family attribution if:

1. He retains no interest in the corporation, other than as a creditor (i.e., he does not hold stock, options, or participate in corporate affairs);
2. He files a signed statement with the tax return (Form 1120, *U.S. Corporation Income Tax Return*) agreeing to notify the IRS if he reacquires an interest in the corporation within 10 years; and
3. He does not acquire any interest for 10 years, except by inheritance.

Assuming Alan meets these requirements, the result is that the family attribution of Teresa's stock is waived and Alan is treated as owning no stock after the redemption. Thus, the redemption qualifies as a complete termination under §302(b)(3) and is taxed as a sale or exchange (capital gain or loss treatment), not as a dividend.

Tips for Proper Planning

Practitioners should consider the following tips when having conversations with clients regarding corporate redemptions.

- **Understand shareholder goals.** Before any redemption, practitioners should clearly define the shareholder's objectives such as whether they are exiting the business entirely, reducing their stake, or planning for retirement. The answers to these questions will guide the choice of redemption strategy.
- **Detailed ownership analysis.** Practitioners should meticulously determine the direct and, critically, **constructive** ownership percentages for all shareholders before and after the proposed redemption. This is paramount for meeting the §§302(b)(2) and (b)(3) tests.
- **Review corporate documents.** Practitioners should examine the corporate bylaws, shareholder agreements, and any existing buy-sell agreements. These documents may contain provisions that affect the redemption process and tax outcomes.
- **Assess E&P.** Practitioners should determine the corporation's current and accumulated E&P. High E&P increases the risk of dividend treatment if a §302(b) exception is not met.

Current E&P is determined by adjusting the corporation's taxable income for items treated differently under E&P rules. To determine current E&P, tax-exempt income (e.g., municipal bond interest) is added back to the corporation's taxable income. Non-deductible expenses (e.g., federal income taxes paid) are then subtracted. Then, an adjustment for depreciation is made. E&P uses straight-line depreciation instead of accelerated tax depreciation. An accounting also needs to be made for deferred income such as installment sales. Finally, other adjustments such as charitable contributions that exceed tax limits need to be accounted for.¹⁹⁰

Accumulated E&P is the sum of prior years' E&P, adjusted for distributions and other transactions. To compute accumulated E&P, the current E&P (if positive) is added to the prior year's accumulated E&P. Dividends paid are then subtracted and lastly, prior-year corrections (such as from tax audits or restatements) are accounted for.

¹⁹⁰. Treas. Reg. §1.312-6.

- **Consider timing.** Tax rates can change. The current favorable tax rates for qualified dividends and long-term capital gains might not last indefinitely. Strategic timing can lock in favorable rates.
- **Document everything.** Practitioners and taxpayers should maintain thorough documentation of the redemption plan, corporate resolutions, and any related agreements. This is vital for substantiating the tax treatment to the IRS.

Traps to Avoid

Similarly, there are several traps to be aware of before entering into a corporate redemption.

- **Constructive ownership rules.**¹⁹¹ As mentioned previously, for purposes of IRC §§302 and 303, a shareholder is deemed to own not only stock they directly hold but also stock owned by certain family members (spouse, children, grandchildren, parents), partnerships, estates, trusts, and corporations in which they have an interest. Failing to account for these attribution rules can cause a redemption that appears to terminate a shareholder's interest to be treated as a dividend because they are still considered to own stock constructively.

The family attribution rules can be waived for a complete termination under §302(b)(3), but specific conditions must be met, including a 10-year look-back/look-forward rule.

- **Insufficient basis.** If a shareholder has a very low or zero basis in their stock (e.g., founders who received stock at incorporation for minimal cost), even capital gain treatment can result in a significant tax liability if the redemption price is high.
- **Accumulated earnings tax.** If a C corporation accumulates earnings beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax. Funding a redemption solely from accumulated earnings, without a valid business purpose, could raise this concern.
- **State law restrictions.** State corporate laws often have restrictions on redemptions, such as requiring sufficient surplus or retained earnings to fund the repurchase. Non-compliance with state law can invalidate the redemption.
- **Improper valuation.** The redemption price should reflect the FMV of the stock. Improper valuation can lead to gift tax issues (if below FMV, especially in family situations) or challenges from the IRS.
- **Debt-financed redemptions.** While common, using corporate debt to finance a redemption requires careful consideration. The interest deductibility on such debt can be complex, and the corporation's ability to service the debt is crucial.

Example 19. Golden Acres Farm, Inc. is a C corporation that has been operating since being formed in 1985. The shares are currently owned as follows.

- Thomas (Father): 500 shares (50% of outstanding voting common stock)
- Stella (Mother): 500 shares (50% of outstanding voting common stock)
- David (Son): 0 shares
- Emily (Daughter): 0 shares

Thomas and Stella are ready to retire and want to transition the farm entirely to their son, David, who has been actively involved in the farm operations for the past 15 years. Emily has a career off the farm and no interest in ownership. Thomas and Stella want to receive a fair value for their shares to fund their retirement, and they want this to be treated as a capital gain for tax purposes.

¹⁹¹. IRC §318.

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Together with their tax advisor and in consultation with their lawyer, they craft the following plan. Golden Acres Farm, Inc., will redeem all 1,000 shares owned by Thomas and Stella for cash and a promissory note. The total redemption price is determined by an independent appraisal of the farm's FMV, less a discount for lack of marketability, resulting in a value of \$2 million. Immediately after the redemption, David will purchase a nominal number of shares from the corporation or receive them as a gift from his parents **before** the redemption is finalized (though this is less common with complete termination via redemption). To ensure the redemption qualifies as a complete termination for Thomas and Stella, they will execute an agreement with the IRS, waiving the family attribution rules under §302(c)(2).

Golden Acres Farm, Inc., pays Thomas and Stella \$2 million for their 1,000 shares. The corporation uses a combination of available cash and a long-term promissory note to finance the redemption. The corporation then issues 100 new shares to David. The following table compares the ownership of Golden Acres before and after the corporate redemption.

Shareholder	Before Redemption	After Redemption (Pre-David's Ownership)	After David's Acquisition (Final Structure)
Thomas (father)	500 shares (50% ownership)	0 shares (0% ownership)	0 shares (0% ownership)
Stella (mother)	500 shares (50% ownership)	0 shares (0% ownership)	0 shares (0% ownership)
David (son)	0 shares (0% ownership)	0 shares (corporation is essentially 100% owned by the corporation itself, temporarily)	100 shares (100% ownership)
Emily (daughter)	0 shares (0% ownership)	0 shares (0% ownership)	0 shares (0% ownership)
Total outstanding shares	1,000 shares	0 shares (this is a temporary state before David's shares are issued/acquired)	100 shares

Because Thomas and Stella's entire stock interest in Golden Acres Farm, Inc. is terminated, and they properly waive the family attribution rules (agreeing not to acquire any interest in the corporation for 10 years, other than as a creditor), the redemption qualifies as a sale or exchange under §302(b)(3).

Thomas and Stella's combined basis in their 1,000 shares was \$100,000 (e.g., original investment plus any capital contributions over the years) and they received redemption proceeds of \$2 million. Therefore, they have a capital gain of \$1.9 million (\$2 million redemption proceeds – \$100,000 basis.)

Observation. If the payment is a dividend, the stock basis provides no tax savings. If the payment is a stock redemption, the stock basis would save \$20,000 ($\$100,000 \times 20\%$).

This \$1.9 million gain will be taxed at the favorable long-term capital gains rates (assuming they held the stock for more than one year). They can also use their basis to offset the proceeds, reducing the taxable amount compared to dividend treatment. If paid over time via a promissory note, they may be able to report the gain using the installment method, spreading the tax liability over several years as payments are received. If other capital losses exist or arise, these could also offset gain from the stock redemption.

Because cash and a promissory note are used in the corporate redemption, Golden Acres does not recognize a gain on the redemption itself.

The family should consider the following issues and traps to avoid.

- **Family attribution waiver.**¹⁹² David will continue to operate the farm (and thus own shares). Thomas and Stella **must** formally waive attribution. They cannot hold any interest in the corporation (other than as a creditor) for 10 years after the redemption. This means no consulting agreements, no director positions, and no direct or indirect ownership.
- **Promissory note.** The promissory note received by Thomas and Stella is allowed as a creditor interest. However, the terms of the note must be commercially reasonable (fair interest rate, payment schedule) to avoid being reclassified as an equity interest, which would violate the “no interest” rule and jeopardize the capital gain treatment.
- **E&P.** If this redemption were treated as a dividend (e.g., if the complete termination rules were not met), the entire \$2 million (to the extent of the corporation’s E&P) would be taxed as **ordinary dividend income**, with no basis recovery. This would be a worse tax outcome.
- **Valuation.** An independent appraisal is critical to establish the FMV of the shares and avoid IRS challenges regarding the redemption price.
- **Corporate liquidity.** The farm corporation must have sufficient cash flow or the ability to secure financing to make the redemption payments without jeopardizing its ongoing operations.
- **Succession planning.** This redemption allows for a clear transfer of ownership and control to the next generation, a common goal in family farm operations.

POST-DEATH REDEMPTIONS

For redemptions occurring post-death, §303 provides for capital gains treatment for redemptions of stock included in a deceased shareholder’s gross estate. The technique can be used to pay federal estate taxes as well as funeral and administrative expenses. This can be a powerful tool for estate planning for closely held businesses such as a farming business.

To qualify for capital gain treatment under §303 for redemptions made to pay estate taxes and related expenses, the stock and redemption must meet the following qualifications.

1. Stock must be included in the decedent’s gross estate.
2. The value of the stock must exceed 35% of the decedent’s adjusted gross estate.
3. The redemption must be used to pay:
 - Federal estate taxes,
 - State death taxes,
 - Funeral expenses, or
 - Administration expenses.
4. The redemption must occur within the time limits specified in the statute, and additional requirements apply if the redemption occurs more than four years after the decedent’s death.

¹⁹². IRC §302(c)(2).

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5. The tax treatment is as follows.

- If the redemption qualifies, it is treated as a sale or exchange (capital gain treatment).
- If it does not qualify, it may be treated as a dividend to the extent of the corporation's E&P, which is generally less favorable.

Example 20. Robert owned a closely held farming corporation during his life. Upon his death, his estate included \$3 million worth of corporate stock, which exceeded 35% of his adjusted gross estate. His estate faces \$800,000 in federal and state estate taxes, funeral expenses, and administration costs.

To cover these costs without forcing the sale of farmland or equipment, the corporation redeems a portion of the stock owned by the estate. The corporation buys back \$800,000 worth of stock from the estate, providing liquidity to pay estate obligations while ensuring the farm remains operational. Since this redemption qualifies under §303, it is treated as a sale (capital gain treatment) rather than a dividend, meaning the estate benefits from capital gains tax treatment instead of higher ordinary income tax rates.¹⁹³

Observation. A corporate redemption under §303 is a strategy that can be used to preserve the farm for Robert's heirs while efficiently handling estate taxes. The technique can be used to prevent financial strain on their estates and maintain family-owned operations.

If the stock owned by an estate had received a stepped-up basis under IRC §1014, the redemption strategy could result in near zero taxable gain. If the transaction is characterized as a dividend, there is no benefit from the stepped-up basis.

Example 21. A shareholder, Daniel Lane, passed away in 2025 owning stock in Cedar Ridge Ag, Inc., a closely held farming corporation. At the time of his death, the stock was worth \$100,000, and the estate received a stepped-up basis to that value under §1014.

To help cover estate expenses, Cedar Ridge Ag redeemed the stock from Robert's estate for \$100,000. Because the redemption qualified under §303, it was treated as a sale or exchange rather than a dividend.

Because the estate's basis in the redeemed stock was also \$100,000, no gain was recognized, and no tax was owed on the transaction.

Had the redemption been treated as a dividend, the estate would have paid \$23,800 in tax (assuming a 23.8% effective rate). The redemption strategy saved the estate that amount and preserved liquidity for other obligations.

PURCHASE VERSUS LEASING FARM EQUIPMENT

The decision to lease or buy farm equipment is important, with potential impacts on a farmer's bottom line. Historically, the traditional approach has been to buy farm equipment, but leasing offers an alternate financing approach. Understanding how leasing works — and the income tax implications that come with it — is vital for farmers seeking to make well-informed decisions that support their operational efficiency and long-term financial strategy.

Leasing, as an alternative to buying, provides certain benefits. Some major benefits include lower upfront costs which allow more funds to be used in other aspects of the farming business, the ability to use newer equipment and the associated technology sooner, fixed leased payments which can help with budgeting and cash flow, flexibility in deciding whether to continue with the same piece of equipment at the end of the lease term or changing to a different model, minimization of maintenance issues, and potential tax advantages.

¹⁹³. The redemption will cause the corporation to reduce its outstanding shares which could potentially shift the ownership structure and the remaining shareholders gaining greater control of the corporation.

The tax treatment of lease payments differs significantly between operating leases and capital leases, impacting a farmer's taxable income and overall financial picture.

CAPITAL LEASE

A capital lease is a lease in which the only thing that the lessor does is finance the “leased” asset, and all other rights of ownership transfer to the lessee.¹⁹⁴ The asset is the lessee's property and, for accounting purposes, is recorded as such in the lessee's general ledger as a fixed asset.

Note. While there is no single Code section that defines a capital lease, the treatment of such leases for tax purposes depends on whether the lease is a true lease (operating lease) or a finance lease (capital lease in accounting). If it is the latter, the asset is treated as owned by the lessee, and tax treatment follows depreciation rules rather than rental deductions.¹⁹⁵

A transaction that is a capital lease has one of the following features.¹⁹⁶

- Ownership of the asset shifted from the lessor by the end of the lease period
- The lessee can buy the asset from the lessor at the end of the lease term for a below-market price (i.e., that the lessee is reasonably expected to exercise)
- The lease term is at least 75% of the estimated economic life of the asset (and the lease cannot be canceled during that time)
- The value of the minimum lease payments (discounted to present value) required under the lease equals or exceeds 90% of the fair value of the asset at the time the lease is entered into
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

For a capital lease, the present value of all lease payments is considered to be the asset's cost which, as noted previously, the lessee records as a fixed asset, with an offsetting credit to a capital lease liability account.¹⁹⁷ For accounting purposes, as each lease payment is made, the lessee records a combined reduction in the capital lease liability account and a charge to interest expense. The lessee records a periodic depreciation charge to gradually reduce the carrying amount of the fixed asset in its accounting records.

The lessor has revenue equal to the present value of the future cash flows from the lease, and records the expenses associated with the lease. For the lessor, a lease receivable is recorded on the lessor's balance sheet and recognizes the interest income as it is paid. If none of the previously listed factors can be satisfied, the transaction is an **operating lease**. In that event, the lessee is able to deduct the lease payment as a business expense and the leased asset is not treated as an asset of the lessee.

Note. Until late 2019, all operating leases were effectively “tax leases.” But, as of the Financial Accounting Standards Board (FASB) rule change in December 2019, an operating lease that lasts longer than one year requires the lessor to account for the leased asset(s) on its own balance sheet. Because of this, operating leases that last longer than a year are not tax leases. The reason for the FASB rule change is that many companies were gaming the system to keep assets off their books. Before the rule change, only capital leases had to be recognized on the lessee's balance sheet.

¹⁹⁴. A capital lease is, therefore, often referred to as a finance lease.

¹⁹⁵. See, e.g., Rev. Rul. 55-540, 1955-2 CB 39.

¹⁹⁶. FASB ASC Topic 842-10-25-2.

¹⁹⁷. Ibid.

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For tax purposes, a capital lease is treated more like a purchase financed by a loan.¹⁹⁸ The farmer, as the deemed owner for tax purposes, can claim depreciation deductions on the leased equipment over its applicable recovery period (typically five or seven years). In addition, a portion of each lease payment under a capital lease is treated as interest expense and is deductible as such. The remaining portion represents the principal payment. The lease agreement often specifies the interest rate and the allocation between principal and interest. Also, the lessee can claim §179 (expense method depreciation) and bonus depreciation subject to the usual limitations and requirements. This can provide a significant tax advantage in the year the equipment is placed in service.

Note. If the transaction is a capital lease, the full lease payment is not deductible as an operating expense. Instead, the farmer deducts depreciation and the interest portion of the payment.¹⁹⁹

Compared to the immediate deduction of operating lease payments, the combination of regular depreciation and interest expense deductions under a capital lease may result in lower deductions in the initial years.

If the farmer exercises a purchase option at the end of a capital lease and subsequently sells the equipment, the tax implications would be similar to selling equipment that was originally purchased.

OPERATING LEASE²⁰⁰

With an **operating lease**, the asset owner (lessor) transfers only the right to use the property to the farmer. Ownership is not transferred as it is with a capital lease, and possession of the property reverts to the lessor at the end of the lease term. The farmer deducts the full lease payment and there is no impact on the farmer's balance sheet. Generally, the §179 expense method depreciation and bonus depreciation are not applicable to leased property under an operating lease because the farmer does not own the equipment.

Because the farmer does not own the equipment under an operating lease, the sale or trade-in of the leased asset is typically not a concern for the lessee. The equipment is simply returned to the leasing company at the end of the lease term.

Caution. Operating leases may not be reported on a lessee's financial statements, which could provide a misleading picture of the lessee's finances.

TAX PLANNING CONSIDERATIONS

The decision to lease or buy farm equipment should be made after careful consideration of various factors, including the farm's financial situation, cash flow needs, tax objectives, and operational requirements. If preserving cash flow is a priority, an operating lease with lower upfront costs and predictable payments might be more attractive. Also, the immediate deductibility of operating lease payments can be beneficial for reducing taxable income in the short term. However, the long-term tax advantages of ownership through depreciation and potential §179 and bonus depreciation under a capital lease should also be considered.

Farmers with a high taxable income might prefer a capital lease with §179 and bonus depreciation to offset that income quickly. Those with lower or fluctuating income might prefer the consistent deduction of an operating lease. If tax rates are expected to decrease, accelerating deductions into the current year (via a capital lease and depreciation) can be advantageous. If rates are expected to increase, deferring deductions might be better. While less common now for many farmers, historically, large depreciation deductions could trigger AMT, which could reduce the benefit. The equipment must be primarily for business use to qualify for these deductions.²⁰¹

¹⁹⁸. Under Treas. Reg. §1.162-11(b), if the lease is in substance a conditional sales contract, the lessee cannot deduct the rental payments but must capitalize and depreciate the asset.

¹⁹⁹. Ibid.

²⁰⁰. Rev. Rul. 55-540, 1955-2 CB 39.

²⁰¹. IRC §167(a).

Regardless of whether equipment is leased under an operating or capital lease, meticulous record-keeping is essential for tax purposes. This includes maintaining copies of the lease agreement, payment schedules, and any related documentation. For capital leases, tracking depreciation and interest deductions is crucial.

Farm equipment leasing presents a compelling alternative to outright purchase, offering potential benefits such as lower upfront costs, access to newer technology, and predictable expenses. This is particularly the case for a farmer that frequently upgrades equipment or uses equipment for a relatively short period, as leasing can mitigate the risks associated with ownership and depreciation.

Example 22. Brady needs a different tractor for his 500-acre corn and soybean operation. The tractor he is considering costs \$300,000. Brady is trying to decide between buying it outright or leasing it. He is exploring two types of leases: a capital lease and an operating lease.

Option 1. Purchase. If Brady buys the tractor, he would likely take out a loan. He would own the tractor and be responsible for all maintenance, repairs, and insurance.

Option 2. Capital lease. If the lease agreement for Brady's tractor states he has an option to buy the tractor at the end of the 7-year lease term for a nominal fee of \$1, this would likely qualify as a bargain purchase option, making it a **capital lease**. This is reported for tax purposes the same as a purchase.

Another option is a 9-year lease for a tractor with a 10-year useful life (90% of useful life), which would be treated like a financed purchase. Brady is considered to have effectively acquired the asset and its associated debt.

Option 3. Operating lease. The lease agreement for Brady's tractor could be for three years, with no purchase option, and the tractor is returned to the leasing company at the end of the term. The lessor (leasing company) retains the risks and rewards of ownership.

Brady first analyzes the **income tax differences** between the two lease options.

- Under the **capital lease**, Brady treats the tractor as if he purchased it. This means Brady can deduct depreciation, including any §179 and bonus expense, which provides a large upfront tax benefit. Additionally, Brady can deduct the interest portion of the lease payment. The tractor is listed on Brady's balance sheet as an asset along with the corresponding lease obligation as liability. This can impact his debt-to-asset ratio.
- Under the **operating lease**, Brady can deduct the **entire** lease payment as a business expense in the year it is incurred. This provides a simpler and often more immediate deduction compared to depreciation and interest. The tractor generally does not appear on Brady's tax basis balance sheet, and there is no corresponding debt from the lease itself. This can make his farm's financial ratios (like debt-to-asset) appear stronger than facts represent.

Brady then analyzes the overall financial and operational considerations of his options.

- The following favor a capital lease (or purchase).
 - ♦ **Long-term ownership and equity.** If Brady intends to keep the tractor for its full useful life and wants to build equity in his assets, a capital lease (leading to ownership) or outright purchase is better.
 - ♦ **Depreciation benefits (especially with §179 and bonus depreciation).** If Brady has high taxable income and can utilize §179 or bonus depreciation, purchasing or a capital lease can provide a substantial upfront tax deduction, potentially more than the annual operating lease payment.
 - ♦ **Control and customization.** Owning the tractor (or effectively owning it through a capital lease) gives Brady full control over its use, modifications, and eventual disposition.

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- ♦ **Total cost.** Over the long term, the total cost of an operating lease can sometimes exceed the cost of purchasing, especially if Brady has a practice of continuously leasing new equipment.
- ♦ **Current taxable income and future projections.** If Brady anticipates high profits in the current year, the immediate and larger deduction from §179 and bonus depreciation on a purchased or capital-leased tractor might be more beneficial than the ongoing operating lease payments.
- ♦ **Desire for ownership.** If Brady wants to own the asset and build equity, he should lean towards a capital lease.
- ♦ **Useful life versus lease term.** If Brady plans to use the tractor for nearly its entire useful life, a capital lease or purchase makes more sense.
- The following favor an operating lease.
 - ♦ **Immediate tax benefit.** If Brady needs to reduce his taxable income significantly in the current year, the ability to deduct the full lease payment as an operating expense with an operating lease can be very attractive. This simplifies tax preparation.
 - ♦ **Cash flow.** Operating leases may have lower payments than loan payments for a purchase, freeing up cash flow. If preserving cash is paramount, the lower and potentially seasonal payments of an operating lease could be ideal.
 - ♦ **Flexibility and obsolescence.** If technology in tractors is advancing rapidly, an operating lease allows Brady to regularly upgrade to newer, more efficient equipment without the hassle of selling old machinery. He avoids the risk of the tractor becoming obsolete.
 - ♦ **Off-balance sheet (for some purposes).** While accounting rules have changed, the tax treatment of an operating lease can still be beneficial for financial ratios if he is seeking other loans.
 - ♦ **Maintenance.** Often, with an operating lease, major maintenance and repairs are the responsibility of the lessor, reducing Brady's unexpected costs.
 - ♦ **Current taxable income and future projections.** If Brady's income is volatile or he prefers consistent, predictable deductions, the operating lease might be better.
 - ♦ **Desire for ownership.** Is Brady simply interested in having access to the latest technology without the burdens of ownership via an operating lease?
 - ♦ **Useful life versus lease term.** If Brady wants to cycle through equipment every few years, an operating lease offers more flexibility.

Caution. Some leases begin with the trade-in of equipment that is owned by the taxpayer as the downpayment on the lease. These situations require further analysis as the trade-in may result in taxable gain with only a portion of the trade-in value available as a deduction in that year as a lease payment.

Brady now starts crunching numbers to help make his decision. The cost of the used tractor is \$300,000. Its estimated useful life is 10 years. Tractors typically fall under 5-year (new) or 7-year (used) property. Brady assumes 7-year MACRS property for his calculations.

Brady has a combined federal and state income tax rate of 25%, and an incremental borrowing rate of 6% for calculating interest expense.

Brady first runs a tax analysis on a **capital lease**. Assuming a 7-year capital lease with monthly payments, the \$300,000 "cost" of the tractor would be amortized over the lease term, with an implicit interest rate.

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Assume the lease terms result in an effective annual interest rate of 6% and a 7-year (84 month) lease term, with a bargain purchase option of \$1 at the end. The initial recorded value of the asset and liability is the FMV of \$300,000. Using a loan amortization formula (or an online calculator), for a \$300,000 loan at 6% annual interest over seven years (84 months), an excerpt of the monthly payments is shown in the following table.

Month	Beginning Balance	Interest Expense (6% ÷ 12)	Principal Payment	Ending Balance
1	\$300,000.00	\$1,500.00	\$2,842.00	\$297,158.00
2	297,158.00	1,485.79	2,856.21	294,301.79
...	...	...	...	...
84	4,319.46	21.60	4,320.46	0.00

For the first month, Brady's payment is approximately \$4,342 (\$1,500 interest + \$2,842 principal). For tax purposes, Brady gets to deduct the **interest portion** of the lease payments. The total interest paid in the first year (12 payments) from the monthly payment schedule is approximately \$17,215 (this value will gradually decrease each year as principal is paid down).

Additionally, under a capital lease, Brady can deduct depreciation expense. He compares the tax benefits between no accelerated depreciation and claiming §179 and bonus depreciation.

- **No accelerated depreciation**
 - ♦ Regular MACRS Depreciation (7-year property, half-year convention, 14.29% Year 1 MACRS rate):
 - ♦ Year 1 regular depreciation: $\$300,000 \times 14.29\% = \$42,870$
- **§179 expensing or 100% bonus depreciation**
 - ♦ Because the \$300,000 tractor is Brady's only capital purchase during 2025 and it is less than the maximum §179 deduction for 2025 of \$2.5 million, Brady can deduct the entire amount. Regardless of whether he selects §179 or bonus, Brady takes the full **\$300,000** in Year 1 and has no remaining basis to depreciate in future years.

If Brady takes no accelerated depreciation, his tax savings with the capital lease in Year 1 is **\$15,021** ($(\$42,870 \text{ depreciation} + \$17,215 \text{ interest}) \times 25\% \text{ tax rate}$).

If Brady claims §179 expensing or 100% bonus depreciation, his tax savings with the capital lease in Year 1 is **\$79,304** ($(\$300,000 \text{ accelerated depreciation} + \$17,215 \text{ interest}) \times 25\% \text{ tax rate}$).

Example 23. Use the same facts as **Example 22**, except Brady decides to use an **operating lease** to acquire the tractor. Brady does not own the tractor, and the lessor (leasing company) retains ownership. As an operating lease, there is not a direct principal/interest breakdown for the lessee. The payment is simply a rent payment.

Brady signs a 3-year operating lease. The lessor factors in the original cost of \$300,000, the expected residual value after three years of \$150,000, the lessor's implicit interest rate (their desired return), and maintenance, insurance, and other costs (which might be included or separate) to calculate a monthly operating lease payment of \$3,500.

