2024 Summer Tax

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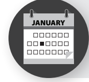

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2024 SUMMER TAX

Course objectives: This course provides comprehensive and critical tax information on rental property, §1031 exchanges, business tax credits, and retirement planning. Topics addressed include: short-term rentals and reporting short-term rental income; converting a rental to a residence or vice versa; passive activity losses; real estate professionals; depreciation planning and recapture; repair regulations for property owners and safe harbor elections; IRC §199A rental real estate safe harbor; general requirements of §1031 exchanges; drop and swap; using a Delaware statutory trust in a §1031 exchange; avoiding constructive receipt; §1033 and involuntary conversions; interplay between §§1033 and 121; California like-kind exchanges; credits comprising General Business Credit; monetizing energy credits; Investment Tax Credit; Research Credit; qualified research expenses; Credit for Smal Employer Pension Plan Startup Costs; Paid Family and Medical Leave Credit; clean vehicle credits under IRC §§30D and 45W; Roth IRAs and 401(k)s; backdoor Roth conversions; CalSavers; cash flow vs. growth investments; net investment income tax (NIIT); annuities; §529 plans; kiddie tax rules; and much more.

After completing this course, you will be able to:

- Determine how to report general expenses for a short-term rental
- Determine if the owner of a rental real estate enterprise may take an IRC §199 deduction
- Recall the limitations when the taxpayer identifies more than one replacement property as part of the same deferred exchange
- Recall the related-party rule for §1033 involuntary conversions
- Identify the maximum amount of a noncorporate taxpayer's net income tax that the General Business Credit can offset
- Identify which projects qualify for the Investment Tax Credit versus the Production Tax Credit
- Determine the timing of income inclusion and income characterization for Treasury bonds
- Identify the five-year holding period if a taxpayer inherits a Roth IRA after the owner's death

Category: Taxes

Recommended CPE Hours: CPAs — 8 Tax
EAs — 8 Federal Tax
CRTPs — 8 Federal Tax

Level: Intermediate

Prerequisite: General tax preparation knowledge is required.

Advance Preparation: None

Expiration Date: July 2025

Part 1

Renée Rodda, J.D.

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PART 1

INTRODUCTION

Rental property tax issues are a critical area of focus for tax professionals because the tax treatment of rental income and expenses can significantly impact a client's overall tax liability. This chapter discusses key areas such as short-term rentals, passive income, depreciation, and other important considerations.

For purposes of the passive loss rules under IRC §469, rental income is deemed passive income by default. However, there are exceptions to the passive activity loss rule. If a taxpayer is a real estate professional and materially participates in their rental activities, then their rental income is nonpassive. This distinction is important because passive losses can only be deducted against passive income, while nonpassive losses can be deducted against all other income, including ordinary income. See the discussion beginning on page 1-14 for more details.

But remember that although a rental activity may be considered passive for purposes of the passive loss rules, it can be treated as a "trade or business" for other rules, such as IRC §179 expensing, or the IRC §199A qualified business income deduction, or as nonpassive for purposes of the net investment income tax. We'll discuss this in more detail below.

Comment

Net rental income is not subject to self-employment tax. This statement is true whether the taxpayer is a passive investor or a materially participating real estate professional who treats their rental income or loss as nonpassive.

However, that does not mean that all income from real estate is exempt from self-employment taxes. For example, dealers in real estate who hold real estate as inventory, as well as hotel or bed and breakfast businesses, are subject to self-employment tax. Dealers in real estate are beyond the scope of today's discussion, but we will discuss short-term rentals treated as Schedule C businesses.

SHORT-TERM RENTALS

With the explosion of the "sharing economy," chances are you have at least one client who is renting out their home or part of their home through Airbnb, VRBO, Booking.com, or similar hosting platform.

However, clients don't always think about all of the tax consequences of renting out their home, or a portion of it.

TYPES OF RENTALS

How the income is treated depends on whether the "host" continues to use the residence between or during rentals, or completely vacates the residence to use it for rentals only:

- If the host continues to use the residence, deductions are computed under the vacation rental rules (IRC §280A; see discussion immediately below);
- In contrast, if the host does not use the dwelling as a residence, then all expenses are deductible for the year or part of the year that the property was used or held for rental purposes, subject to the passive activity loss rules (IRC §469) discussed on page 1-14; and
- If a portion of the house is used exclusively for rentals, the hotel/bed and breakfast rules may apply; see page 1-7.
  (IRC §280A(f)(1)(B); Prop. Treas. Regs. §1.280A-1(c)(2))

How the income is reported will impact which deductions may be claimed.

USE AS A RESIDENCE: VACATION RULES

If a taxpayer uses the dwelling as a residence, the rental falls under the "vacation home rules." A taxpayer uses a dwelling unit as a residence during the taxable year if they use the property for personal purposes for a number of days which exceeds the greater of:

- 14 days; or
- 10% of the total days it was rented to others.
  (IRC §280A(d)(1)(B))

Example of counting personal days

Jane owns a vacation rental in Mammoth Lakes that she rents to others for 315 days during the year. Jane is an avid skier and loves to fish, so she uses the property for 15 days in the winter and 15 days in the summer.

Jane's total personal use days (30) does not exceed 10% of the total days her property is rented to others (315) (30 personal use days ÷ 315 days rented to others = 9.5%).

Jane is not deemed to have used the property as a residence during the year.

If a home or portion of the home is used as a residence, rental deductions are limited to the amount of rental income. Any deductions that cannot be claimed may be carried over to future years. (Prop. Treas. Regs. §1.280A-3(d)(3))

Deductions must be claimed in the following order:

1. Expenses directly related to the rental (e.g., advertising, commissions, which can range from between 3% to 12%, etc.);
2. Interest and taxes (always-deductible expenses);
3. Operating costs that do not affect basis; and
4. Depreciation.
   (IRC §280A(g))

Note however, if the taxpayer rents out a portion of the house and never uses that portion for personal purposes, the bed and breakfast rules apply (see page 1-7).

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> ***Comment***
>
> Revisiting the example of Jane above, we quickly see the impact of a rental property that is also used as a residence. For Jane, because the number of days she uses her property is low enough that the property is not treated as a residence, she can deduct all of her rental income and expenses. Rental losses may be limited by the passive loss rules but not the vacation home rules of IRC §280A.
>
> However, if Jane's personal use days are great enough that the property is treated as a residence during the year, then her rental losses are first limited to rental income based on the ordering rules of IRC §280A before the passive loss rules come into play.
>
> Whether a property is treated as a residence is a determination that must be made each year and can change year-to-year.

RENTAL FOR 14 DAYS OR LESS DURING THE YEAR (AUGUSTA RULE)

If a taxpayer uses a dwelling as a residence during the tax year and rents the dwelling for 14 days or less during the year, then the rental income is excluded from the taxpayer's gross income (meaning that it's not reported at all). The taxpayer also cannot claim any deductions related to the rental. (IRC §280A(g)) However, they can still deduct items that are deductible in the absence of the rules related to rental properties (which are generally itemized deductions for mortgage interest and property taxes).

The income is not required to be reported on the return, and Schedule E does not need to be completed to claim this exclusion, but the taxpayer should make sure to keep good records regarding which days the housing was rented and which days the home was used for personal use.

> ***Comment***
>
> This tax treatment is known as the Masters Rule (or the Augusta Rule) due to the use of this provision by the residents of Augusta, Georgia, during the annual Masters Golf Tournament.
>
> This is especially beneficial in cities, like Augusta, that host major events that bring in thousands of visitors to the city for a short period (e.g., Comic-Con in San Diego, Bay to Breakers in San Francisco, or the Boston Marathon). Some people have been known to collect the rent, store valuable items, take a European vacation, and still pocket a little cash.

HOW TO REPORT SHORT-TERM RENTAL INCOME

For those clients who are renting out a dwelling *they use as a residence* based on the days of personal use discussed earlier – either a room in their home or an entire home – income received from the rental must be included in the taxpayer's gross income.

Most taxpayers will likely report this income on Schedule E. However, if the activity rises to the level of a trade or business, the income will be reported on Schedule C.

Direct expenses 100% deductible

When a rental is used as a residence, direct expenses are 100% deductible to the extent they do not exceed the taxpayer's gross rental income from that rental activity. Direct expenses include

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Airbnb commissions, advertising, credit background checks, rental insurance, linens and beddings (if used exclusively for rental purposes), etc.

Prorate always-deductible expenses

Always-deductible rental expenses are deducted on a *pro rata* basis: days rented over days in the year. (IRC §280A(b)) Always-deductible expenses are deductible as rental expenses to the extent they do not exceed the taxpayer's gross rental income from that rental activity, and the balance is deductible on Schedule A.

Always-deductible expenses generally involve interest and taxes.

Prorate general expenses

General expenses are also deducted on a *pro rata* basis: days rented over days used. (IRC §280A(e)) Days used is a combination of both fair rental days and days used by the taxpayer as a residence.

General expenses include utilities, insurance repairs, etc.

Practice Pointer

There is an important distinction that must be made between prorating always-deductible expenses versus general expenses.

Always-deductible expenses are prorated using the formula:

$$\frac{\text{Days rented}}{\text{Days in the year}}$$

General expenses are prorated using the formula:

$$\frac{\text{Days rented}}{\text{Days used}}$$

Depreciation

If only a portion of the unit is rented, the expenses must be further prorated to account for the portion of the house/unit that is actually rented.

Depreciation deductions may also be claimed for the rental portion of the home or for the days of the year the entire home was rented. The basis for purposes of depreciating a principal residence converted to a rental is the lesser of the adjusted basis of the property or its fair market value at the time of conversion, after subtracting the amount allocated to nondepreciable land. (Treas. Regs. §1.167(a)-5 and (g)-1)

Any excess amounts over the income limitation are carried over.

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Example of allowable deductions for a vacation rental

Jean lives in her San Diego condominium for 200 days during the year and leaves and rents it out for 100 days and brings in $10,000 of rental income. The condominium is vacant the remaining 65 days of the year.

Total rental days over total days **in year:** 100 ÷ 365 = 27.4%

Total rental days over total days **used** (see "days of use," below): 100 ÷ 300 = 33.3%

Allowable deductions					
	Total expense	**Applicable percentage**	**Allocable amount**	**Schedule E deduction**	**Cumulative deduction**
Direct expenses	$2,000	100.0%	$2,000	$2,000	$2,000
Interest and taxes	$26,000	27.4%	$7,124	$7,124	$9,124
General expense	$6,000	33.3%	$2,000	$876*	$10,000
Depreciation	$4,000	33.3%	$1,333	$0	$10,000
* Deductions are limited to gross rental income, so Jean's cumulative deductions cannot exceed $10,000 for the year					

Jean reports interest and taxes of $18,876 ($26,000 - $7,124) on her Schedule A (interest and taxes are broken out ratably).

She carries forward general expenses of $1,124 ($2,000 - $876) and depreciation of $1,333.

DAYS OF USE

When is a day a "rental use" day?

A rental use day is:

- Any day the unit is rented at a fair rental price is a day of rental use even if the host used the unit for personal purposes that day (this rule does not apply when determining whether the host used the unit as a home); and
- Any day the unit is available for rent but not actually rented is not a day of rental use if the unit is subject to the vacation home rules of IRC §280A.
  (IRS Publication 527, Residential Rental Property (Including Rental of Vacation Homes))

When is a day a "personal use" day?

A taxpayer is considered to have used a dwelling unit for personal purposes on any day if, for any part of the day, the unit is used by:

- The taxpayer or any other person who owns an interest in the unit;
- The taxpayer's family members, including a spouse, sibling, half-sibling, lineal ancestor, and lineal descendant (unless the family member is pays full rental value);
- Anyone who uses the unit under a reciprocal agreement ("I use your place, you use mine"); and
- Any other individual who uses the unit without paying fair rental.

A day spent cleaning, repairing, or otherwise maintaining the property is not a day of personal use (it is neither a rental use day nor a personal use day). Any day that the unit is donated for charitable use is counted as a personal use day.

Example of maintenance work days

Al and Peggy own a lakeside cottage that they rent during the summer. Al and Peggy arrive late Thursday evening after a long drive to prepare the cottage for the rental season. Al and Peggy prepare dinner but do no work on the unit that evening. Al spends a normal work day working on the unit on Friday and Saturday; Peggy helps for a few hours each day but spends most of the time relaxing. By Saturday evening, the necessary maintenance work is complete. Neither Al nor Peggy works on the unit on Sunday; they depart shortly before noon.

The principal purpose of the use of the unit from Thursday evening through Sunday morning is to perform maintenance work on the unit. Consequently, the use during this period is not counted as personal use. (Prop. Treas. Regs. §1.280A-1(e)(7) Example 3)

Where to Claim Rental Expenses

Type of expense	**Description**	**How much to deduct**	**Where to report**
Direct expenses	Include Airbnb or other hosting-platform commissions, advertising, credit background checks, rental insurance, linens/beddings/other supplies (if used exclusively for rental purposes)	100% deductible subject to income limitations	Schedule E or Schedule C if rises to a trade or business
Always-deductible expenses	Generally interest and taxes	Deductible as rental expenses *pro rata*: days rented/days in year*	Schedule E or Schedule C if rises to a trade or business Balance may be deductible as itemized deductions on Schedule A
General expenses	Utilities, insurance, repairs, etc.	Deductible as rental expense *pro rata*: days rented/days used*	Schedule E or if rises to a trade or business, Schedule C

* If only a portion of the unit is rented, the expenses must be further prorated to account for the portion of the house/unit that is actually rented

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Comment

If the rental activities rise to the level of a trade or business the taxpayer may also qualify for an IRC §199A deduction (see page 1-54 for more information).

But remember, the tests for determining whether an activity is a trade or business may not be the same for all purposes. For instance, just because a rental activity is a trade or business for IRC §199A purposes doesn't mean it's also a trade or business for other purposes.

HOTEL OR BED AND BREAKFAST

In some instances, the rental of a room or a residence may be treated as a hotel or a bed and breakfast, which requires the host to treat the rentals as a trade or business, reportable on Schedule C. This applies in situations where a room or a residence is regularly made available for occupancy by paying customers and isn't used by an owner as a "home" during the year.

If a host provides substantial services such as regular cleaning, breakfast or other meals, changing linen, or maid service, then the activity is treated as a bed and breakfast. Under the exclusive-use rule, deductions for expenses incurred for dual-use areas such as kitchens, offices, and laundry rooms are not allowed.

Hosts that fall into this category must report the income on Schedule C, if a sole proprietor, and are required to pay self-employment taxes on the income. However, because the activity is treated as from a sole proprietorship, neither the passive activity loss rules nor the vacation home rules apply.

LOCAL RESTRICTIONS

Transient occupancy taxes

Many localities impose a transient occupancy tax (TOT) or hotel occupancy tax (HOT) on rentals of 30 days or less. The following are the rates for some larger cities:

- **Chicago:** 10.5%;
- **Dallas:** 7%
- **Los Angeles:** 12%;
- **New York:** 5.87% plus a per-rental-unit flat fee;
- **San Diego:** 10.5% plus a 0.55% Tourism Marketing District Assessment; and
- **San Francisco:** 14%.

It is important for hosts to contact their cities to see if the city imposes a TOT or HOT. Airbnb and other hosting platforms are beginning to collect and remit these taxes in some cities. A listing of the cities where Airbnb collects TOT taxes is available at:

Website
www.airbnb.com/help/article/653?topic=264

Note: These taxes may be claimed as a deductible direct expense but not in excess of the rental income if the vacation rental rules apply.