Note. A common way to conceptualize this is that the lease payments cover the depreciation of the asset during the lease term plus a financing charge.

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On Brady's tax return, he reports the entire operating lease payment as deductible business rent expense. In Year 1 (as well as Years 2 and 3), Brady claims \$42,000 (\$3,500 monthly payment $\times$ 12 months). With the operating lease, Brady has tax savings of \$10,500 (\$42,000 $\times$ 25% tax rate.)

Note. The **lessor**, not Brady, would claim depreciation (including §179 or bonus depreciation) on the tractor for their tax purposes.

The following table compares the first-year tax impact.

Feature	Capital (No Accelerated Depreciation)	Capital Lease (\$179 or 100% Bonus)	Operating Lease
Initial cost	\$300,000 (tractor)	\$300,000 (tractor)	\$0 (initial payment)
Year 1 deduction	\$60,085 (\$42,870 depreciation + \$17,215 interest)	\$317,215 (\$300,000 full expensing + \$17,215 interest)	\$42,000 (rent expense)
Year 1 tax savings	\$15,021	\$79,304	\$10,500
Future deductions	Remaining MACRS depreciation and decreasing interest	Decreasing interest (no more depreciation)	\$42,000 per year (rent expense)
Ownership	Yes (at end of lease via bargain option)	Yes (at end of lease via bargain option)	No (return to lessor)
Balance sheet impact	Asset and liability recorded	Asset and liability recorded	Right-of-use asset and lease liability (for financial reporting, not tax ownership)

Brady comes to the following conclusions after reviewing his analysis.

- If Brady has substantial taxable income in the current year, the **capital lease with §179 or 100% bonus expensing** offers the largest immediate tax deduction (\$317,215), leading to the highest immediate tax savings (\$79,304). This is a powerful incentive if he wants to significantly reduce his tax bill now.
- The **operating lease** provides a consistent, annual deduction of the full lease payment (\$42,000). While this is a smaller upfront deduction compared to the capital lease options with accelerated depreciation, it offers simplicity and predictability. This might be preferred if Brady's taxable income fluctuates, or he does not want the complexity of tracking depreciation schedules. It also avoids the depreciation recapture issues if the asset is disposed later.
- The operating lease generally has lower monthly payments, which helps cash flow, but the total tax deduction over the life of the asset is often lower (as Brady does not get to deduct the initial cost of the asset through depreciation). A capital lease (or purchase) might have higher monthly payments, but the ability to take large depreciation deductions can offset that cash outflow with significant tax savings.
- A **net present value analysis** may also be helpful to measure the financial benefits related to the timing of tax savings from the current year over future years.

OBBBA AGRICULTURAL ISSUES

Title I, Subtitles C, D, E, and F of the OBBBA primarily focus on agricultural commodities, disaster assistance, and crop insurance. These provisions collectively represent a substantial federal investment in the agricultural sector, estimated to include over \$65 billion with \$52.3 billion specifically tied to enhancing the farm safety net. These Subtitles cover critical aspects such as effective prices, base acres, program elections, price loss mechanisms, marketing loans, and updates specific to the dairy, sugar, and textile industries, alongside improvements to income and eligibility caps.

SUBTITLE C — COMMODITIES

This Subtitle revises numerous farm commodity programs by adjusting effective payment rates, base acreage calculations, price-loss coverage (PLC) options, and marketing loan rules. It also updates dairy, sugar, and textile assistance provisions. The policy goal is to refine crop income supports and eligibility thresholds, update the farm safety net to better stabilize prices, and shield producers from severe market fluctuations.

Reference Prices (§10301)

The core of these provisions revolves around enhancing and extending federal support programs for agricultural producers. The OBBBA significantly updates and continues key commodity risk management programs, including agriculture risk coverage (ARC) and PLC payments.²⁰² These payments are paid based on the effective reference price (EFP) which is based on a formula. Under the revised formula, the minimum price is set at 88% of the Olympic average price for the previous five years (not counting the first year back).²⁰³ The maximum price cannot exceed 113% of the statutory reference price.²⁰⁴

The provision also raises statutory reference prices for major commodities by 11–21%. For example, the reference price for corn is \$4.10, wheat is \$6.35, soybeans is \$10.00, and peanuts is \$630/ton.²⁰⁵ Also introduced is an annual escalator of 0.5%, beginning with the 2031 crop year, capped at 113% of the new baseline (i.e., the original statutory reference price).²⁰⁶

The provision permanently extends PLC, ARC, marketing assistance loans, and dairy margin coverage (DMC) through the 2031 crop year.

Observation. Expanding access to crop insurance tools like Supplemental Coverage Option (SCO) for ARC enrollees provides farmers with greater flexibility in managing risk. The automatic higher payment for ARC or PLC for 2025 simplifies decision-making for producers.

²⁰². *One Big Beautiful Bill Act*, PL 119-21, §§10304 and 10305.

²⁰³. *Ibid.*, §10301. This is up from 85% under prior law. Olympic average price is a specific method used to calculate benchmark prices and revenues, primarily for ARC and PLC.

²⁰⁴. *Ibid.* The EFR cannot be lower than the statutory reference price.

²⁰⁵. *Ibid.*, §10301.

²⁰⁶. *Ibid.*

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Base Acres (§10302)

This provision allows a one-time voluntary opportunity for farmers to enroll up to 30 million new base acres based on 2019–2023 planting history beginning with the 2026 crop year.²⁰⁷ Thus, the 2025 ARC and PLC will continue to be paid based on a producer's current base acres with the increase starting with the 2026 crop year. The base acre calculations will reconcile planted/history averages minus current base acres, with USDA applying pro-rata reductions if limits are exceeded. In any event, when it becomes effective, payments to farmers will increase.²⁰⁸

Note. Approximately 242 million base acres were signed up for ARC and PLC in 2024. The increase in base acres allows for greater eligibility for commodity support.

Producer Election (§10303)

The **greater** of ARC or PLC will be paid for the 2025 crop year.²⁰⁹ No prior election is necessary. This means that any anticipated increase in PLC payments will likely be the minimum amount that a farmer would receive, with the payments beginning in October of 2026. Also, Federal Crop Insurance SCO is available to a producer that has elected ARC, effective with the 2026 crop year.²¹⁰

Agriculture Risk Coverage (§10305)

Like crop insurance, ARC pays a benchmark revenue with a guarantee that was based on 86% of benchmark revenue with a maximum payment of 10% of benchmark revenue. Thus, a farmer would not receive payments until the final harvest revenue (based on county yields and national average prices) dropped below 86%.

Under this provision, the 86% figure is set at 90% and the 12% figure is changed to 10% beginning with the 2025 crop year.²¹¹

Note. As of July 10, 2025, farmdoc at the University of Illinois released an estimate indicating that ARC and PLC payments under the OBBBA are significantly higher than under prior law. This increase is primarily due to the updated reference price formulas and expanded base acre eligibility. Tax practitioners should be aware that these enhanced payments may affect farm income projections, entity-level planning, and timing of income recognition for clients receiving commodity program support.²¹²

Example 24. Sunny Slope Farms, LLC, an Iowa farming operation, elected Agriculture Risk Coverage-County Option (revenue protection based on county-levy data) for 2026 for its corn crop. County-level benchmark revenue is projected to be \$1,230 per acre. Final harvest revenue was \$1,100 per acre.

Sunny Slope Farms qualifies for a payment because their actual revenue (\$1,100/acre) fell below 90% of the benchmark (\$1,230) or \$1,107/acre. This triggers a \$7/acre payment (\$1,107 guarantee – \$1,100 actual). Thus, Sunny Slope Farms, LLC qualifies for a payment of \$7 per acre.

The maximum amount of payments (subject to the overall per person payment limit) is \$147.60/acre (12% of \$1,230) and does not come into play. With this set of facts, Sunny Slope Farms, LLC would have received no ARC payments under prior law.

²⁰⁷ Ibid., §10302.

²⁰⁸ Under OBBBA, §10302, the increase in base acres will be the 5-year average of the average planted acres of all covered commodities for harvest, grazing, haying, silage or other similar practices for 2019–2023, plus any prevented planting acres, plus 15% of total acres of eligible noncovered crops that may have been planted on those acres including prevented planting acres, plus any unassigned base acres.

²⁰⁹ *One Big Beautiful Bill Act*, PL 119-21, §10303. Subject to the applicable payment limitation.

²¹⁰ Ibid.

²¹¹ Ibid., §10305. Benchmark revenue refers to an historical average revenue calculated for a specific crop.

²¹² *Policy Toolbox*. Farmdoc. [farmdoc.illinois.edu/policy-toolbox] Accessed on Jul. 10, 2025.

Equitable Treatment of Certain Entities (§10306)

Under the OBBBA, a qualified pass-through entity will have the number of payment limits based on the number of owners with the payment to a particular owner based on that owner's ownership percentage.²¹³

Under the provision, pass-through entities such as LLCs, limited liability partnerships (LLPs), limited partnerships (LPs), and S corporations will be treated as a general partnership for payment limitation purposes. Historically, under the payment limitation rules, any entity that limits liability was limited to a single payment limit with the members of the entity splitting the payment amount amongst them in accordance with their ownership percentages. However, with this provision, the result is that there will not be an entity-level limitation for such entities.²¹⁴

The provision reads in pertinent part as follows:

The term 'qualified pass-through entity' means — "(A) a partnership (within the meaning of subchapter K of chapter 1 of the Internal Revenue Code of 1986); "(B) an S corporation (as defined in section 1361 of that Code); "(C) a limited liability company that does not affirmatively elect to be treated as a corporation; and "(D) a joint venture or general partnership."

Thus, if an LLC elects to be an S corporation, it is treated as a corporation for tax purposes (specifically, an S corporation). But the statutory language is a bit confusing. If (C) explicitly said "a limited liability company that does not affirmatively elect to be treated as a C corporation," it would more clearly encompass all LLCs that are taxed as pass-through entities, including those that choose S corporation status. However, the phrasing in (C) can be read in conjunction with (B) to avoid redundancy and ensure proper classification. If an LLC defaults to partnership taxation (multi-member) or disregarded entity (single-member), it has **not** affirmatively elected to be treated as a corporation, so it would qualify under (C). If an LLC affirmatively elects to be taxed as an S corporation, it is **no longer** simply an LLC "that does not affirmatively elect to be treated as a corporation" in the general sense of the word "corporation." Instead, it is specifically an S corporation, which is **explicitly covered** under (B).

Therefore, the intent is that if an LLC is taxed as a partnership or disregarded entity, it falls under (C). If the LLC has elected S corporation status, it falls under (B) because it is now, for tax purposes, an S corporation. If the LLC has elected C corporation status, it does **not** fall under (A), (B), (C), or (D) because C corporations are not pass-through entities.

The conclusion is that the provision attempts to cover all forms of pass-through entities, and an LLC that elects S corporation status is properly classified under (B) rather than (C). The language in (C) is designed to capture the default pass-through treatment of LLCs, while (B) specifically handles the elected S corporation treatment.

Observation. Given the new qualified pass-through entity, a question remains whether the USDA will update its current adjusted gross income (AGI) calculations to include all items of income and loss reported on Schedule K of the entity's federal tax return.²¹⁵

Payment Limitations (§10307)

The payment limit a person or legal entity can receive annually from certain USDA commodity support programs is increased from \$125,000 to \$155,000.²¹⁶ The increase in the payment limit is effective beginning with the 2025 crop year (e.g., payments beginning in the fall of 2026) and is adjusted annually for inflation.²¹⁷

²¹³. *One Big Beautiful Bill Act*, PL 119-21, §10306.

²¹⁴. A C corporation, as a non-pass-through entity, remains entitled to a single payment limit regardless of the number of owners.

²¹⁵. Form CCC-902E, *Farm Operating Plan for an Entity*, and related Form CCC-941, *Average Adjusted Gross Income (AGI) Certification and Consent to Disclosure of Tax Information*.

²¹⁶. *One Big Beautiful Bill Act*, PL 119-21, §10307.

²¹⁷. *Ibid*.

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AGI Limitation (§10308)

This section clarifies that if greater than or equal to 75% of the AGI of the person or legal entity derives from farming, the AGI limitation to receiving program payments does not apply.²¹⁸ The provision also clarifies that farm income includes income from agri-tourism activities, direct-to-consumer marketing of agricultural products, and gain from the sale of agricultural equipment that the producer or legal entity owns.²¹⁹

Example 25. Farmer Giles is a sole proprietor farmer with an average Schedule F income of \$245,000. He also has an average \$500,000 of Form 4797 income from the trade-in of farm equipment. His total average AGI is \$845,000. Thus, under the prior rule, his farm income is 29% of total average AGI because the equipment gains were not considered farm income unless at least 66.66% of his average AGI was from Schedule F. As such, he would not qualify for an extra payment limit and be subject to certain AGI requirements.

However, under the OBBBA provision, his farm AGI is 88.2% ($(\$245,000 \text{ Schedule F income} + \$500,000 \text{ Form 4797 income}) \div \$845,000 \text{ total average AGI}$) and he will not be subject to the AGI limitation and could qualify for an extra payment limit.

Marketing Loans and Repayment of Marketing Loans (§§10309 and 10310)

The OBBBA amends the Agricultural Act of 2014 to extend nonrecourse marketing assistance loans through the 2031 crop year.²²⁰ For example, marketing assistance loan rates for covered commodities are increased for corn to \$2.42, wheat to \$3.72, and soybeans to \$6.82 for the years 2026 through 2031.²²¹ Payment of cotton storage costs will continue with certain cost adjustments based on where the grower is located.²²²

The repayment rules are also updated by allowing the repayment of the lower of the fixed rate or the prevailing world market price for each commodity.²²³

Observation. Producers now have nonrecourse loan access extended through 2031, offering more predictability and risk protection. In addition, the ability to lock in fixed loan rates removes uncertainty for supply planning and cash flow, which is especially critical during volatile market periods. Also, enabling repayment at world prices and occasional refunds keeps U.S. loan terms in sync with global commodity markets.

Sugar Program Updates (§10312)

The U.S. sugar program is extended through 2031, with increased sugar loan and storage rates.

Dairy Policy Updates (§10313)

The DMC program is enhanced by increasing Tier I coverage eligibility from 5 million to 6 million pounds per farm and allowing producers to use their highest production year from 2021–2023 as a new enrollment baseline.

Observation. The long-term extension of DMC for dairy and the U.S. sugar program provides critical stability for these specialized agricultural sectors, enabling better long-term planning and investment.

²¹⁸ Ibid., §10308. The provision applies primarily to certain farm programs dealing with conservation. The current AGI limitation is \$900,000 for most Farm Service Agency (FSA) and Natural Resources Conservation Service (NRCS) programs.

²¹⁹ *One Big Beautiful Bill Act*, PL 119-21, §10308. The provision also specifies that the term farming includes other agriculture-related activities, as determined by the Secretary.

²²⁰ *One Big Beautiful Bill Act*, PL 119-21, §10309.

²²¹ Ibid.

²²² Ibid.

²²³ *One Big Beautiful Bill Act*, PL 119-21, §10310.

SUBTITLE D — DISASTER ASSISTANCE PROGRAMS

This subtitle focuses exclusively on disaster assistance programs under the jurisdiction of the House Agriculture, Nutrition and Forestry Committee. It provides an emergency support mechanism that supplements existing federal disaster programs, aiming to help agricultural producers recover and stabilize following catastrophic events.

Supplement Agricultural Disaster Assistance (§10401)

This provision significantly expands disaster assistance for livestock, honeybees, farm-raised fish, and forage programs. Producers suffering death losses of unborn livestock — such as pregnant cattle, pigs, sheep, goats, and poultry — on or after January 1, 2024, are eligible for additional payments beyond standard indemnity rates. The Secretary of Agriculture sets the payment rate at up to 85% of the base rate for the lightest weight class. The total payment is calculated using multipliers based on livestock type.

- 1x for beef cattle, swine, goats, etc.
- 2x for dairy cattle
- 12x for poultry
- A species-specific average multiplier for other livestock

The provision also amends the Livestock Forage Disaster Program by extending forage assistance from one to two monthly payments in qualifying drought/fire counties. A lower threshold for payments is established with eligibility now requires only four consecutive weeks of adverse grazing conditions during the county's normal grazing period, replacing the previous 8-week rule.

New coverage is provided for fish losses from bird depredation. Producers suffering losses from piscivorous birds (fish-eating birds) are eligible for disaster assistance. The payment rate is set by USDA based on deterrence cost, lost revenue, and disease, with a floor of \$600 per acre of farm-raised fish, covering 85% of the affected acreage.

The provision revises the Tree Assistance Program to align payments to normal mortality — eliminating the earlier 15% threshold, making aid more accessible for damaged orchards and vineyards.

Note. The provision increases coverage levels and lowers the threshold needed to qualify for payments, making assistance more broadly available to farmers and ranchers. Likewise, the provision increases support for SCO and Whole-Farm Revenue Protection.

SUBTITLE E — CROP INSURANCE

This Subtitle focuses on comprehensive reforms to the federal crop insurance program.

Beginning Farmer and Rancher Benefit (§10501)

This provision amends the definition in the Federal Crop Insurance Act so that individuals qualify as “beginning” for up to 10 years (instead of the previous five). This means that beginning farmers now receive additional premium assistance on top of standard rates as follows.

- An additional 5% for years 1–2
- An additional 3% for year 3
- An additional 1% for year 4

Note. This subtitle also introduces an index-based insurance pilot program for poultry (addressing energy, temperature, and health risks).²²⁴

²²⁴ Ibid., §10507.

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Area-Based Crop Insurance Coverage and Affordability (§10502)

This section makes two important enhancements to crop insurance policies.

- Provides higher coverage levels for area-based plans by amending Section 508(c)(4) of the Federal Crop Insurance Act to allow individual yield/revenue coverage up to 85% (previously lesser); aggregate coverage across multiple commodities up to 90%; and area-based (county-level) yield or revenue coverage up to 95%.
- Provides increased SCO by adjusting premium subsidy eligibility by reducing the trigger from 14% to 10% and boosts maximum subsidy from 86% to 90%, and the premium subsidy increases to 80% from 65%.

Premium Support (§10504)

This provision increases **premium support for crop insurance in addition to** existing federal subsidies under Section 508(e)(2) of the Federal Crop Insurance Act²²⁵ as follows.

Coverage Level	Premium Subsidy	
	Old	New
65%	64%	69%
70%	59%	64%
75%	55%	60%
80%	48%	51%
85%	38%	41%

Observation. This front-loaded tiered structure aims to significantly reduce financial barriers in the earliest insurance years (years 1–5), before stabilizing to steady support through year 10.

SUBTITLE F — ADDITIONAL INVESTMENTS IN RURAL AMERICA

Conservation (§10601)

This section amends a provision in the 1985 Farm Bill²²⁶ to increase funding through fiscal year 2031 for various conservation-related programs.

FARM REAL ESTATE RELATED PROVISIONS

The OBBBA contains numerous provisions of benefit to farmers and ranchers. Two of them deal with agricultural real estate. One is a provision that provides a tax break to lenders where agricultural land secures the loan. Another allows a farmer to sell farmland to another farmer with the ability to spread the payment of tax the gain over four years.

New IRC §139L

Section 70435 of the OBBBA creates new IRC §139L to provide an exclusion from gross income for 25% of the interest that a qualified lender receives on a qualified real estate loan. A **qualified real estate loan** is any loan that is secured by rural or agricultural real estate or a leasehold mortgage with lien status on such real estate, that is made to a person after July 4, 2025. The refinancing of a loan that was made on or before July 4, 2025, does not qualify the loan for interest exclusion in the hands of the lender.

Note. A loan that is made to a specified foreign entity does not qualify the lender for the exclusion. Also, the determination of whether the loan is secured by ag land is made at the time interest income is accrued.

^{225.} 7 USC §1508(e)(2).

^{226.} 16 USC §3841.

Definitions. The term **rural or agricultural real estate** is defined as any real estate in the United States that is substantially used for the production of at least one agricultural product as well as real estate that is substantially used in the trade or business of fishing or seafood processing. It also includes any aquaculture facility.

A **qualified lender** is any bank or savings association the deposits of which are insured under the Federal Deposit Insurance Act. This includes traditional banks and savings and loan associations whose customer deposits are protected by the Federal Deposit Insurance Corporation (FDIC). The definition also includes any state or federally regulated insurance company. This covers insurance companies that are overseen by either state or federal regulatory bodies, and Farm Credit Associations. Also contained in the definition is any entity wholly owned, directly or indirectly, by a company that is treated as a bank holding company. This part of the definition includes entities that are part of a larger corporate structure, specifically those owned by a company considered a bank holding company under the International Banking Act. However, there are two crucial conditions for such an entity to be a qualified lender — the entity itself must be legally established under U.S. federal or state laws, and its main operational base must be within the United States or its territories. This prevents foreign-based entities, even if owned by U.S. bank holding companies, from automatically qualifying. The same definition applies the same requirements to entities owned by state-regulated insurance holding companies.

No Double Tax Benefit. The provision bars the lender from deducting expenses associated with the tax-exempt interest on the loan by tying into IRC §265. In general, §265 is designed to prevent taxpayers from getting a double benefit by:

1. Receiving income that is **tax-exempt** (meaning no federal income tax is paid on it), **and**
2. Deducting expenses (like interest on a loan) that were incurred to earn or carry that tax-exempt income.

The most common application of §265 is to disallow the deduction for interest expense on money borrowed to purchase or carry tax-exempt bonds (like municipal bonds). For example, if a taxpayer borrows money to buy municipal bonds and the interest on those bonds is tax-free, the taxpayer cannot deduct the interest paid on the loan used to buy the bonds. Section 70435(d) adjusts this general rule specifically for qualified real estate loans. It essentially **partially overrides** §265 for these types of loans, allowing for some deductibility where it might otherwise be disallowed.

For the purpose of applying §265(a)(2) (which disallows interest deductions related to tax-exempt obligations), the provision **treats** a qualified real estate loan as if it were an obligation whose interest is wholly tax-exempt. This legal fiction brings these specific loans under the purview of §265, even if their interest is not **actually** wholly tax-exempt under other parts of the tax code. Instead of disallowing 100% of the interest on indebtedness incurred to carry these tax-exempt qualified real estate loans, it only disallows 25%. This means that for a qualified lender holding a qualified real estate loan, they can still deduct 75% of the interest expense associated with financing that loan, even though the loan is treated as if it generates tax-exempt income for the purpose of §265. This is a significant benefit for lenders dealing with these types of loans.

Example 26. First Farmer's Bank, a qualified lender, makes a \$10 million qualified real estate loan to a large farming client at 6% interest. To fund the loan, the bank borrows \$8 million from another bank at an interest rate of 4%. First Farmer's Bank pays \$320,000 in interest annually (\$8 million × 4%) on this loan. First Farmer's Bank has significant taxable income.

The \$10 million qualified real estate loan is **treated** as an obligation whose interest is wholly exempt from tax. Therefore, the amount of interest expense that First Farmer's Bank is disallowed from deducting is \$80,000 (25% × \$320,000 interest paid).

First Farmer's Bank is still allowed to deduct 75% of the interest expense incurred to fund the qualified real estate loan. Thus, the allowed deduction is \$240,000 (\$320,000 – \$80,000).

Observation. Without this new provision, First Farmer's Bank would have faced a disallowance of \$320,000, leading to a higher taxable income and higher tax liability. With the addition of §70435(d), the disallowance is limited to \$80,000, meaning First Farmer's Bank can still deduct \$240,000 of its financing costs. In addition, First Farmer's Bank will exclude from income 25% of the interest received on the loan, which is \$150,000 (\$10 million × 6% × 25%).

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Basis. As for income tax basis calculations, the provision treats 25% of the adjusted basis of the qualified loan as adjusted basis of a tax-exempt obligation. Thus, this provision states that for these calculations, only 25% of the adjusted basis of the qualified real estate loan is considered as the adjusted basis of a tax-exempt obligation. This further limits the portion of the loan that is subject to the disallowance rules of §265. There is also another part of the provision that reinforces the 25% principle to ensure that only a quarter of the related indebtedness is considered for the purposes of the disallowance.

Note. Lenders must keep sufficient records to document the nature of the loan, the property it secures, and the amount of interest excluded.

New IRC §1062

Effective for sales or exchanges occurring in **tax years beginning after** July 4, 2025, §70437 of the OBBBA creates new IRC §1062. This new Code section allows the net income tax from the sale of farmland to be paid over four years. The gain must derive from the sale or exchange of qualified farmland property to a qualified farmer (defined later). In that event, the seller can elect to pay the portion of the seller's net income tax for the taxable year of sale or exchange that is equal to the net tax liability in four equal installments. If the election is made, the first installment is to be paid on the due date for the return (without regard to any extensions) for the return of the tax year in which the sale or exchange occurred. Each succeeding payment is to be paid by the due date of the return for the tax year following the tax year with respect to which the preceding installment was made.

If an addition to tax occurs from the taxpayer's failure to timely pay an installment, the unpaid portion of all remaining installments become **immediately due**. Similarly, if the taxpayer dies, the unpaid portion of all remaining installments are to be paid on the due date for the return of the tax year of death. On this point, if the taxpayer is a C corporation, trust, or estate, if there is a liquidation or cessation of business or some similar event, the unpaid portion of all remaining installments become due on the date of such event. An exception from this last point exists for the sale of substantially all the assets of the taxpayer to a buyer where the buyer is liable for the remaining installments due.

Handling Underpayments. If the election is made and a deficiency is assessed, it "shall be prorated to the installments payable under subsection (a)." In other words, instead of demanding the entire deficiency immediately, the additional tax burden is spread out proportionally across the remaining scheduled installment payments the taxpayer is already making. If an installment's payment due date has not arrived yet, the portion of the deficiency allocated to that future installment will simply be added to it. It will be collected "at the same time as, and as a part of, such installment." This means the taxpayer will just pay a slightly higher amount for those upcoming scheduled payments. If an installment's payment due date has arrived (meaning it is already due or has already been paid), the portion of the deficiency allocated to that past or current installment "shall be paid upon notice and demand from the Secretary." In this case, the IRS will send a direct bill or demand for that immediate portion of the deficiency.

However, if the underpayment is determined to have resulted from the taxpayer's own fault, such as carelessness (negligence), deliberate disregard of tax laws, or outright fraudulent intent to avoid paying taxes, then the flexibility of prorating the deficiency into installments is forfeited. In such cases, the full deficiency would (likely) be due immediately, and the taxpayer could face additional penalties. This provision aims to prevent taxpayers from intentionally underpaying their taxes with the expectation of being able to pay any discovered deficiency in installments.

Election Timeline. The election is to be made not later than the due date for the return of tax for the taxable year in which the qualified sale or exchange occurs. This sets the deadline for making the election. The taxpayer must choose to pay in installments by the original due date of the tax return for the year in which the applicable net tax liability arose. In the case of a sale or exchange by a partnership or S corporation, the election is to be made at the partner or shareholder level. Thus, even though the sale or exchange might have occurred within the partnership or S corporation, the election to pay in installments for the resulting applicable net tax liability is not made by the partnership or S corporation itself. Instead, it is the individual partners or individual shareholders who must each decide whether to make this election for their respective share of that liability. This maintains the pass-through nature of these entities, placing the election decision and the ultimate tax payment responsibility on the individual owners.