Business license fees/taxes

Some cities also require hosts to obtain a business license and pay a business fee in addition to the transient occupancy tax. For instance, San Francisco requires qualified hosts to register with the city and pay a $50 fee. Chicago requires hosts to register and pay a $125 registration fee.

Personal property taxes

Many states and localities require short-term rental hosts to file a business personal property tax statement and pay the personal property tax on the property reported.

For instance, starting in May 2024, owners of short-term rentals (such as rentals offered through a platform like Airbnb) in California must complete new Form BOE-571-STR, Short Term Rental Property Statement, to report business personal property (although some counties such as San Francisco had required this in previous years). Unlike real property, business personal property generally is reappraised annually. Business owners must file a business property statement each year detailing costs of all supplies, equipment, and fixtures at each location.

Items such as furniture (televisions, computers, bed frames, mattresses, tables, chairs, entertainment units, artwork), kitchen items (such as dishes, flatware, and appliances), washing/drying machines, and any other property provided to renters as part of the rental activity are considered business personal property.

The form that was approved by the BOE for counties to adopt contains a table for itemizing the original cost of belongings for various rooms and the furniture and equipment/supplies that may appear in each, plus an “other” category for items such as bikes, hot tub, gazebo, sports equipment, vacuum cleaner, security system, patio furniture, and pool equipment.

While the form is only required if the taxable personal property has an aggregate cost of $100,000 or more, it may be prudent for the host to file the form even if the value is less than $100,000 so the county assessor doesn’t make assumptions about the value of the property that far exceeds the actual costs.

We’ve heard of other states, such as Washington, also requiring similar reporting. It’s important to check with the local county assessor of where the rental property is located to determine if a similar report is required in that jurisdiction.

OTHER NONTAX ISSUES

The news is filled with all types of controversies surrounding Airbnb-type rentals, and localities are responding with a whole array of approaches to handle the effects of short-term rentals on communities.

Communities are truly divided over the best way to deal with this booming shared economy. It is important to advise your clients of all the potential implications and to advise them to do their research to see just how expensive this supposedly easy income endeavor might be.

Many localities are limiting who can host short-term rentals. Examples include limiting:

- Short-term rentals to those rooms or units where an owner lives on the premises;
- The number of days in a year a unit can be rented for short-term occupancy; or
- The number of short-term rental occupancy licenses that will be issued in a municipality.

Hosts should also be careful to review their leases, homeowner association and subdivision rules, and rent control/zoning ordinances to see if they may be at risk of evictions or fines for

renting out their units/rooms. In San Diego, the city issued a $25,000 fine against a homeowner who failed to register her home as a bed and breakfast when she rented out two of her five bedrooms on Airbnb, even though she didn't provide breakfast to any of her short-term renters. (Hargrove, Dorian (August 10, 2015) "AirBnb, the Elephant in the Room," *San Diego Reader*)

CONVERTING RENTAL TO RESIDENCE OR VICE VERSA

CONVERSION TO RENTAL AND NONQUALIFIED USE

Under IRC §121(a), for home sales after December 31, 2008, the gain from the sale or exchange of a principal residence is not excluded from gross income for periods that the home was not used as the principal residence (nonqualified use). (IRC §121(b)(4))

Nonqualified use is commonly an issue for taxpayers who convert a rental to a residence and then subsequently sell the property, hoping to exclude 100% of the gain from the sale of the home under IRC §121. However, periods during which taxpayers owned a second home and didn't use it as a principal residence is also considered nonqualified use. For example, a taxpayer who owns a vacation home and moves into it for two years before selling it must also grapple with nonqualified use issues.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction: The numerator is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, and the denominator is the period the taxpayer owned the property.

Example of rental converted to a residence

Joe bought a property on January 1, 2019, for $600,000 and used it as rental property for two years, claiming $30,000 of depreciation deductions. Thus, his adjusted basis is $570,000. On January 1, 2021, Joe converted the property to his principal residence when the fair market value was still $600,000. On January 1, 2023, Joe moved out. He sold the property for $800,000 on January 1, 2024.

Sales price	$800,000
Basis	570,000
Gain	$230,000

The $30,000 gain attributable to the deduction for depreciation is recaptured. Of the remaining $200,000 gain, 40% is nonqualified use (two years nonqualified out of five years total ownership). Gain attributable to nonqualified use is $80,000 (40% of $200,000).

As such, the remaining $200,000 gain is taxed as follows:

Gain	$200,000
Reduction for nonqualified use	(80,000)
Remaining gain	120,000
IRC §121 exclusion amount	(120,000)
Gain after exclusion	0
Nonqualified gain	80,000
Total recognized gain	$ 40,000

Calculation: Computing the gain with a period of nonqualified use

Follow these steps to compute the taxable gain on the sale of a principal residence:

Step 1

$$\text{Gain} \times \frac{\text{Period of nonqualified use}}{\text{Total period of ownership}} = \text{Nonqualified gain}$$

Step 2

Total gain	________
Less nonqualified gain	(________)
Excludable gain under IRC §121	________
Less IRC §121 exclusion	(________)
Gain after exclusion (not less than zero)	________
Add nonqualified gain	________
Total recognized gain	________

Exception to nonqualified use

One of the exceptions to the IRC §121 primary residence two-year qualified use requirement is where a taxpayer converts a residence into a rental property and then sells the home within three years of the conversion. (IRC §121(b)(5)(C)(ii)) In this scenario, the taxpayer still meets the two-out-of-five-year test.

Example of rental use after last use as a principal residence

Jerry purchased his home on January 1, 2013, for $600,000 and used it as his principal residence until January 1, 2022, when he began renting it out. At that time, the FMV of the property was greater than $600,000. On January 1, 2023, he sold the home for $850,000. There is no period of nonqualified use because the rental period occurred after the last use as a principal residence. He may exclude the entire $250,000 gain.

The exception only applies to any portion of the five-year period that is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse.

DEPRECIABLE BASIS WHEN RESIDENCE CONVERTED TO RENTAL

The depreciable basis of a residence converted to a rental property is the lesser of:

- The property's adjusted basis; or
- Its fair market value at the time of conversion.
  (Treas. Regs. §§1.165-9(b)(2), 1.167(g)-1)

Example #1 of depreciable basis of former residence

Mary purchased her principal residence on May 10, 2012, for $500,000 ($200,000 allocated to land and $300,000 allocated to buildings). On June 27, 2023, Mary converted her residence to a rental property when the fair market value of her home was $800,000 ($320,000 allocated to land and $480,000 allocated to buildings).

The depreciable basis for Mary's former residence based on the lesser of basis or FMV is $300,000 (depreciable over 27.5 years) and $200,000 to nondepreciable land (the lesser of adjusted basis or fair market value at the time of conversion).

Example #2 of depreciable basis of former residence

Luke purchased his principal residence on September 12, 2017, for $500,000 ($200,000 allocated to land and $300,000 allocated to buildings). On July 9, 2023, Luke converted his residence to a rental property when the fair market value of his home was $400,000 ($160,000 allocated to land and $240,000 allocated to buildings). The depreciable basis for Luke's former residence based on the lesser of the original basis or FMV is $240,000 (depreciable over 27.5 years) and $160,000 to nondepreciable land (the lesser of adjusted basis or fair market value at the time of conversion).

SINGLE DWELLING UNIT HOME USED FOR BOTH PERSONAL AND BUSINESS PURPOSES

Taxpayers may treat the entire home as a single unit if the residential part and the rental or business part are both within the same dwelling. (Treas. Regs. §1.121-1(e)(2)) In this case, the entire property qualifies for the gain exclusion if it otherwise meets the requirements for a residence.

A single structure may have more than one dwelling unit. A dwelling unit includes a house, apartment, condominium, boat, mobile home, or similar property. It does not include a detached garage; a basement or any part of the home that has its own entrance, bathroom, and cooking facilities; a guest house; or any other structure separate and away from the main residence.

Example of a single dwelling unit

Molly is a financial planner with a home office she used exclusively for business. It met all of the requirements to be deductible as her home office, including depreciation. When Molly sold her home, no allocation of gain was necessary as both the residential and nonresidential portions were within the same dwelling unit. Even though a portion of the residence was business-related at the time of the sale, it was not disqualified from excluding the applicable IRC §121 amount. Depreciation recapture was taxed as an unrecaptured IRC §1250 gain subject to a maximum 25% tax rate.

MULTI-DWELLING UNIT HOME USED FOR BOTH PERSONAL AND BUSINESS PURPOSES

Properties with multiple structures used for both personal and business purposes must be allocated *pro rata* to the entire property. (Treas. Regs. §1.121-1(e)) When the property is sold, the transaction is treated as separate sales. The tax basis and sales proceeds are allocated between the business unit and residence. The gain attributable to the residence portion qualifies for the IRC §121 exclusion if otherwise applicable.

Example of multi-dwelling unit

Tran built a mechanics shop in the back of his one-acre property. It had a separate driveway and entrance with a fence enclosure. The structure shared utilities, internet, phone system, and security with the main house. The FMV of Tran's home prior to the shop building was $400,000. His cost basis was $300,000. The cost of the shop structure was $100,000. When construction was completed, the FMV increased in total to $600,000. Tran deducted $12,000 of depreciation based on the lesser of FMV or cost. He sold the home and shop for $1 million. Tran's taxable gain is calculated as follows:

Original cost of home and land	$300,000	75%
Cost of shop	100,000	25%
Total cost	$400,000	
Shop building adjusted basis ($100,000 - $12,000)	$88,000	

Gain on home sale	
Allocated sale price ($1,000,000 × 75%)	$750,000
Original cost	(300,000)
IRC §121 gain exclusion	(250,000)
Tran's capital gain on home sale	$200,000
Gain on shop portion	
Allocated sale price ($1,000,000 × 25%)	$250,000
Adjusted basis	(88,000)
Net IRC §1250 capital gain	$162,000

Other examples of property separate from the residential dwelling excludable from IRC §121 are:

- Ranch or farm buildings not attached to the taxpayer's home;
- A duplex in which the taxpayer lives in one unit and rents the other unit; and
- A commercial building such as a store where the building owner lives in an upstairs apartment.

CONVERTING VACATION OR RENTAL PROPERTY TO PERSONAL RESIDENCE

When a taxpayer converts a vacation or rental property to their principal residence, any gain upon the sale attributable to the period of nonqualified use after 2008 is taxable and not eligible for any benefit from the IRC §121 exclusion. Nonexcludable gain is calculated *pro rata* based on the period of ownership to the period of nonqualified use.

$$\frac{\text{Nonqualified use}}{\text{Years of ownership}} \times \quad \text{Total gain} \quad = \quad \text{Nonexcludable gain}$$

The consequences to taxpayers for renting out their home are different depending on whether the host:

- Rented out a room in their home;
- Rented out a separate unit; or
- Rented out their own home for a portion of the year.

Renting of rooms

If the Airbnb host rented out a room in their home and the room/rooms were not separate units, when they sell the home:

- They must recapture any depreciation claimed for the rooms; and
- The amount of any IRC §121 primary residence gain exclusion is reduced by any depreciation recapture.
  (Treas. Regs. §1.121-1(e)(1))

Example of reduction of IRC §121 gain exclusion

Javier has rented two rooms in his home on Airbnb for the last five years and claimed $9,000 in depreciation for these rooms. He sells his home for a $100,000 gain. He must report the $9,000 in depreciation recapture and can only exclude $91,000 of the gain under §121.

Renting out a separate unit in a home

If a taxpayer lives in a home but converts a part of the home or a garage into a separate unit with a separate entrance, the portion of the gain attributable to the separate unit will not be eligible for the primary residence exclusion. (Treas. Regs. §1.121-1(e)(1)) The depreciation deductions taken on the separate unit will be subject to depreciation recapture. (Treas. Regs. §1.121-1(d))

Example of separate dwelling unit

In 2016, Anika bought a three-story townhouse and converted the basement level, which has a separate entrance, into a separate apartment by installing a kitchenette and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property is comprised of two dwelling units.

Anika used the first and second floors of the townhouse as her principal residence and rented the basement level to Airbnb guests from 2019 to 2023. Anika claimed depreciation deductions of $2,000 for that period with respect to the basement apartment. She sells the entire property in 2023, realizing gain of $20,000, with $2,000 depreciation recapture.

Because the basement apartment and the upper floors of the townhouse are separate dwelling units, Anika must allocate the gain between the portion of the property that she used as her principal residence and the portion of the property that she used for nonresidential purposes. The basement unit is one third of the property.

Anika must recapture the $2,000 of depreciation, leaving a gain of $18,000. One-third of the gain is allocated to the rental property. (Treas. Regs. §1.121-1(e)(4), Ex. 3)

Anika's gain is computed as follows:

Basement apartment		**Principal residence**	
Depreciation recapture	$2,000	Gain	$12,000
Gain (Form 4797)	6,000	IRC §121 exclusion	(12,000)
Total recognized gain	$8,000	Total recognized gain	$ 0

Beware of new basis

Remember that the depreciable basis for a residence converted to a rental property is the lesser of:

- The property's adjusted basis; or
- Its fair market value at the time of conversion.
  (Treas. Regs. §§1.165-9(b)(2), 1.167(g)-1)

Example of depreciable basis of former residence

Larry purchased his principal residence on September 12, 2020, for $450,000 ($175,000 allocated to land and $275,000 allocated to buildings). On July 9, 2023, Larry converted his residence to a rental property when the fair market value of his home was $400,000 ($160,000 allocated to nondepreciable land and $240,000 allocated to buildings).

The depreciable basis for Larry's former residence is the lesser of the FMV, $240,000, or his adjusted basis, $275,000.

✐ **Practice Pointer**

There are many tax planning strategies to consider when advising clients on converting their personal residence to an income property. While excluding taxable gain under IRC §121 is viewed as an appealing tax planning opportunity and benefit, you and the taxpayer may want to consider some of the following points before making that final decision:

- Rental property operational expenses are deductible — utilities, repairs, maintenance;
- There is no limit on property tax deductions for rentals;
- There is no mortgage interest deduction limit on rentals;
- Passive losses generated by the rental may offset other passive income;
- Passive income generated may offset other passive losses;
- Loss on the sale of property used exclusively for business is deductible;
- Loss on the sale of a personal residence is not deductible; and
- Being a landlord takes time, patience, and can be challenging.

Converting a residence to a rental brings on more scrutiny by the IRS. An auditor will look closely at:

- The purpose, intentions, and primary motivation for the conversion;
- Having a rental or other income property requires more stringent record keeping, and creates extra tax filings and compliance; and
- Owning rental property increases the taxpayer's liability risk.

PASSIVE ACTIVITY LOSSES

Rental real estate activities are treated as *per se* passive for purposes of the passive activity rules. This means losses generated from rental real estate are nondeductible against nonpassive income, with the limited exception of a maximum $25,000 deduction for active participation and the exception for "real estate professionals" under IRC §469(c)(7).

Similar rules apply to tax credits. Tax credits attributable to passive activities may only be used to offset taxes attributable to income from passive activities unless the real estate professional exception applies.

$25,000 DEDUCTION

Taxpayers who actively participate in a rental real estate activity may qualify for limited relief from the passive activity rules. (IRC §469(i))

If the taxpayer's AGI is $100,000 or less ($50,000 for married taxpayers filing separately), then a taxpayer may be able to deduct up to $25,000 ($12,500 for MFS) of their Schedule E rental losses, even if they have no other passive income. The $25,000 maximum amount is reduced when the taxpayer's AGI exceeds $100,000 and is fully phased out once their AGI reaches $150,000 ($75,000 for MFS). These numbers are not subject to inflation adjustments and haven't changed since IRC §469 was added to the Internal Revenue Code in 1986.

A taxpayer actively participates in a rental real estate activity if:

- They owned at least 10% of the rental property; and
- Made management decisions or arranged for others to provide services (such as repairs) in a significant and bona fide sense.