Note: Further guidance may be necessary to clarify how partners/shareholders determine their specific share of the applicable net tax liability for which they can make the installment election.

Definitions. The **applicable net tax liability** is the amount of tax that is directly attributable to the gain from the specific property involved in the sale or exchange. Thus, this definition isolates the tax impact of that one transaction. The taxpayer calculates total tax with the gain, then total tax without the gain. The difference between these two numbers is the applicable net tax liability that can be paid in four equal installments.

Example 27. Cecilia has \$100,000 in regular income and \$50,000 in qualifying gain from a sale or exchange of property. Cecilia's total income is \$150,000 resulting in a net income tax liability of \$30,000. Her net income tax without the gain is \$18,000.

Her applicable net tax liability is \$12,000 (\$30,000 – \$18,000). Cecilia could elect to pay the \$12,000 tax liability in installments over four years with the first payment due when filing the tax return for the year of sale.

Observation: The preceding example points out that the computation accounts for how the gain impacts a taxpayer's marginal tax rates, deductions, and credits.

Qualified property is real property (land and associated structures on the land) in the United States that the taxpayer has used as a farm for farming purposes or leased to a qualified farmer for farming purposes during substantially all of the 10-year period ending on the date of the qualified sale or exchange. The property must also be subject to a covenant or other legally enforceable restriction which prohibits the use of the property other than as a farm for farming purposes for any period before the date that is 10 years after the date of the sale or exchange. This condition is designed to ensure that the property remains productive agricultural land after the sale, preventing its immediate conversion to non-farm uses (like residential or commercial development) once the tax benefit is received. It ties the tax advantage to the continued preservation of farmland.

Note: A taxpayer making an election must include a copy of the covenant or other legally enforceable restriction with the return for the taxable year of the sale or exchange.

If the taxpayer is a partnership or S corporation, the individual partners or shareholders can still meet the 10-year use/lease requirement. If the entity (partnership or S corporation) used the property as a farm or leased it to a qualified farmer, then each individual who has a direct or indirect ownership interest in that entity is considered to have also used or leased the property in that manner. This prevents a situation where the structure of ownership (through an entity) would disqualify the property for the individual owners seeking this tax treatment.

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Farm and farming purposes are defined in accordance with IRC §2032A(e). IRC §2032A(e)(4) defines farm very broadly to include, “stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.” IRC §2032A(e)(5) defines farming purposes to include activities such as the following.

- Cultivating the soil or raising/harvesting agricultural or horticultural commodities (including animal raising, shearing, feeding, etc.).
- Handling, drying, packing, grading, or storing agricultural/horticultural commodities on a farm, if the owner/tenant/operator regularly produces more than half of the commodity so treated.
- Planting, cultivating, caring for, or cutting trees, or preparing trees for market (excluding milling).

Qualified farmer is any individual who is actively engaged in farming (within the meaning of subsections (b) and (c) of §1001 of the Food Security Act of 1986²²⁷). This is a section of the 1986 Farm Bill that defines the active engagement test for purposes of eligibility for federal farm program payments. There, subsection (b) generally defines actively engaged in farming for individuals as making a significant contribution of:

- Capital, equipment, or land, **and**
- Active personal labor or active personal management.

In addition, the person’s share of profits/losses must be commensurate with contributions, and contributions must be at risk.

Subsection (c) of this part of the 1986 Farm Bill provides specific rules for certain classes of individuals or entities to be considered **actively engaged**, such as the following.

- Landowners receiving rent based on production (sharecropping)
- Adult family members making significant contributions of active personal management or personal labor
- Sharecroppers making significant personal labor contributions

By incorporating this definition, the provision ensures that the qualified farmer leasing the land is someone genuinely and substantively involved in the farming operation, not merely a passive investor or landlord. This aligns the tax benefit with individuals who are truly contributing to agricultural production.

Conclusion

Both provisions demonstrate a clear legislative intent to support the agricultural industry and rural economies through tax incentives. Section 70435 serves as a targeted tax incentive designed to lower the cost of capital for loans secured by rural and agricultural property, thereby encouraging investment in these vital sectors and supporting the financial health of farmers and rural communities. Clearly, the primary goal of §70435 is to stimulate investment and development in rural and agricultural areas. By providing a partial tax exclusion for interest income on loans related to agricultural properties, Congress is attempting to incentivize an increase in access to capital to ag borrowers and encourage investment in ag land (and associated equipment and infrastructure.) Perhaps lenders will offer lower interest rates on qualified rural and agricultural loans, as their effective return on investment will be higher due to the tax savings. This could be a significant benefit for farm borrowers.

²²⁷. 7 USC §1308–1(b) and (c).

The primary impact of §70437 is to allow taxpayers to pay the portion of their income tax specifically attributable to the gain from a qualifying farmland sale in installments, rather than having the entire tax due by the normal tax return deadline. This directly addresses a common financial challenge faced by farmers and landowners who sell valuable agricultural land – a large, one-time tax bill that can be difficult to manage, especially if the proceeds are reinvested or used for other purposes. This provision makes it easier to manage the tax burden on farmland sales and can help facilitate the transfer of farmland, whether within families or to new farmers, by easing the immediate financial strain on the seller. In addition, the requirement for a 10-year use restriction ensures that the land remains in agricultural use **after** the sale, preventing immediate conversion to other uses like commercial or residential development.

NEW TREATMENT OF RESEARCH AND DEVELOPMENT EXPENSES

Under TCJA, the research and development (R&D) tax credit and the rule for expensing research and experimental (R&E) expenditures was significantly changed. Effective for tax years beginning after December 31, 2021, TCJA eliminated the option for businesses to immediately deduct all R&D expenses in the year they were incurred. Instead, it mandated that these costs be capitalized and amortized over a set period. That period was five years for domestic R&D expenses and 15 years for foreign R&D expenses. The amortization period for both domestic and foreign expenses began at the midpoint of the tax year in which the expenditures were paid or incurred.

This change had a major impact on many companies, particularly those that are research-intensive, as it increased their taxable income and, therefore, their tax liability, even if their R&D activities were not yet generating revenue.

However, the OBBBA puts in place a transition rule that reverses the TCJA treatment for eligible taxpayers. Section 70302 of the OBBBA addresses the R&D tax credit and the expensing of R&E expenditures. Included is a transition rule that allows for a retroactive application of new rules. This is a significant change designed to address the previous requirement from the TCJA, which mandated the 5-year amortization of R&E expenses starting in 2022.

For domestic R&E expenditures, the OBBBA effectively reverts the rule to pre-2022 law. This means that for qualified expenses, they do not have to be amortized over five years but can be fully deducted in the same year they are incurred. This change applies to taxable years beginning after December 31, 2024. For certain taxpayers, this can be applied retroactively to 2022, 2023, and 2024.

The Retroactive Election

The OBBBA permits a specific election for certain taxpayers to apply these new rules retroactively to R&E expenses paid or incurred in tax years beginning after December 31, 2021. This means taxpayers can file amended returns to claim the full deduction for 2022, 2023, and 2024, which could, in a particular situation, result in a significant tax benefit and refund.

The retroactive relief is generally available to small businesses that meet a specific test. This test is defined as having average annual gross receipts of \$31 million or less for the three taxable years preceding the year in question. The calculation for this threshold is based on the rules in IRC §448(c).

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Example 28. Green Acres Farm is a family-owned operation specializing in corn and soybean production. To improve crop yield and reduce fertilizer costs, the farm's owner, Jacob, experimented with a new cover crop and no-till planting system from 2022 to 2024. This involved new planting techniques, custom-designed equipment modifications, and extensive testing of soil and nutrient levels. Assume that these activities qualify for the R&D tax credit and that Jacob has kept extensive records to support claiming the credit.

Green Acres Farm's financial data is as follows.

Item	Amount	Notes
Average gross receipts (2019–2021)	\$25 million	
Taxable income (before R&E expenses and credits)		
2022	\$ 2 million	
2023	2.1 million	
2024	2.2 million	
Qualified research expenditures (QRE)		
2022	\$100,000	Labor wages, testing supplies, contractor fees
2023	120,000	
2024	130,000	
Federal R&D tax credit calculation		Based on the QREs, the farm determines it is eligible for these credits
2022	\$10,000	
2023	12,000	
2024	13,000	

Before the OBBBA, TCJA required that the QREs be amortized over a 5-year period.

The Old Way (Prior to the OBBBA). Below is what was reported on Green Acres Farm's 2022 tax return.

- **Initial taxable income.** \$2 million
- **R&E deduction.** Instead of deducting the full \$100,000, the farm could only deduct a portion. The 5-year amortization rule meant only 10% of the QREs could be deducted in the first year ($\$100,000 \times 10\% = \$10,000$). The remaining \$90,000 would be deducted over the next five years.
- **Taxable income (after R&E deduction).** $\$2 \text{ million} - \$10,000 = \$1,990,000 + \$10,000$ addition to income from R&D credit amount that also needed to reduce expenses.
- **Tax liability (based on standard corporate rates, for simplicity).** The 21% tax rate on \$2 million equals \$420,000.
- **R&D tax credit application.** The farm applied the \$10,000 R&D credit to reduce its tax liability.
- **Final tax due.** $\$420,000 - \$10,000 = \$410,000$

This process repeated for 2023 and 2024, with only a small portion of the R&E costs being deducted each year, thereby keeping taxable income artificially high.

The New Way (Filing Amended Returns under the OBBBA). With the OBBBA's transition rule, the farm can make an election to retroactively apply the new expensing rules. The farm decides to file amended returns for all three years.

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Below is what is reported on Green Acres Farm's **amended** 2022 tax return.

- **Initial taxable income.** \$2 million
- **R&E deduction (new rule).** The farm can now deduct the full \$100,000 of QREs in 2022.
- **Taxable income (after R&E deduction).** \$2 million – \$100,000 = \$1,900,000 + \$10,000 addition to income from R&D credit amount that must also reduce expenses.
- **Tax liability.** A 21% tax rate on \$1,910,000 would be \$401,100.
- **R&D tax credit application.** The farm applies the \$10,000 R&D credit to reduce its tax liability.

Note: The farm must also reduce its Schedule F deductions by the amount of the credit.

- **Final tax due.** \$401,100 – \$10,000 = \$391,100
- **Total savings for 2022 under the new provision.** \$410,000 (Old) – \$391,100 (New) = \$18,900

The farm would see similar, or even greater, savings for 2023 and 2024 because the higher R&E costs for those years would also be fully deductible.

By making the election under the OBBBA's transition rule, Green Acres Farm can:

- **Fully deduct R&E expenses.** Instead of a small amortization each year, the farm can take a full deduction in the year the expenses were incurred. This significantly lowers its taxable income for 2022, 2023, and 2024.
- **Generate a refund.** The reduction in tax liability will result in a substantial refund for each year, providing a crucial cash infusion back into the business.

Note. Green Acres Farm will need to act quickly to take advantage of the new transition rule and file amended returns for all three years by July 4, 2026.

Observation. Taxpayers that chose not to seek R&D credits and did not have to amortize qualifying research expenditures for tax years 2022, 2023, 2024 now may revisit those years to determine if seeking R&D credits for those years is now worthy of filing amended returns for those years.

Promoters

It is anticipated that there will be a strong push by promoters to encourage businesses, including farm taxpayers, to take advantage of this change. The deadline for making this election is a critical component of the legislation. The election must be made within one year of the bill's enactment, which sets the deadline at July 6, 2026. This tight deadline will likely spur a rush of amended returns.

While the R&D tax credit is a legitimate and valuable incentive for innovation, the IRS is cracking down on abusive practices by promoters who exploit its complexity for their own financial gain. The IRS has repeatedly issued warnings about aggressive and misleading promotions related to various tax credits, including the R&D credit.

Some promoters use overly broad interpretations of the R&D credit eligibility criteria to persuade ineligible taxpayers they qualify. They might blast ads, promising large refunds without thoroughly understanding a business's operations. This often leads to businesses claiming the credit when they do not legitimately meet the requirements. Promoters may also encourage businesses to claim the R&D credit for routine activities that do not actually meet the IRS's 4-part test for qualified research.²²⁸ Examples include routine dental cleanings, fittings, or general business process improvements that lack the necessary technical uncertainty and process of experimentation.

²²⁸. IRC §41.

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Another problem is that some promoters might inflate the amount of QREs to maximize the credit and often charge a high percentage of the calculated benefit as their fee. This creates a strong incentive for them to overstate the credits, even if it puts the taxpayer at risk.

The R&D tax credit has stringent documentation requirements. Promoters may encourage claims without ensuring the taxpayer has the necessary records to support their R&D activities, such as detailed descriptions of research goals, outcomes, and expense tracking by business component. This significantly increases audit risk.

The IRS is well aware of these issues and has increased its scrutiny of R&D tax credit claims. The IRS has updated the required reporting requirements and is actively auditing claims and pursuing cases against fraudulent promoters.

Note. The R&D tax credit has appeared on the IRS's Dirty Dozen list of tax scams, which highlights abusive tax promotions to warn taxpayers. Taxpayers should be highly skeptical of promoters promising large, easy R&D tax credits without a thorough review of their specific activities. In all situations, maintaining meticulous records of all R&D activities, including research goals, experiments, outcomes, and expenses is critical.

For more details and a summary of the 2025 Dirty Dozen list, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

The problems with R&D tax credit promoters extend to targeting farmers and ranchers. Agricultural businesses are often particularly susceptible to these aggressive promotions for several reasons. Many farmers and ranchers are genuinely unaware that their day-to-day activities, which often involve innovation, experimentation, and problem-solving, could qualify for the R&D tax credit. Promoters capitalize on this knowledge gap.

Farmers and ranchers often experiment with new crop varieties, irrigation techniques, livestock management methods, pest control, soil blends, and efficiency improvements. These activities can genuinely qualify if they meet the IRS's criteria. However, the IRC §41 R&D tax credit rules are complex. This complexity makes it difficult for businesses, especially those without in-house tax expertise, to determine eligibility and calculate the credit correctly. Promoters often exploit this complexity by offering simplified (and often misleading) interpretations.

Note: Similar to other industries, farmers and ranchers are enticed by the promise of significant tax refunds or reductions. Promoters often highlight the potential for large benefits, sometimes downplaying the stringent requirements and the need for robust documentation.

Promoters will often present examples of agricultural activities that **might** qualify, such as the following.

- Developing new irrigation systems
- Experimenting with new fertilizers or soil blends
- Testing new livestock feeding techniques
- Implementing new methods to protect crops from pests or disease
- Developing new crop strains or animal breeds
- Improving harvesting or planting techniques
- Optimizing waste management or energy efficiency on the farm

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While these activities **can** qualify, the key is whether they meet the 4-part test (technological in nature, resolving technical uncertainty, process of experimentation, and new or improved business component) and if proper documentation exists. Promoters often gloss over these crucial details.

Promoters might tell a farmer they approach that they qualify, without understanding the nuances of their specific operations. A farm taxpayer should be wary of a promoter that does not ask for detailed information about the farmer's specific experimental activities, technical uncertainties faced, or the process of experimentation. To claim the credit, taxpayers must maintain detailed, contemporaneous documentation, such as the following.

- Records of experimental plots or herds.
- Data on different inputs (fertilizers, feeds, pesticides) and their effects.
- Notes on challenges encountered and solutions attempted.
- Records of employee time spent on research activities.
- Receipts for supplies directly used in experimentation.

Note. Claims for common farming practices that do not involve a true process of experimentation (e.g., simply adopting a new, widely available technology without further development or modification) are a major red flag.

Observation. The R&D credit can have a broad application to many activities that occur on a farm or ranch. However, the IRS is unlikely to allow the R&D credit to be applied to the whole farm. The credit is for research and development — in other words, something that would occur in a laboratory. The entire farm is not a laboratory, but a test plot is. It is likely that the IRS will argue that the qualified research activities (which give rise to QREs) would have to occur in a test plot or similar research focused area, with expenses (including qualified wages, and the cost of chemicals, fertilizer, seed, etc.) allocated to the specific area of the test plot. That will result in a small number for most farmers, especially in the Midwest. Higher value crops, such as potatoes, onions, and fruits, might have bigger numbers, but the point remains that the QREs (and, hence, the R&D credit) must be associated with a test plot or similar research focused area and not the entire farm.

Conclusion

The OBBBA's change in the tax treatment of the R&D tax credit and R&E expenditures to pre-TCJA rules is a welcome change to many businesses, including farm and ranch businesses. However, those that can take advantage of the transition rule will need to be diligent in filing amended returns by the July 6, 2026, deadline.

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RULINGS AND CASES

SE TAX

Limited Partners and SE Tax

Soroban Capital Partners LP v. Comm’r, 161 TC 310 (2023)

A question in SE tax planning is whether an LLC member is a limited partner. In 1997, the IRS/Treasury issued a proposed regulation²²⁹ to address the issue, but it has never been finalized. The regulation establishes a fact-based analysis based on participation in management to determine limited partner status. A limited partner does not participate in management. For businesses other than those providing professional services, characterization of an LLC member’s interest is determinative of whether the member has SE tax liability on amounts distributed to the member (other than guaranteed payments). That means that proper structuring of the entity matters as does the drafting of the LLC operating agreement and the conduct of the members.

Here, the U.S. Tax Court issued a fully reported opinion confirming that state law classifications of a partner’s interest is not conclusive on the SE tax issue. The petitioner allocated a portion of its ordinary income to its limited partners. However, the petitioner excluded distributions of ordinary income to its limited partners from its computation of net earnings from SE. Its basis for doing so was that the limited partners’ interest conformed to state law. The IRS disagreed asserting that was not enough and that the functions and roles of the limited partners also had to be analyzed for SE tax purposes. The Tax Court agreed with the IRS.

At issue was the definition of a limited partner for purpose of the exception from SE tax under IRC §1402(a)(13). The Tax Court noted that the proposed regulations provided a definition, that the Congress froze the finalization of the regulation for six months, and has said very little about the issue since the freeze was lifted and has not provided a definition. The Tax Court noted that it had applied a functional analysis test in *Renkemeyer, Campbell & Weaver, LLP*²³⁰ but that this was the first time the Tax Court was asked to determine the SE tax status of limited partner in a state law limited partnership (having passed on the issue in a 2020 case).

The Tax Court determined that the functional analysis test applied based largely on statutory construction of §1402(a)(13) which excludes from SE tax “the distributive share of any item of income or loss of a limited partner, as such.” The court concluded that the “as such” language meant that there was not a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner who is acting as a limited partner. If a limited partner is anything more than merely an investor, SE tax applies to the limited partner’s distributive share.

Note. The Tax Court noted that the petitioner cited legislative history in an attempt to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that the petitioner put forth “myriad other arguments” none of which were persuasive. The petitioner even cited language in the instructions for Form 1065, *U.S. Return of Partnership Income*, which it claimed defined a limited partner, but the Tax Court noted that the definition did not purport to define a limited partner.

²²⁹ Prop. Treas. Reg. §1.1402(a)-2.

²³⁰ *Renkemeyer, Campbell & Weaver, LLP v. Comm’r*, 136 TC 137 (2011).

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The Tax Court held that a functional inquiry into the roles and activities of the petitioner's individual partners under §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied the petitioner's motion for summary judgment and set forth the rule going forward in evaluating the application of SE tax for limited partners in professional service businesses.

Note. The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For those that are, the S corporation is the business form to use to achieve a better tax result. For an S corporation, **reasonable** compensation will need to be paid subject to SE tax, but the balance drawn from the entity can be received SE tax-free. For farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than the use of an S corporation because of the ability to eliminate the NIIT.

Observation. With this decision, the Tax Court laid down the rule that it is not enough to simply hold a limited partnership interest under state law (in the context of a professional service business). A limited partner must truly be acting as an investor and no more.

The Tax Court's opinion in *Soroban* was followed in *Sirius Solutions, LLLP v. Comm'r*.²³¹ The parties in *Sirius Solutions* stipulated that the functional analysis test dictated that the state-law limited partners or *Sirius Solutions* are not "limited partners as such" for purposes of §1402(a).²³¹ An appeal was filed with the U.S. Court of Appeals for the Fifth Circuit on May 15, 2024.

Note. The Tax Court reached the same conclusion in *Denham Capital Management LP et al. v. Comm'r*,²³² to hold that under the functional analysis test, the distributive shares of five limited partners in a private equity firm did not qualify for the limited partner exception of §1402(a)(13) and were includible in net earnings from SE activities. The partners were functionally self-employed persons and not limited partners. They devoted substantially all of their time to the LP and participated in management, their skill and expertise was a significant draw for fund investors, they exercised significant control over personnel decisions, and they had made more than an insignificant investment in the LP. An appeal was filed on April 7, 2025, with the Court of Appeals for the First Circuit.

On the merits, the Tax Court upheld the IRS determination of a \$140 million underreported SE income deficiency on the basis that the limited partners were such in name only and were functionally managing the petitioner's business substantially in several respects based on an analysis of the facts.²³³

Note. Another case presently in the Tax Court on the same issue is *Point72 Asset Management LP v. Comm'r*.²³⁴

²³¹. *Sirius Solutions, LLLP v. Comm'r*, No. 11587-20 (U.S. Tax Court, Feb. 20, 2024).

²³². *Denham Capital Management LP et al. v. Comm'r*, TC Memo 2024-114 (Dec. 23, 2024).

²³³. *Soroban Capital Partners, LP et al. v. Comm'r*, TC Memo 2025-52 (May 28, 2025).

²³⁴. *Point72 Asset Management LP v. Comm'r*, No. 12752-23 (Aug. 11, 2023).

ACCOUNTING METHOD

Change in Tax Treatment of Base Acres

Conmac Investments, Inc. v. Comm'r, TC Memo 2023-40 (Mar. 27, 2023)

In this case, the petitioner was a corporation that owned and leased farmland to tenant farmers under oral leases. The petitioner did not personally farm any of the land. The farmland contained base acres — such as wheat, corn, soybeans, cotton, rice, etc., as defined and used by USDA to compute farm program payments. The farm program payments (paid pursuant to the 2008 and 2014 Farm Bills) were paid to the tenants. Under the oral leases, the tenants received all the payments attributable to the base acres and the annual rent payment was generally 25% of the gross income from the farmland, with “gross income from the farmland” including any farm subsidy payments calculated in part by the amount of the base acres.

Before 2009, the petitioner did not claim any deductions for amortization or depreciation of the base acres. But, starting in 2009, the petitioner began claiming an amortization or depreciation deduction for base acres acquired and placed in service in 2004 through 2013 (i.e., asserting an ownership interest in an intangible asset). Changing the treatment of an asset from non-depreciable to depreciable or non-amortizable to amortizable (or vice-versa) is a change of accounting that results in an IRC §481 adjustment.

Note. It is unknown why the petitioner decided to claim deductions against, essentially, cash rent. It was the tenants that were assuming the risk of production under the leases, not the petitioner. In essence, the petitioners started claiming deductions against guaranteed rental income without assuming any of the risk of the expenses under the leases. One theory could be that base acres contributed to the calculation of USDA payments to the tenant which in turn increased gross income available from the farmland.

However, the petitioner did not attach Form 3115, *Application for Change in Accounting Method*, to its Form 1120 or otherwise seek IRS consent to change its accounting method. The petitioner also did not file amended returns with an explanatory statement for all open years reclassifying the base acres as amortizable under IRC §197. Furthermore, the petitioner did not adopt the same accounting treatment for all bases acres that it owned.

The IRS determined that the petitioner had adopted an impermissible method of accounting and asserted deficiencies of approximately \$116,000 for 2013 and \$114,000 for 2014, and that a §481 adjustment of \$141,614 for 2009-2012 was required. The petitioner claimed that it had not changed its accounting method because of a change in underlying facts impacting its business. In addition, the petitioner claimed that even if there were not a change in the underlying facts that supported an accounting method change, the lack of IRS consent did not matter because the relevant tax years had closed. The petitioner also claimed that a §481 adjustment was not necessary because it should have been made for the “year of change” (e.g., 2009) and that IRS could no longer require the adjustment because 2009 was a closed tax year.

The Tax Court (opinion by Judge Paris) agreed with the IRS noting that the petitioner had changed an accounting method in violation of IRC §446(e) which requires IRS consent for such a change, and that a §481 adjustment was proper. The Tax Court relied primarily on Treas. Reg. §1.446-1(e)(2)(ii)(d)(2) which specifies that a change in depreciation or amortization of an asset is an accounting method change. The facts did not involve the application of an existing accounting method to any change in business practices - the petitioner continued to serve as landlord to the tenant farmers and did not change the terms of the leases. Instead, the only economic consequence was the tax benefit that the petitioner received on account of the change. There was no change in existing legal or economic relationships. In addition, the petitioner continued to treat base acres acquired and placed in service in other years as nonamortizable or non-depreciable. The Tax Court determined that the petitioner has simply made a business decision in 2009 to start claiming amortization deductions on farmland that it had acquired and placed in service beginning in 2004. The corporation, the Tax Court pointed out, failed to identify the facts that had changed that caused it to change its tax treatment of the rented farmland.

Note. Judge Paris brought up on her own the case of *Comm'r v. Brookshire Bros. Holding, Inc.*²³⁵ In that case, the appellate court, affirming the Tax Court, held that an IRS challenge to a method change for which consent was not given must be for the year of the improper change, and that failure to obtain prior consent did not serve as a basis to challenge the change for a closed year. In the present case, the Tax Court distinguished *Brookshire* on the basis that the corporation in the present case did not file amended returns with an explanatory statement for all open years reclassifying the base acres. In addition, based on the corporation's inconsistent treatment of the base acres depending on the year the farmland was placed in service, the Tax Court determined that finding an unauthorized change in accounting would promote consistency and would not offend basic fairness.

The Tax Court also sustained the §481 adjustment. The Tax Court rejected the petitioner's argument that the §481 adjustment was barred by the statute of limitations after finding that the year of the change was the oldest open tax year. The Tax Court explained that the only limitation on an §481(a) adjustment is that no pre-1954 adjustments may be made. So long as a change in an accounting method has occurred, the IRS may adjust a taxpayer's income in an open year to reflect amounts attributable to years for which the applicable statute of limitations has expired (i.e., time-barred years).²³⁶

On June 6, 2025, the Eighth Circuit affirmed the Tax Court.²³⁷ The petitioner claimed that the Tax Court had ignored the exception in the Treas. Reg. that specifies that a change in method of accounting "does not include adjustment of any... deduction that does not involve the proper time for... taking of a deduction... A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts."²³⁸ The petitioner claimed that its changes were not an adjustment involving the time for taking the deduction, but merely a change in the characterization of whether the deduction was allowable. The appellate court disagreed, noting that had the petitioner continued not claiming any amortization deduction for base acres, it would have recovered the original cost at the time of the eventual disposition. However, by starting to claim amortization of the base acres, the petitioner changed the time it recovered the original cost by deducting it over the years before disposition.

The appellate court also dismissed the petitioner's argument that the change resulted from a change in underlying facts, noting that the petitioner failed to identify any facts that changed. On this point, the appellate court noted that the Code has allowed for amortization since February 28, 1913, and, as such, the petitioner's "subjective misunderstanding of fact or law does not equate" to "a change in underlying facts" within the meaning of the regulation.

The appellate court agreed with the Tax Court that a §481 adjustment applied for the year in which the IRS changed the petitioner's method of accounting to trigger such an adjustment, rejecting the petitioner's claim that the year of change specified in §481(1) was when the petitioner changed its method of accounting. The appellate court reasoned that adopting the petitioner's claim would essentially void the statute if it did not affect closed years (which was the situation in this case).

Observation. The opinions of the Tax Court and the 8th Circuit do **not** mean that base acres are **not** amortizable. They might be. At issue was whether the petitioner had adopted an impermissible method of accounting.

Note. The Tax Court has stayed its opinion in *Sandhill Land Co. v. Comm'r*,²³⁹ pending the Eighth Circuit's opinion in *Conmac Investments, Inc.*

²³⁵. *Comm'r v. Brookshire Bros. Holding, Inc.*, 320 F.3d 507 (5th Cir. 2003), *aff'g* TC Memo 2001-150 (Jun. 22, 2001).

²³⁶. *See, e.g., Huffman v. Comm'r*, 518 F.3d 357 (6th Cir. 2008), *aff'g* 126 TC 322 (2006).

²³⁷. *Conmac Investments, Inc. v. Comm'r*, No. 24-1605 (8th Cir. Jun. 6, 2025).

²³⁸. Treas. Reg. §1.445-1(e)(2)(ii)(b).

²³⁹. *Sandhill Land Co. v. Comm'r*, No. 33234-21 (Oct. 26, 2021).

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CONSERVATION EASEMENTS

Appraisal

***Excelsior Aggregates, LLC et al. v. Comm’r*, TC Memo 2024-60 (May 30, 2024)**

The Tax Court addressed the valuation of charitable contribution deductions claimed by three partnerships that had donated property interests in 13 parcels of the Big Escambia Tract in rural Alabama. The total claimed charitable deduction was \$187 million for donated conservation easements and fee simple interests. The IRS disallowed approximately \$30 million of these deductions for the 2014 tax year, leading to the issuance of Notices of Final Partnership Administrative Adjustments (FPAAs).

The central issue was determining the appropriate valuation of the donations. The partnerships’ appraiser assessed the highest and best use (HBU) of the parcels as commercial sand and gravel mining. However, the Tax Court, after evaluating expert testimonies, concluded that the HBU before granting the easements was primarily for silviculture, recreation, and limited residential use, with potential for local sand and gravel mining. This assessment significantly reduced the valuations compared to the partnerships’ claims. Additionally, the Tax Court addressed procedural aspects, noting that in a prior related decision, it had granted partial summary judgment to the IRS. The Tax Court found that the IRS complied with the supervisory approval requirements for penalties under IRC §§6662 and 6662A, because a civil penalty approval form was signed before issuing the FPAAs.

Valuation

***Seabrook Property, LLC v. Comm’r*, TC Memo 2025-6 (Jan. 21, 2025)**

The petitioner granted a perpetual conservation easement over 622 acres of land to a qualified charity in 2017 and claimed a charitable deduction in excess of \$32 million on its 2017 return. The deduction was based on an appraised value of \$35.85 million. The property had been owned by a person who contributed it to the petitioner in exchange for a 99% interest before the easement was donated. In addition, that contributor later sold a 97% interest in the petitioner to an investment entity for \$4.74 million shortly before the easement was granted. The IRS disallowed the entire deduction and levied penalties for gross valuation misstatement and failure to report a reportable transaction.

The Tax Court determined that the petitioner and its members had the requisite donative intent because the perpetual conservation easement was donated to a qualified organization, and any tax benefits received did not negate that charitable intent. The Tax Court also held that the appraisal attached to petitioner’s return substantially complied with the qualified appraisal requirements under Treas. Reg. §1.170A-13(c), despite some deficiencies. In determining the value of the easement, the Tax Court rejected the analyses of the parties’ experts as flawed and instead relied primarily on comparable sales data and the amount the contributor received for her 97% interest in the petitioner. The Tax Court concluded that the petitioner was liable for the 40% gross valuation misstatement penalty because the value it claimed for the easement (\$32.6 million) was more than double the Tax Court’s determined value of \$4.7 million, and no reasonable cause exception applies to gross valuation misstatements.

***Ranch Springs, LLC v. Comm’r*, 164 TC No. 6 (2025)**

In late 2016, the petitioner (as part of a syndicated easement transaction) bought a 110-acre property for \$715,000 in an arms’ length transaction for FMV. A year later, the petitioner granted a conservation easement over the property to a qualified charity and claimed an associated charitable deduction on its 2017 return under IRC §170 for almost \$26 million. The deduction was based on an appraisal value using the owner-operator method and assuming that limestone mining was the HBU of the property.

The property was zoned for agricultural and light residential use only, and there was substantial evidence that the local town would oppose rezoning for mining at least, in part, because there were several operating limestone quarries in the area with unused capacity to meet demand. The IRS allowed a deduction equal to the before and after valuation of the easement of \$335,500. The Tax Court agreed with the IRS noting that the petitioner failed to establish that limestone mining was a legally permissible use of the property or that rezoning to permit mining was reasonably probable. As a result, limestone mining was not the HBU of the property. But even if limestone mining was legally permissible, the Tax Court determined that it was not financially feasible due to the existing supply of limestone in the area and the unused capacity of local quarries. The Tax Court also upheld the IRS’s imposition of a 40% gross misstatement penalty under §6662(h).

***JL Minerals LLC et al. v. Comm’r*, TC Memo 2024-93 (Oct. 8, 2024)**

The petitioner, a partnership, donated a permanent conservation easement on a 65-acre tract in Georgia containing steep slopes and ravines that the petitioner claimed should be valued for its potential for kaolin clay mining. In a previous action, *JL Minerals, LLC et al. v. Comm’r*,²⁴⁰ the Tax Court determined that summary judgment was improper as to whether the petitioner satisfied the “exclusively for conservation purposes” requirement of §170(h)(1) where the terms “surface mining method,” “extraction” and “removal” were not defined in the statute or treasury regulations. In addition, the Tax Court noted that neither the petitioner nor the IRS offered a convincing interpretation of the terms’ meanings at the time of enactment. Without proper grounding in the statutory language, the court was unable to credit either party’s interpretation of the meaning of the provision as a whole and whether it encompassed the reservation of rights to borrow pits as set forth in the easement deed.

In the current case, the partnership’s claim that the charitable deduction associated with the donation was \$16.7 million was reduced by the Tax Court to \$93,000. The Tax Court also upheld the imposition of penalties against the petitioner for the gross overvaluation of the contribution. The Tax Court noted that the record included testimony that multiple kaolin producers decided the tract was not worth mining or even keeping as part of a long-term reserve. Also noted was that multiple companies had drilled and tested the property, with only one deciding to mine it, and that company later shut down its mine without a lease for future mining.

²⁴⁰. *JL Minerals, LLC et al. v. Comm’r*, No. 17076-21 (Feb. 15, 2023).

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Conservation Easement Regulation Invalidated

***Valley Park Ranch, LLC v. Comm'r*, 162 TC 110 (2024)**

The petitioner claimed a charitable deduction for a donated conservation easement. The easement deed provided that if the conservation restriction was terminated, the donee would receive an amount determined by a court, unless otherwise provided by state or federal law, or in the event of the government's exercise of eminent domain, the respective share of the proceeds from a qualified appraisal. The IRS claimed that the deed language failed to satisfy the requirements of §170(h) and Treas. Reg. §1.170A-14(g)(6)(ii). The petitioner claimed that the regulation was invalid under the APA. Following *Hewitt v. Comm'r*,²⁴¹ the Tax Court held that Treas. Reg. §1.170A-14(g)(6)(ii) is procedurally invalid under the APA and that the deed therefore need not comply with its requirements. The Tax Court also concluded that to the extent *Oakbrook Land Holdings, LLC, v. Comm'r*²⁴² holds otherwise, the Tax Court will no longer follow it. The court also held the easement deed satisfies the "restriction (granted in perpetuity)" requirement under §170(h)(2)(C) and the "protected in perpetuity" requirement of §170(h)(5).

Note. In *Cox Point Propco, LLC v. Comm'r*,²⁴³ the Tax Court denied the IRS motion for partial summary judgment that the petitioner's deed of easement regarding extinguishment proceeds failed to satisfy Treas. Reg. §1.170A-14(g)(6)(ii), because the regulation had previously been ruled invalid in *Valley Park Ranch*.

***Buckelew Farm, LLC et al. v. Comm'r*, No. 24-12365 (11th Cir. Oct. 7, 2024)**

In *Buckelew v. Comm'r*,²⁴⁴ the IRS disallowed the petitioner's charitable contribution deduction for a perpetual conservation easement based on the failure to meet the perpetuity requirement and imposed penalties. The Tax Court allowed the deduction on the basis that the statutory requirements for a deduction had been satisfied. The fact that the conservation purpose was not protected in perpetuity as required by Treas. Reg. §1.170A-14(g)(6)(ii) was not relevant because the court was bound to follow *Hewitt v. Comm'r*, that invalidated the regulation in the 11th Circuit. However, the Tax Court held that the amount of the allowable charitable contribution deduction under §170 was the difference between the before and after value of the property, which was substantially less than the claimed deduction. The Tax Court determined that while a civil fraud penalty was not warranted, a penalty under §6662 was warranted due to the gross valuation misstatement for the property.

The petitioners are two former pitchers for the Atlanta Braves. They appealed the Tax Court's decision that dramatically cut the value of a conservation easement deduction by 90% on a 1,500-acre property in Georgia at issue in the case. The appellate court dismissed the appeal for lack of jurisdiction because the appeal was filed before the Tax Court decision had become final. The appellate court noted that the Tax Court invoked Rule 155 requiring the petitioners and the IRS to submit competing computations for the final dollar amount of tax liability. Invoking Rule 155 meant that the Tax Court had withheld entry of its decision and made its memorandum opinion not appealable because it was not a final order.

²⁴¹. *Hewitt v. Comm'r*, 21 F.4th 1336 (11th Cir. 2021), *rev'g and remanding* TC Memo 2020-89 (Apr. 17, 2020).

²⁴². *Oakbrook Land Holdings, LLC, v. Comm'r*, 154 TC 180 (2020), *aff'd* 28 F.4th 700 (6th Cir. 2022).

²⁴³. *Cox Point Propco, LLC v. Comm'r*, No. 16731-19, 2024 U.S. Tax Ct. (U.S. Tax Ct. Apr. 22, 2024).

²⁴⁴. *Buckelew v. Comm'r*, TC Memo 2024-52 (Apr. 25, 2024).

Basis Limitation

***Glade Creek Partners, LLC v. Comm’r*, No. 23-14039 (11th Cir. Jun. 6, 2025), *aff’g* TC Memo 2023-82 (Jun. 29, 2023)**

Recently, the IRS has argued that deductions for conservation easements should be limited to the donor’s adjusted basis in the property, rather than FMV, particularly where the property was held as inventory by a developer. In this case, the appellate court upheld the Tax Court in finding that the donated property was an inventory item in the hands of the prior owner that contributed it to the petitioner. Therefore, the petitioner’s deduction for the conservation easement it donated to the Atlantic Coast Conservancy was properly limited to its adjusted basis in the easement under IRC §§170(e) and 724(b). IRC §724(b) provides that gain from the sale of property contributed to a partnership by a partner is treated as ordinary income for five years if the property was an inventory item in the hands of the contributing partner.

IRC §170(e) limits charitable deductions for contributed property to the taxpayer’s adjusted basis in the property if it would have yielded ordinary income or short-term capital gain upon sale. For the year the prior owner contributed the property to the petitioner, it reported that it was a real estate dealer and reported the land contributed to the petitioner as inventory. In addition, the appellate court noted that the petitioner failed to challenge the applicability of those Code sections by failing to raise them before the Tax Court.

PASSIVE LOSSES

Hours

***Foradis et al. v. Comm’r*, TC Summ. Op. 2024-13 (Jul. 11, 2024)**

The petitioner claimed a \$22,000 loss deduction on a joint return associated with a carriage house he built, a short-term rental property. The petitioner claimed that he worked 40 hours per week at his regular job and also worked 48 hours per week building the carriage house which qualified him as a real estate professional under IRC §469(c)(7)(B) for the tax year at issue. However, the Tax Court did not find it credible that the petitioner spent more time constructing the carriage house than he did at his full-time job. Thus, he did not spend more time in real estate activities during the tax year at issue as he did at non-real estate activities and did not qualify as a real estate professional. His spouse also did not qualify as a real estate professional.

Active Participation Exception

***Warren v. Comm’r*, TC Summ. Op. 2024-20 (Oct. 3, 2024)**

In 2015, the petitioner formed an LLC to open an assisted living facility providing professional caregiver services. In 2016, he purchased a single-family home near his residence intending to convert it into a group home. He began renovating the property soon after the purchase, later opting to redesign the layout to add more bedrooms and bathrooms. During 2017, the year in question, the petitioner was employed as an engineer by Lockheed Martin, where he worked 1,913 hours. Throughout the renovation, the petitioner also attended courses on caregiving and business management. He rented out habitable rooms in the group home and received \$6,000 in rental income. However, he did not provide any evidence or testimony to show that the tenants received caregiving services or assisted with the renovations while living in the home.

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On his timely filed 2017 Form 1040, the petitioner reported AGI of \$199,974, which included \$86,305 in wages and \$155,402 in pension and annuity income. He did not report any rental income on Schedule E (Form 1040), *Supplemental Income and Loss*, but claimed a net loss of \$41,733 from rental real estate expenses. The IRS denied the loss deduction, determined that the petitioner failed to report the rental income, and was not eligible for the active participation exception to the passive loss rules under §469(i). The IRS issued a deficiency notice of \$15,392 and an accuracy-related penalty under §6662(a) of \$3,078.

The Tax Court agreed with the IRS, holding that the petitioner did not qualify as a real estate professional under §469(c)(7) because the time he spent managing the group home was fewer hours than the time he worked at Lockheed Martin. Additionally, the Tax Court determined that the taxpayer was not eligible for a deduction of up to \$25,000 in passive activity losses under §469(i) because his AGI exceeded \$150,000.

Rental Real Estate

***Gossain v. Comm’r*, TC Memo 2024-97 (Oct. 21, 2024)**

The petitioners, a married couple, began renting out a California property that they owned in 1994. Their activity log showed that they worked 751 hours on the property in 2009 and 2010, 753 hours for 2014, and 752 hours for 2016. They bought another property in Hawaii in 2016 and began renting it out in 2017. Their activity log for this property showed that for 2018 he worked 117.5 hours on the California property, and she worked 58.5 hours on the same property and that together they worked four hours on the Hawaii property.

The IRS (and the Tax Court) rejected the logs as insufficiently substantiated. The husband also had a full-time job during 2018 and 2019 where he worked at least 40 hours per week. The issue was whether the petitioners’ rental property activity for the years in issue was a passive activity such that passive losses from the properties were not currently deductible. The petitioners claimed that the husband was materially participating in managing and maintaining the properties by doing such tasks as conducting repairs, communicating with tenants, and managing the finances associated with the properties.²⁴⁵

As such, the IRS denied the losses from the rental activities. The Tax Court agreed, determining that the husband satisfied the material participation test of Treas Reg. §1.469-5T(a) by participating for more than 100 hours in the tax years at issue (and not less than the participation of any other individual) and by materially participating for at least five of the last ten tax years. The petitioners however, could not satisfy the real estate professional exception of §469(c)(7)(B), which requires that the taxpayer performs more than 750 hours of services in real property trades or businesses in which the taxpayer materially participates, and more than half of the personal services performed by the taxpayer are performed in real property trades or businesses in which the taxpayer materially participates. The Tax Court also upheld an accuracy-related penalty under §6662(a) noting that IRS has satisfied the timely supervisory approval requirement of IRC §6751(b).

Observation. The 750-hour test can only be attributed to one spouse of a married couple. Hours worked by the other spouse cannot be combined. It is critical that taxpayers with rental activities maintain clear and detailed logs recording the hours worked on the rental activity to qualify as a real estate professional.

²⁴⁵. Even if a taxpayer materially participates in an activity, the activity is still considered a passive activity if (1) it is “any rental activity” and (2) the taxpayer is not a real estate professional per IRC §469(c)(2).

BUSINESS DEDUCTIONS

Substantiation

***Thompson v. Comm’r*, TC Memo 2024-14 (Feb. 5, 2024)**

The petitioners, a married couple, had income for the years in question from farming (raising and selling cattle, chickens, eggs, and turkeys), and the wife had income from a tax preparation business. The IRS adjusted the return, significantly reducing claimed Schedule F expenses. The petitioners filed delinquent returns for some of the years at issue and did not include a Schedule C for 2014 even though the tax preparation business was conducted that year.

The IRS conducted a bank deposit analysis to determine the petitioners’ income, the result of which the petitioners did not dispute. As for the disallowed expenses, the Tax Court determined that the petitioners failed to produce evidence to substantiate their claimed amount of deductions. Payments for contract labor were largely disallowed because payments for labor to the petitioners’ daughter were commingled with non-business payments in the petitioners’ bank account. The wife’s testimony was merely self-serving and uncorroborated. The Tax Court upheld a willful neglect penalty, a failure to timely pay penalty, and a penalty for failure to pay estimated tax.

Disproportionate Distributions

***Maggard v. Comm’r*, TC Memo 2024-77 (Aug. 7, 2024)**

The petitioner founded an engineering consulting partnership that was ultimately converted to an S corporation. The bylaws provided for 10,000 shares of one class of common stock entitling each owner under state law to a pro-rata share of any dividends and any distribution of the corporation’s assets on liquidation. The petitioner maintained a 40% interest in the corporation and sold a 60% interest to two individuals. Those two individuals proceeded to misappropriate funds and make disproportionate distributions to themselves. They also did not file Forms 1120-S, *U.S. Income Tax Return for an S Corporation*, with the IRS or send the petitioner Schedules K-1 (Form 1120-S) showing his share of distributions.

The petitioner accused the individuals of embezzling more than \$1 million from 2012 to 2015. They then cut him off from the corporate books and kept him out of meetings, voted to increase their salaries and benefits, and authorized payouts to themselves based on retroactively increasing their paid time off. They then sued him in state court alleging breach of contract and fraud, and the petitioner countersued. The state court found that the corporation had over-distributed to one of the individuals and under-distributed to the petitioner and ordered the company to make corrective distributions to the petitioner, which they refused to do. The petitioner then agreed to an offer from one of the individuals to buy his entire stake in the corporation for approximately \$1.26 million.

In 2018, the petitioner filed his taxes for tax years 2011 through 2016. His attorney asked one of the individuals to give him the petitioner’s share of the corporation’s income and expenses and was provided with a napkin with the number \$300,000 written on it representing the petitioner’s pro-rata portion of the corporation’s losses for tax year 2014. The same thing occurred in 2015 with the napkin showing a loss of \$50,000. The corporation subsequently issued Schedules K-1 to the petitioner for the 2011 through 2016 tax years showing his proportionate share of the earnings and profits, not losses. Upon audit, the IRS determined that the petitioner did not correctly report income from the corporation for the years 2014 through 2016. The petitioner claimed, however, that the corporation’s S election terminated before the years in issue by virtue of the repeated disproportionate distributions that the corporation made which, he claimed, violated IRC §1361(b)(1)(d)’s requirement for an S corporation to have only a single class of stock. Consequently, he claimed that the corporation was no longer a pass-through entity from 2014 to 2016, and he should not be required to pay tax on his share of the corporation’s income.

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The Tax Court noted that Treas. Reg. §1.1361-1(l)(2) bases the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements around distribution and liquidation proceeds. That regulation further states that a “corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights.” The court also noted that the IRS had previously taken the position in Rev. Proc. 2022-19²⁴⁶ that it would not treat any disproportionate distributions made by a corporation as violating the single class of stock requirement if the corporation’s governing provisions provide for identical rights. Thus, the Tax Court concluded that the disproportionate distributions made before the years at issue did not terminate the corporation’s S election. The Tax Court noted that the corporation had not formally changed its governing documents or authorized or created a second class of stock. Instead, the governing provisions continued to provide for identical rights to distributions and liquidation proceeds.

Observation. It will not violate the single class of stock requirement if the S corporation does not make every distribution precisely pro rata. The regulations look not to what a corporation actually does in making its distributions, but rather to what the corporation’s governing provisions say. A corporation may make years of disproportionate distributions, but those distributions should not create a second class of stock as long as the governing provisions provide for identical rights to distribution and liquidation proceeds. On the other hand, if an S corporation makes every distribution pro-rata but confers nonidentical rights to distribution and liquidation proceeds in its governing provisions, the election will terminate. It should be of little concern that the IRS would treat a pattern of repeated disproportionate distributions as creating a deemed or implied governing provision.

This is not to say that an S corporation should make disproportionate distributions, however. An S corporation should make each distribution pro-rata. An S corporation must allocate all income pro-rata on a per-share, per-day basis. Thus, if distributions are made disproportionately, a shareholder could be burdened with a tax obligation without a pro-rata share of cash to pay the tax. But, from a tax and transition planning standpoint, this could be what is desired.

USDA’s Climate Smart Agriculture (CSA) Pilot Program

IRS Notice 2024-37, 2024-21 IRB 1191

The USDA’s CSA pilot program establishes CSA practices for cultivating domestic corn (CSA corn) and domestic soybeans (CSA soybeans) for use as sustainable aviation feedstocks. Currently, credits under IRC §40B apply through the end of 2024. Then the credits under IRC §45Z apply. The relevant information is found in section 4 of the IRS Notice.

Under the current rules, to qualify for the credit, sustainable aviation fuel (SAF) must have a minimum reduction of greenhouse gas emissions of 50% when compared to the production of petroleum-based jet fuel. Presently, the airline industry has committed to using 3 billion gallons of SAF annually by 2030 (10% of anticipated fuel needs). The credit increases by \$.01 for every percentage point increase in greenhouse gas emissions reduction percentage until the credit is maximized at \$1.75 per gallon. Only corn and soybeans are considered as eligible for the program.

To qualify for CSA practices, producers must engage in three activities for corn (no-till, cover crops, and enhanced efficiency nitrogen application). Soybean producers must only utilize no-till and cover crops. Practices are to be applied at the field scale. The definitional requirements are lengthy and specific.

²⁴⁶ Rev. Proc. 2022-19, 2022-41 IRB 282.

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Cover crops must meet the following requirements.

- Plant species, seedbed preparation, seeding rates, seeding dates, seeding depths, fertility requirements, and planting methods must be consistent with applicable local criteria and soil/site conditions.
- Select species must be compatible with other components of the cropping system.
- Herbicides used with crops must be compatible with cover crop selections and purpose(s).
- Cover crops may be established during the fallow season prior to planting the feedstock crop, or companion planted, or relay-planted into production crops.
- Cover crop residue must not be burned.
- The method and timing of termination must be determined to meet the grower's objective and the current Natural Resources Conservation Service Cover Crop Termination Guidelines.
- Must ensure that the planned management of grazed or hayed cover crops will not compromise the soil health and organic matter content.
- Cover crops must not be harvested for seed.
- If the specific rhizobium bacteria for the selected legume are not present in the soil, treat the seed with the appropriate inoculum at the time of planting.

Records must be maintained for each CSA practice and a producer must attest to compliance in certification documents.

Update. In April of 2025, the USDA announced the termination of the Partnerships for Climate-Smart Commodities (PCSC) initiative. It has been replaced by a new program called Advancing Markets for Producers (AMP). The primary reasons cited for this change include the following.

- Excessive administrative costs and inefficiencies under the previous program.
- A perception that a significant portion of the funding was going to corporations, non-governmental organizations, and universities rather than directly to farmers.
- A desire to cut bureaucratic red tape, streamline reporting, lower the paperwork burden on producers and put farmers first.

Key changes and implications of this shift:

- **Renaming.** The program is now the AMP initiative, with references to climate change largely removed from the official program name and communications.
- **Direct farmer benefit.** A new requirement mandates that at least 65% of federal funds must directly benefit producers.
- **Project review.** Existing grant agreements from the PCSC program are being individually reviewed against new criteria. Projects must demonstrate that a significant amount of federal funds will go to farmers, and grant recipients must have enrolled and made payments to at least one producer by December 31, 2024, to continue.
- **No new funding.** The AMP initiative will operate within existing PCSC funding; no new funds are being allocated for these partnerships. Eligible costs incurred before April 13, 2025, will be honored.

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Chapter 12: Retirement Plans for Small Businesses

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- For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.
- For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.
- Useful IRS tax rates tables for the 2025 tax year can be downloaded at **uofi.tax/ref**.
- Any important corrections made after the book went to press can be found at **uofi.tax/update**.

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When a small business client asks for advice on choosing appropriate retirement plans, they should consider the client's business structure, number of employees, and long-term retirement goals. Several retirement plan alternatives may be suitable for the client, including the following.

- **Solo §401(k) plan.** For self-employed individuals or business owners with no employees other than a spouse, this plan is often chosen because it offers higher contribution limits and can permit loans.
- **Simplified employee pension (SEP) plan.** Self-employed individuals and small business owners can make tax-deductible contributions to their own and their employees' retirement accounts, typically chosen for its ease of setup, low administrative costs, and high contribution limits.
- **Savings incentive match plan for employees (SIMPLE) individual retirement arrangement (IRA) plan.** This plan is designed for small businesses with 100 or fewer employees, offering easy setup and administration with mandatory employer contributions, making it ideal for employers who want to provide a retirement benefit without the complexity of a §401(k) and allow employee contributions.
- **SIMPLE §401(k) plan.** This type of plan combines features of a traditional §401(k) with the simplicity of a SIMPLE IRA, and is suitable for small businesses with 100 or fewer employees.
- **Safe harbor §401(k) plan.** Because it automatically satisfies nondiscrimination testing requirements, this plan is attractive for businesses seeking to maximize owner contributions while avoiding complex compliance issues.
- **Starter §401(k) plan.** This plan allows a small business to start a retirement plan without the obligation to make employer contributions.
- **Pooled employer plan (PEP).** If multiple businesses wish to offer similar retirement benefits to their employees, they can opt for a PEP for which a specialized provider assumes responsibility for compliance. Multiple employer plans are an older, less flexible version.
- **Multiple employer plan (MEP).** This retirement plan allows two or more unrelated employers to participate in a single, pooled plan, offering reduced administrative burden, shared fiduciary responsibility, and potential cost savings, making it attractive for small businesses seeking a more efficient alternative to sponsoring their own individual plans.