The active participation standard is easier to satisfy than the material participation standard discussed on page 1-18. In order to meet the active participation standard, the taxpayer must simply participate in the rental activity in a significant way, including making management decisions or arranging for others to provide services (such as hiring the plumber to fix a leak), approving new tenants, setting rental policies and terms, and approving capital expenditures and repairs. (***Madler v. Comm.***, TCM 1998-112)

Example of active participation

Al and Mira are siblings, and each owns 50% of a residential rental property they inherited when their mother died. They use a management company for the day-to-day rental activity.

Al is the main contact with the management company. He approves rental applications, pays the semi-annual property tax bill, makes the monthly mortgage payments, and he approves any major expenditures proposed by the management company. Mira cashes a monthly check she receives.

In this scenario, Al actively participates in the rental activity, but Mira does not.

A taxpayer cannot satisfy the active participation standard if their ownership in the rental activity drops below 10% at any point during the year. (IRC §469(i)(6)(A))

LOSSES FROM SHORT-TERM RENTALS

The $25,000 passive loss limitation exception does not apply if the taxpayer's average rental period is seven days or less. This short-term rental property is technically removed from the Code's definition of "rental activity." (Treas. Regs. §1.469-1T(e)(3)(ii)(A)) This means that these short-term rentals are not treated as "per se" passive, and the $25,000 passive loss limitation exception will not apply for many short-term rentals on Airbnb and VRBO, etc.

It also means that hours spent in short-term rentals do not count toward meeting the real estate professional tests discussed below.

REAL ESTATE PROFESSIONAL

The real estate professional exception from the passive activity rules is one of the most misunderstood concepts of tax. Many tax professionals fail to get this correct, and the IRS and even the Tax Court have had mixed opinions on this exception. There was and still is very little consistency in how the IRS deals with this area. One thing that is certain, however, is if large rental losses are claimed on Form 1040, the IRS will look at it.

The key is either understanding the law and preparing your case or not taking the deduction when preparing the return.

The losses could be legitimate, such as from a sale of a property that had suspended loss carryovers, or the taxpayer may legitimately qualify as a real estate professional. When you are dealing with the former scenario, be sure that the sale of the rental is reported on Form 4797, Sales of Business Property, so that the system can match it up.

Alternatively, if you or your client thinks they are a real estate professional, be sure that you and your client know what is required to qualify and provide adequate substantiation to back up that position.

Net investment income tax

Having the activity treated as nonpassive also provides the extra benefit of having the income treated as business income, which is not subject to net investment income tax (NIIT).

✐ **Practice Pointer**

This is especially important in the year the property is sold.

THE TESTS

To achieve real estate professional status, an individual must meet two tests:

- More than half of the personal services performed by the taxpayer during the year must be in real property trades or businesses; and
- At least 750 hours of the personal services performed by the taxpayer during the year must be in real property trades or businesses.
  (IRC §469(c)(7))

✐ **Practice Pointer**

But qualifying as a real estate professional is not enough to overcome the passive loss limitations. **The limitation will still apply unless the real estate professional materially participates in the rental real estate activity for which the loss is claimed.**

Failure to do so means IRC §469(c)(7) does not apply, and losses are generally limited to $25,000.

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Employee hours

A taxpayer can only count their employee hours in a real estate trade or business if the taxpayer is at least a 5% owner in the business. (IRC §469(c)(7)(D)(ii))

Verify that one spouse alone meets both of the following tests

Practice Pointer

For purposes of the real estate professional tests discussed immediately below, in the case of spouses filing a joint return, the hours worked by both spouses cannot be combined. The tests are only satisfied if either spouse separately satisfies each of the requirements. So, if one spouse provides 300 hours of personal services and the other spouse provides 500 hours of personal services, neither spouse can qualify as a real estate professional.

Similarly, if one spouse provides 750 hours of personal services but spends less than 50% of their work time in the real estate trade or business, whereas the other spouse didn't meet the 750-hour test but did meet the 50% test, neither spouse qualifies as a real estate professional.

50% test

More than half of personal services in all trades or businesses for the year must be performed in real property trades or businesses and rental real estate.

A "real property trade or business" includes:

- Development and redevelopment;
- Construction;
- Acquisition;
- Conversion;
- Rental;
- Operation;
- Management;
- Leasing; or
- Brokerage (including real estate agents, see ***Agarwal v. Comm.***, TCS 2009-29). (IRC §469(c)(7)(C))

In ***Calvanico v. Comm.*** (TCS 2015-64), the Tax Court rejected the taxpayer's argument that he qualified as a real estate professional due to his work as a real estate appraiser for a large accounting firm. However, it's important to note that the Tax Court did not reject the argument because a real estate appraiser is not involved in a "real property trade or business." Rather, the Tax Court held that he didn't qualify because employees can only count their employee hours toward their personal service real property trade or business hours if they are a 5% owner in the employer's business.

In CCA 201504010, the IRS clarified that a mortgage broker of financial instruments does not qualify as a real estate professional.

We believe that whether an attorney can treat their legal work as a real property trade or business requires a facts and circumstances analysis. In ***Stanley v. U.S.*** ((November 12, 2015) U.S. Dist. Ct., W.D. Ark, Case No. 5:14-CV-05236), a U.S. district court ruled that an attorney who was more than a 5% owner and acted as president and general counsel of a property management company was engaged in a real property trade or business.

In contrast, in ***Lengille v. Comm***. (TCM 2010-49), the Tax Court held that an attorney failed to qualify as a real estate professional because she failed to show that more than 50% of her time was spent on real estate activities rather than on her legal practice. However, the court failed to address whether legal work related to real estate transactions would qualify as real property trade or business personal service hours. Many commentators are stating that if the attorney's legal work is related to real estate activities, then these hours may count.

This is where most taxpayers fail the test

Most taxpayers who work full-time in another field fail to meet the 50% test. A full-time employee in a non-real property trade or business is considered to work at least 2,000 hours a year, 40 hours a week, 50 weeks a year. That would mean a taxpayer would need to log another 2,001 or more hours tending to the rental activity. This is not an easy feat as there are only 8,760 hours in a year.

The Tax Court consistently sides with the IRS in disallowing real estate professional classification when the taxpayer has a full-time job in a field outside of real estate. (***Penley, et ux. v. Comm.,*** TCM 2017-65; ***Escalante v. Comm.***, TCS 2015-47; ***Hassanipour v. Comm***, TCM 2013-88) However, if adequate records are maintained, a taxpayer working part-time in a non-real property trade or business can qualify. (***Windham v. Comm.***, TCM 2017-68; ***Miller v. Comm.,*** TCM 2011-219)

750-hour test

The taxpayer must spend more than 750 hours in real property businesses and rentals in which they materially participate.

✐ **Practice Pointer**

Taxpayers can group their various activities to meet the 50% and 750-hour test. Unlike the grouping election that is required for the material participation test discussed below, no election needs to be made to group these activities. For example, if a taxpayer is a part-time employee of a property management company in which they are a partial owner and rents out three properties, they can combine their hours worked for the property management company with the hours they spent managing their own properties to determine if they meet the 50% and 750-hour tests (see ***Miller v. Comm***, TCM 2011-219 and CCA 201427016).

MATERIAL PARTICIPATION

If the answer is yes to both tests discussed above, then the taxpayer next must evaluate whether they materially participated in each rental real estate activity to determine whether the activity is treated as passive or nonpassive. (Treas. Regs. §1.469-5T; ***Gragg v. U.S.*** (August 4, 2016) U.S. Court of Appeals, Ninth Circuit, Case No. 4:12-cv-03813-YGR)

Single-activity (grouping) election

In assessing a taxpayer's material participation, each rental property is treated as a separate activity unless the taxpayer makes an election to treat all rental activities as a single activity (the single-activity election). (IRC §469(c)(7)(A))

The single-activity election permits a taxpayer to treat all interests in rental real estate as one activity, thereby creating a single, bigger activity, and one for which it will be easier to meet the material participation test. (IRC §469(c)(7); Treas. Regs. §1.469-9(g)(3)) The election is binding for the

tax year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer. (Treas. Regs. §1.469-9(g)) The election is made by filing a statement with the taxpayer's original income tax return. Simply aggregating losses from various rental activities and reporting them on the tax return is not a sufficient election.

Sample single-activity election

Pursuant to IRC §469(c)(7)(A) and Treasury Regulation §1.469-9, the taxpayer hereby elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity for the tax year ended December 31, 20XX, and subsequent tax years. The taxpayer hereby declares themself a qualifying taxpayer for the tax year ended December 31, 20XX.

A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. This statement must contain a declaration that the taxpayer is revoking the election under IRC § 469(c)(7)(A) and an explanation of the nature of the material change.

Suspended losses may be trapped

It's important to remember that if the taxpayer makes the single-activity election, any previously suspended losses are still suspended. If the taxpayer sells a property with previously suspended losses and that property is grouped with other properties, the losses do not get released on the sale of the single property.

Under IRC §469(g), all previously suspended losses are released on a complete disposition of the entire interest. If the property is grouped with other properties, then the entire interest is not considered sold. When this occurs, the previously suspended losses do not get released, but instead, they are allocated to the remaining properties.

Example of suspended losses

Bill owns five rental properties and makes the election under IRC §469(c)(7)(A) to group the properties starting in 2020. Prior to 2020, Bill had accumulated $65,000 of suspended losses:

Property 1	($20,000)
Property 2	($10,000)
Property 3	($25,000)
Property 4	($5,000)
Property 5	($5,000)

Bill sells Property 2 in 2024. The $10,000 of suspended losses are now split up between the remaining four properties. For simplicity, he will allocate $2,500 of the previously suspended loss to each property.

The material participation tests

Under Treas. Regs. §1.469–5T, a taxpayer materially participates in an activity in a taxable year if they meet one of seven tests.

Spouse's participation

Unlike the real estate professional tests above, a taxpayer's participation in an activity can include their spouse's participation. This is true even if the spouse doesn't:

- Own any interest in the activity; and/or
- File a joint return with the taxpayer.

1. The 500-hour test

A taxpayer materially participates in an activity if the individual participates in the activity for more than 500 hours during such year. (Treas. Regs. §1.469-5T(1))

Unless a single-activity election is made, the 500-hour test is applied on a per-property basis, not for all properties as is the case for the 750-hour real estate professional test discussed above.

Interplay between 750-hour test and 500-hour test

Luis owns 10 rental properties and averages working on each property 10 hours per month, meaning that he meets the 750-hour real estate professional test. However, unless he elects to group the properties, he does not meet the 500-hour material participation test because he only works 120 hours on any given property throughout the year. Luis must look to the other material participation tests to determine whether he can treat his activity as nonpassive.

The 500 hours must be performed by the taxpayer. This means a taxpayer may not qualify if they have a substantial amount of the work performed on the property in any year by a contractor or property manager.

✎ **Practice Pointer**

Make sure your clients keep detailed logs as to how their time was spent (see discussion below). The IRS and Tax Court carefully examine the logs to ensure that time claimed was actually spent. For instance, they may cross-check credit card statements and will question a taxpayer's claim that they worked all weekend on property maintenance when their credit card statement shows they were vacationing in Mexico that weekend.

2. The substantially all test

A taxpayer materially participates in an activity if the individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year. (Treas. Regs. §1.469-5T(2)) Taxpayers who hire a property manager will not likely qualify under this test.

Comment

Again, we need to focus on who is actually doing the work — are there landscapers, plumbers, electricians? This is easy for our client who is handy and does the majority of all repairs, maintenance, and cleaning. However, the client who simply chooses the paint and hires the painter may not qualify. Also make sure that your client's claims are consistent with the deductions claimed on their returns. Are there more expenses claimed for repairs and maintenance than are reflected on the time logs?

3. The majority participation test

A taxpayer materially participates in an activity if the individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.

Comment

Although 100 hours is only 20% of the 500-hour test discussed above, when you weigh that against time spent on the property by other persons (e.g., gardeners, repair persons, maintenance workers), it is often not easy to meet this test.

If trying to qualify under this test, taxpayers not only have to document how many hours they spent on the property, but the amount of time gardeners, repair people, etc., also spent on the property.

4. The significant participation activity test

A taxpayer materially participates in an activity if the activity is a significant participation activity under Treas. Regs. §1.469-5T(c), and the taxpayer's aggregate participation in all significant participation activities exceeds 500 hours.

Comment

Remember that the material participation tests apply to all types of businesses, not just real estate activities, and the regulations don't allow real estate activities to qualify as a Treas. Regs. §1.469-5T(c) significant participation activity, so this would not apply.

5. The prior years participation test

A taxpayer materially participates in an activity in a tax year if the taxpayer met any of the other six material participation tests outlined during any five years out of the 10 years immediately preceding the tax year. The five years do not have to run consecutively.

Comment

This test can come into play in a year in which the activity does not require much hands-on participation by the taxpayer.

6. Personal service activity test

A taxpayer materially participates in an activity if the activity is a personal service activity under Treas. Regs. §1.469-5T(d), and the taxpayer materially participated in the activity for any three taxable years preceding the current tax year.

Comment

Similar to the material participation test #5 above, this test does not apply to real estate activities.

7. Facts and circumstances test

A person materially participates in an activity if, based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Material participation: the bottom line

A yes to any of the following, and the taxpayer materially participates:

1. Did the taxpayer work more than 500 hours in the rental activity during the year?
2. Did the taxpayer perform substantially all the work in the activity? Were there any others who were involved with this rental activity? This would include outside services, as well as a spouse.
3. Did the taxpayer work more than 100 hours and more than anyone else (including nonowners)? This is where we lose a few of our clients from qualifying. The 500-hour test is hard enough, but when you are dealing with a smaller number of hours, it would seem to be easier — yet it is not. We need to closely examine what other services are being provided.
4. Did the taxpayer materially participate in the activity for any five of the last ten years? Again, this is where we can get a little relief in a year or two when we have good tenants and minimal time is required.
5. Under all the facts and circumstances, did the taxpayer work on a regular, continuous, and substantial basis in the activity? This goes back to the theory that it is allowable if the activity is "in the course of an ordinary trade or business."

COUNTING HOURS

Driving time may count

The Tax Court ruled that a taxpayer's log that was revised to include drive time to her rental properties could be used to prove she satisfied the 750-hour threshold to qualify as a real estate professional. (***Leyh v. Comm.***, TCS 2015-27)

The ruling in this case contradicts ***Truskowsky***, a prior Tax Court case in which the court refused to count travel time because it represents commuting that "is an inherently personal activity and as such does not constitute 'work' in connection with a trade or business." (***Truskowsky v. Comm.***, TCS 2003-13) The IRS refused to accept the additional hours.

Caution

Neither ***Leyh*** nor ***Truskowsky*** may be cited as precedent as they are Tax Court Summary decisions. Therefore, a real estate professional may not rely on the ***Leyh*** decision in deducting expenses incurred in driving from the taxpayer's home to their rental properties. And, the IRS may not rely on ***Truskowsky***.

Management activities don't count

Managing and overseeing another's work generally does not count toward satisfying the hour requirements outlined above. (Treas. Regs. §1.469-5T(b)(ii); ***Hairston v. Comm***, TCM 2019-104)

Investment research and education hours

Work done by an individual in the individual's capacity as an investor in an activity does not count unless the individual is directly involved in the day-to-day management or operations of the activity. (Treas. Regs. §1.469-5T(f)(ii))

In ***Padilla v. Comm.***, TCS 2015-38, although a taxpayer presented a time log showing 764 hours spent in the real estate trade or business, he failed to qualify as a real estate professional. After reviewing the log, the court found that many of the hours claimed were investor-related time, which doesn't count even if the investor time relates to real estate investments.

Padilla, a part-time IT specialist, owned five single-family residence rental properties. Because of the extra time available due to no longer having a full-time job and the overall economic downturn that was impacting his rental properties, he spent more time trying to refinance his rentals and in other activities related to the property. He reported 764 hours working in the rental activity.

Under Treas. Regs. §1.469-5T(f)(2)(ii)(A), these activities performed by Padilla are considered investor activities (and therefore do not count toward the hours spent):

- Research into properties near properties already owned;
- Refinance research;
- Foreclosure research; and
- Researching new businesses.

In ***Barniskis***, the Tax Court found that the following activities were also investor activities:

- Organizing personal records;
- Preparing their taxes;
- Paying bills; and
- Reviewing their monthly statements of their rentals.
  (***Barniskis v. Comm.***, TCM 1999-258)

FACTS AND CIRCUMSTANCES CAN SAVE BAD RECORDS

A disabled veteran won his real estate professional case because he personally performed all activities related to managing and maintaining a triplex apartment near his home. (***Lewis v. Comm.***, TCS 2014-112) Taking into consideration the taxpayer's disabilities, the Tax Court rejected the IRS's contention that it was highly unusual to achieve real estate professional status for a taxpayer who only owned a single small property. The taxpayer did not have a log but estimated the time he spent and gave a narrative summary of the services he performed. For example, on Mondays he would clean the washhouse, and on Tuesdays and Fridays he did the landscaping and cleaned.

The court disagreed with the IRS's contention that the total time spent was less than 750 hours, but the taxpayer prevailed because based on his age and disability, the activities would likely take longer.

In another case, a taxpayer's material participation was determined based on all the facts and circumstances. In ***Hailstock***, the taxpayer filed income tax returns for multiple years at one time. (***Hailstock v. Comm.***, TCM 2016-146) The IRS audited the taxpayer, and due to her scarce records, determined deficiencies based on a bank deposits analysis. The IRS also denied her determination that she was a real estate professional that materially participated in her real estate activities.

Thankfully for Ms. Hailstock, a taxpayer must only meet one of the material participation tests. One of those tests treats a taxpayer as materially participating in an activity for a tax year if,

based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis. (Treas. Regs. §1.469-5T(a)(7)) Despite Ms. Hailstock's poor records, the Tax Court found her testimony regarding her activities credible and held that she was a real estate professional that materially participated in her rental activities. The court found persuasive the fact that she owned many properties and did not have other employment.

✐ Practice Pointer

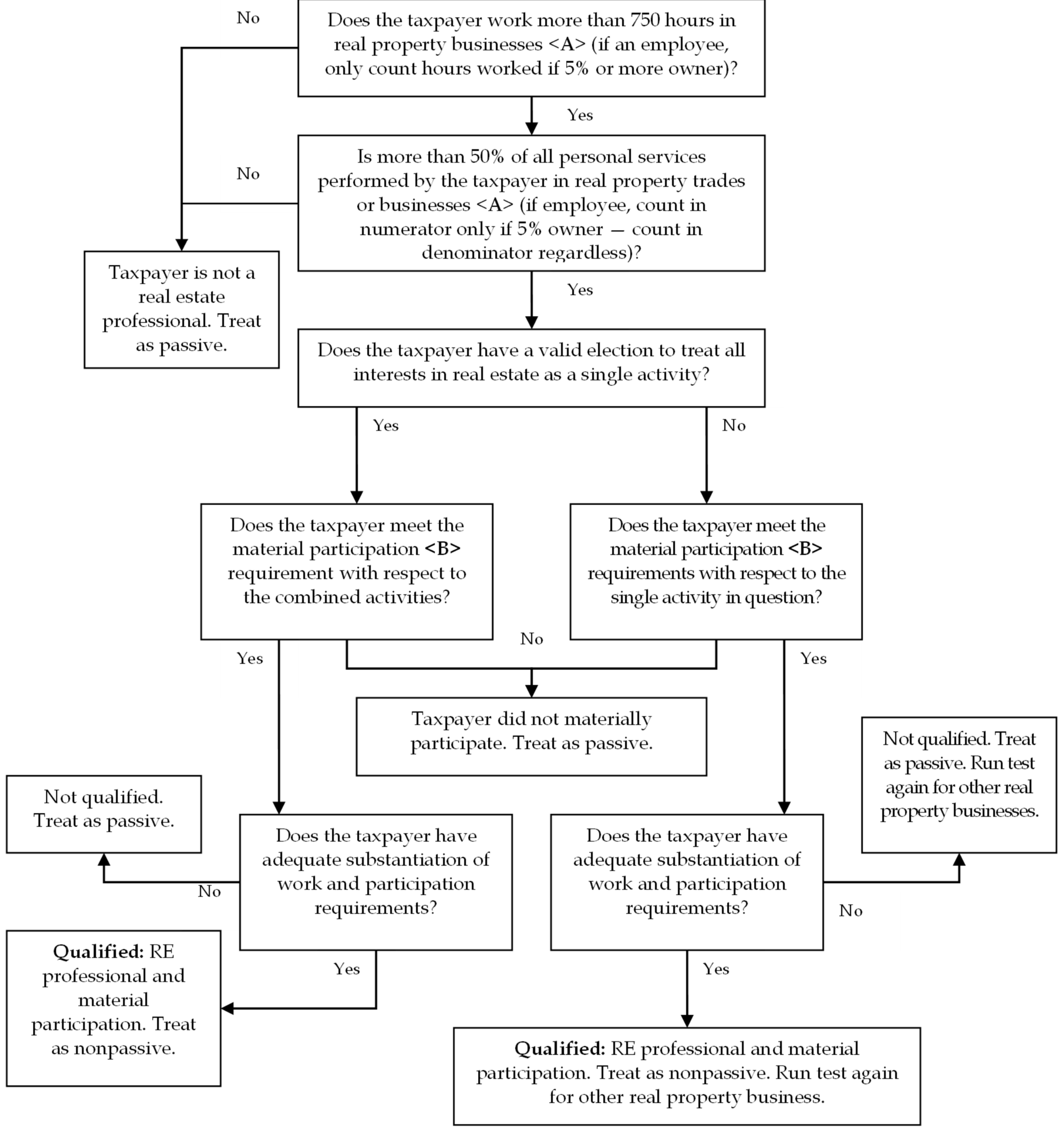
Most taxpayers maintain better records than Ms. Hailstock, but most are also likely missing time records or logs to determine material participation. Using the facts and circumstances test, practitioners can help document their client's time spent well before an audit. Factors that may help determine material participation are multiple properties, lack of other employment, activities located close enough to the taxpayer to enable their reasonable management (not 200 miles away), and absence of a management company.

Example of challenges in establishing material participation

Mick lives in southern California and owns two residential rental properties in Oregon. Mick is unemployed and spends all his time driving to and from his rental properties and investigating new properties. Mick performs most ordinary repairs and maintenance on the properties himself but has a management company that can respond to emergencies and collect and deposit rent checks on the first of each month.

Absent a very detailed time log, Mick will have a difficult time proving material participation. Negative factors are that travel time and time investigating properties aren't counted toward material participation, he employs a management company, and the properties, consisting of only two residential rentals, are 900 miles away. Favorable factors are Mick's lack of other employment and the fact that he performs most repairs and maintenance himself. In this example, Mick will need a lot of help reconstructing his time records.

Real estate professional flowchart



<A> Real property businesses include:

Development	Rental
Redevelopment	Operation
Construction	Management
Reconstruction	Brokerage
Acquisition	
Conversion	

<B> To materially participate you must meet one of the following tests:

1. Spend more than 500 hours in the activity
2. Perform substantially all the work in the activity
3. Spend more than 100 hours in the activity, and no one else does more
4. Spend more than 100 hours and aggregate more than 500 hours in significant participation activities
5. Materially participate in the activity any 5 of the last 10 years
6. The activity is a personal service activity
7. Facts and circumstances support regular, continuous, and substantial participation

* **Note:** Limited partners may only use tests 1, 5 and 6

DEPRECIATION ISSUES

Under MACRS, residential rental property is deducted over a period of 27.5 years using the straight-line method and mid-month convention, and nonresidential rental property is deducted over a period of 39 years.

However, taxpayers may frequently be able to expedite claiming property-related deductions by:

- Taking bonus depreciation or IRC §179 where appropriate;
- Reclassifying certain expense as a noncapital expense under the repair regulations; and/or
- Through utilizing cost-segregation studies, having a portion of the property reclassified as property with a shorter recovery period.

DEPRECIATION PLANNING WITH BONUS DEPRECIATION AND IRC §179

Depreciation planning is one of the most effective tools taxpayers have to change the outcome of an already-closed tax year. Most tax professionals automatically assume that taking bonus depreciation is always the most beneficial decision for their clients, but there are situations where bonus depreciation isn't available or may not be the best option.

Declining bonus depreciation amounts

Beginning with assets placed in service in 2024, the bonus depreciation amount decreased by 20% and is scheduled to decrease by 20% per year each year thereafter. (IRC §168(k)) The TCJA had enacted 100% bonus depreciation, but only for assets placed in service from September 28, 2017, through December 31, 2022.

Bonus Depreciation General Rates	
Date placed in service	**Depreciation rate**
2023	80%
2024	60%
2025	40%
2026	20%
2027 and thereafter	0%

Bonus depreciation is the default

When a taxpayer places qualifying property in service during the year, bonus depreciation is the default and must be claimed unless a taxpayer makes an election out. (IRC §168(k)(7)) Even though it is the default, bonus depreciation is taken after IRC §179 expensing and before regular depreciation.

The election out of bonus depreciation applies to a class or classes of property (e.g., property in a three-year class), not to a particular asset within that class. To make the election, taxpayers must attach a statement to a timely filed return (including extensions) indicating the class of property for which they are making the election. (Instructions, Form 4562, Depreciation and Amortization)

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Potential legislative relief coming?

The Tax Relief for American Families and Workers Act of 2024 (H.R. 7024) would, among other things:

- Extend the 100% bonus depreciation rate through the 2024 and 2025 tax years; and
- Increase the maximum amount of the IRC §179 current expense deduction to $1.29 million and the investment limitation cap to $3.22 million for property placed in service in 2024, providing inflation adjustments for post-2023 tax years.

Although the bill passed the U.S. House of Representatives with large bipartisan support, the bill has stalled in the Senate. It is unlikely this bill will pass before the November elections, if at all. Many commentators are speculating that these provisions will be negotiated as part of the larger package addressing the expiration of many of the TCJA provisions at the end of 2025, which would make retroactive relief unlikely.

IRC §179 expensing

IRC §179 can be claimed for tangible personal property used in a trade or business. For nonresidential real property it can also be claimed for qualified improvement property and roofs, HVAC systems, fire protection and alarm systems, and security systems.

A prorated IRC §179 deduction can be claimed for property used for both business and nonbusiness purposes only if the property is used more than 50% for business in the year you place it in service.

Unlike bonus depreciation, IRC §179 expensing can be used on an asset-by-asset basis, giving taxpayers more flexibility.

Caution

Remember IRC §179 can only be claimed if the property is used in a "trade or business." It cannot be used if the property is held only for investment purposes. Nor can it be claimed for rental property if the taxpayer is not in the trade or business of renting property.

Deduction amount

For 2023, taxpayers can use IRC §179 expensing on up to $1.16 million of qualifying assets placed in service during the year. If the total assets placed in service by the taxpayer during 2022 exceed the expensing limit threshold of $2.89 million, then the IRC §179 expense is subject to a dollar-for-dollar limitation. Both the IRC §179 expensing limit and the phaseout threshold are adjusted annually for inflation.

For 2024, these figures are increased to $1.22 million and $3.05 million, respectively.

Example of IRC §179 expense limitation

Ninety-Niner, Inc. placed $3.5 million of assets in service during 2024. Their phaseout is calculated as follows:

Total assets placed in service	$3,500,000
Phaseout threshold	(3,050,000)
Reduction of IRC §179 expensing limit	$ 450,000

Ninety-Niner can only claim IRC §179 expensing on $780,000 of its assets, calculated as follows:

2024 IRC §179 expensing limit	$1,220,000
Reduction of IRC §179 expensing limit*	(450,000)
IRC §179 expensing limit	$ 770,000

* Calculated in previous step

Loss or no loss?

Determining whether the taxpayer wants to generate a loss can affect whether bonus depreciation or IRC §179 expensing is claimed. The IRC §179 deduction is limited to a taxpayer's net income from the business and cannot create a tax loss. Disallowed IRC §179 expense is carried forward and can be used in a future year.

However, bonus depreciation may create a loss that can offset the taxpayer's income in the current year from other sources.

Combining bonus depreciation and IRC §179

Bonus depreciation and IRC §179 can be combined to generate larger depreciation deductions than using either method alone.

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Example of combining bonus depreciation and IRC §179

FND Materials, Inc. placed $2.5 million of assets in service in 2024. All assets are eligible for bonus depreciation and IRC §179.

If FND only used the default bonus depreciation, then its depreciation deduction would be:

Assets placed in service during 2024	$2,500,000
Bonus depreciation rate	60%
Depreciation deduction	$1,500,000*

* FND can also claim regular depreciation for the year on the remaining $1,000,000 of assets not consumed by bonus depreciation

If FND elected out of bonus depreciation and only used IRC §179 expensing, then its depreciation deduction would be limited to the $1.22 million expensing limit for the year.

FND can also claim regular depreciation for the year on the portion of its assets not consumed by bonus depreciation.

FND can combine bonus depreciation and IRC §179 to maximize its depreciation deductions.

Assets placed in service during 2024	$2,500,000
IRC §179 expensing limit up to the annual limit	($1,220,000)
Remaining assets eligible for bonus depreciation	$1,280,000
Bonus depreciation in effect for 2024	60%
Bonus depreciation	$ 768,000
Combined bonus and IRC §179 depreciation	$1,988,000

* FND can also claim regular depreciation for the year on the remaining $512,000 of assets not consumed by bonus depreciation and IRC §179 expensing

Effect on IRC §199A

Consider the maximum 20% qualified business income deduction. A taxpayer may benefit by opting out of bonus depreciation and not electing IRC §179, thus increasing taxable income and potentially increasing the IRC §199A deduction.

Conversely, consider decreasing income using either or both of these options if their taxable income is over the phaseout threshold to maximize the IRC §199A deduction.

☑ Planning Pointer

Taxpayers ineligible to or not wanting to claim an IRC §179 or bonus depreciation deduction should see if their expenses can be currently deducted rather than depreciated under the tangible property repair regulations (see discussion on page 1-31). This can be done if the expenses are not considered capital expenses or if the taxpayer can qualify for one of several different safe harbors.

The IRC §179 election is only available for qualified purchases and is limited to a taxpayer's taxable income from the active conduct of a trade or business. It cannot be claimed for property purchased for investment.

And while the TCJA expanded the definition of property eligible for bonus depreciation to include used property, it cannot be used for qualified improvement property. In addition, taxpayers may not wish to claim bonus depreciation for all items in the same class (which is a requirement), and the bonus depreciation deduction began phasing out in 2023.

Another consideration is that both deductions are subject to depreciation recapture (discussed on page 1-42).