The tax practitioner faces a challenge in providing advice on the right plan or combination of retirement plans that best meets the client's needs. The practitioner should work closely with their client to identify the most suitable retirement plan or combination of plans that aligns with the client's goals. This chapter considers and compares each of these retirement plans in detail. This chapter discusses factors that influence the decisions about the optimal plan for a business, including available tax credits. Decision tools are at the end of the chapter that tax practitioners can use to guide their clients in selecting appropriate retirement plans.

Regular §401(k) plans are not analyzed in this chapter because they are subject to greater reporting requirements and potentially onerous nondiscrimination testing. Additionally, this chapter does not include a detailed analysis of retirement plan distributions or rollovers.

The SECURE 2.0 Act, enacted in December 2022, introduced significant reforms to retirement plans that enhance retirement security for small business employees.¹ Key changes include expanded coverage options, increased retirement savings opportunities, and simplified plan rules. These changes facilitate small businesses offering retirement benefits, while helping employees prepare financially.

Note. Traditional and Roth IRAs are beyond the scope of this chapter. For more information on these plans, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 8: Retirement Plan Issues for Individuals. See also the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Retirement Plans for Small Businesses. These can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

¹ SECURE 2.0 Act of 2022, PL 117-328.

TYPES OF RETIREMENT PLANS

Retirement planning for owner-only businesses — such as sole proprietors, single-member LLCs, and partnerships or corporations with no employees — offers unique opportunities and simplified plan options. These businesses are not subject to the same nondiscrimination testing, top-heavy rules, or administrative burdens² that apply to large-employer plans. As a result, they can take advantage of streamlined retirement plans that allow for high contribution limits, flexible funding, and minimal compliance requirements.

The most common retirement plans for owner-only businesses include the **solo §401(k)** and the **SEP plan**, both of which allow the business owner to make contributions in both an employee and employer capacity (in the case of the solo §401(k)) or solely as the employer (in the case of the SEP). These plans are particularly attractive to high-income individuals seeking to maximize retirement savings and reduce taxable income. In addition, traditional and Roth IRAs remain viable options for sole proprietors, especially those just starting or looking to supplement other retirement savings strategies. This section explores each of these options in detail, highlighting their contribution limits, tax treatment, as well as their advantages and disadvantages for different business profiles.

When a small business has one or more employees beyond the owner, retirement plan selection becomes more complex. Employers must balance their own retirement savings goals with the need to offer competitive benefits, manage administrative responsibilities, and comply with nondiscrimination and eligibility rules under the Code. Fortunately, the SECURE³ and SECURE 2.0 Acts have expanded the range of plan options and introduced incentives to make it easier for small businesses to offer retirement benefits.

The most common retirement plan options for businesses with employees include the SIMPLE IRA, SIMPLE §401(k), safe harbor §401(k), and the newly introduced starter §401(k). It also covers innovative structures like PEPs, which allow small businesses to share administrative and fiduciary responsibilities. Each plan type is examined in terms of eligibility, contribution limits, tax treatment, administrative complexity, and suitability for different business goals and employee demographics.

SOLO §401(k) PLAN

Solo §401(k) plans are available to sole proprietors, partnerships, C corporations, and S corporations. Other names for solo §401(k) plans include the following.

- One-participant §401(k) plan
- Solo-k
- Uni-k
- One-participant k

A solo §401(k) plan has the same rules and requirements as any other §401(k) plan. It is a traditional §401(k) plan that may be suitable for a business with no employees. Such a plan covers only:⁴

- The owner,
- The owner of a wholly owned trade or business (whether or not incorporated) and their spouse,
- Partners (or partners and their spouses) of a business partnership, or
- 2% shareholders of an S corporation.

² *One-participant 401(k) plans*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Jun. 12, 2025.

³ *SECURE Act of 2019*, PL 116-94.

⁴ *Form 5500 Corner*. Dec. 27, 2024. IRS. [www.irs.gov/Retirement-Plans/Form-5500-Corner] Accessed on Feb. 6, 2025.

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Loans to participants are permitted, subject to the rules of the §401(k) plan.⁵ Generally, §401(k) plan loans must be repaid within five years, but a loan used to purchase the employee's principal residence may be paid back over a period of more than five years.⁶

Establishment⁷

The same basic actions are necessary to set up a solo §401(k) as are required for multi-participant §401(k) plans.

One of the first decisions that must be made is whether the owner wants to establish the plan or use a professional or financial institution (e.g., a bank, mutual fund provider, or insurance company) to establish and maintain the plan. After the owner makes that decision, the following actions are necessary for a tax-advantaged §401(k) plan.

1. Adopt a written plan
2. Arrange a trust fund for the plan's assets
3. Develop a recordkeeping system
4. Provide plan information to the participating employees who meet age and service requirements

In the special case of a solo §401(k), the last step is automatically completed because no other person is employed.⁸

Note. For detailed information about these steps, go to **uofi.tax/16a1x5** [www.irs.gov/retirementplans/irc-401-k-plans-establishing-a-401-k-plan].

Contributions⁹

The business owner has two roles in a solo §401(k) plan: employer and employee. Plan contributions can be made in both capacities. The **owner** can contribute both of the following.

- **Elective deferrals** up to 100% of compensation, not to exceed the annual contribution limit. In 2025, the limit is \$23,500 or \$31,000 (\$23,500 maximum §401(k) elective deferral + \$7,500 catch-up contribution) if the employee is age 50 or over and the plan allows catch-up contributions.¹⁰ Individuals can make an even larger catch-up contribution of \$11,250 if they fall within a narrow age range of 60 to 63 years.¹¹
- **Employer nonelective contributions** up to 25% of compensation as defined by the plan (limits for self-employed individuals are discussed later).¹²

The limits on elective deferrals are by person, not by plan. Therefore, a business owner who is also employed by another company and participates in its qualified retirement plan must consider the limit for **all** the elective deferrals they make during a year.

⁵ IRS Pub. 4222, *§401(k) Plans for Small Businesses*.

⁶ *Retirement plans FAQs regarding loans*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans] Accessed on Feb. 7, 2025.

⁷ *IRC 401(k) Plans — Establishing a 401(k) Plan*. Nov. 15, 2024. IRS. [www.irs.gov/retirement-plans/irc-401k-plans-establishing-a-401k-plan] Accessed on Feb. 7, 2025; *One-participant 401(k) plans*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Aug. 25, 2025.

⁸ *How Starter 401(k) Plans Compare to Safe Harbor and Traditional Plans*. Droblyen, Eric. Jan. 3, 2025. Employee Fiduciary. [www.employeefiduciary.com/blog/starter-401k-plan] Accessed on Jun. 25, 2025.

⁹ *One-participant 401(k) plans*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Aug. 25, 2025.

¹⁰ IRS News Rel. IR-2024-285 (Nov. 1, 2024).

¹¹ IRC §414(v)(2) with updates for 2025 amounts in IRS Notice 2024-80, 2024-47 IRB 1120.

¹² *One-participant 401(k) plans*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Aug. 25, 2025.

Example 1. Dylan, age 36, is employed by Albion LLC, which has a §401(k) plan. He contributes \$23,500 to his employer's §401(k) plan for 2025. He is also the sole employee and member of a side business, Kart Racing, LLC, which has elected tax treatment as an S corporation. Dylan receives compensation of \$250,000 in 2025. In 2023, Dylan set up a solo §401(k) plan for his S corporation. He wants to contribute the maximum amount to this plan. However, he cannot make elective deferral contributions to his solo §401(k) plan because he has already contributed the maximum deferral amount to his employer's plan.

The **overall limit on contributions** (annual additions) in 2025 to a participant's account (elective deferrals and nonelective contributions) **cannot exceed the lesser of:**¹³

- \$70,000 for individuals under age 50, or
 - ♦ \$77,500 for other individuals ages 50 and over
 - ♦ \$81,250 for individuals ages 60–63
- 100% of the participant's compensation.

Note. Elective deferrals are not treated as catch-up contributions until they exceed the 2025 annual limit of \$23,500, the actual deferral percentage (ADP) test limit of §401(k)(3), or the plan limit (if any).¹⁴ For more information about the ADP test, see the 2013 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

As with the limit on elective deferrals, the annual overall limit on total contributions applies by **person**.¹⁵

Example 2. Use the same facts as **Example 1**. While Kart Racing, LLC can make a nonelective contribution of up to 25% of Dylan's 2025 compensation (which would be \$62,500, or $\$250,000 \times 25\%$), the contribution cannot exceed the overall contribution limit for 2025, which is \$70,000. Therefore, Kart Racing's nonelective contribution is limited to \$46,500 (\$70,000 overall limit – \$23,500 elective deferral). The overall retirement plan contribution limit for Dylan must consider his own elective deferrals and contributions from all employers.

Example 3. Use the same facts as **Example 2**, except Dylan is 57 years old and eligible to make catch-up contributions. He can contribute an additional \$7,500 in elective deferrals for 2025. His catch-up contributions can be split between the plans in any proportion he chooses. If Dylan elects to make catch-up contributions to his solo §401(k) plan, then his overall limit on total contributions to that plan is increased by the catch-up contributions (from \$70,000 to a maximum of \$77,500 for 2025¹⁶).

¹³ IRC §415(c); IRS Notice 2024-80, 2024-47 IRB 1120.

¹⁴ *Retirement Topics — Catch-Up Contributions*. Aug. 19, 2024. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-catch-up-contributions] Accessed on Feb. 7, 2025.

¹⁵ IRC §415(c); *Retirement Topics — 401(k) and Profit-Sharing Plan Contribution Limits*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on Aug. 25, 2025.

¹⁶ Adapted from Example 2 in *Retirement topics — 401(k) and profit-sharing plan contribution limits*. Aug. 19, 2024. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits] Accessed on Feb. 7, 2025.

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Plan contributions are generally applied to the year in which they are made. However, they can be applied to the previous year if all the following requirements are met.¹⁷

1. They are made by the due date of the tax return for the previous year (**including** extensions).
2. The plan was established by the end of the previous year.
3. The plan treats the contributions as though they had been received on the last day of the previous year.
4. The contributor accomplishes **both** of the following.
 - a. Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
 - b. The contributions are deducted on the previous year's tax return. (A partnership shows contributions for partners on Form 1065, *U.S. Return of Partnership Income*.)

Retroactive First-Year Elective Deferrals Under §401(k) for Sole Proprietors.¹⁸ For plan years beginning after December 31, 2022, an individual who owns the entire interest of an unincorporated business and is the sole employee may establish and make the elective deferral portion of the contributions to a new §401(k) plan after the close of the tax year but before the due date of the individual's tax return, without extensions. Such contributions will be treated as having been made for the plan's first tax year. This exception is only applicable for the **first year** of establishing the plan.

Caution. The election to defer earnings into a solo §401(k) plan must be made by December 31 of the calendar year for which the deferral applies.¹⁹ For participants receiving wages on Form W-2, *Wage and Tax Statement*, deferred contributions must be deposited no later than January 15 of the following year.²⁰ Sole proprietors or partners must deposit deferred earnings by the due date of the individual's tax return, including extensions.

Catch-Up Rules.²¹ Catch-up contributions are available to participants who are **age 50 or older** by the end of the calendar year. For 2025, the standard elective deferral limit is \$23,500. Eligible participants can contribute an additional \$7,500 as a catch-up contribution. This brings the total elective deferral limit to \$31,000 for those age 50 and older.

The SECURE 2.0 Act added indexing for the annual catch-up limits for traditional IRAs beginning in 2024. Previously, catch-up limits were indexed for §401(k), §403(b), and §457(b) plans. Because the inflation adjustment is rounded down to the next lower multiple of \$100, this provision has not yet affected the catch-up contributions for traditional IRAs.²²

Special Rule under SECURE 2.0.²³ Individuals aged 60–63 may be eligible for a larger catch-up contribution of \$11,250 (50% more than the standard catch-up). This provision is designed to help those nearing retirement boost their savings.

Note. Beginning in **2026** (delayed from 2024), participants with compensation exceeding \$145,000 will be required to make all catch-up contributions on an after-tax basis.²⁴ This includes catch-up contributions for those participants age 50 or older and for those age 60–63. Many plan providers are still in the process of updating their systems to support the necessary tracking and reporting for this change.

¹⁷ IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

¹⁸ SECURE 2.0 Act of 2022, PL 117-328, §317.

¹⁹ Treas. Reg. §1.401(k)-1(a)(3)(iii).

²⁰ 29 CFR §2510.3-102(b)(1).

²¹ SECURE 2.0 Act of 2022, PL 117-328, §108, affecting IRC §219(b)(5).

²² IRC §219(b)(5)(C)(iii).

²³ SECURE 2.0 Act of 2022, PL 117-328, §109, affecting IRC §414(v)(2).

²⁴ SECURE 2.0 Act of 2022, PL 117-328, §603, creating IRC §414(v)(7)(A).

Reporting and Compliance

An annual report must generally be filed for a solo §401(k) if it has \$250,000 or more in assets at the end of the year. A report for solo §401(k) plans must use Form 5500-EZ, *Annual Return of A One-Participant (Owners/Partners and Their Spouses) Retirement Plan or A Foreign Plan*, not Form 5500, *Annual Return/Report of Employee Benefit Plan*, or 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan*.²⁵ Although the Department of Labor instructions state that all Form 5500-series returns must be filed electronically,²⁶ the IRS Instructions for Form 5500-EZ state that it can be paper-filed.²⁷

A solo §401(k) plan that has less than \$250,000 in assets at the end of the year is generally exempt from the annual filing requirement.²⁸ However, for **every** solo §401(k) plan, a 5500-series return must be filed for the **final plan year** to indicate that all assets were distributed.²⁹

Testing Requirements

If the business hires employees who meet the plan eligibility requirements, they must be included in the plan. At that time, the solo §401(k) must be converted into a regular §401(k). When this occurs, the employee's elective deferrals are subject to nondiscrimination testing unless the §401(k) plan is a safe harbor plan or other plan exempt from testing.³⁰ Nondiscrimination testing is required only if the business has employees and the plan is not converted into a safe harbor §401(k), which is discussed later.³¹ An employee may be lawfully excluded from a §401(k) plan if they meet **any** of the following conditions.³²

- Has not attained age 21
- Has not completed a year of service during which they worked at least 1,000 hours
- Is covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good-faith bargaining

Advantages and Disadvantages

The **advantages** of a solo §401(k) plan are the following.

- It is suitable for business owners and their spouses.
- An employer can make nonelective contributions and/or elective deferrals.
- Nondiscrimination testing is not required if no employees exist (other than the owners).

The **disadvantages** of a solo §401(k) plan are the following.

- An annual report is required if there is more than \$250,000 in plan assets.
- It becomes a regular §401(k) plan if the business hires other eligible employees.

²⁵ *One-Participant 401(k) Plans*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Feb. 7, 2024; *Form 5500 Series*. U.S. Department of Labor. [www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500] Accessed on Aug. 25, 2025.

²⁶ Ibid.

²⁷ 2024 Instructions for Form 5500-EZ.

²⁸ Ibid.

²⁹ Ibid.

³⁰ *One-Participant 401(k) Plans*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/one-participant-401k-plans] Accessed on Feb. 7, 2025.

³¹ Ibid.

³² IRC §410.

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SEP PLAN³³

A SEP plan allows the employer to create SEP IRAs for its eligible employees. Generally, only the employer contributes to this type of plan. Under a salary reduction simplified employee pension (SARSEP) plan, employees can make voluntary contributions. However, a SARSEP plan cannot be established after 1996.

SEP plans do not permit loans to plan participants.³⁴

Establishment

Most employers, including self-employed individuals, can establish SEP plans. SEPs have low start-up and operating costs and, in most cases, can be established by adopting an IRS-model SEP using Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*.

If an employer adopts an IRS-model SEP using Form 5305-SEP, no prior IRS approval or determination letter is required. The employer keeps the Form 5305-SEP and does not file it with the IRS. Using Form 5305-SEP usually provides relief to the employer from annual filing requirements for retirement plan information returns.

An employer **cannot use** Form 5305-SEP if **any** of the following apply.

1. The employer currently maintains another qualified retirement plan other than another SEP.
2. The employer has eligible employees for whom SEP plans were not set up.
3. The employer uses the services of leased employees who are not the employer's common-law employees.
4. The employer is a member of any of the following unless **all** eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
 - a. An affiliated service group as described in IRC §414(m)
 - b. A controlled group of corporations, as described in §414(b)
 - c. Trades or businesses under common control as described in §414(c)
5. The employer does not pay the cost of the SEP contributions.

The employer must give each eligible employee a copy of Form 5305-SEP, its instructions, and the other information listed in the Form 5305-SEP instructions. An IRS-model SEP is not considered adopted until the employer provides this information to each employee.

A SEP IRA **must** be established for every eligible employee. It can be established with a bank, insurance company, or other qualified financial institution. The employer sends SEP contributions to the financial institution that maintains the plan.

The employer can establish a SEP for any year as late as the due date (including extensions) of its income tax return for that year. As discussed later, some small employers are eligible for a \$500 annual tax credit for establishing and contributing to a new SEP plan. This credit is available for three years.³⁵

³³ IRC §408(k); IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

³⁴ *Retirement plans FAQs regarding loans*. May 27, 2025. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans] Accessed on Aug. 12, 2025.

³⁵ *General Explanation of Tax Legislation Enacted in the 116th Congress*. p. 106. Feb. 2022. Joint Committee on Taxation. [www.congress.gov/116/cprt/JPRT45906/CPRT-116JPRT45906.pdf] Accessed on Jan. 31, 2025.

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Eligible Employees. The most significant downside to a SEP plan is that it has broad eligibility requirements. The plan **must** cover all employees who:

1. Are at least 21 years of age,
2. Have been employed for three of the last five years by the employer, and
3. Have received at least \$750 in compensation during the current year (2024 and 2025 threshold \$750, indexed annually).³⁶

An employer can use less restrictive participation requirements than these but **not more** restrictive requirements.

Any employee who meets these three requirements during the year **must** be covered regardless of whether they were temporary, part-time, or **not** employed at yearend.³⁷ This includes employees who are over age 70½.

The following employees **can be excluded** from coverage under a SEP.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who have received no U.S.-source wages, salaries, or other personal services compensation from the employer

Contributions

The employer must contribute a uniform percentage of pay for each employee, but the **employer is not required to make contributions to the plan every year**. Because the employer can decide how much to put into a SEP each year, this plan gives the company the flexibility to deal with fluctuating business conditions.

The employer has until the due date of the tax return, **including** extensions, to make contributions to the plan. The contributions are deductible for the designated tax year, even if the employer uses the cash receipts and disbursements method for tax reporting.

Employer contributions are not taxable to the employee until withdrawn. In addition, they are **not reported** on the employee's Form W-2, although the "retirement plan" box (box 13 on the 2024 Form W-2) must be checked.

Note. Because the employer makes SEP contributions, these contributions are not subject to payroll taxes.³⁸

³⁶ IRS Notice 2024-80, 2024-47 IRB 1120.

³⁷ *SEP Plan Fix-It Guide - Eligible employees were excluded from participating*. Aug. 8, 2024. IRS. [www.irs.gov/retirement-plans/sep-fix-it-guide-the-plan-excluded-eligible-employees-from-participating-in-the-sep] Accessed on Jan. 30, 2025.

³⁸ IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

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Elective deferrals by an employee in a SARSEP plan reduce the wages reported in box 1 of Form W-2 and are reported in box 12 using code “F.”³⁹

Employer contributions for 2025 to an employee’s SEP IRA are limited to the **lesser** of:⁴⁰

- 25% of the employee’s compensation (up to \$350,000 of compensation),⁴¹ or
- \$70,000.

Employees are immediately vested in contributions to SEP IRA accounts.⁴² SEP plans were initially intended to be funded with **pre-tax** contributions from employers, similar to traditional IRAs. This arrangement provides the employee with tax-deferred retirement savings. Catch-up contributions cannot be made to SEP plans.⁴³

Roth Contribution Election. The SECURE 2.0 Act allows employees to elect to treat their SEP plan as a Roth IRA. The SEP plan must be designated as a Roth IRA at the time of the election. The employer’s contributions to the SEP plan are treated as Roth contributions, which are made with after-tax dollars. Although permitted starting January 1, 2023, many custodians needed years to update their systems for Roth contributions.⁴⁴

Caution. Many financial institutions and custodians are not yet equipped to handle Roth reporting for employer-sponsored IRA plans. As a result, it can be difficult for small business owners to find a provider that supports Roth options within SIMPLE or SEP IRA structures. Practitioners should advise clients to confirm whether a prospective custodian can accommodate Roth contributions and fulfill the associated reporting requirements before selecting a provider.

Limits for Self-Employed Individuals

Self-employed taxpayers must make a special calculation to determine the maximum amount of their contributions. When calculating such a contribution, the compensation amount is the taxpayer’s earned income, which is defined as net earnings from self-employment (SE) after deducting both of the following.

- Half of the SE tax
- Contributions for the self-employed taxpayer

The compensation amount and the amount of the taxpayer’s plan contribution depend on each other (i.e., this is a circular calculation). One way to make the calculation is to use a reduced plan contribution rate, which is calculated by dividing the plan contribution rate by the sum of 100% plus the plan contribution rate.⁴⁵ This means a self-employed taxpayer is effectively limited to a nonelective contribution rate of 20% of compensation (25% maximum contribution rate ÷ (100% + 25% contribution rate)).

A worksheet in IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*, can also be used to determine the maximum deductible contribution for a self-employed taxpayer.

³⁹ General Instructions for Forms W-2 and W-3.

⁴⁰ IRS Notice 2024-80, 2024-47 IRB 1120.

⁴¹ IRC §408(k)(3)(C) with updates for 2025 amounts in IRS Notice 2024-80, 2024-47 IRB 1120.

⁴² *Simplified Employee Pension plan (SEP)*. Aug. 19, 2024. IRS. [www.irs.gov/retirement-plans/plan-sponsor/simplified-employee-pension-plan-sep#operate] Accessed on Jan. 30, 2025.

⁴³ IRC §414(v)(2), which omits reference to IRC §408(k), which authorizes SEP plans.

⁴⁴ *SECURE 2.0 Act of 2022*, PL 117-328, §601; see, for example, *Introducing Roth employee deferrals for SIMPLE IRAs*. Sep. 16, 2024. Capital Group. [www.capitalgroup.com/advisor/news/roth-employee-deferrals-simple-iras.html] Accessed on Jun. 13, 2025.

⁴⁵ *Self-employed individuals — Calculating your own retirement-plan contribution and deduction*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/self-employed-individuals-calculating-your-own-retirement-plan-contribution-and-deduction] Accessed on Jan. 30, 2025.

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Example 4. Beth is the sole proprietor of a successful consulting business. She has one employee, Randall. The company has a SEP plan.

In 2025, Randall's wages are \$40,000. Beth's net income on Schedule C (Form 1040), *Profit or Loss from Business*, is \$250,000 before taking into account any SEP contributions. After meeting with her tax accountant, Beth decides to make the **maximum** contributions to her and Randall's SEP accounts.

The maximum amount that Beth can contribute to Randall's SEP plan is \$10,000 ($\$40,000 \times 25\%$). Beth can deduct this contribution on her 2025 Schedule C even though she does not remit the money until after the end of the year. She has until the due date of her return, including extensions, to make the contribution.

The amount that Beth can contribute to her SEP plan for 2025 is \$45,174, which is calculated as follows.

Net profit from SE before SEP contributions	\$250,000
Less: contribution to Randall's SEP plan	(10,000)
Net profit from SE after SEP contribution	\$240,000
Less: $\frac{1}{2}$ SE tax ($\$176,100^a \times 6.2\% + \$240,000 \times 92.35\% \times 1.45\%$)	(14,132)
Net profit reduced by $\frac{1}{2}$ SE tax	\$225,868
Multiplied by reduced plan contribution rate ($(25\% \text{ plan contribution rate} \div (100\% + 25\% \text{ plan contribution rate}))$)	$\times 20\%$
Beth's SEP plan contribution	\$ 45,174

^a *Contribution and Benefit Base*. SSA. [www.ssa.gov/oact/cola/cbb.html] Accessed on Jan. 30, 2025.

Reporting and Compliance

Employers with SEPs have relatively simple reporting requirements regarding notification, annual reporting, and testing.

Employee Notification Requirements. As mentioned earlier, the employer must give eligible employees certain information about the SEP when it is established. In addition, the employer must give eligible employees an annual statement showing any contributions made to their SEP plans.

Note. For further details about the information that must be provided to employees, see the instructions for Form 5305-SEP.

Annual Reporting. SEP plans are generally **not required** to file annual reports (Form 5500 series).⁴⁶

Testing Requirements. SEP plans are subject to the top-heavy rules of IRC §416. These rules are designed to ensure that lower-paid employees receive at least a minimum benefit in plans in which higher-paid employees (referred to as **key employees**) own most assets. Top-heavy plans are subject to additional requirements, such as faster vesting and minimum contributions for participants who are not key employees.

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⁴⁶ *SEP plan fix-it guide — SEP plan overview*. Aug. 26, 2024. IRS. [www.irs.gov/retirement-plans/sep-fix-it-guide-sep-plan-overview] Accessed on Jan. 30, 2025.

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Although a SEP plan must provide for immediate vesting regardless of the top-heavy rules,⁴⁷ a SEP plan is treated as a defined contribution plan for purposes of the minimum contribution top-heavy requirements under §416.⁴⁸ A SEP plan is generally top-heavy if the sum of the IRA balances of the key employees⁴⁹ is more than 60% of the plan's balances for all employees.⁵⁰ In a top-heavy plan year, the minimum contribution an employer must make for each eligible non-key employee in the SEP plan is the lower of 3% of the employee's pay or the highest percentage made for any key employee.⁵¹

Note. For more information about the top-heavy requirements, see IRS Pub. 7002, *Employee Benefit Plans*.

Advantages and Disadvantages

Some **advantages** of SEP plans include the following.

- No upper limit on the number of employees covered.
- Employees immediately vest in all contributions.
- Employer contributions are not required every year.
- Contributions can be made for participants over age 70½.
- Some small employers are eligible for a tax credit when establishing a SEP plan.

Some **disadvantages** of SEP plans include the following.

- The eligibility requirements are broad.
- Plans are subject to top-heavy requirements.
- Employees cannot make voluntary contributions except for pre-1997 SARSEP plans.
- Employer contributions to SEP plans do not qualify for the qualified retirement savings contributions credit.
- Employers cannot make catch-up contributions for employees ages 50 and over, although much larger contributions are possible.

SIMPLE IRA PLAN⁵²

A SIMPLE IRA plan is a retirement plan option for employers with 100 or fewer employees. To qualify, employees must have received at least \$5,000 in compensation for the preceding year. An employer with a SIMPLE IRA plan that is not eligible in a subsequent year due to exceeding the 100-employee rule can nevertheless be treated as an eligible employer for the two years following the last year the employer complied with the 100-employee rule.⁵³ However, this 2-year grace period does not apply if such failure is due to any acquisition, disposition, or similar transaction involving the employer.⁵⁴

⁴⁷ *Retirement topics — Vesting*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-vesting] Accessed on Jan. 30, 2025.