Comparison of IRC §179 and Bonus Depreciation Deductions		
Requirements/limitations	**Bonus depreciation (IRC §168(k))**	**IRC §179 deduction**
Caps	• 100% for property placed in service on or after 9/28/2017 through 12/31/2022; • 80% in 2023; • 60% in 2024; • 40% in 2025; • 20% in 2026; and • 0% after 2026 No aggregate cap (**Note:** Can claim deduction for applicable % of basis after IRC §179 deduction claimed)	Maximum aggregate deduction of $1.16 million for 2023 and $1.22 million for 2024 Maximum investment limitation $2.89 million for 2023 and $3.05 million for 2024 Both amounts are adjusted for inflation after 2024
Use in active trade or business required?	No. Can be used for investment property	Yes
Must property be new?	No. Used property was ineligible for property placed in service before 9/28/2017 (Can be claimed for personal property converted to business property)	No
Sunset date	December 31, 2026	Available indefinitely
		(continued)

Comparison of IRC §179 and Bonus Depreciation Deductions (continued)		
Requirements/limitations	**Bonus depreciation (IRC §168(k))**	**IRC §179 deduction**
Taxable income limitation	No Can create NOL	Yes Deduction cannot exceed taxable income from a trade or business Unused deduction may be carried over
Per purchase versus per class	Must be claimed/elected out of by class of property (e.g., five-year property)	Elected on asset-by-asset basis (or portion of asset)
Minimum trade or business use	50% business use requirement applies only to listed property	All property purchased must be used over 50% of the time in business activity
Subject to recapture	Yes	Yes. Also subject to recapture if used less than 50% of time in business activity
Treatment of real property	Only available for: roofs, HVAC property, fire protection, alarm systems, security systems for nonresidential property	Only available for qualified improvement property and roofs, HVAC property, fire protection, alarm systems, security systems for nonresidential property
How claimed	Must be claimed unless the taxpayer makes an election out on a timely filed return	Taxpayers must make an election to claim the deduction on Form 4562, Depreciation and Amortization

KEY REPAIR REGULATIONS FOR PROPERTY OWNERS

In 2013, the IRS adopted tangible property repair (TPR) regulations to clarify which expenses property owners incur must be capitalized and depreciated over a period of years and which expenses may be currently expensed.

Of special note for most property owners, the regulations contain several "safe harbors" under which taxpayers may elect to treat certain expenses as deductible repairs without fear of being audited years later and having these expenses reclassified as capital expenses subject to depreciation. These safe harbors include the following:

- *De minimis* safe harbor (see page 1-32);
- Small taxpayer safe harbor (see page 1-34); and
- Routine maintenance safe harbor (see page 1-36).

In addition, the rules:

- Allow taxpayers to elect to claim a partial disposition of an asset and recognize loss on the retirement or abandonment of the partial asset rather than having to depreciate both the original and replacement asset;
- Allow taxpayers to elect to simply capitalize all expenses that are capitalized for financial book purposes so that they do not have to bother maintaining two separate books and evaluating whether a capital expense can be treated as a deductible repair expense (see page 1-37); and
- Provide extensive guidance as to what acquisition costs must be capitalized and when activities are classified as improvements that must be capitalized (see page 1-38).

While the increased IRC §179 limits and bonus depreciation may mitigate the current tax cost of capitalizing and depreciating assets, not all assets will qualify for either of these tax benefits.

DE MINIMIS SAFE HARBOR ELECTION

Businesses whose expenses would be considered capital expenses under the above rules may find some help in the form of the *de minimis* safe harbor. Many businesses may be able to use this *de minimis* safe harbor election to expense certain business assets and may even come out ahead because there is no IRC §179 expense limit, placed-in-service limit, or taxable income limit. (Treas. Regs. §1.263(a)-1(f))

In brief, if a taxpayer files a proper election and follows certain rules, the taxpayer may deduct tangible "units of property" with costs up to $2,500 or $5,000, depending on whether the taxpayer has an "applicable financial statement."

Applicable financial statement (AFS)

An "applicable financial statement" is defined in Treas. Regs. §1.263(a)-1(f)(4). An AFS is, generally, one that is submitted to the SEC or is subject to a certified audit. This applies to larger taxpayers.

Transactional costs such as delivery fees, installation, or similar costs included on the same invoice must be included in the cost of the property.

Safe harbor election rules and amounts

The rules for both taxpayers with and without an AFS are the same with the exception of the dollar amount considered to be *de minimis* and whether their accounting procedure must be written. Taxpayers with an AFS must have a written accounting procedure in order to elect this *de minimis* safe harbor. To qualify:

1. The taxpayer must have an accounting procedure treating as an expense for nontax purposes:
   a. Amounts paid for property costing less than a specific dollar amount; or
   b. Amounts paid for property with an economic useful life of 12 months or less; and
2. The taxpayer must treat the amounts paid for the property as an expense on its AFS (or on its books if no AFS) in accordance with their accounting procedures; and
3. The amount paid for the property may not exceed $5,000 ($2,500 without an AFS) per invoice (or per item as substantiated by the invoice).

> ✐ **Practice Pointer**
>
> The regulation requires the accounting procedure be written for those taxpayers expensing costs up to $5,000. Although those using the $2,500 limit are not required to have the procedure in writing, it is better to play it safe so there can be no question that such a procedure existed.
>
> Remember that the written procedures must be in place at the **start** of the tax year.

Accounting procedures are generally part of a company's overall accounting policies. For clients that do not have adequate (or any) accounting policies, consider providing them with a sample capitalization policy that they can adopt.

> *Sample capitalization policy*
>
> **Purpose**
>
> This accounting policy establishes the minimum cost (capitalization amount) that shall be used to determine the capital assets to be recorded in [BUSINESS ENTITY]'s books and financial statements.
>
> **Capital asset definition and thresholds**
>
> A "capital asset" is a unit of property with a useful life exceeding one year and a per-unit acquisition cost exceeding [SPECIFY AMOUNT]. Capital assets will be capitalized and depreciated over their useful lives. [BUSINESS ENTITY] will expense the full acquisition cost of tangible personal property below these thresholds in the year purchased.
>
> **Capitalization method and procedure**
>
> All capital assets are recorded at historical cost as of the date acquired.
>
> Tangible assets costing below the aforementioned threshold amount are recorded as an expense for [BUSINESS ENTITY]'s annual financial statements (or books). In addition, assets with an economic useful life of 12 months or less must be expensed for both book and financial reporting purposes.
>
> **Documentation**
>
> Invoices substantiating the acquisition cost of each unit of property are to be retained for a minimum of 10 years.
>
> **Tax capitalization threshold:** The permissible ceiling for deducting otherwise capitalizable expenditures is $5,000 when our business has applicable financial statements. The threshold is limited to $2,500 in the absence of applicable financial statements.

Election

A taxpayer must make an annual election to apply the safe harbor by including a statement on the taxpayer's timely filed original return (including extensions). (Treas. Regs. §1.263(a)-1(f)(5)) If made, the election applies to **all** qualifying expenses that meet the requirements; an electing taxpayer cannot exclude particular qualifying expenses. The election automatically extends to materials and supplies.

✐ **Practice Pointer**

Should a taxpayer not want to expense an item under the *de minimis* safe harbor, the taxpayer can simply not expense them on the books and records.

The regulations provide that the statement must:

- Be titled "Section 1.263(a)-1(f) *de minimis* safe harbor election";
- Include the taxpayer's name, address, and taxpayer identification number; and
- Include a statement that the taxpayer is making the *de minimis* safe harbor election under Treas. Regs. §1.263(a)-1(f).

In the case of a partnership or S corporation, the election is made by the partnership or S corporation and not by the partners or shareholders.

Once made, the election is irrevocable for that year. (Treas. Regs. §1.263(a)-1(f)(5))

Example of de minimis election

Tinyco does not have an applicable financial statement but has written accounting policies in place at the start of the tax year treating as expenses for financial statement purposes amounts paid for property costing $2,500 or less.

During the tax year, Tinyco purchases 10 refrigerators costing $2,000 each, five washing machines costing $1,000 each, and 10 leaf blowers costing $200 each for a total cost of $27,000. They also purchase five separate security systems each costing $7,500.

If Tinyco makes the *de minimis* election, they may expense the $27,000 for the refrigerators, washing machines, and leaf blowers, and still have their full IRC §179 election amount available to expense the security systems.

SAFE HARBOR FOR SMALL TAXPAYERS WITH BUILDINGS

The regulations include a $10,000 annual safe harbor election for buildings owned or leased with an unadjusted basis no greater than $1 million. (Treas. Regs. §1.263(a)-3(h)) If the taxpayer qualifies and makes the election, the taxpayer is not required to capitalize, and may deduct, qualifying expenditures.

Small taxpayer

To qualify, the taxpayer must have average annual gross receipts of $10 million or less during the three preceding taxable years. Gross receipts include income from sales (not reduced by cost of goods sold), services, and investment income.

For new businesses, average annual gross receipts are determined using the average annual gross receipts for the number of taxable years that the taxpayer (or its predecessor) has been in existence. For short taxable years, the gross receipts are annualized.

Qualified building

An eligible building property includes a portion of a building that is a separate unit of property, such as leased office space or an individual condominium or cooperative unit, as long as the unadjusted basis of the property is no greater than $1 million. (**Note**: Unadjusted basis does not include land value.)

Cliff test

Under the safe harbor, a small taxpayer is not required to capitalize improvements if the total amount paid with respect to an eligible building for repairs, maintenance, improvements, and similar activities does not exceed the lesser of $10,000 or 2% of the building's unadjusted basis.

In computing the amounts expended, the taxpayer must include amounts not capitalized under the *de minimis* safe harbor election and under the routine maintenance provisions.

If the amount of such expenditures exceeds the threshold, the taxpayer is not eligible to make the election. The threshold is applied separately to each building owned or leased by the taxpayer. A condominium or co-op is considered an individual building property.

Making the election

The election is made annually by attaching a statement to the taxpayer's timely filed (including extensions) original return for the tax year for which the property is placed in service. The statement must be titled "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers" and include the taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election.

In the case of a partnership or S corporation, the election is made by the partnership or S corporation, and not by the partners or shareholders.

Once made, the annual election is irrevocable.

Example of small taxpayer with building

Judy and John own three rental properties. Their average annual gross receipts are less than $10 million.

Property A

This property has an unadjusted basis of $700,000 in the building and $100,000 in land. They build a new room on the property at a cost of $8,000 and have repair and maintenance costs of $1,000.

The total spent for improvements and maintenance is $9,000.

The threshold amount is $10,000 (lesser of $10,000 or 2% of the *building's* unadjusted basis (2% × $700,000 = $14,000)).

They may elect to expense the cost of the new room and the repairs because they otherwise qualify, and the sum of the costs of improvements and maintenance is less than the threshold amount.

Property B

This property has an unadjusted basis of $300,000 for the building and $50,000 for the land. They build a spa at the property at a cost of $6,000 and have $500 of general repairs.

The total spent for improvements and maintenance is $6,500.

The threshold amount is $6,000 (lesser of $10,000 or 2% of the *building's* unadjusted basis (2% × $300,000 = $6,000)).

They may not elect to expense the cost of the spa because the total cost of improvements and maintenance exceeds the threshold amount. They may deduct the maintenance costs as general repairs.

Property C

This property has an unadjusted basis of $800,000 for the building and $50,000 for the land. They build a garage at the property at a cost of $12,000 and have $3,000 of maintenance costs.

The total spent for improvements and maintenance is $15,000.

The threshold amount is $10,000 (lesser of $10,000 or 2% of the *building's* unadjusted basis (2% × $800,000 = $16,000)).

They may not elect to expense the cost of the garage because the total cost of improvements and maintenance exceeds the threshold amount. They may deduct the maintenance costs as general repairs.

(Treas. Regs. §1.263(a)-3(h)(10), Ex. 3)

SAFE HARBOR FOR ROUTINE MAINTENANCE

The regulations provide that routine maintenance need not be capitalized, including routine maintenance for buildings and their structural components. (Treas. Regs. §1.263(a)-3(i)) An election is not required to take advantage of the safe harbor.

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"Routine"

The regulations specify that maintenance is routine only if:

- The maintenance is performed to keep a unit of property in its ordinarily efficient operating condition and not to improve or better the property; and
- At the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the routine maintenance more than once during the property's class life (more than once every 10 years in the case of a building).
  Note: Maintenance does not actually have to be performed within those time frames so long as the taxpayer has a reasonable expectation of such at the time the property is placed in service.

Examples of routine maintenance include inspection, cleaning, testing, and the replacement of parts. It also includes the replacement of damaged or worn parts with comparable and commercially available replacement parts.

Ineligible expenses

The safe harbor provisions do not apply to IRC §263A costs (costs incurred for production of property or for resale, i.e., inventory).

In addition, amounts expended for the following are not routine and are not eligible for the safe harbor:

- For the betterment of a unit of property (see page 1-39);
- For the cost of replacing components if:
  - A retirement loss is claimed; and
  - Gain or loss is realized upon the sale of the replaced component;
- For which a basis adjustment is required on account of a casualty loss or event;
- To restore deteriorated and nonfunctional property to its ordinarily efficient operating condition; or
- To adapt property to a new or different use.

✐ Practice Pointer

A change in accounting method is required with a full IRC §481(a) adjustment.

ELECTION TO CAPITALIZE REPAIR AND MAINTENANCE EXPENDITURES

Taxpayers wanting to reduce the administrative burden of maintaining two separate accounting systems may elect to treat repair and maintenance expenditures as depreciable capital expenditures as long as:

- The expenses are incurred in the taxpayer's trade or business; and
- The expenses are capitalized on the taxpayer's books and records.
  (Treas. Regs. §1.263(a)(-3(n)(1))

If an election is made, all repair and maintenance expenditures capitalized in the taxpayer's books and records for the taxable year must be capitalized for tax purposes as well.

Costs must be capitalized at the time the property is placed in service.

> ***Comment***
>
> This is a "one-way" election. If the book-conformity election is made, it does not mean that all items that are expensed on the taxpayer's books can automatically be expensed for tax purposes. These items must still be evaluated under the other TPRs to see if they qualify to be expensed for tax purposes.

Note: This book-conformity election applies only to repair and maintenance costs deductible under Treas. Regs. §1.162-4. It does not apply to costs incurred for material and supplies or other costs deducted under other IRC sections.

Making the election

The election is made annually by attaching a statement to the taxpayer's timely filed (including extensions) original return for the tax year for which the property is placed in service. The statement must be titled "Section 1.263(a)-3(n) Election" and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making an election to capitalize repair and maintenance costs under Treas. Regs. §1.263(a)-3(n).

In the case of a partnership or S corporation, the election is made by the partnership or S corporation and not by the partners or shareholders.

In the case of a consolidated group, the election is made for each member of the group by the common parent, and the statement must include the name and taxpayer identification number of each member of the group.

CAPITAL EXPENSE VS. REPAIR

Under IRC §263, amounts paid to acquire, produce, or improve tangible property must be capitalized and depreciated. However, under IRC §162, expenses for materials and supplies and repair and maintenance costs are treated as a deductible business expense. The TPRs were adopted to clarify which is which, especially as they relate to clarifying what is a "deductible repair" and what is a "capital improvement" that must be depreciated.

Through FAQs, the IRS has identified a two-step analysis taxpayers should use to distinguish capital improvements from deductible repairs.

> ✐ **Practice Pointer**
>
> The IRS's facts and circumstances analysis described here from their FAQs, while very detailed, is designed as a guide only. And remember, if any of the three tangible property repair regulation safe harbor rules discussed above applies (the *de minimis* safe harbor, the safe harbor for small taxpayers with buildings, or the safe harbor for routine maintenance), then a facts and circumstances analysis for amounts spent by the taxpayer is not necessary.

Step 1: What is the unit of property to which you should apply the improvement rules?

For buildings: The unit of property is generally the entire building including its structural components. However, under the final tangible property regulations and for these purposes only, the improvement analysis applies to the building structure and each of the key building systems.