⁴⁸ IRC §416(i)(6)(A).

⁴⁹ See IRC §416(i)(1).

⁵⁰ IRC §§408(k)(1)(B), 416(c)(2), and 416(g)(1)(A)(ii).

⁵¹ IRC §416(c)(2); IRS Pub. 7002, *Employee Benefit Plans*.

⁵² IRC §408(p); IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

⁵³ IRC §408(p)(2)(C)(i)(II).

⁵⁴ *Ibid.*

For the SIMPLE IRA to be a qualified salary reduction arrangement, an employer cannot offer any other retirement plan to their employees.⁵⁵

These plans allow the **employee** to contribute a percentage of their salary each pay period. They also require the **employer** to contribute a certain minimum amount.

SIMPLE IRAs do not permit loans to plan participants.⁵⁶

Establishment

A small business can establish a SIMPLE IRA plan with little administrative burden. Form 5304-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — Not for Use With a Designated Financial Institution*, is used if the plan participants are allowed to select the financial institution at which the SIMPLE IRA is established. Form 5305-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — for Use With a Designated Financial Institution*, is used if all the contributions under the plan are deposited initially at a designated financial institution of the **employer's** choosing.

The SIMPLE IRA plan is adopted when the appropriate form is completed and signed by the employer (and the designated financial institution, if any). The employer should retain a copy of the form; it is not filed with the IRS.

To make a SIMPLE IRA effective for the current tax year, the employer generally must adopt the plan by **October 1** of that tax year.⁵⁷ However, new employers coming into existence after October 1 of the year the SIMPLE IRA is established are permitted to set up a SIMPLE IRA plan as soon as administratively feasible after the business comes into existence.

A SIMPLE IRA must be established for each eligible employee. Form 5305-S, *SIMPLE Individual Retirement Trust Account*, and Form 5305-SA, *SIMPLE Individual Retirement Custodial Account*, are model trust and custodial account documents, respectively, that the participant and the trustee or custodian can use for this purpose.

Contributions to a SIMPLE IRA are not counted towards the maximum amount an individual can contribute to a Roth or traditional IRA.

Eligibility

The eligibility requirements for SIMPLE IRA plans are more employer-friendly than those for SEP plans. Any employee who received at least \$5,000 in compensation during any two years preceding the current calendar year and who is reasonably expected to receive at least \$5,000 during the current calendar year is eligible to participate. Here, the term **employee** includes a self-employed individual who realizes a profit from their sole proprietorship. Employees who are over 70½ years of age are also eligible to participate.⁵⁸

The employer can use less restrictive eligibility requirements by eliminating or reducing the prior-year compensation requirements, the current-year compensation requirements, or both. However, the employer cannot impose additional employee eligibility conditions or more restrictive requirements.

If the plan provides for it, the employer can automatically enroll employees in a SIMPLE IRA plan. However, the employees must be allowed to choose the amount of their salary reduction contributions or to contribute nothing.

⁵⁵ IRC §408(p)(2)(D).

⁵⁶ *Retirement topics — Plan loans*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-loans] Accessed on Feb. 6, 2025.

⁵⁷ IRS Notice 98-4, 1998-2 IRB 25.

⁵⁸ *SIMPLE IRA plan FAQs*. Nov. 15, 2024. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-simple-ira-plans] Accessed on Feb. 6, 2025.

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The following employees **can be excluded** from coverage under a SIMPLE IRA plan.

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer
- Nonresident alien employees who received no U.S. source wages, salaries, or other personal services compensation from the employer

Contributions

Under a SIMPLE IRA plan, an employee can generally contribute up to \$16,500 in 2025 by payroll deduction. The maximum employee salary deferral is \$20,000 (\$16,500 + \$3,500 catch-up contribution limit) if they are age 50–59 or above age 63.⁵⁹ The maximum deferral increases further to \$21,750 (\$16,500 + \$5,250 catch-up contribution limit) if they are ages 60–63.

The SECURE 2.0 Act contains a 110% provision that allows the employees to contribute an additional 10% if they work for either of the following classes of employers.⁶⁰

- Employers with 25 or fewer employees each earning \$5,000 during the preceding year
- Employers who have exceeded the 25-employee limit only within the last two years and elect the higher limit

In 2025, if an employer satisfies one of these requirements, covered employees can contribute \$17,600 to the SIMPLE IRA accounts if they are under age 50, \$21,450 (\$17,600 + \$3,850 catch-up amount) if they are age 50–59 or age 64 and above, and \$22,850 (\$17,600 + \$5,250) if they are age 60–63.⁶¹

Each year, employees choose the amount they contribute to their SIMPLE IRA and can choose to contribute nothing.

Special Increase in Catch-Up Employee Contributions.⁶² The SECURE 2.0 Act introduced changes to SIMPLE IRA plans under IRC §408(p), permitting larger contributions by employees age 50 and older. Specifically, the Act permits these employees to make catch-up contributions of 110% of the regular catch-up contribution.⁶³ The 2025 regular catch-up contribution is \$3,500.⁶⁴ The total catch-up amount with the 110% provision is \$3,850 ($\$3,500 \times 110\%$).⁶⁵

This SIMPLE catch-up provision is available to employees working for employers that had 25 or fewer employees earning \$5,000 or more in the previous year. It is also available to employees age 50 and older who worked for employers with 26-100 employees earning \$5,000 or more, but only if their employers agree to make either **4% elective** contributions or **3% nonelective** contributions.⁶⁶ This provision also applies to employers that had no retirement plan in the 3-year period ending when the SIMPLE IRA plan went into effect.

⁵⁹ IRS News Rel. IR-2024-285 (Nov. 1, 2024).

⁶⁰ *SECURE 2.0 Act of 2022*, PL 117-328, §117(a); *General Explanation of Tax Legislation Enacted in the 117th Congress*, p. 354, Dec. 2023. Joint Committee on Taxation. [www.jct.gov/publications/2023/jcs-1-23] Accessed on Feb. 7, 2025.

⁶¹ IRS News Rel. IR-2024-285 (Nov. 1, 2024).

⁶² *SECURE 2.0 Act of 2022*, PL 117-328, §117; IRS Notice 2024-2, 2024-2 IRB 316.

⁶³ IRC §408(p)(2)(E)(ii).

⁶⁴ IRS Notice 2024-80, 2024-47 IRB 1120. See page 2.

⁶⁵ Ibid.

⁶⁶ IRC §408(p)(2)(E)(ii)(IV).

Example 5. Jim and Joane are twin siblings born in 1968. Jim works for ABC Manufacturing, Inc., an S corporation with 20 employees who each earned more than \$5,000 in 2024. ABC implements a SIMPLE IRA plan effective January 1, 2025, and it provided the appropriate notices to employees before the October 1, 2024, deadline, as required.

Because he is over 50 years old, Jim can make salary reduction contributions to his SIMPLE IRA account up to \$21,450 (\$17,600 regular SIMPLE contribution limit + \$3,850 catch-up amount) during 2025, even though ABC has not made a special election. ABC makes matching 3% contributions to its employees' SIMPLE IRA accounts. Because Jim's salary is \$70,000, ABC contributes \$2,100 (matching limit is $\$70,000 \times 3\%$) to his SIMPLE IRA account.

Joane also earns \$70,000 at her employer, DEF Dairy, Inc., an S corporation that employs 80 people who earned more than \$5,000 in 2024. With its SIMPLE IRA plan, DEF Dairy elects to follow the provisions allowing increased catch-up contributions. It makes the **4%** matching contributions required by the SECURE 2.0 Act, §117. Accordingly, it deposits \$2,800 (matching limit is $\$70,000 \times 4\%$) into Joane's SIMPLE IRA account in 2025.

Employer Contributions. Employers can choose either of two methods for making contributions to employees' SIMPLE IRA accounts, depending on whether they want to **match** a percentage of contributions that employees make to their own retirement accounts or whether they want to **contribute** to all eligible employees' retirement accounts regardless of whether the employee elects to participate or not.

Matching Contributions Made by Employer.⁶⁷ This method calls for the employer to match individual employees' own contributions dollar-for-dollar up to 3% of the employee's compensation. If an employee contributes less than 3% of their compensation, the employer only matches the amount contributed. An employer can contribute as little as 1% of the employee's compensation, but this cannot be lower than 3% for more than two years of any 5-year period that ends with the calendar year of when the employer lowered contribution.

Note. While the matching percentage is based on employee compensation, it is important to note that employee contributions are subject to annual limits set by the IRS (e.g., \$16,500 for 2025, adjusted annually). Additionally, compensation used for calculating contributions may be subject to limits under other sections of the tax code (e.g., IRC §401(a)(17)).

Example 6. Use the same facts as **Example 4**, except Beth has a SIMPLE IRA plan instead of a SEP. In October 2024, Beth notified Randall that she would match employee contributions up to 3% of compensation in 2025. Randall chose to contribute the maximum amount allowed; he is age 51 in 2025, so his voluntary payroll deduction is \$21,450 (\$17,600 regular contribution + \$3,850 catch-up contribution) for 2025.

Randall's 2025 wages are \$40,000; therefore, Beth's 3% match into Randall's SIMPLE IRA is \$1,200 ($\$40,000 \times 3\%$). Beth has 30 days after withholding Randall's voluntary contributions to deposit them into his SIMPLE IRA account. She has until the due date of her return, including extensions, to deposit the \$1,200 matching contribution.

Beth is age 46, so her maximum deferral for 2025 is \$17,600. The calculation of her matching contribution of \$6,893 is shown on the following page.

⁶⁷ IRC §408(p)(2)(C)(ii)(II).

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Net profit from SE before SIMPLE contributions	\$250,000
Less: matching contribution to Randall's SIMPLE IRA	(1,200)
Net profit from SE after SIMPLE matching contribution	\$248,800
Multiplied by taxable SE percentage	× 92.35%
Net SE earnings (from Schedule SE, line 4a)	\$229,767
Multiplied by matching percentage	× 3%
Beth's SIMPLE IRA matching contribution	\$ 6,893

Observation. SE income is determined differently in **Example 4** (SEP) and **Example 6** (SIMPLE). SE income under the **SEP plan** is based on the qualified pension plan rules of §401(c)(2), while SE income under the **SIMPLE plan** is based on IRC §1402(a).⁶⁸ There are two distinguishing factors in the calculations.

1. The SEP calculation subtracts the self-employed person's IRA contribution from qualified earnings, while the SIMPLE calculation does not.
2. The SEP calculation includes a deduction for the employer's portion of SE taxes, while the SIMPLE calculation adjusts for this factor by multiplying earnings by 92.35%.

In **Example 4**, Beth is permitted to contribute **\$45,174** to her retirement funds, while in **Example 6**, her maximum contribution is only **\$24,493** (\$17,600 elective deferral + \$6,893 matching contribution). Which plan is better for Beth depends on how much available cash she has each year to fund the plan. Her contribution for Randall in **Example 4** is \$10,000, whereas in **Example 6**, the amount is only \$1,200.

Nonelective Contributions Made by Employer.⁶⁹ Prior to January 1, 2024, employers using the nonelective contribution method under a SIMPLE IRA plan were required to contribute 2% of each eligible employee's compensation, regardless of whether the employee made salary deferrals. The SECURE 2.0 Act introduced a new option starting in 2024 that employers may now make additional nonelective contributions of up to the lesser of 10% of compensation or \$5,000 per employee, indexed for inflation. These contributions must be made uniformly to all eligible employees.

Employers with 26-100 employees may only offer higher employee deferral limits if they also provide at least a 4% matching contribution or a 3% nonelective contribution. For 2025, the higher employee deferral limits are as follows.⁷⁰

- \$17,600 for employees under age 50
- \$21,450 for employees 50-59
- \$22,850 for employees age 60-63
- \$21,450 for employees age 64 and above

While SIMPLE IRA contributions are generally based on employee compensation, the **maximum compensation that can be considered** for contribution purposes is subject to the **annual limit under §401(a)(17)** (e.g., \$350,000 in 2025, adjusted annually). This provision also applies to SIMPLE §401(k) plans, which are discussed later.⁷¹

Note. This provision offers a valuable opportunity for employers who wish to provide enhanced retirement benefits to employees — particularly in competitive labor markets — while maintaining the simplicity of a SIMPLE IRA structure. However, practitioners should ensure that clients understand the uniformity requirement, the notice obligations, and the interaction with other contribution rules.

⁶⁸ IRC §§408(p)(6)(A)(ii) and 1402(a)(12).

⁶⁹ IRC §408(p)(2); *SECURE 2.0 Act of 2022*, PL 117-328, §§117(c)(2), creating IRC §408(p)(2)(C)(ii)(IV) and 116.

⁷⁰ IRS News Rel. IR-2024-285 (Nov. 1, 2024).

⁷¹ IRC §401(k)(11)(B)(i)(III).

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The employer's choice of making matching contributions or nonelective contributions is not permanent.⁷² In the 60 days before a new calendar year begins, the employer must notify eligible employees whether they will make matching contributions or nonelective contributions in the upcoming year.

Example 7. Olivia owns a boutique architecture firm with 18 employees, all of whom earned more than \$5,000 in 2024. She currently sponsors a SIMPLE IRA plan and is considering ways to enhance employee benefits to improve retention. Olivia already makes the standard 2% nonelective contribution for all eligible employees.

After consulting with her tax advisor, Olivia learns that under the SECURE 2.0 Act, she may now make an **additional nonelective contribution of up to 10% of compensation**, capped at **\$5,000 per employee**, in addition to the required 2% contribution. She decides to implement this optional contribution for 2025.

Olivia continues to make the standard 2% nonelective contribution for all employees. She elects to make an additional 10% nonelective contribution for each eligible employee, capped at \$5,000.

One of her employees, Marcus, earns \$48,000 in 2025. Olivia contributes the following.

- \$960 ($2\% \times \$48,000$) as the required nonelective contribution
- \$4,800 ($10\% \times \$48,000$) as the optional nonelective contribution

Because Marcus's total additional contribution does not exceed the \$5,000 cap, Olivia may deduct the full \$5,760 (\$960 + \$4,800) on her business return.

Olivia must include this election in her 2025 SIMPLE IRA plan notice and ensure that the plan is amended to reflect the new contribution structure by **December 31, 2026**.

Observation. This optional contribution allows Olivia to offer a more competitive retirement benefit while maintaining the administrative simplicity of a SIMPLE IRA. However, she must ensure that the contribution is applied **uniformly** across all eligible employees and that the election is properly documented and communicated.

Additional Employer Contribution Details. In addition to choosing between matching and nonelective contributions, employers must be aware of several important administrative, tax, and timing considerations related to contributions.

- **Employee taxations on employer contributions.**⁷³ Employees are immediately vested in contributions to their SIMPLE IRA accounts. Contributions are not taxable until withdrawn.
- **These additional employer contributions are not subject to payroll taxes.**⁷⁴
- **Employer reporting of employee contributions.**⁷⁵ Plan contributions made by the employer for their **employees** are deducted on the employer's tax return. For example, sole proprietors deduct contributions on Schedule C, or Schedule F (Form 1040), *Profit or Loss From Farming*; partnerships deduct them on Form 1065, *U.S. Return of Partnership Income*; and corporations deduct them on Form 1120, *U.S. Corporation Income Tax Return*, or Form 1120-S, *U.S. Income Tax Return for an S Corporation*. Contributions made for partners by a partnership are reported to the partners on their Schedules K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* Sole proprietors and partners deduct contributions for **themselves** on Schedule 1 of Form 1040, *U.S. Individual Income Tax Return*. Employee contributions are reported in box 12 of Form W-2 using code "S", provided that the SIMPLE plan is not part of a §401(k) plan.⁷⁶ Also, the "Retirement Plan" box must be checked. Employer matching and nonelective contributions are not reported on Form W-2.

⁷² IRC §408(p)(5)(C).

⁷³ IRC §408(p)(1)(A).

⁷⁴ IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

⁷⁵ IRC §408(p)(2)(A).

⁷⁶ 2024 General Instructions for Forms W-2 and W-3.

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- **Contribution timing issues.**⁷⁷ Matching and nonelective contributions for a particular tax year must be made by the due date, including extensions, of the employer's income tax return. The employer must make the salary reduction contribution to the SIMPLE IRA within 30 days after the end of the month in which the amount was withheld from the employee's pay.

The tax year of the deduction for matching and nonelective contributions is based upon the **calendar year** for which the contributions are made. For fiscal year taxpayers, the deductions for the entire calendar year are taken on the return for the fiscal year which includes December 31.

Example 8. The fiscal year for Westmorland Water Works Inc. (Westmorland) ends on August 31. Matching and nonelective contributions made under the company's SIMPLE IRA plan for calendar year 2024 are deductible by Westmorland for the tax year beginning September 1, 2024, and ending August 31, 2025.

- **Plan amendment timing.**⁷⁸ Generally, employers with 25 or fewer employees do not need to formally adopt plan changes because the changes automatically apply. However, if an employer has more than 25 employees and wants to take advantage of the larger contribution amounts, they must formally adopt the changes in their plan documents by **December 31, 2026**. Making this election enables larger employers to make matching contributions of 4% or nonelective contributions of 3%.

The following table illustrates the SIMPLE IRA details enhanced SECURE 2.0 enhancements.

Feature	SECURE 2.0 Enhancement
Nonelective contribution	Up to 10% of compensation, capped at \$5,000 (in addition to the 2% mandatory contribution)
Higher employer elective deferrals	Requires matching 4% or nonelective 3% for more than 25 employees
Plan amendment deadline	December 31, 2026
110% elective provision	Employee election if employer has 25 or fewer employees; for employers with 26–100 employees, only available if employer elects higher deferrals

Roth Option

The SECURE 2.0 Act allows employees to designate their SIMPLE IRA as a Roth IRA. The employees must make this election when setting up the account, and both employee and employer contributions are made with **after-tax** dollars. Although permitted starting January 1, 2023, many custodians needed years to update their systems for Roth contributions.⁷⁹ Employers must amend SIMPLE plan documents by December 31 before the first year Roth contributions are offered.

⁷⁷ IRC §408(p)(5)(A).

⁷⁸ IRC §408(p)(2); IRS Notice 2024-2, 2024-02 IRB 316. See Section E.

⁷⁹ *SECURE Act of 2022*, PL 117-328, §601; See, for example, *Introducing Roth employee deferrals for SIMPLE IRAs*. Sep. 16, 2024. Capital Group. [www.capitalgroup.com/advisor/news/roth-employee-deferrals-simple-iras.html] Accessed on Jan. 31, 2025.

Reporting and Compliance

Although notification and reporting requirements for SIMPLE IRAs are less cumbersome than for qualified plans, employers must still follow some basic rules. In contrast to the notification rules for SEP plans, notifications for SIMPLE plans must generally precede the end of the calendar year. **Thus, a SIMPLE IRA plan must be in effect by October 1 of the plan year in which it becomes effective.**⁸⁰

Employee Notification Requirements.⁸¹ The employer is required to provide the following information to each employee before the beginning of the election period.

1. The employee's opportunity to make or change a salary reduction choice
2. The employer's decision to make either matching contributions or nonelective contributions
3. A summary description provided by the financial institution
4. Written notice that the employee's balance can be transferred without cost or penalty if they use a designated financial institution

The **election period** is generally the 60 days immediately preceding January 1 (November 2 to December 31 of the preceding calendar year). However, these dates are modified if the employer establishes a SIMPLE IRA plan midyear or if the 60-day period falls before the first day an employee becomes eligible to participate in the plan. (For more information, see IRS Pub. 560.) Additionally, if an employer offers Roth contribution elections, employees must be notified before January 1 of the year during which this becomes effective.

Annual Reporting. An employer is **not required** to file a Form 5500 for a SIMPLE IRA plan.⁸²

Advantages and Disadvantages

The **advantages** of a SIMPLE IRA plan include the following.

- Employees may make salary reduction contributions, and catch-up contributions are permitted for employees ages 50 and older.
- Employee eligibility requirements are more employer-friendly than the requirements for the SEP IRA.
- Employees are immediately vested in all contributions.
- Nondiscrimination testing is not required.
- There is no annual reporting requirement.
- Contributions can be made for participants over age 70½.
- Some small employers are eligible for a tax credit, discussed later, when they establish a SIMPLE IRA plan.

The **disadvantages** of a SIMPLE IRA plan include the following.

- They are only for employers with 100 or fewer employees.
- Either employer matching or nonelective contributions are required every year.
- The employer cannot offer any other retirement plan.

⁸⁰. 2023 IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

⁸¹. IRC §401(p)(5)(C).

⁸². *SIMPLE IRA plan*. Aug. 26, 2024. IRS. [www.irs.gov/retirement-plans/plan-sponsor/simple-ira-plan] Accessed on Feb. 6, 2025.

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SIMPLE §401(k) PLAN⁸³

Similar to the SIMPLE IRA plan, a SIMPLE §401(k) plan is a retirement plan option for an employer with 100 or fewer employees. Like the SIMPLE IRA, the SIMPLE §401(k) plan **allows the employee to elect to contribute** a percentage of their salary each pay period. **Employer contributions** are also **required**. Unlike a SIMPLE IRA, a SIMPLE §401(k) plan may allow participants to borrow funds from their accounts. Another difference is that annual reporting is required for SIMPLE §401(k) plans.

An exclusive plan requirement applies, whereby SIMPLE §401(k) plan participants cannot also participate in another qualified plan maintained by the same employer.⁸⁴ An employer with a SIMPLE §401(k) plan that fails to be eligible in a subsequent year because they exceeded the 100-employee rule can nevertheless be treated as an eligible employer for the two years following the last year the employer was an eligible employer.⁸⁵ However, this 2-year grace period may not apply if such failure is due to any acquisition, disposition, or similar transaction involving the employer.⁸⁶

Establishment

Establishing a SIMPLE §401(k) plan involves following the same rules and requirements as any other traditional §401(k) plan, as discussed previously in the solo §401(k) section.⁸⁷

Contributions

Like other §401(k) plans, SIMPLE §401(k) plans accept both employee and employer contributions. Importantly, a SIMPLE §401(k) plan is not subject to the nondiscrimination and top-heavy rules if the following conditions are met.⁸⁸

1. Employees can make **elective deferrals** up to 100% of compensation, not to exceed the annual contribution limit. In 2025, the general limit is \$16,500, or \$20,000 if the employee is age 50–59 or age 64 and over if the plan allows catch-up contributions.⁸⁹ Employees can make elective deferrals, as discussed previously in the section on SIMPLE IRA plans, which the following table summarizes.⁹⁰

Age	Employer Has 1–25 employees	Employer Has 26–100 Employees and Makes No Election
Up to 50	\$17,600	\$16,500
50–59	21,450	20,000
60–63	22,850	21,750
64 and up	21,450	20,000

2. In 2025, no more than \$350,000⁹¹ of the employee's compensation can be taken into account when calculating matching contributions and nonelective contributions.

^{83.} *Choosing a Retirement Plan: SIMPLE 401(k) Plan*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/choosing-a-retirement-plan-simple-401k-plan] Accessed on Feb. 11, 2025; IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

^{84.} Treas. Reg. §1.401(k)-4(c).

^{85.} Treas. Reg. §1.401(k)-4(b)(2).

^{86.} *Ibid.*

^{87.} IRC §416(g)(4)(G).

^{88.} IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

^{89.} IRS News Rel. IR-2024-285 (Nov. 1, 2024).

^{90.} *Ibid.*

^{91.} IRS Notice 2024-80, 2024-47 IRB 1120.

3. The employer must make one of the following:
 - a. **Matching contributions** up to 3% of compensation for the year, or
 - b. **Nonelective contributions** of 2% of compensation on behalf of each eligible employee who earned at least \$5,000 of compensation for the year. However, SIMPLE §401(k) plans allow for the same increased limits as SIMPLE IRA plans, as discussed previously.⁹²
4. No other contributions can be made to the plan.
5. No contributions are made, and no benefits accrue, under any **other** qualified retirement plan sponsored by the employer on behalf of any employee eligible to participate in the SIMPLE §401(k) plan.
6. Employees vest in all contributions immediately.

Plan contributions are generally applied to the year in which they are made. However, they can be applied to the previous year if **all** the following requirements are met.⁹³

1. They are made by the due date of the tax return for the previous year (plus extensions).
2. The plan was established by the end of the previous year.
3. The plan treats the contributions as though it had received them on the last day of the previous year.
4. The contributor accomplishes **both** of the following.
 - a. Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
 - b. The contributions are deducted on the previous year's tax return. (A partnership shows contributions for partners on Form 1065.)

Reporting and Compliance

Like safe harbor §401(k) plans, which are discussed later, SIMPLE §401(k) plans have stringent employee notification and reporting requirements compared to IRA alternatives. These notifications ensure employees are aware of their options, while the annual reports filed with the Department of Labor confirm the employer's compliance with tax laws.

Employee Notification Requirements.⁹⁴ Similar to the SIMPLE IRA, an employer with a SIMPLE §401(k) plan is required to provide the following information to each employee before the beginning of the election period.

- The employee's opportunity to make or change a salary reduction choice
- The employer's decision to make either matching contributions or nonelective contributions
- A summary description provided by the financial institution
- Written notice that the employee's balance can be transferred without cost or penalty if they use a designated financial institution

The **election period** is generally the 60 days immediately preceding January 1 (November 2 to December 31 of the preceding calendar year). However, these dates are modified if the employer establishes the SIMPLE §401(k) plan midyear or if the 60-day period falls before the first day an employee becomes eligible to participate in the plan.

⁹² SECURE 2.0 Act of 2022, PL 117-328, §117(g), amending IRC §401(k)(11).

⁹³ IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

⁹⁴ Treas. Reg. §1.401(k)-4(d).

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Annual Reporting. SIMPLE §401(k) plans (that are not also solo §401(k) plans) must file an annual report regardless of the value of the assets in the plan. The annual report must be filed electronically using Form 5500-SF.⁹⁵ The following requirements to file Form 5500-SF reflect SIMPLE plan requirements and are met by virtually all SIMPLE §401(k) plans.

- There are fewer than 100 participants at the beginning of the plan year.
- The plan's books and records are not subject to independent audit requirements.
- All the plan assets are invested in certain secure investments with a readily determinable fair value.
- The plan does not invest in employer securities.
- The plan is not a multi-employer plan.

Advantages and Disadvantages

The **advantages** of a SIMPLE §401(k) plan include the following.

- Employees may make salary reduction contributions.
- Nondiscrimination testing is not required.
- Employees are immediately vested in all contributions.
- An employer can make nonelective contributions or matching contributions.

The **disadvantages** of a SIMPLE §401(k) plan include the following.

- It is only for employers with 100 or fewer employees.
- An annual report is always required.
- Participating employees cannot also participate in other pension plans from the same employer.

SAFE HARBOR §401(k) PLAN

A major drawback of traditional §401(k) plans for small business employers with employees is the annual nondiscrimination testing requirements, which are complex and, therefore, time-consuming.⁹⁶ The Small Business Job Protection Act of 1996 addressed this problem by introducing the safe harbor §401(k) plan.⁹⁷

Like solo §401(k) plans, safe harbor §401(k) plans are available to sole proprietors, partnerships, C corporations, and S corporations. A safe harbor §401(k) plan has the same rules and requirements as any other §401(k) plan. However, unlike a solo §401(k) plan, it is geared towards businesses with employees.