The key building systems are the plumbing system, electrical system, HVAC system, elevator system, escalator system, fire protection and alarm system, gas distribution system, and the security

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system. Lessees of portions of buildings apply the analysis to the portion of the building structure and portion of each building system subject to the lease. Lessors of an entire building apply the improvement rules to the entire building structure and each of the key building systems.

For nonbuildings: The unit of property is, and the analysis applies to, all components that are functionally interdependent. Components of property are functionally interdependent if the taxpayer cannot place in service one component of property without placing in service another component of property.

For plant property, e.g., manufacturing plant, generation plant, etc.: The unit of property is, and the analysis applies to, each component or group of components within the plant that performs a discrete and major function or operation.

For network assets, e.g., railroad track, oil and gas pipelines, etc.: The taxpayer's particular facts and circumstances or industry guidance from the Treasury Department and the IRS determines the unit of property and the application of the improvement analysis.

There are two additional rules, based on depreciation conformity, that determine when a component or group of components of a unit of property must be treated as a separate unit of property. These are:

For the year placed in service: This rule, only for nonbuilding property, is triggered at the time the taxpayer initially places the unit of property in service. If, at the time the unit of property is first placed in service, the taxpayer properly treats the component of the unit of property as being within a different MACRS class than the MACRS class for the unit of property of which the component is a part, or the taxpayer properly depreciates the component using a different depreciation method than the depreciation method used for the unit of property of which the component is a part, then the taxpayer must treat the component as a separate unit of property.

Subsequent change in classification: This rule for both building and nonbuilding property is triggered when the taxpayer makes a subsequent change in classification of the property for MACRS. In any taxable year after the unit of property is initially placed in service, if the taxpayer or the IRS changes the treatment of that property to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), then the taxpayer must change the unit of property determination for that property under this rule to be consistent with their change in treatment for depreciation purposes.

Step 2: Is there an improvement to the unit of property, or in the case of a building, the building structure or any key building system, identified in Step 1?

A unit of tangible property is improved only if the amounts paid are:

- For a betterment to the unit of property;
- To restore the unit of property; or
- To adapt the unit of property to a new or different use.

A betterment is an amount paid:

- To fix a material condition or material defect that existed before the acquisition or arose during production of the unit of property;
- For a material addition, including a physical enlargement, expansion, extension, or addition of a major component, to the property or a material increase in capacity, including additional cubic or linear space, of the unit of property; or
- That is reasonably expected to materially increase productivity, efficiency, strength, quality, or output of the unit of property where applicable.

The term "material" is not defined in the final tangible property regulations. Although examples are included that refer to percentage increases, these examples are provided to assist taxpayers in understanding the rules. These percentages are not intended to set a standard, for example, a particular percentage increase in square footage or capacity, or for determining whether the amount paid is a "material" betterment. In determining whether a betterment is "material," taxpayers should use common sense and reasonable judgment as applied to their own facts and circumstances.

Examples of a material betterment include:

- **Ameliorates (fixes) a material condition or defect:** A taxpayer acquires land with a leaking underground storage tank left by previous owner. Costs to clean up the land would be for an improvement because they fix a material condition or defect that arose prior to the acquisition;
- **Material addition:** A taxpayer adds a stairway and loft to its retail building to increase its selling space. Costs to build the stairway and loft are for an improvement because they materially increase the capacity of the taxpayer's building structure; and
- **Material increase in strength:** A taxpayer adds expansion bolts to its building that is located in an earthquake-prone area. These bolts anchor the building frame to its foundation, providing additional structural support and resistance to seismic forces. Costs incurred to add these expansion bolts would be for an improvement because they increase the strength of the building structure.

The following characterize amounts to restore a unit of property:

- **Replacement of a major component or substantial structural part:** Amounts paid for the replacement of a part or combination of parts that make up a major component or a substantial structural part of the unit of property; or
- **Recognition of gains or losses and basis adjustments:** The taxpayer has taken into account or adjusted the basis of the unit of property or component of the unit of property, including:
  - **Deducted loss:** Amounts paid for the replacement of a component of the unit of property, and the taxpayer has properly deducted a loss for that component, other than a casualty loss;
  - **Sale or exchange:** Amounts paid for the replacement of a component of the unit of property, and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component; or
  - **Casualty loss or event:** Amounts paid for the restoration due to damage to the unit of property for which the taxpayer is required to take a basis adjustment because of a casualty loss under IRC §165, or relating to a casualty event described in §165, but limited to the basis in the unit of property; or
- **Deterioration to state of disrepair:** Amount paid to return the unit of property to its ordinarily efficient operating condition if the unit of property has deteriorated to a state of disrepair and is no longer functional for its intended use; or
- **Rebuilding to like-new condition:** Amounts paid for the rebuilding of the unit of property to a like-new condition after the end of its class life.

Examples of restoration expenditures include:

- **Restoration after casualty loss or event:** A taxpayer owns an office building. The building is damaged by a hurricane. The taxpayer either deducts a casualty loss under IRC §165 because of the damage or receives insurance proceeds after the accident to compensate for the loss. The taxpayer properly reduces the basis of the building by the amount of the loss or by the amount of the insurance proceeds. Assuming that the reduction in basis is less than or equal to the taxpayer's adjusted basis in the building, amounts paid to restore the damaged building must be treated as an improvement and must be capitalized. Note: If the amounts paid to restore the property exceed the adjusted basis of the property prior to the loss, the amount required to be capitalized may be limited (see Treas. Regs. §1.263(a)-3(k)(4)(i) for application of this limitation);
- **Deterioration to a state of disrepair:** A taxpayer operates a farm with several outbuildings. The taxpayer did not use or maintain one of the outbuildings on a regular basis, so it fell into a state of disrepair and could no longer be used in the taxpayer's business. The taxpayer decides to restore the building by shoring the walls and replacing siding. The costs are for restorations, and therefore improvements, because the building was returned to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use; and
- **Rebuild of property to like-new condition:** A taxpayer owns a fleet of vehicles. After the end of the class life of each vehicle, the taxpayer disassembles and rebuilds each vehicle according to the manufacturer's original specification. Costs paid to rebuild each vehicle are for restorations, and therefore are improvements because each fleet vehicle is restored to a like-new condition after the end of its class life.

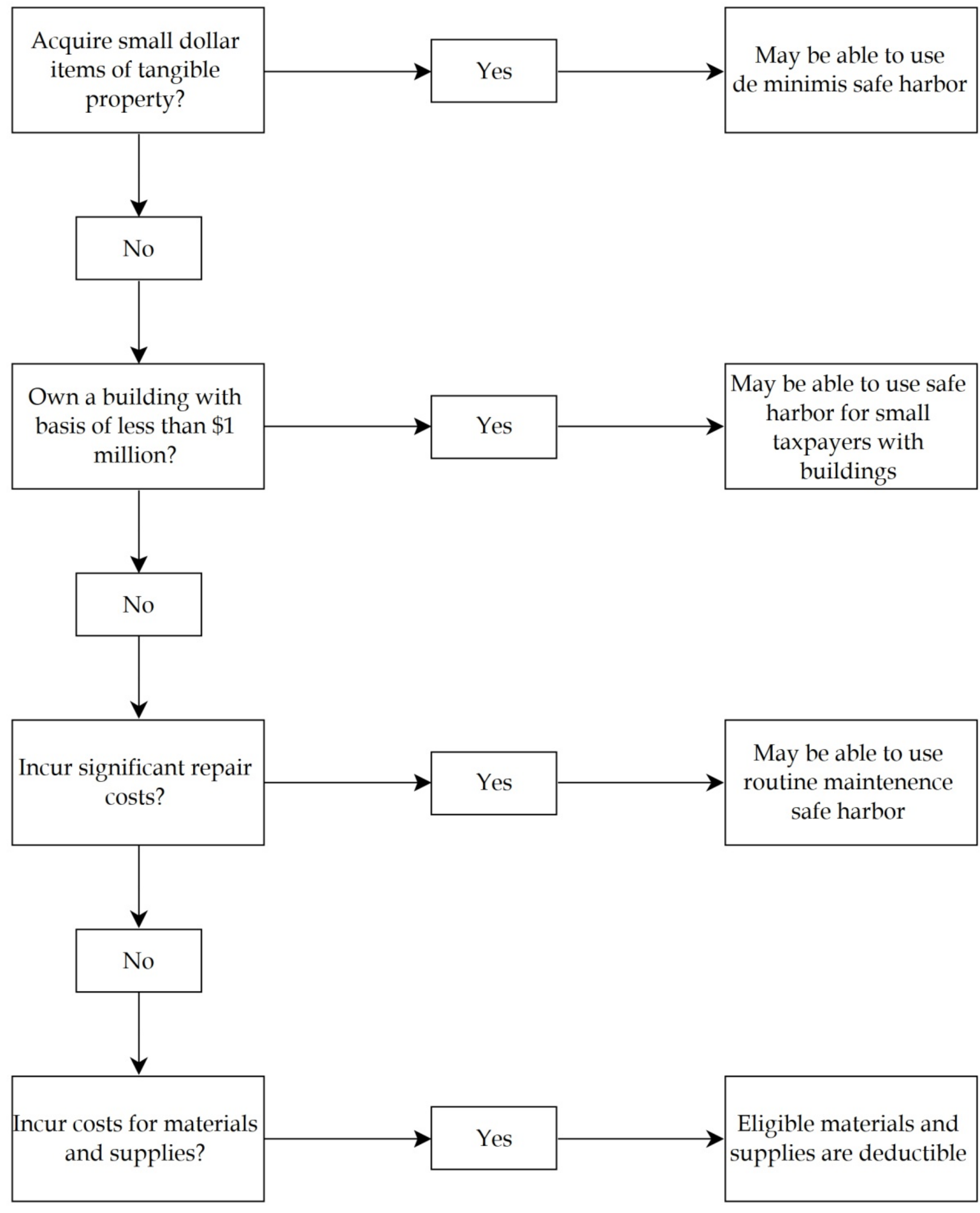
The following example adapts the unit of property to a new or different use:

- An amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the ordinary use of the unit of property at the time the taxpayer originally placed it in service.

Examples of what may or may not constitute a new or different use include:

- A taxpayer owns a manufacturing building that it used to manufacture items for several years beginning when the building was placed in service by the taxpayer. The taxpayer pays amounts to convert the manufacturing building into a showroom through modifications to the building structure and various building systems. Costs to convert the manufacturing building into a showroom are improvements because the structure and systems are converted to a new or different use that is inconsistent with the intended ordinary use of the building (manufacturing items) at the time it was placed in service;
- A taxpayer owns a fishing boat that it used in its fishing business for several years beginning when it was placed in service. The taxpayer pays amounts to convert the fishing boat into a sightseeing boat that it plans to offer for scenic passenger tours. Costs to convert the fishing boat into a sightseeing boat adapt the unit of property to a new or different use that is inconsistent with the intended ordinary use of the fishing boat at the time it was placed in service. The conversion is an improvement that must be capitalized; and
- A taxpayer owns a building that it plans to sell. In order to prepare the property for viewing, the taxpayer paints the walls and refinishes the floors. Preparing the property for sale by painting walls and refinishing floors is not adapting the building to a new or different use for purposes of determining whether there is an improvement to the property.

TANGIBLE PROPERTY FLOWCHART



DEPRECIATION RECAPTURE

DEPRECIATION RECAPTURE GENERALLY

The gain received from the sale or other disposition of IRC §1245 or §1250 property for which depreciation was claimed or was allowable must be treated as ordinary income rather than capital gain income. This is referred to as "depreciation recapture," which prevents taxpayers from receiving a double benefit of claiming depreciation deductions against ordinary income during the

year the property is held and then having all the gain from the sale of the property subject to the lower capital gains tax rate.

How the depreciation recapture is computed depends on whether the property sold is IRC §1245 property or IRC §1250 property. Special recapture rules apply to IRC §179 property if the business use of the property falls below 50%.

Depreciation recapture for both sales of business property and sales of investment property is reported on Form 4797, Sales of Business Property.

If there is any gain from the sale of investment property in excess of the amount recaptured, the excess amount is reported on Form 8949, Sale and Other Dispositions of Capital Assets.

IRC §1245 PROPERTY

IRC §1245 property is depreciable personal property, such as furniture, autos, and appliances. It also includes qualified improvement property for which an IRC §179 expense deduction was claimed. Otherwise, it does not include structural components of buildings such as HVACs.

To compute the amount subject to depreciation recapture, subtract the property's adjusted tax basis from the lesser of the property's:

- Recomputed basis (the original cost of the property before any depreciation deductions, including IRC §179 and bonus depreciation); or
- The sales price.

The result will be taxed as ordinary income, rather than capital gains. With the exception of IRC §197 intangibles, the computation is done for each asset separately.

Example of IRC §1245 depreciation recapture

Yoshi sells a furnished condominium that was a rental property for $500,000 total, with $450,000 allocated to the condominium and $50,000 for the furniture and appliances. The original cost of the furniture/appliances was $75,000, and Yoshi had previously claimed $30,000 depreciation on these items.

The recapture amount of the furniture/appliances is determined as follows:

Lesser of sales price or recomputed basis	$50,000
Adjusted tax basis ($75,000 - $30,000)	(45,000)
Total	$ 5,000

The $5,000 of the $20,000 gain ($50,000 - $30,000) will be treated as ordinary income. We will address what happens with the remaining $15,000 of gain shortly.

Depreciation included

Depreciation includes the amounts claimed on the IRC §1245 property by the taxpayer as well as the following depreciation amounts:

- Amounts claimed on property the taxpayer exchanged for, or converted to, the IRC §1245 property in a like-kind exchange or involuntary conversion; and
- Amounts a previous owner of the IRC §1245 property claimed if the taxpayer's basis is determined with reference to that person's adjusted basis (for example, the donor's depreciation deductions on property the taxpayer received as a gift).

Example of depreciation tack-on

Shawn owned a residential rental property that he gifted to his daughter Marianne. Shawn had previously claimed $10,000 in depreciation deductions on appliances at the property. If Marianne later sells the property, she must count the $10,000 paid by Shawn in her depreciation recapture calculations.

IRC §1250 PROPERTY

IRC §1250 property is depreciable real property, essentially buildings and their structural components, including walls, floors, windows, doors, central air conditioning systems, light fixtures, etc. Land is not depreciable, so it is not subject to IRC §1250 recapture. However, a leasehold of land is subject to recapture.

Although IRC §1250 recapture provisions are almost identical to the IRC §1245 treatment, there is one huge caveat. IRC §1250 only requires recapture of prior depreciation that is in excess of what straight-line depreciation would have been (aka "additional depreciation"). Because all real estate purchased after 1986 must be depreciated using the straight-line method over 27.5 years for residential property and 39 years for nonresidential property, this issue rarely arises anymore.

Unrecaptured gain

However, as in all things tax, nothing is that simple. IRC §1(h)(1)(E) subjects "unrecaptured IRC §1250 gain" to a tax of 25%, rather than the lower capital gains rates, if the taxpayer has a "net capital gain" for the year. Unrecaptured IRC §1250 gain is the lesser of:

- The amount of depreciation taken on the property that is not recaptured as ordinary income under IRC §1250; or
- The actual gain on the sale.

"Net capital gains" is the sum of all of the taxpayer's long-term and short-term capital gain recognized during the taxable year. Essentially, this means that a taxpayer must first add in the IRC §1250 gain into the IRC §1231 netting computation. If there is a net capital gain and it exceeds the amount of depreciation claimed on the IRC §1250 property, then the IRC §1250 unrecaptured gain is subject to the 25% tax rate, and any remaining gain is taxed at the taxpayer's applicable capital gains tax rate.