Generally, §401(k) plans cover both owners and managers (generally highly compensated employees (HCEs)) and rank-and-file employees (generally, non-highly compensated employees (NHCEs)).⁹⁸ However, some employees may be **excluded** from a §401(k) plan if they meet any of the following conditions.⁹⁹

- Have not attained age 21
- Have not completed a year of service during which they worked at least 1,000 hours
- Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good-faith bargaining

⁹⁵ 2024 General Instructions for Form 5500-SF.

⁹⁶ *The Safe-Harbor Solution*. Sherman Jr., Charles W. and Collins, Michael J. Jul. 1, 1999. Journal of Accountancy. [www.journalofaccountancy.com/issues/1999/jul/sherman.html] Accessed on Feb. 11, 2025.

⁹⁷ *Small Business Job Protection Act of 1996*, PL 104-188.

⁹⁸ *Operating a 401(k) Plan*. Jul. 30, 2024. IRS. [www.irs.gov/retirement-plans/operating-a-401k-plan] Accessed on Feb. 11, 2025.

⁹⁹ IRC §410.

A person is considered an HCE if either they owned more than 5% of the business anytime during the year or they received compensation about the annual HCE threshold in the preceding year. In 2025, the compensation threshold is \$160,000.¹⁰⁰

Establishment

Small business owners who wish to establish a safe harbor §401(k) plan must follow the same rules and requirements as those for a traditional §401(k) plan, as discussed previously with solo §401(k) plans.

Contributions¹⁰¹

Like other §401(k) plans, safe-harbor plans accept both employee and employer contributions.

Employees can make **elective deferrals** up to 100% of their compensation, not to exceed the annual contribution limit. In 2025, the limit is \$23,500 or \$31,000 if the employee is age 50 or over, and the plan allows catch-up contributions.¹⁰² Additionally, taxpayers of ages 60–63 can contribute up to \$34,750 in 2025 if their employer’s plan has adopted the relevant modifications of the SECURE 2.0 Act.¹⁰³

The employer contribution requirements for safe harbor §401(k) plans are more stringent than for traditional §401(k) plans. Employer contributions can be either **matching** or **nonelective** according to **one** of the following formulas.¹⁰⁴

1. **Matching contributions.** The employer makes matching contributions in accordance with the following rules.
 - a. The employer contributes an amount equal to 100% of each NHCE’s elective deferrals, **up to** 3% of any compensation.
 - b. The employer contributes an amount equal to 50% of each NHCE’s elective deferrals that **exceed** 3% but do not exceed 5% of compensation.
 - c. The rate of matching contributions for HCEs, including a self-employed owner, does **not** exceed the rates for NHCEs.
2. **Nonelective contributions.** The employer makes nonelective contributions, without regard to whether the employee made elective deferrals, on behalf of all NHCEs eligible to participate in the plan, equal to at least 3% of the employee’s compensation.¹⁰⁵

Plan contributions are generally applied to the year in which they are made. However, they can be applied to the previous year if all the following requirements are met.¹⁰⁶

1. They are made by the due date of the tax return for the previous year (plus extensions).
2. The plan was established by the end of the previous year.
3. The plan treats the contributions as though it had received them on the last day of the previous year.
4. The contributor accomplishes **both** of the following.
 - a. Specifies in writing to the plan administrator or trustee that the contributions apply to the previous year.
 - b. The contributions are deducted on the previous year’s tax return.

¹⁰⁰. IRS Notice 2024-80, 2024-47 IRB 1120.

¹⁰¹. *Operating a 401(k) Plan*. Jul. 30, 2024. IRS. [www.irs.gov/retirement-plans/operating-a-401k-plan] Accessed on Feb. 11, 2025; *The Safe-Harbor Solution*. Sherman Jr., Charles W. and Collins, Michael J. Jul. 1, 1999. Journal of Accountancy. [www.journalofaccountancy.com/issues/1999/jul/sherman.html] Accessed on Feb. 11, 2025.

¹⁰². IRS News Rel. IR-2024-285 (Nov. 1, 2024).

¹⁰³. *SECURE 2.0 Act of 2022*, PL 117-328, §109; IRS News Rel. IR-2024-285 (Nov. 1, 2024).

¹⁰⁴. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*; Treas. Regs. §§1.401(k)-3(b) and (c).

¹⁰⁵. IRS Notice 98-52, 1998-2 CB 634; Treas. Reg. §1.401(k)-3(b)(1).

¹⁰⁶. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

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Limit on Combined Contributions.¹⁰⁷ In addition to the limit on employee contributions, a separate limit applies to the total of regular employee contributions plus employer contributions. Employee catch-up contributions are not counted toward this goal. The limit on combined contributions is 100% of the employee's compensation or a set dollar amount. In 2025, the set dollar amount is \$70,000.¹⁰⁸ However, catch-up contributions could allow the total contributions to exceed this amount.

Reporting and Compliance¹⁰⁹

Employers providing **safe harbor** §401(k) plans for their employees must adhere to stricter notification and annual reporting requirements than those required for **solo** §401(k) plans. Although safe harbor §401(k) plans permit larger contributions, this benefit comes with the following administrative costs.

Employee Notification Requirements. Every plan year, the employer **must** provide each eligible employee with an information notice regarding the plan that satisfies both content and timing requirements. The notice must be accurate and comprehensive enough to inform the employee of their rights and obligations under the plan and be written in a manner that should be understood by the average employee eligible to participate in the plan. Generally, the company must distribute the notice between 30 and 90 days before the beginning of the plan year.¹¹⁰

Note. For further information on employee notification requirements, see **uofi.tax/18b5x1** [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-notices].

Annual Reporting.¹¹¹ Safe harbor §401(k) plans (that are not also solo §401(k) plans) **must** file an annual report regardless of the value of the assets in the plan. The annual report must be filed electronically using either Form 5500 or 5500-SF.

Form 5500-SF is a simplified reporting form. It can only be filed when the plan meets **all** the following conditions.

1. There are fewer than 100 plan participants at the beginning of the plan year.
2. The plan is exempt from the requirement that an independent public accountant audit its books and records.
3. All the plan assets are invested in certain secure investments with a readily determinable fair value.
4. The plan does not invest in employer securities.
5. The plan is not a multi-employer plan.

Advantages and Disadvantages

The **advantages** of safe harbor §401(k) plans include the following.

- Suitable for businesses with employees
- Not subject to nondiscrimination testing
- Employees may make elective deferrals
- Can include an automatic contribution arrangement for eligible employees

¹⁰⁷. IRC §415(c)(1).

¹⁰⁸. IRS News Rel. IR-2024-285 (Nov. 1, 2024).

¹⁰⁹. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

¹¹⁰. Treas. Reg. §1.401(k)-3(d).

¹¹¹. Instructions for Form 5500.

The **disadvantages** of safe harbor §401(k) plans include the following.

- An annual report is always required
- Potentially onerous employee notification requirements

STARTER §401(k) PLAN¹¹²

The starter §401(k) plan, introduced under the SECURE 2.0 Act, is designed to expand retirement plan access for small businesses by offering a streamlined, low-cost alternative to traditional §401(k) plans. These plans are particularly attractive to employers who are not yet ready to commit to complex plan administration or employer contributions.

Establishment

A starter §401(k) is designed to be easy for small businesses with employees to implement, although only employers that do not have an existing qualified plan can implement it. The employer must set up an automatic enrollment process, although employees can opt out of it. The only funds deposited are those employees contribute through salary reduction; starter §401(k) plans do not permit employer contributions.

Eligibility

Starter §401(k) plans are available to employers without an existing retirement plan. They must be offered to **all employees who meet eligibility requirements**, typically age 21 or older with at least one year of service. **Part-time employees** may also qualify after working **500 or more hours in two consecutive years**.

Contributions

All contributions must be made on a **Roth (after-tax) basis**. Pre-tax deferrals are **not permitted** under a starter §401(k). This simplifies tax reporting because all contributions are treated the same way — as after-tax Roth contributions — so there is no need to distinguish between pre-tax and Roth amounts.

Employers are **not allowed** to make matching or nonelective contributions. This feature reduces cost and administrative complexity for small businesses.

The **overall limit on contributions** (annual additions) in 2025 to a participant's account (elective deferrals and nonelective contributions) is 100% of the participant's compensation up to \$6,000 for individuals under age 50 (plus \$1,000 catch-up contributions if age 50 or over).¹¹³

Advantages and Disadvantages

The **advantages** of starter §401(k) plans include the following.

- Low cost and minimal administrative burden
- Availability of automatic enrollment to encourage employee savings, generally 3%–15% of their compensation
- No fiduciary liability on employer for investment performance, assuming a safe harbor investment portfolio is used
- Helps small employers comply with state mandates for retirement plan access.

¹¹². SECURE 2.0 Act of 2022, PL 117-328, §121.

¹¹³. IRS Notice 2024-80, 2024-47 IRB 1120.

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The **disadvantages** of starter §401(k) plans include the following.

- Reduced employee engagement due to absence of employer match
- Roth-only contributions not suitable in all employees' tax situations
- Limited plan design flexibility compared to traditional §401(k) or SIMPLE IRA plans
- Lower annual contribution limit than standard §401(k) plans

POOLED EMPLOYER PLAN¹¹⁴

PEPs, introduced under the SECURE Act, are a modern retirement plan solution designed to help unrelated employers band together under a single §401(k) plan. By consolidating administrative duties and fiduciary responsibilities under a pooled plan provider (PPP), PEPs aim to reduce costs, simplify compliance, and expand access to retirement savings, especially for small and mid-sized businesses.

Establishment

PEPs became available starting January 1, 2021. A PEP is a defined contribution plan operated by a **PPP**. A PPP has the following responsibilities.

- Act as the Employee Retirement Income Security Act (ERISA) 3(16) plan administrator¹¹⁵
- May also serve as an ERISA 3(38) investment fiduciary¹¹⁶
- Oversee plan operations, compliance, and vendor management (e.g., recordkeepers, third-party administrators, auditors)¹¹⁷

There are several administrative benefits with PEPs, including the following.¹¹⁸

- Centralized administration, reducing the need for in-house human resources or benefits staff
- Standardized processes and documentation, streamlining onboarding and maintenance
- Bundled services recordkeeping, compliance, investment management, reducing vendor coordination
- Potential for economies of scale in pricing and service quality
- Inability for one incompassant employer to impute a violation for all employers in the PEP, as could happen with MEPs, as discussed later¹¹⁹

¹¹⁴. *SECURE Act of 2019*, PL 116-94, §101, creating IRC §413(e); See *Employee Retirement Income Security Act of 1974* (ERISA), 29 USC §1002(43) for a formal definition of pooled employer plans.

¹¹⁵. 29 USC §1002(16)(A).

¹¹⁶. 29 USC §1002(38).

¹¹⁷. 29 USC §1002(44).

¹¹⁸. *Pooled Employer Plans—Employer Considerations*, pp. 1–2. 2021. American Academy of Actuaries. [www.actuary.org/wp-content/uploads/2021/05/PooledEmployerPlans.5.2021.pdf] Accessed on Jun. 24, 2025.

¹¹⁹. This is known colloquially as the “one bad apple” rule and is codified in IRC §413(c)(5)(A).

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Eligibility

PEPs are open to any unrelated employers, regardless of industry or affiliation. There is no requirement for a shared nexus or common interest among participating employers. Employers must not already sponsor another §401(k) plan unless they are replacing it with the PEP.

Note. PEPs are ideal for small and mid-sized businesses that lack internal resources to manage a standalone §401(k), want to offer competitive retirement benefits without high administrative overhead, and are seeking a turnkey solution with minimal fiduciary risk. Additionally, PEPs can also help small employers comply with state-mandated retirement plan laws.

Contributions

Employers may choose whether or not to make matching or nonelective contributions. Employee contributions follow standard §401(k) limits.¹²⁰

- 2025 elective deferral limit: \$23,500
- Catch-up (age 50 and older): \$7,500

Contributions can be pre-tax or Roth, depending on plan design.

Reporting and Compliance

The PPP handles most compliance responsibilities, including:

- Form 5500 filings
- Nondiscrimination testing
- Plan audits (if applicable)

The **“one bad apple” rule** has been eliminated; noncompliance by one employer does **not** disqualify the entire plan.¹²¹

Employers retain responsibility for the timely remittance of employee contributions and for providing accurate employee data.

Advantages and Disadvantages

The **advantages** of PEPs include the following.

- Administrative relief, as the PPP assumes most fiduciary and operational duties
- Cost sharing, because administrative and compliance costs are spread across multiple employers
- Improved access to retirement plans because small businesses can offer competitive retirement benefits
- Simplified onboarding through standardized plan documents and processes that reduce setup time
- Attract and retain talent, as businesses can offer a robust benefit without the complexity of a standalone plan

¹²⁰. IRS Notice 2024-80, 2024-47 IRB 1120.

¹²¹. *PEP Talk: Pooled employer plans*. Bortz, Jason. Feb. 11, 2025. Capital Group. [www.capitalgroup.com/advisor/insights/articles/ir-pooled-employer-plans.html] Accessed on Aug. 26, 2025; IRC §413(c)(5)(A).

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The **disadvantages** of PEPs include the following.

- Less customization in retirement plan choices as employers may have limited flexibility in plan design and investment options
- Shared costs if employers pay for services they do not need (e.g., audits for small plans)
- Reliance on PPP if quality and performance of the plan depend heavily on the selected provider
- Potentially hidden fees, as bundled services may obscure true costs

MULTIPLE EMPLOYER PLAN¹²²

MEPs are retirement plans that allow multiple employers to join a single plan, similar to PEPs. MEPs are designed to provide a retirement savings option for employees of small and medium-sized businesses. By pooling resources, employers can offer competitive retirement benefits while reducing administrative burdens and costs.

While both MEPs and PEPs enable multiple employers to participate in a single retirement plan, they differ in their regulatory requirements. PEPs were introduced under the SECURE Act and are overseen by a PPP, which handles administrative duties, compliance, and fiduciary responsibilities. MEPs, on the other hand, originated with the Taft-Hartley Act,¹²³ although their concept was advanced by ERISA legislation.

Establishment

Because MEPs are typically restricted to businesses that share a connection, they are commonly called “closed MEPs.” Mutual connection may be established by a trade association, membership in a chamber of commerce, or perhaps receiving similar services from the same professional employer organization (PEO). Thus, companies sharing a common connection must each become clients of a PEO or other shared third-party administrator. The MEP offers retirement plans, typically a §401(k) plan.

Eligibility

Employees are eligible to participate in an MEP based on the eligibility criteria established in the plan document adopted by their employer. These criteria typically include age and service requirements, such as attaining age 21 and completing one year of service (generally 1,000 hours during a 12-month period).¹²⁴

As mentioned, employers participating in a MEP must share a commonality of interest unless the MEP is sponsored by a PEO. In that case, the PEO must perform substantial employment functions for each participating employer.

Contributions

Employees participating in an MEP may make elective deferrals to their IRAs under the plan, typically through payroll deduction. These contributions are subject to the same limits and rules as other defined contribution plans, including annual deferral limits and catch-up contributions for those age 50 and older.

Employers participating in the MEP may make matching contributions or nonelective contributions, depending on the terms of the plan document. The contribution formula — such as a dollar-for-dollar match up to a percentage of compensation — is determined by each employer’s adoption agreement within the MEP.

¹²². 29 CFR §2510.3-55.

¹²³. *Labor-Management Relations Act of 1947*, PL 80-101.

¹²⁴. IRC §410(a); Treas. Reg. §1.410(a)-3.

Reporting and Compliance

MEPs are subject to a distinct set of compliance obligations under the Code and ERISA. These requirements differ from those applicable to PEPs and single-employer plans.

- **Form 5500 filing.** MEPs must file an annual Form 5500, which includes information about plan operations, financial condition, and compliance. If the plan covers 100 or more participants, an independent audit is also required.
- **Fiduciary responsibility.** Each participating employer retains fiduciary responsibility for its portion of the plan, including ensuring timely remittance of employee contributions and accurate reporting of employee data.
- **Disclosure and notices.** Employers must ensure that participants receive required disclosures, such as Summary Plan Descriptions, fee disclosures, and annual notices, in accordance with ERISA and DOL regulations.

Advantages and Disadvantages

The **advantages** of MEPs include the following.

- Improved access to retirement plans because small businesses can offer plans that appeal to potential employees
- Administrative relief, as the third-party administrator assumes most fiduciary and operational duties
- Lower costs, because administrative and compliance costs are spread across multiple employers
- Delegation of audit responsibilities to the third-party administrator when a closed MEP is involved
- Support provided by experts, rather than company employees
- Compliance with state requirements for employers to offer retirement plans

The **disadvantages** of MEPs include the following.

- Less customization in retirement plan choices as employers may have limited flexibility in plan design and investment options
- Shared costs if employers pay for services they do not need (e.g., audits for small plans)
- Reliance on PPP if quality and performance of the plan depend heavily on the selected provider
- Potentially hidden fees, as bundled services may obscure true costs
- Potential disqualification under the “one bad apple” rule of IRC §413(c)(5)(A) if another employer fails a regulatory requirement

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OTHER NOTEWORTHY RETIREMENT PROVISIONS

In addition to the plans previously covered in this chapter, the SECURE 2.0 Act also provides for other retirement plan provisions, which may be less common. These plans include the following.

- **Military spouse retirement plan eligibility credit for small employers.**¹²⁵ This provision offers a tax credit to eligible small employers who provide retirement plan eligibility to military spouses. The credit is designed to encourage small businesses to support military families by offering retirement benefits to spouses of active-duty service members.
- **Small immediate financial incentives for contributing to a plan.**¹²⁶ This provision allows employers to offer an immediate de minimis financial incentive to employees who elect to have the employer make contributions under the plan. Prior to this change, such payment would have violated §401(k)(4)(A). The intention is to encourage employee participation in a retirement savings program. The incentive is only considered de minimis if it does not exceed \$250 in value.¹²⁷ The incentive cannot be paid for with plan assets.
- **Withdrawals for certain emergency expenses.**¹²⁸ This provision allows qualifying participants to withdraw small amounts for emergencies without incurring the 10% excise tax on early distributions. An emergency expense is an unforeseeable or immediate financial need relating to necessary personal or family emergency expenses. While this may be helpful for some participants, such distributions are limited to \$1,000 once per year.
- **Improving coverage for part-time workers.**¹²⁹ One of the changes made by SECURE 2.0 includes a requirement under §401(k)(2)(D) that §401(k) plans must include certain long-term, part-time workers. This provision may serve to benefit such workers, but for small businesses, this may increase the cost of a §401(k) plan.
- **Emergency savings accounts linked to individual account plans.**¹³⁰ Under IRC §402A(e), employers may now include a provision in their defined contribution plan allowing non-highly compensated plan participants to establish a pension-linked emergency savings account. All contributions are Roth contributions and cannot exceed a maximum of \$2,500.

QUALIFIED BUSINESS INCOME DEDUCTION¹³¹

The qualified business income deduction (QBID), introduced by the Tax Cuts and Jobs Act, allows eligible taxpayers to deduct up to 20% of their qualified business income (QBI) from pass-through entities such as sole proprietorships, partnerships, and S corporations. While retirement plan contributions are a valuable tax deferral tool, they also **reduce QBI**, which can, in turn, reduce the QBID. This creates a nuanced planning opportunity for tax practitioners advising small business clients.

OVERVIEW OF QBID MECHANICS

The QBID is generally calculated as the lesser of:

- 20% of QBI, or
- 20% of taxable income minus net capital gains.

¹²⁵ SECURE 2.0 Act of 2022, PL 117-328. See §112; IRC §45AA.

¹²⁶ Ibid., §113.

¹²⁷ IRS Notice 2024-2, IRB 316. See Q&A D-1.

¹²⁸ SECURE 2.0 Act of 2022, PL 117-328, §115.

¹²⁹ Ibid., §125; IRC §401(k)(2)(D).

¹³⁰ Ibid., §127; IRC §402A(e).

¹³¹ IRC §199A; IRS Pub. 535, *Business Expenses*.

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For higher-income taxpayers, the deduction may be limited by:

- Form W-2 wage and qualified property thresholds, or
- Complete phaseout for certain specified service trades or businesses (SSTBs).

Note. For information on changes made to QBID for 2026 by the One Big Beautiful Act, see the 2025 *University of Illinois Federal Tax Workbook*, Chapter 2: The One Big Beautiful Bill Act.

HOW RETIREMENT CONTRIBUTIONS AFFECT QBI

Retirement plan contributions—such as those made to SEP, SIMPLE, or §401(k) plans — are **deductible business expenses**. As such, they reduce the business’s net income, which in turn reduces QBI. This can be beneficial or detrimental depending on the taxpayer’s income level and whether they are near a QBID phaseout threshold.

Note. Employee Roth contributions do not reduce QBI because they are made with after-tax dollars and are not deductible. However, **employer** contributions are treated as though they were matching or nonelective contributions that were immediately made to the employee’s IRA “that was not a Roth IRA and then immediately converted to a Roth IRA.”¹³²



Practitioner Planning Tip

Tax practitioners should evaluate with their clients whether maximizing deductible retirement contributions is the best strategy or whether preserving QBI to maximize the QBID yields a better overall tax outcome.

Example 9. Maria, single, is a sole proprietor with \$180,000 in net Schedule C income before retirement contributions. In 2024, she contributes \$33,457 to a SEP plan (20% of net SE income). She has no other income or deductions.

- QBI before SEP contribution: \$180,000
- SEP contribution: \$33,457
- Adjusted QBI: \$133,826
- QBID before income limitation: \$26,765 ($\$133,826 \times 20\%$)
- Taxable income: \$119,226 ($\$180,000 - \$12,717 \frac{1}{2} \text{ social security} - \$33,457 \text{ SEP contribution} - \$14,600 \text{ standard deduction}$)
- QBID limited to taxable income: \$23,845 ($\$119,226 \times 20\%$)

Maria’s SEP contribution reduces both her taxable income and her QBID. However, the **combined tax benefit** of the SEP deduction and the reduced QBID may still be favorable, depending on her marginal tax rate.

¹³² IRS Notice 2024-2, 2024-02 IRB 316, 334. See answer K-5.

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Example 10. Jared is an S corporation shareholder who receives \$150,000 in Form W-2 wages and \$100,000 in pass-through income. Acting as an **employee** of the S corporation, he makes an elective contribution of \$23,500 to a solo §401(k), electing Roth treatment. This contribution has the following impact on Jared's individual tax return.

- His employee Roth contributions do not reduce QBI or taxable income.
- His QBI remains at \$100,000.
- His QBID is \$20,000 ($\$100,000 \times 20\%$).

By choosing employee Roth contributions, Jared preserves his full QBID while still saving for retirement. This strategy is particularly effective for taxpayers in lower current tax brackets who expect higher rates in retirement.



Practitioner Planning Tip

Tax practitioners should consider the following steps when providing tax guidance to clients who control businesses.

- Model scenarios both with and without retirement contributions
- Consider Roth options to preserve QBI while still saving
- Use retirement contributions strategically to enter or exit QBID phaseout ranges

TAX CREDITS AND INCENTIVES

A small employer implementing any of the retirement plans already discussed is potentially eligible for a tax credit or incentive. Although implementing a plan involves some effort, the credits offer a relatively quick way of recovering those costs.

START-UP PLAN CREDIT¹³³

Small employers that establish new retirement plans can benefit from a tax credit to offset a portion of the plan's start-up costs. The SECURE 2.0 Act significantly enhanced the credit for small employer pension plan start-up costs beginning **January 1, 2023**.¹³⁴

Because the credit is for **new** plans, the employer cannot have had another qualified employer plan within the **three years** immediately before the new retirement plan is created. If the employer had a §401(k) plan, a SEP, or any other plan identified in IRC §4972(d)(1), they are ineligible for the credit for small employer pension plan start-up costs.

The credit consists of two components: one for the initial year's start-up costs and another for certain employer contributions to qualified small employer pension plans. For S corporations, the credit is passed through to shareholders via Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*, using code AE in box 13, *Credits*.¹³⁵ Partners are notified by partnerships of their allocation of the credit for establishing pension plans by their Schedule K-1 (Form 1065), using box 15, *Credits*, with code AE for credit for small employer pension plan start-up costs.

^{133.} *Retirement plans startup costs tax credit*. Aug. 26, 2024. IRS. [www.irs.gov/retirement-plans/retirement-plans-startup-costs-tax-credit] Accessed on Feb. 4, 2025.

^{134.} *SECURE 2.0 Act of 2022*, PL 117-328, §102.

^{135.} 2024 Shareholder's Instructions for Schedule K-1 (Form 1120-S).

Component 1: Start-Up Costs

The credit can cover the following start-up costs.¹³⁶

- Establishing the plan
- Administering the plan
- Educating employees about the plan

Employers with 50 or fewer employees are generally entitled to a credit of **100% of start-up costs**, limited to the greater of the following.

- \$500
- The **lesser** of :
 - ♦ \$250 for each employee who is not highly compensated as defined in §414(q)
 - ♦ \$5,000

Thus, the first component is limited to \$5,000 per employer.

Employers with 51–100 employees with \$5,000 of earned income receive a credit of **50% of start-up costs**, subject to the same limitations as above.

The effective limit, regardless of the employer size, is \$5,000 as long as the employer has 100 or fewer employees.

Component 2: Plan Contributions

The second component provides small employers with an additional tax credit for amounts they contribute to certain employees' qualified small employer pension plans. For 2025, only contributions for employees earning less than \$105,000 are included in this component of the credit.

Eligible employers can receive the credit for the first five years of the new retirement plan's existence. The following table shows the credit to which the employer is entitled each year based on their employee count.

Year	Qualified Employers with 1–50 Employees Who are Not Highly Compensated	Qualified Employers with 51–100 Employees Who are Not Highly Compensated
First plan year	100% of contributions; \$1,000 maximum	100% minus 2% for each employee exceeding the 50-employee limit
Second plan year	100% of contributions; \$1,000 maximum	100% minus 2% for each employee exceeding the 50-employee limit
Third plan year	75% of contributions; \$1,000 maximum	75% minus 2% for each employee exceeding the 50-employee limit
Fourth plan year	50% of contributions; \$1,000 maximum	50% minus 2% for each employee exceeding the 50-employee limit
Fifth plan year	25% of contributions; \$1,000 maximum	25% minus 2% for each employee exceeding the 50-employee limit

When employers claim the start-up credit, they cannot use the same amounts as a deduction that they use for either component of the credit.

¹³⁶ IRC §45E(d)(1).

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Example 11. Titan Corporation makes 3-D printed aeronautical components and was established in 2020 as an S corporation. In April 2024, during the review of its 2023 tax return, Titan's five equal shareholders decide to establish a SEP plan as a retention incentive for its 55 dedicated employees, which includes its five shareholders.