Example of IRC §1250 unrecaptured gain

Yves sells a commercial building for $1 million in 2024.

The property was purchased for $600,000 in 2017. Yves claimed $90,000 in depreciation deductions on the property. Yves had a total of $400,000 in net capital gain in 2024.

Because the $90,000 unrecaptured gain is less than Yves' net capital gain for the year, the $90,000 would be subject to the 25% capital gains rate, and the remaining $310,000 would be subject to the 20% capital gains rate (assuming Yves is in the top capital gains rate).

Comment

If there is no net capital gain, there is no IRC §1250 recapture.

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Home offices

If a taxpayer sells their home and a portion of the home was used as a home office, the amount of depreciation claimed on the home office may be subject to the 25% tax on IRC §1250 unrecaptured gain tax.

However, if the taxpayer used the simplified option for claiming home office expenses available under Revenue Procedure 2013-13, then the amount deducted under the simplified method is not subject to recapture.

INTERPLAY WITH IRC §1231 NETTING RULES

The depreciation recapture provisions (other than the IRC §1250 unrecaptured gain provisions) are computed prior to the IRC §1231 netting procedure.

Under IRC §1231, if total gains from the sale of IRC §1231 assets is a net gain, the gain is treated as a capital gain (unless the taxpayer is a C corporation), whereas if the sum of the taxpayer's gains and losses from the sale of IRC §1231 assets results in a net loss, then the loss is treated as an ordinary loss.

However, if some of the IRC §1231 assets are IRC §1245 or IRC §1250 property, gain from the sale of these assets may be taxed as ordinary income, rather than capital gain under the depreciation recapture rules. This ordinary income computation is conducted prior to the IRC §1231 netting calculation, so that only the capital gains from the sale of these assets are used in the IRC §1231 netting process.

Unlike the IRC §1231 netting rules, the depreciation recapture rules are computed on an asset-by-asset basis.

Example of IRC §1231 interplay

In 2024, Bo sells residential rental property that was purchased in 2020. Below is Bo's balance sheet from the sale:

	Cost	**Tax Basis**	**FMV**	**§1231 asset**	**§1245 asset**	**§1250 asset**
Building	$500,000	$410,000	$600,000	Yes	No	Yes
Furniture/appliances	$25,000	$15,000	$10,000	Yes	Yes	No
Land	$120,000	$120,000	$175,000	Yes	No	No

The sale of the furniture/appliances results in $0 in depreciation recapture ($10,000 - $15,000).

To determine the amount of IRC §1250 unrecaptured gain, if any, we must first determine whether there is a net capital gain.

Building	$190,000
Furniture/appliances	(5,000)
Land	55,000
Net capital gain	$240,000

$90,000 of the gain from the sale of the building is IRC §1250 unrecaptured gain (the amount of depreciation taken on the building) and is taxed at 25%. The remaining $150,000 is treated as IRC §1231 net capital gains subject to the 20% capital gains tax rate.

WHAT TRIGGERS RECAPTURE?

The following is a list of transactions and events that either trigger or escape depreciation recapture:

- A sale in a sale and leaseback transaction, a sale under a conditional sales contract, and a transfer of title back to the seller, creditor, or new purchaser upon foreclosure of a security interest trigger recapture. But, a transfer of legal title to a creditor upon creation of a security interest, or to a debtor upon termination of a security interest, escapes recapture. (Treas. Regs. §§1.1245-1(a)(3), 1.1250-1(a)(2)(i))
- For like-kind exchanges and involuntary conversions, IRC §1245 depreciation isn't recaptured unless gain is recognized or non-IRC §1245 property is acquired (IRC §1245(b)(4); Treas. Regs. §1.1245-4(d)); and IRC §1250 depreciation isn't recaptured except where gain is recognized, stock is bought to acquire control of a corporation owning replacement property, or non-IRC §1250 property is acquired. (IRC §1250(d)(4); Treas. Regs. §1.1250-3(d))
- Conversion to personal use (except for IRC §179 property) doesn't trigger recapture, but a later sale will.
- Termination or disposition of a lease where depreciation was taken by the lessee (or sublessee) generally triggers recapture. (Treas. Regs. §1.1245-2(a)(3)(i))
- Incorporation of a business triggers recapture only if gain is otherwise recognized. (IRC §§1245(b)(3), 1250(d)(3); Treas. Regs. §§1.1245-4(c), 1.1250-3(c))
- Corporate distributions in kind (including liquidating distributions) generally trigger recapture, except in a tax-free complete liquidation of a subsidiary with carryover basis, where recapture is triggered upon disposition by the parent-transferee. (IRC §§1245(b)(3), 1250(d)(3); Treas. Regs. §§1.1245-4(c), 1.1250-3(c))
- Corporate split-ups and reorganizations generally don't trigger recapture, except to the extent that gain is otherwise recognized on transfer of the property. (IRC §§1245(b)(3), 1250(d)(3); Treas. Regs. §§1.1245-4(c), 1.1250-3(c))
- S corporation elections or termination of S status doesn't trigger recapture.
- Sale of a partnership interest triggers recapture. Contributions to a partnership generally don't trigger recapture but may if property is subject to a liability. (IRC §§1245(a) and (b)(3), 1250(a) and (d)(3); Treas. Regs. §§1.1245-4(c), 1.1250-3(c))
- Gifts generally don't trigger recapture, but recapturable depreciation carries over to the donee. (IRC §§1245(b)(1), 1250(d)(1); Treas. Regs. §§1.1245-4(a), 1.1250-3(a))
- For transfers by reason of death, recapturable depreciation is neither triggered nor carried over. (IRC §§1245(b)(2), 1250(d)(2); Treas. Regs. §§1.1245-4(b), 1.1250-3(b))
- When a trust or estate realizes gain from the distribution of depreciable property in satisfaction of a fixed-dollar bequest, or from a distribution of property in satisfaction of a bequest of other property, recapture is triggered. (Treas. Regs. §§1.1245-4(b), 1.1250-3(b))

IRC §179 RECAPTURE

Recapture of amounts expensed under IRC §179 is triggered when the business use of the property is reduced to 50% or less during the recapture period. The recapture period is the entire recovery period of the qualifying property. (Treas. Regs. §1.179-1(e)) The recapture amount is the expensed amount under IRC §179 minus the amount of the depreciation that would have been allowable for all prior tax years up to and through the recapture year. This amount is taxed as ordinary income during the year of recapture.

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Example of IRC §179 recapture

In January 2022, Paul, a calendar-year taxpayer, bought and placed in service IRC §179 property costing $10,000. The property is three-year property. He elected a $5,000 IRC §179 deduction for the property and also elected not to claim a special depreciation allowance. He used the property only for business in 2022 and 2023. In 2024, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

IRC §179 deduction	
2022	$5,000
Allowable depreciation	
2022	$1,666
2023	1,666
2024 ($1,666.66 × 40% business)	666
Allowable depreciation	$3,998
Recapture amount ($5,000 - $3,998)	$1,002

The recapture amount is reported on the 2024 Form 4797, Sales of Business Property.

Interplay with IRC §1245 recapture rules

The IRC §179 recapture rules only apply if the property's use drops below the 50% business use requirement. If the property is sold, exchanged, or otherwise disposed of, the IRC §1245 recapture rules apply.

FIXING DEPRECIATION DEDUCTIONS

Taxpayers that have underclaimed the amount of depreciation they were required to claim have two options:

- They can file amended returns for open tax years if the error is due to a mathematical or posting error, or if the taxpayer has not adopted a method of accounting (by using the same method for two consecutive years) for property placed in service after 2003; or
- They can change their method of accounting to claim the correct amount of depreciation by either filing a complete Form 3115, Application for Change in Accounting Method, and receiving prior IRS approval, or via the IRS's automatic consent procedures available for specified method changes by submitting an abbreviated Form 3115 and making an IRC §481(a) adjustment to claim a "catch-up" depreciation deduction. (IRC §446; Treas. Regs. §1.446(e); IRS Publication 946, How to Depreciate Property)

The changes that qualify for the automatic consent process are listed in revenue procedures that have been periodically updated since 1997. The latest update is contained in Revenue Procedure 2023-24.

IRC §199A RENTAL REAL ESTATE SAFE HARBOR (NOTICE 2019-38)

The rental real estate safe harbor provides taxpayers with an administrative method of proving whether rental real estate is deemed to be a trade or business for purposes of IRC §199A. (Rev. Proc. 2019-38) Only activities that are deemed to be trades or businesses are eligible for the IRC §199A deduction.

Under the safe harbor rule, the owner of a rental real estate enterprise may take an IRC §199A deduction if the owner and/or their agents spend 250 or more hours of rental service on the enterprise and meet other requirements.

Revenue Procedure 2019-38 emphasizes that if an enterprise fails to satisfy the safe harbor requirements, then the rental properties that make up the rental real estate enterprise may still be treated as trades or businesses for purposes of IRC §199A if those rental properties otherwise meet the definition of a trade or business under Treas. Regs. §1.199A-1(b)(14). That regulation defines a trade or business as a trade or business under IRC §162 other than the trade or business of performing services as an employee.

Passthrough entities may also use the rental real estate safe harbor to determine whether a rental real estate enterprise is a trade or business at the entity level.

> ✐ **Practice Pointer**
>
> It is up to the person or entity that actually owns the property to determine whether a rental activity is a trade or business. As such, the decision to apply the safe harbor rule is made by the property owner.
>
> For example, if an LLC owns a commercial rental property and reports each member's share of the net rental income on Schedule K-1, then the LLC is the one that must determine whether the rental property is a trade or business for IRC §199A purposes. The individual members of the LLC cannot make their own separate trade or business determination.
>
> If the LLC determines that the rental property is a trade or business (by using the safe harbor or by using Treas. Regs. §1.199A-1(b)(14)), then the LLC will also report IRC §199A items on each member's K-1.

THE SAFE HARBOR REQUIREMENTS

There are four requirements to meet the rental real estate safe harbor:

1. Separate books and records must be maintained to reflect income and expenses for each rental real estate enterprise;
2. 250 or more hours of rental services must be performed per year with respect to each rental real estate enterprise;
3. Contemporaneous records must be maintained, including time reports, logs, or similar documents, regarding:
    a. Hours of services performed;
    b. Description of services performed;
    c. Dates services were performed; and
    d. Who performed the services; and
4. The taxpayer must attach an election statement to their return.

Taxpayers must meet the rental real estate safe harbor requirements annually.

Separate books and records

Revenue Procedure 2019-38 does not define the term "separate books and records." The only place in the Code and Treasury Regulations that defines separate books and records is found in Treas. Regs. §1.989-1(d)(1), dealing with definitional and special rules for purposes of foreign

currency transactions. Foreign currency transactions are completely unrelated to rental real estate enterprises, but it's the closest we're going to get.

Separate books and records include books of original entry and both general and subsidiary ledger accounts or similar records. For example, in the case of a taxpayer using the cash receipts and disbursements method of accounting, the books of original entry include a cash receipts and disbursements journal where each receipt and disbursement is recorded. (Treas. Regs. §1.989-1(d)(1))

Similarly, in the case of a taxpayer using an accrual method of accounting, the books of original entry include a journal to record sales (accounts receivable) and a journal to record expenses incurred (accounts payable).

In general, a journal represents a chronological account of all transactions entered into by an entity for an accounting period. A ledger account, on the other hand, chronicles the impact during an accounting period of the specific transactions recorded in the journal for that period upon the various items shown on the entity's balance sheet (i.e., assets, liabilities, and capital accounts) and income statements (i.e., revenues and expenses). (Treas. Regs. §1.989-1(d)(1)) This requirement also makes keeping the books easier and better for the taxpayers.

Comment

Revenue Procedure 2019-38 provides some additional clarity to the separate books and records requirement. It states:

"If a rental real estate enterprise contains more than one property, then the separate books and records requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated."

When multiple properties are combined into a single rental real estate enterprise, they are only combined for purposes of the IRC §199A deduction calculation. Each individual property in the rental real estate enterprise must still be reported separately on Schedule E (or Form 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation, in the case of a partnership or S corporation). So how could multiple properties maintain one set of books and records for one purpose (IRC §199A) but still be reported independently for another purpose (Schedule E/Form 8825)?

By allowing taxpayers to consolidate books and records for each of the properties in their rental real estate enterprise at the end of the year, the IRS has effectively eased the taxpayer's administrative burden.

250-hour requirement

If a rental real estate enterprise has been in existence for less than four years, then the taxpayer must perform 250 or more hours of rental services per year with respect to the rental real estate enterprise. (Rev. Proc. 2019-38)

For rental real estate enterprises that have been in existence for at least four years, the taxpayer must perform 250 or more hours of rental services in any three of the five consecutive taxable years that end with the taxable year at issue.

Rental activities lasting less than 12 months

The rental real estate safe harbor does not contain any provision permitting taxpayers to prorate the 250-hours-or-more requirement in years where a rental real estate enterprise is owned for less than

a full year. Absent such a provision, taxpayers must meet the full 250-hours-or-more requirement for their real estate enterprise regardless of whether the enterprise is owned for part of the year.

Election statement

To take advantage of the rental real estate safe harbor, the taxpayer or passthrough entity must attach a statement to a timely filed original return for each taxable year in which the taxpayer or passthrough entity relies on the safe harbor.

The statement must include the following information:

- A description (including the address and rental category (commercial or residential) of all rental real estate properties that are included in each rental real estate enterprise;
- A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
- A representation that the requirements of Revenue Procedure 2019-38 have been satisfied.

Single statement for all rental real estate enterprises

An individual or passthrough entity with more than one rental real estate enterprise relying on Revenue Procedure 2019-38 may submit a single statement, but the statement must list the required information separately for each rental real estate enterprise. Most professional tax software products will produce the required statement automatically.

Excluded real estate

There are four rental real estate arrangements that are excluded from the safe harbor:

1. Property used as a residence by the taxpayer for any part of the year under IRC §280A (vacation home rules);
2. Property rented to a trade or business conducted by a taxpayer or a passthrough entity which is commonly controlled under Treas. Regs. §1.199A-4(b)(1)(i);
3. Property that has any portion treated as a specified service trade or business (SSTB) under Treas. Regs. §1.199A-5(c)(2), which provides special rules where property or services are provided to an SSTB; and
4. Property subject to a triple net lease. In a triple net lease, the owner, by contract with the tenant, has shifted the burden of upkeep and maintenance to the lessee. Therefore, the owner only has to cash a check.

Revenue Procedure 2019-38 defines triple net leases for purposes of excluding them from the rental real estate safe harbor as: "a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities."

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RENTAL SERVICES

Rental services that count toward the 250-hour requirement and that are specifically listed in Revenue Procedure 2019-38 and Notice 2019-07 include time spent on the following activities:

- Advertising to rent or lease the real estate;
- Negotiating and executing leases;
- Verifying information contained in prospective tenant applications;
- Collection of rent;
- Daily operation, payment of expenses, maintenance, and repair of the property, including the purchase of materials and supplies;
- Management of real estate; and
- Supervision of employees and independent contractors.

Rental services that do not count toward the 250-hour requirement include financial or investment activities, such as:

- Arranging financing;
- Procuring property;
- Studying reports on operations;
- Planning, managing, or construction of long-term capital improvements; or
- Hours spent traveling to and from the real estate.

Who performs the services?

Revenue Procedure 2019-38 states that rental services may be performed by owners, including owners of a passthrough entity, or by employees, agents, and/or independent contractors of the owners.

If the taxpayer can count an agent's hours of services, then, presumably, the taxpayer can count an agent's agent's hours of services. So, if the property owner hires a property manager and the property manager hires a gardener, the property owner can count the hours spent by both the property manager and the gardener.