The five shareholder-employees earn \$55,000 annually and are considered HCEs under §414(q)(1)(A). Each of the remaining 50 employees is paid \$50,000 annually. None of the 50 employees is related to any shareholder or considered to be highly compensated. With no employee turnover for the last two years, the same 55 employees also worked for Titan in 2023.

In 2024, Titan spends \$15,000 on employee education for the plan. The company also pays an additional \$10,000 to Virtue Investments for establishing the plan and \$6,000 to administer the plan. Titan's total start-up costs to establish the SEP for its employees total \$31,000 (\$15,000 + \$10,000 + \$6,000).

Later in 2024, Titan makes contributions to each employee's SEP account of 10%, or \$5,000 (\$50,000 salary $\times$ 10%). It contributes \$5,500 (\$55,000 $\times$ 10%) to each shareholder-employee's account. Thus, its total employer contribution for 2024 is \$277,500 (50 employees $\times$ \$5,000 contribution per employee + 5 shareholder-employees $\times$ \$5,500 contribution). However, only the first \$1,000 of the contribution to each employee's SEP IRA can potentially be eligible for the credit, meaning that the sum of potentially eligible contributions is \$55,000 (55 employees $\times$ \$1,000).

Titan lists the sum of its potentially eligible contributions on line 6c of Form 8881, *Credit for Small Employer Pension Plan Startup Costs*, of its 2024 Form 1120-S because no employees made elective deferral contributions and because SEP plan contributions are considered nonelective contributions. The company has earned a small employer pension plan start-up costs credit of \$54,500 under IRC §45E, as calculated on Form 8881 in part I, line 8, shown on the following page.

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For Example 11

Form **8881**
(Rev. December 2023)
Department of the Treasury
Internal Revenue Service

Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation

Attach to your tax return.

Go to www.irs.gov/Form8881 for instructions and the latest information.

OMB No. 1545-1810

Attachment
Sequence No. **130**

Name(s) shown on return

Titan Corporation

Identifying number

11-1111119

Part I Credit for Small Employer Pension Plan Startup Costs (Including Employer Contributions)

A	Enter the number of qualifying employees. See instructions	55	
1	Qualified startup costs incurred during the tax year	1	31,000
2	Employers with 1-50 employees enter the amount from line 1. Employers with 51-100 employees enter 50% (0.50) of line 1	2	15,500
3	Enter the number of employees eligible to participate in the pension plan. See instructions. 50 X \$250	3	12,500
4	Enter the greater of \$500 or the amount from line 3 (Do not enter more than \$5,000)	4	5,000
5	Enter the smaller of line 2 or line 4	5	5,000
6a	Enter the number of employees from the preceding tax year. See instructions	6a	55
b	Enter employer contributions made to the plan, but don't include (i) elective deferrals, (ii) contributions made to employees whose wages paid to the employee were in excess of \$100,000 and (iii) any amount of contributions to an employee to whom you made contributions of more than \$1,000	6b	
c	For employees for whom you made matching and nonelective contributions of more than \$1,000, (and who are not disqualified because they meet 6b(ii) above), see the instructions for information on how to determine the amount to enter on line 6c. If you did not make this type of contributions, enter -0-	6c	55,000
d	Add lines 6b and 6c If the number of employees entered on line 6a is 50 or less, enter the amount from line 6d on line 6f. If the number of employees entered on line 6a is 51-100, continue to line 6e(1).	6d	55,000
e (1)	Subtract 50 (50.0) from the number of employees entered on line 6a	6e(1)	5
(2)	Multiply line 6e(1) by 2% (0.02)	6e(2)	0.10
(3)	Multiply line 6e(2) by line 6d	6e(3)	5,500
(4)	Subtract line 6e(3) from line 6d	6e(4)	49,500
f	If you did NOT complete line 6e, enter the amount from line 6d. If you completed line 6e, enter the amount from line 6e(4)	6f	49,500
g	Applicable percentages. See instructions. • If this is treated as the first or second year of the plan, enter the amount from line 6f. • If this is treated as the third year of the plan, multiply line 6f by 75% (0.75). • If this is treated as the fourth year of the plan, multiply line 6f by 50% (0.50). • If this is treated as the fifth year of the plan, multiply the amount on line 6f by 25% (0.25).	6g	49,500
7	Credit for small employer pension plan startup costs from partnerships and S corporations	7	
8	Add lines 5, 6g, and 7. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j	8	54,500

Part II Small Employer Auto-Enrollment Credit

9	Enter \$500 if an auto-enrollment option is provided for retirement savings	9	
10	Small employer auto-enrollment credit from partnerships and S corporations	10	
11	Add lines 9 and 10. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1dd	11	

Part III Military Spouse Participation Credit

Caution: You can't claim the credit if you had more than 100 employees in the preceding tax year.

12	Enter the number of military spouse employees participating in an eligible plan. See instructions. X \$200	12	
13	Amount of contributions paid by employer for each eligible military spouse employee. Do not enter more than \$300 per employee. See instructions	13	
14	Credit for small employer military spouse retirement plan from partnerships and S corporations	14	
15	Add lines 12, 13, and 14. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1ee	15	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 33435N

Form **8881** (Rev. 12-2023)

Titan reduces its deduction for the pension administration cost by the \$5,000 credit. The company's deduction for pension plan expenses on line 8 of its Form 1120-S is reduced by \$49,500. The Titan shareholders have earned a total credit of \$54,500 (\$5,000 for component 1 and \$49,500 for component 2).

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Example 12. Use the same facts as **Example 11**, except that Titan Corporation establishes a SIMPLE IRA plan instead of a SEP plan and makes nonelective contributions of 2% to all 60 employees' retirement plans. The firm is eligible for the credit for small employer pension plan start-up costs, and neither component of the credit changes, even though the company's contributions to employees' retirement plans are 80% less than under the SEP plan.

AUTOMATIC-ENROLLMENT CREDIT¹³⁷

As retirement plan sponsors seek to increase employee participation and streamline plan administration, automatic enrollment features have become a popular solution.¹³⁸ Two key types of automatic enrollment arrangements — **eligible automatic contribution arrangements (EACAs)** and **qualified automatic contribution arrangements (QACAs)** — offer distinct advantages and compliance considerations. While both structures aim to simplify enrollment and encourage savings, they differ in terms of default contribution rules, withdrawal options, employer obligations, and testing relief. Understanding these differences is essential for tax practitioners advising clients on plan design and compliance strategies.

EACA

A safe harbor §401(k) plan may have an EACA.¹³⁹ With this feature, the employer can automatically reduce an employee's pay by a fixed percentage and contribute that amount to the §401(k) plan on the employee's behalf. The employer must give employees notice before any deferrals are withheld. An employee must have the option of not having any deferrals withheld or having a different amount withheld. This automatic contribution continues until the participant chooses to stop the deferrals or selects a different percentage of their income to be contributed. These automatic contributions are still considered elective deferrals. The automatic enrollment feature encourages employees to save for retirement and helps the plan pass nondiscrimination testing, if applicable.¹⁴⁰

Note. For more information, see IRS Pub. 4674, *Automatic Enrollment 401(k) Plans for Small Businesses*.

Under an EACA, the plan may allow participants to withdraw their automatic contributions to the plan if **both** of the following conditions are met.¹⁴¹

1. The participant elects to withdraw no later than 90 days after the date of the first elective contributions under the EACA.
2. The participant withdraws the entire amount of EACA default contributions, including any earnings thereon.

If the plan allows withdrawals under the EACA, the withdrawal amount, other than the amount of any designated Roth contributions, must be included in the employee's gross income for the tax year in which the distribution is made. The additional 10% tax on early distributions does not apply to the distribution.¹⁴²

¹³⁷. IRC §45T.

¹³⁸. *Retirement Topics — Automatic Enrollment*. Aug. 20, 2024. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-automatic-enrollment] Accessed on Feb. 11, 2025.

¹³⁹. Treas. Reg. §1.401(k)-1(a)(3)(ii).

¹⁴⁰. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

¹⁴¹. *Ibid.*

¹⁴². *Ibid.*

QACA¹⁴³

A QACA is another type of safe-harbor plan that uses an automatic enrollment feature. In addition, mandatory employer contributions are required. If a plan includes a QACA, it is not subject to annual ADP testing and may not be subject to actual contribution percentage nondiscrimination testing requirements.

Under a QACA, each employee who is eligible to participate in the plan is treated as having elected to make elective deferral contributions equal to a certain default percentage of compensation. In order not to have default elective deferrals made, an employee must make an affirmative election specifying a deferral percentage (which can be zero, if desired). If an employee does not make an affirmative election, the default deferral percentage must meet the following conditions.

- It must be applied uniformly.
- It must not exceed 10% in the first year after an employee initially contributes to the plan and 15% thereafter.¹⁴⁴
- It must be at least 3% in the first plan year that it applies to an employee and through the end of the following year.
- It must increase to at least 4% in the following plan year.
- It must increase to at least 5% in the following plan year.
- It must increase to at least 6% in subsequent plan years.

Under the terms of the QACA, the employer must make **either** matching or non-elective contributions according to the following terms.

- 1. Matching contributions.** The employer must make matching contributions on behalf of each NHCE in the following amounts.
 - a.** 100% of elective deferrals, **up to** 1% of the NHCE's compensation
 - b.** 50% of elective deferrals that **exceed** 1% but do not exceed 6% of the NHCE's compensation
 - c.** The rate of matching contributions for HCEs, including a self-employed owner, must not exceed the rates for NHCEsOther formulas may be used as long as they are at least as favorable to NHCEs.
- 2. Nonelective contributions.** The employer must make nonelective contributions on behalf of every NHCE eligible to participate in the plan, regardless of whether they elected to participate, in an amount equal to at least 3% of their compensation.

If the benefits arise from matching or nonelective contributions under the QACA, the employee must be fully vested in them after they complete two years of service. However, specific regulations restrict the withdrawal of these contributions, and these restrictions are beyond the scope of this text.

Although provisions for EACA and QACA have existed for some time, the SECURE Act provided a new incentive for automatic enrollment beginning January 1, 2020. If an employer has 100 or fewer employees who were paid at least \$5,000 in the previous year, it can benefit from this new credit. Employers can earn this credit if they adopt new plans with automatic enrollment provisions or if they convert existing plans to automatic enrollment.

¹⁴³. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

¹⁴⁴. IRC §401(k)(13)(C)(iii), as amended by the *SECURE Act of 2019*, PL 116-94, §102. Before January 1, 2020, the maximum rate was 10%.

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These employers may claim a credit of up to \$500 annually for a 3-year period if they maintain a provision for automatic enrollment. The credit applies to automatic enrollment in SEP plans, SIMPLE IRA plans, §401(k) plans, and §403(b) plans.¹⁴⁵

- SEP plans
- SIMPLE IRA plans
- Qualified requirement plan, including §401(k) plans
- Annuity plans, including §403(b) plans

However, governmental plans do not qualify for this credit.

DECISION TOOLS

The following tools are available to help practitioners advise their clients on which plan works best based on the facts and circumstances of their particular needs.

COMPARISON TABLE

The table on the following page provides a list of key features that distinguish the retirement plans discussed thus far in this chapter. The limits shown apply to 2025 deferrals and contributions.

¹⁴⁵. IRC §4972(d).

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	SEP IRA	SIMPLE IRA	Solo \$401(k)	Safe Harbor \$401(k)	SIMPLE \$401(k)
Number of employees	No upper limit	100 or fewer	Business owners and spouses only	No upper limit	100 or fewer
Employee eligibility requirements	Employees who received at least \$750 in compensation in at least three of last five years, and have attained age 21	Employees who received at least \$5,000 in compensation in any prior two years before the current calendar year	N/A	Employees have completed one year of service (1,000 hours) and have attained age 21 ^a	Employees have completed one year of service (1,000 hours) and have attained age 21 ^a
Employee elective deferrals maximum	N/A (except for pre-1997 SARSEPs)	\$16,500	\$23,500	\$23,500	\$16,500
Catch-up contributions (if age 50 or older)	N/A	\$3,500 if age 50–59, or above age 63; \$5,250 if age 60–63 ^b	\$7,500 if age 50–59, or above age 63; \$11,250 if age 60–63	\$7,500 if age 50–59, or above age 63; \$11,250 if age 60–63	\$3,500 if age 50–59, or above age 63; \$5,250 if age 60–63 ^b
Employer contributions	From zero to a maximum of the lesser of: • \$70,000, or • 25% of employee's compensation (up to \$350,000)	• Matching up to 3% of each participant's pay, or • Nonelective of 2% of employee's pay (up to \$350,000)	From zero to a maximum of the lesser of: • \$70,000, or • 25% of employee's compensation	• Matching up to 3% of each participant's pay and 50% of each NHCE's elective deferrals that exceed 3% but do not exceed 5%, or • Nonelective of 3% of employee's pay	• Matching up to 3% of each participant's pay (up to \$350,000), or • Nonelective of 2% of participant's pay (up to \$350,000)
Loans from plan allowed	No	No	Yes, subject to plan rules	Yes, subject to plan rules	Yes, subject to plan rules
Annual reporting requirements	Generally not required	None	Yes, if \$250,000 or more in plan assets	Yes	Yes
Testing requirements	Subject to top-heavy plan requirements	None	None (if no other employees)	None	None

^a Under the Secure 2.0 Act, employees with at least 500 hours worked per year for at least two consecutive years will be eligible to participate.

^b Under the Secure 2.0 Act, a 110% provision allows for a catch-up contribution of \$3,850 for employees age 50–59, or above age 63, for certain applicable plans.

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RETIREMENT PLAN CHECKLIST FOR SMALL BUSINESS CLIENTS

Business Profile and Goals

- ☐ What is the legal structure of your business? (e.g., sole proprietorship, partnership, S corporation)
- ☐ How many employees do you have, and what are their compensation levels?
- ☐ Do you anticipate hiring more employees in the near future?
- ☐ What are your primary goals for offering a retirement plan? (e.g., tax savings, employee retention, owner retirement savings, simplicity)

Financial Considerations

- ☐ How much can you afford to contribute annually to employee retirement accounts?
- ☐ Are you interested in making contributions for yourself only, or for employees as well?
- ☐ Do you want to allow employees to make salary deferrals?
- ☐ Would you prefer to make pre-tax or Roth (after-tax) contributions?

Tax and Administrative Preferences

- ☐ Are you looking to reduce your current taxable income or preserve your QBID?
- ☐ Would you like to take advantage of available tax credits for starting a plan?
- ☐ How much administrative responsibility are you willing to take on?
- ☐ Do you want to offer loans or hardship withdrawals to employees?

Timing and Compliance

- ☐ When do you want the plan to be effective?
- ☐ Are you open to automatic enrollment features?

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Acronyms and Abbreviations

AAA	Accumulated adjustments account	CARES	Coronavirus Aid, Relief, and Economic Stimulus Act
AAR	Administrative adjustment request	CASST	Coalition Against Scam and Scheme Threats
ABLE	Achieving a Better Life Experience Act of 2014	CBO	Congressional Budget Office
ACA	Affordable Care Act of 2010	CCA	Chief Counsel Advice
ADP	Actual deferral percentage	C-CPI-U	Chained consumer price index
ADR	Alternative dispute resolution	CCRC	Continuing care retirement community
ADS	Alternative depreciation system	CDCC	Child and dependent care credit
AEA	Applicable exclusion amount	CDP	Collection due process
AFR	Applicable federal rate	CFA	Chartered financial analyst
AFS	Applicable financial statement	CFC	Controlled foreign corporation
AFSI	Adjusted financial statement income	CFR	Code of federal regulations
AGI	Adjusted gross income	CNC	Currently not collectable
AI	Artificial intelligence	COLA	Cost of living adjustment
AICPA	American Institute of Certified Public Accountants	COGS	Cost of goods sold
AIME	Average indexed monthly earnings	CRT	Charitable remainder trust
AMI	Area median income	CRAT	Charitable remainder annuity trust
AMP	Advancing markets for producers	CRUT	Charitable remainder unitrust
AMT	Alternative minimum tax	CSA	Climate Smart Agriculture
AMTI	Alternative minimum taxable income	CSRS	Civil Service Retirement System
AO	Appeals officer	CTC	Child tax credit
AOD	Action on Decision	DAF	Donor-advised funds
AOF	Acknowledgement of facts	DCAP	Dependent Care Assistance Program
AOTC	American opportunity tax credit	DCFSA	Dependent care flexible spending account
APA	Administrative Procedure Act	DCN	Designated change numbers
ARC	Agricultural risk coverage	DDIA	Direct Debit Installment Agreement
ARC-CO	Agricultural risk coverage-county option	DeFi	Decentralized finance
ARPA	American Rescue Plan Act of 2021	DISC	Domestic international sales corporation
ATI	Adjusted taxable income	DMC	Dairy margin coverage
AUR	Automated Underreporter	DNI	Distributable net income
BEA	Basic exclusion amount	DO	Designated official
BTA	Business tax accounts	DOJ	Department of Justice
CAF	Centralized Authorization File	DSUE	Deceased spousal unused exclusion
CAMT	Corporate alternative minimum tax	DU	Designated user

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E&P	Earnings and profits	GLBA	Gramm-Leach-Bliley Act
EACA	Eligible automatic contribution arrangement	GPO	Government Pension Offset
EBL	Excess business loss	GRAT	Grantor-retained annuity trust
EEI	Energy-efficiency improvements	GRIT	Grantor-retained income trust
EFI	Elected farm income	GRUT	Grantor-retained unitrust
EFP	Effective reference price	GST	Generation-skipping transfer
EIC	Earned income credit	GSTT	Generation-skipping transfer tax
EIN	Employer identification number	HBU	Highest and best use
ERC	Employee retention credit	HCE	Highly compensated employees
ERISA	Employee Retirement Income Security Act of 1974	HDHP	High-deductible health insurance plan
ERO	Electronic Return Originators	HoH	Head of household
ESBT	Electing small business trust	HSA	Health savings account
ESOP	Employee stock ownership plan	IA	Installment agreement
ETIP	Estate tax inclusion period	IDGT	Intentionally defective grantor trust
FAQ	Frequently asked question	IDR	Information document request
FASB	Financial Accounting Standards Board	ILIT	Irrevocable life insurance trust
FBAR	Report of Foreign Bank and Financial Accounts	ILM	Internal Legal Memorandum
FDIC	Federal Deposit Insurance Corporation	IPO	Initial public offering
FEIN	Federal employer identification number	IP PIN	Identity protection personal identification number
FEMA	Federal Emergency Management Agency	IRA	Individual retirement arrangement
FICA	Federal Insurance Contributions Act	IRB	Internal Revenue Bulletin
FIFO	First-in, first-out	IRC	Internal Revenue Code
FLSA	Fair Labor Standards Act	IRD	Income in respect of a decedent
FMV	Fair market value	IRM	Internal revenue manual
FOIA	Freedom of Information Act	IRMAA	Income-related monthly adjustment amount
FPAA	Final Partnership Administrative Adjustment	ITA	Interactive tax assistant
FRA	Full retirement age	ITC	Investment tax credit
FSA	Farm Service Agency	ITIN	Individual taxpayer identification number
FTMC	Fast track mediation-collection	IVES	Income Verification Express Services
FTS	Fast track settlement	LB&I	Large Business and International
FUTA	Federal Unemployment Tax Act	LFP	Livestock Forage Disaster Program
GDS	General depreciation system	LGM	Litigation Guideline Memorandum
GILTI	Global intangible low-tax income	LIHTC	Low-income housing tax credit
		LLC	Limited liability company
		LLP	Limited liability partnership

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LOC	Line of Credit	PLC	Price-loss coverage
LP	Limited partnership	PMI	Private mortgage insurance
LTC	Long-term care	POA	Power of attorney
MACRS	Modified accelerated cost recovery system	POMS	Program operations manual system
MAGI	Modified adjusted gross income	PPP	Pooled plan provider
MEP	Multiple employer plans	PPS	Practitioner Priority Service
MFJ	Married filing jointly	PTE	Pass-through entity
MFS	Married filing separately	PTIN	Preparer tax identification number
MIP	Mortgage insurance premium	PTP	Publicly traded partnership
MSA	Medical savings account	PYA	Prior year adjustment
NAEA	National Association of Enrolled Agents	QACA	Qualified automatic contribution arrangement
NFT	Nonfungible token	QBI	Qualified business income
NHCE	Non-highly compensated employees	QBIID	Qualified business income deduction
NICRUT	Net income charitable remainder trust	QBL	Qualified business loss
NII	Net investment income	QCD	Qualified charitable distribution
NIIT	Net investment income tax	QJV	Qualified joint venture
NIMCRUT	Net income with make-up charitable remainder trust	QOF	Qualified opportunity fund
NOL	Net operating loss	QOZ	Qualified opportunity zone
NOPA	Notice of proposed adjustment	QPRT	Qualified residence trust
NRCS	Natural Resources Conservation Service	QRE	Qualified research expenditures
OBBBA	One Big Beautiful Bill Act	QSS	Qualifying surviving spouse
ODC	Credit for other dependents	QSST	Qualified subchapter S trusts
OIC	Offer in compromise	QSub	Qualified subchapter S subsidiary
ORRI	Overriding royalty interest	QTIP	Qualified terminable interest property
PAB	Private activity board	RA	Revenue Agent
PAL	Passive activity loss	R&D	Research and development
PAM	Post-appeals mediation	R&E	Research and experimental
PCSC	Partnerships for Climate-Smart Commodities	REAP	Rural Energy for America Program
PEO	Professional employer organization	REDA	Renewable Energy Development Assistance
PEP	Pooled employer plan	RES	Renewable Energy Systems
PFML	Paid family and medical leave	RET	Retirement earnings test
PIA	Primary insurance amount	RMD	Required minimum distribution
PII	Personally identifiable information	RPE	Relevant pass-through entity
PIN	Personal identification number	RSPT	Retirement Security Plan and Trust
		SAF	Sustainable aviation fuel

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SALT	State and local taxes	SSN	Social security number
SAM	System for Award Management	SSTB	Specified service trade business
SARSEP	Salary reduction simplified employee pension	TAG	Technical assistance grants
SCA	Service Center Advice	TAM	Technical advice memoranda
SB/SE	Small Business/Self-Employed	TARP	Troubled Asset Relief Programs
SBA	Small Business Administration	TCJA	Tax Cuts and Jobs Act of 2017
SCO	Supplement Coverage Option	TD	Treasury Decision
SE	Self-employment	TDS	Transcript Delivery System
SEC	Securities and Exchange Commission	TIA	Tax information authorization
SECURE	Setting Every Community Up for Retirement Enhancement Act	TIGTA	Treasury Inspector General for Tax Administration
SEP	Simplified employee pension	TIN	Tax identification number
SERS	State Employees Retirement System	TPA	Third-party administrators
SFS-SM	Secured file sharing-secure messaging	TPSO	Third-party settlement organization
SGO	Scholarship-granting organization	TRA	Tax Reform Act of 1986
SIFL	Standard Industry Fare Label	UBIA	Unadjusted basis immediately after acquisition
SIMPLE	Savings incentive match plan for employees	UBTI	Unrelated business taxable income
SLAT	Spousal lifetime access trust	UEI	Unique entity identifier
SMLLC	Single-member limited liability company	UFIPA	Uniform Fiduciary Income and Principal Act
SNAP	Supplemental nutrition assistance program	UPE	Unreimbursed partnership expenses
SNT	Special needs trust	UPIA	Uniform Prudent Investor Act
SOR	Secure object repository	USC	United States Code
SPA	Significant participation activity	USDA	United States Department of Agriculture
SPLAT	Split-purchase annuity trust	UTC	Uniform Trust Code
SSA	Social Security Administration	VIN	Vehicle identification number
SSB	Specified service business	VPFC	Variable prepaid forward contracts
SSCA	Significant service center advice	WEP	Windfall Elimination Provision
SSFA	Social Security Fairness Act		
SSI	Supplemental security income		

Quick Tips for Deciphering Citations

When reading cases and other legal materials, you will often encounter citations to other materials. While it may look overwhelming, it is really quite simple with the help of these tips.

Some examples of the types of citations you might see:

- Statute: **7 USC 1308** or **7 USC §1308**
- Case: ***Bush v. Gore*, 121 S.Ct. 525 (2000)**

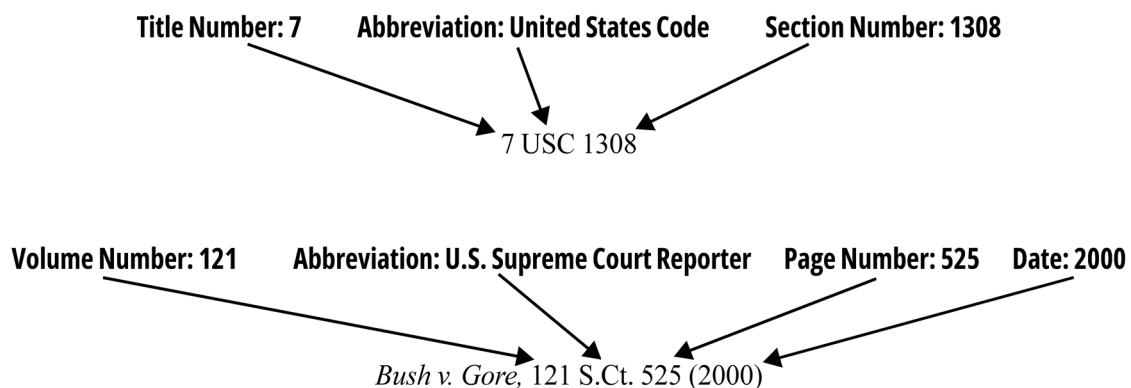
Here are some tips for finding these types of citations:

- To determine what the abbreviation stands for, please reference the following table:

Abbreviation	Meaning
USC	United States Code
CFR	Code of Federal Regulations
AFTR	American Federal Tax Reporter
U.S. or S.Ct.	U.S. Supreme Court Reporter
F.2d or F.3d	Federal Reporter (Circuit Court of Appeals Opinions)
Fed.Appx.	Federal Appendix (Circuit Court Rulings)
F.Supp or F.Supp.2d	Federal Supplement (U.S. District Courts)
TC	U.S. Tax Court (Opinions)
TC Memo	U.S. Tax Court (Memorandum opinions)
TC Summ. Op.	U.S. Tax Court Summary Opinion
Fed.Cl. or Cl.Ct.	U.S. Court of Federal Claims
Bankr. or B.R.	Bankruptcy Court Reports
<i>Aff'd</i>	Decision affirmed by appellate court
<i>Rev'd</i>	Decision overturned by appellate court
<i>Cert. denied</i>	Appeal refused by U.S. Supreme Court

- The **number preceding** the abbreviation is:
 - ♦ Case: volume number
 - ♦ Statute: title number
- The **number following** the abbreviation is:
 - ♦ Case: page number where case or law review article starts
 - ♦ Statute: section number (may include a § symbol)
- Often, the **date** of the article or case decision is included in parentheses.

Using the examples above, they break down as follows:



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Tax Workbook Topics from Past 10 Years

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