The property manager and agent challenge

Properties managers, gardeners, plumbers, etc., don't typically maintain and provide time logs for the work they perform, but contemporaneous time logs are required if the taxpayer wants to count the work performed by their agents for the 250-hour requirement.

Revenue Procedure 2019-38 provides that if rental services are performed by employees or independent contractors, then the taxpayer is only required to provide:

- A description of the rental services performed by the employee or independent contractor;
- The amount of time such employee or independent contractor *generally* spends performing such services for the rental real estate enterprise; and
- Time, wage, or payment records for such employee or independent contractor.

Comment

Revenue Procedure 2019-38 that allows taxpayers to estimate time spent by agents, such as property managers, should be a great relief to taxpayers.

Example #1 of performing services

John and Mitchy own an office park as tenants-in-common, and each owns 50%. John is retired on an exotic beach somewhere in the Caribbean, and Mitchy works full time managing the office park.

As tenants-in-common, John and Mitchy must each report their respective share of the income and expenses of the office park on Schedule E of their personal income tax returns. As such, each must apply the 250-hour-or-more requirement and attach the required statement to each of their returns pursuant to Revenue Procedure 2019-38.

John and Mitchy both satisfy the 250-hour-or-more requirement based on the time spent by Mitchy. His time spent is countable both for himself and for John because he is acting as John’s agent when he manages the property they both own.

Example #2 of performing services

What if John and Mitchy own the office park in an LLC?

In this scenario, the LLC, not the individual members, must meet the requirements of Revenue Procedure 2019-38, and it is the LLC that attaches the required statement to its income tax return.

WHAT IS A RENTAL REAL ESTATE ENTERPRISE?

Solely for purposes of the 250-hours-or-more safe harbor (Rev. Proc. 2019-38), a rental real estate enterprise is defined as an interest in real property held for the production of rents. A taxpayer may combine multiple properties into a single enterprise, but if they do so, they must continue this treatment from year to year unless there has been a significant change in facts and circumstances.

Combine rental properties under safe harbor versus aggregation

Properties combined into a “rental real estate enterprise” and the aggregation rules are not the same. They are separate sets of rules that operate independently of one another. The aggregation rules are used to treat multiple trades or businesses as a single trade or business for IRC §199A calculation purposes.

The rental real estate safe harbor rules of Revenue Procedure 2019-38 are used to combine multiple rental properties into a single trade or business. In essence, when multiple rental properties are combined into a single rental real estate enterprise (a single trade or business), then they are effectively aggregated already, and taxpayers do not need to meet the aggregation requirements nor report the multiple properties on Schedule B to Form 8995-A, Qualified Business Income Deduction.

Both of these grouping rules only apply for purposes of IRC §199A.

Two types of rental real estate categories

Revenue Procedure 2019-38 defines two rental real estate enterprise categories:

- Residential; and
- Commercial.

Commercial and residential property **cannot** be combined into the same enterprise. Thus, for purposes of the safe harbor, a taxpayer with both residential and commercial properties must meet the safe harbor requirements separately with respect to each type of property.

Example of multiple properties

Zal owns one residential apartment building, three residential houses, and two pieces of commercial rental property. He keeps one set of books for the apartment building and the house rentals and a separate set of books for the commercial properties. His time spent in 2023 was as follows:

	Residential	**Commercial**
Apartment building	125 hours	
Rental house 1	50 hours	
Rental house 2	50 hours	
Rental house 3	25 hours	
Commercial property 1		50 hours
Commercial property 2		100 hours
Total	250 hours	150 hours

Zal can combine his residential rental properties into a single enterprise and meet the 250-hour safe harbor.

His commercial rentals do not qualify for the safe harbor even if he combines them together because he does not spend at least 250 hours on them, but they may still qualify as a trade or business under IRC §162.

Mixed-use properties

Interests in mixed-use properties may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. (Rev. Proc. 2019-38)

Revenue Procedure 2019-38 defines mixed-use properties as a single building that combines residential and commercial units.

An interest in mixed-use property, if treated as a single rental real state enterprise, may not be part of the same enterprise as other residential, commercial, or mixed-use properties.

Example of mixed-use properties

Denny owns three rental properties:

- A residential duplex;
- A retail strip mall (commercial property); and
- A five-story building that contains retail on the ground floor and apartments above it (mixed-use property).

Assuming Denny meets the other rental real estate safe harbor requirements, she can:

- Treat each rental property as its own separate rental real state enterprise (one residential, one commercial, and one mixed-use); or
- Bifurcate her mixed-use property and combine the residential portion with her duplex and combine her commercial portion with her strip mall.

Schedule E reporting

Taxpayers that combine rental properties together into a single rental real estate enterprise for purposes of meeting the 250-hour-or-more safe harbor must still report the rental income and expenses of each property separately on Schedule E. This is because properties combined into a single rental real estate enterprise are deemed to be a single trade or business only for purposes of calculating the IRC §199A deduction. They are not treated as a single trade or business for *any* other purpose.

ESTABLISHING "TRADE OR BUSINESS" WITHOUT THE SAFE HARBOR

Self-rentals

If rental real estate activities are rented or leased to a commonly controlled taxpayer (Treas. Regs. §1.199A-4(b)(1)(i)) and the rental property is used in an operating trade or business ("self-rental"), then the rental real estate is treated as part of the operating business. (Treas. Regs. §1.199A-1(b)(14))

Example of self-rental

Cass and Sebastian are married and own a rental property. The property is rented to the tax practice that Cass operates as an S corporation.

Because the rental property is a self-rental, it is treated as part of its related business. As such, the property rented to the tax practice is deemed to be a trade or business (the rental real estate safe harbor is unnecessary). Thus, rental income from the property rented to the tax practice is qualified business income. For Cass, this means that the rental income is also SSTB income.

When performing the IRC §199A calculation, the QBI, W-2 wages, and unadjusted basis immediately after acquisition (UBIA) of the rental property and tax practice must be combined into a single trade or business.

The self-rental rules override the triple net lease conundrum

If a property is a self-rental but is leased under a triple net lease scenario, then the rental property is still deemed to be part of the commonly controlled operating business. This is because triple net leases are not precluded from being classified as a trade or business. Taxpayers are simply prevented from using the rental real estate safe harbor to establish it.

Rental real estate safe harbor is irrelevant where self-rentals are involved

Likewise, if a self-rental is part of an operating business that is a trade or business, then the 250-hour-or-more safe harbor is not required because the rental property is automatically deemed to be a trade or business.

Minority investors are affected, too

Minority owners of a rental property are affected by the self-rental rules as well. This is because the determination of whether a rental property is a trade or business is made for the property as a whole. So, if the majority owner of the rental property leases it to their own business, then under the self-rental rules, the entire rental property is deemed to be a trade or business.

Example of minority owners of self-rental properties

Daniel and Joshua are partners in a law firm that operates as a limited liability partnership. Daniel owns 80% and Joshua owns 20%.

Daniel and Christian are members of an LLC that owns the office building for Daniel and Joshua's law firm. Daniel owns 60% of the LLC and Christian owns 40%.

The law firm and the LLC are commonly controlled by Daniel. Therefore, the LLC's rental income from the office building is deemed to be a trade or business. Christian, as the 40% owner of the office building, can benefit from this determination if the property produces net income (QBI). Christian may be harmed if the property produces negative QBI.

Comment

Interestingly, it appears that the rental income to Daniel is SSTB income, but it is not SSTB income to Christian (see Treas. Regs. §1.199A-5(c)(2)(i)).

The determination of whether a business is an SSTB is made based on the activity of the business as a whole. But Treas. Regs. §1.199A-5(c)(2)(i) provides that "if a trade or business provides property or services to an SSTB … and there is 50% or more common ownership of the trade or business, that portion of the trade or business of providing property or services to the 50% or more commonly owned SSTB will be treated as a separate SSTB *with respect to the related parties* [emphasis added]."

Using self-rental to circumvent SSTB rules?

Rental real estate that qualifies as a trade or business generates non-SSTB QBI. Further, income from self-rentals is automatically deemed to be a trade or business. Some practitioners have asked whether this means that owners of an SSTB can rent space to their SSTB and generate non-SSTB QBI.

Not exactly — the aforementioned rules apply here as well. Because the operating business is an SSTB, the rental income generated from the self-rental is also income from an SSTB, but only as to the related parties. (Treas. Regs. §1.199A-5(c)(2)(i))

Comment

The discussion here revolves around real property rentals, but the self-rental rules apply to the rental or licensing of tangible and intangible property as well.

Single rental properties

One of the most common questions we're asked is whether a taxpayer with a single rental property qualifies to claim the qualified business income deduction, especially where the safe harbor is not available or cannot be satisfied.

There is no clear answer. There are no Tax Code sections that define "trade or business," and prior case law and guidance has been scarce, conflicting, or nonexistent.

The reason is that under current law, deductions are generally the same whether a single rental is treated as a "trade or business" or an "investment property."

Rental real estate enjoys all the benefits of trade or business treatment even if it is classified as investment property and then some. Like trades or businesses:

- Taxpayers can take deductions above line, including depreciation (IRC §212);
- Losses on dispositions are IRC §1231 and are, therefore, ordinary losses that can generate NOLs; and
- Unlike other trades or businesses, income is exempt from self-employment tax. (IRC §1402(a))

Therefore, taxpayers have had little incentive to force a determination as to whether rental real estate is a trade or business until IRC §199A came about.

Similar to NIIT trade or business exception

Like IRC §199A, the net investment income tax (NIIT) presents an issue for taxpayers as to how to treat income from single rental properties. Although income from rents is subject to the NIIT, there is an exclusion if the rents are received by a trade or business.

While to date there are no court decisions addressing whether a single rental is a "trade or business" for purposes of the NIIT, the IRS did address this issue in the preamble adopting the final NIIT regulations. (T.D. 9644) Like the IRC §199A deduction, the IRS applies an IRC §162 analysis to determine whether the rental activity rises to the level of a "trade or business." And like IRC §199A, the IRS refused to adopt a bright-line test for purposes of determining when a rental activity rises to the level of a "trade or business."

The IRS did state that in making a trade or business determination it will look at:

- The type of property (commercial real property versus a residential condominium versus personal property);
- The number of properties rented;
- The day-to-day involvement of the owner or its agent; and
- The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).

The IRS listed these same criteria in the preamble adopting the final IRC §199A regulations.

In an example, the IRS also stated that an individual who owned a commercial building and rented it out for $50,000 but was not involved in the activity of the commercial building on a "regular and continuous basis" was not involved in the conduct of a trade or business.

Filing 1099s

The IRS did not specifically list that filing a 1099 to report services purchased for the property was a determining factor. However, the IRS did note that they will "closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of the net investment income tax (IRC §1411), but not a trade or business for other such provisions.

"For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of IRC §1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by IRC §6041."

So, it appears that the filing of the 1099s may not establish that a rental property is a "trade or business," but the failure to file them may be used against a taxpayer claiming they are operating a trade or business.

Groetzinger standard

When determining whether any activity is a trade or business or an investment, courts and commentators alike turn to the 1987 ***Groetzinger*** case. (***Comm. v. Groetzinger*** (1987) 480 US 23) In this case, the U.S. Supreme Court examined whether a full-time gambler was in the trade or business of gambling and therefore not subject to AMT. The court found that Groetzinger, who devoted between 60–80 hours a week wagering on dog races, was in a trade or business. In making that determination, the court stated that to be engaged in a trade or business, the taxpayer:

- Must be involved in the activity with continuity and regularity; and
- The taxpayer's primary purpose for engaging in the activity must be for income or profit.

The court also stated that whether an activity rises to the level of a trade or business "requires an examination of the facts in each case."

Trade or business rental cases

Most of the U.S. district and appellate courts use a standard similar to the ***Groetzinger*** standard, requiring a finding of some form of continuous and regular activity in relation to the rental property before finding that the taxpayer was engaged in a trade or business. The one exception is the Seventh Circuit's decision in ***Reiner v. U.S.***, in which the court adopted the Tax Court's ***Lagreide*** reasoning that the owning of a single rental property amounts to a "trade or business." (***Reiner v. U.S.*** (1955) 222 F.2d 770; ***Lagreide v. Comm.*** (1954) 23 TC 508)

The Tax Court had historically adopted the position taken in ***Lagreide***. However, in 1980, the Tax Court too began following a similar position as the other federal appellate and district cases. In ***Curphey v. Comm.***, the Tax Court allowed a dermatologist to claim a home office deduction because the taxpayer used the office in relation to managing six rental properties. (***Curphey v. Comm.*** (1980) 73 TC 766) The court noted that his activities in screening tenants, supplying furnishings, and maintaining the units were "sufficiently systematic and continuous to place him in the business of real estate."

The Tax Court reached the opposite conclusion but applied the same standard in ***Anderson v. Comm.*** in 1982, in which another dermatologist rented out farmland, finding that the taxpayer simply leased the farmland to a tenant farmer and relieved himself of all responsibilities for the land and that he failed to "establish that his activities were sufficiently regular, systematic, and continuous as to place him in the business of farm management." (***Anderson v. Comm.***, TCM 1982-576)

Similarly, in ***Jafarpour v. Comm.*** in 2012, the Tax Court denied GO-Zone bonus depreciation to California taxpayers who purchased three rental properties in Louisiana and Alabama. (***Jafarpour v. Comm.***, TCM 2012-165) The court noted that the taxpayer simply reviewed rental agreements and left all management of the properties to property managers. (**Note:** Other court cases have found that the property managers were agents of the taxpayers, and the managers acted as the taxpayers' agents for purposes of establishing the requisite level of continuous and regular activities.)

Substantiating a trade or business

While we feel it is possible to establish a rental activity as a trade or business even if the taxpayer and their agents do not meet the 250-hour threshold of Revenue Procedure 2019-38, it's important that the taxpayer conduct its activities in a business-like manner. This means:

- Establishing separate accounts for the activity;
- Documenting what work was done and time spent (both for the taxpayer and any agents such as property managers, repair persons, landscapers, etc.); and
- Sending out Forms 1099-MISC if appropriate.

SAFE HARBOR K-1 REPORTING

Revenue Procedure 2019-38 does not require a passthrough entity to provide specific disclosure on the K-1s it issues to its owners or beneficiaries. Therefore, if a passthrough entity combines two or more properties together into a single rental real estate enterprise (and therefore a single qualified trade or business) for purposes of the safe harbor, it must report the QBI, W-2 wages, and UBIA for the combined rental properties as a single line item.

As previously discussed, the safe harbor rules are not the same as the aggregation rules. Treas. Regs. §1.199A-4(b)(2)(ii), (c)(3) and (c)(4) discuss aggregation of trades or businesses by a passthrough entity and K-1 reporting of that aggregation on Schedule K-1.

Passthrough entities must attach a statement to each Schedule K-1 identifying each trade or business aggregated by the entity. But combining properties for purposes of meeting the 250-hour safe harbor is not aggregation. This is because the rental real estate enterprise is not yet deemed to be a trade or business until after the 250-hour safe harbor requirement is met.

In other words, the aggregation disclosure rules apply if two or more real estate enterprises are aggregated by the passthrough entity.

✐ Practice Pointer

We have received many questions from tax professionals whose clients receive a K-1 from a passthrough entity engaged in rental real estate activities and want to know how they can tell if the passthrough entity applied the rental real estate safe harbor rules.

The answer is that you can’t tell because it doesn’t matter. The sole purpose of the safe harbor is to determine whether rental properties are a trade or business and therefore whether their income is qualified business income.

If the tax professional that prepares the passthrough entity’s income tax return determines that rental properties are trades or businesses, then they will report the requisite IRC §199A information on the K-1 (QBI, W-2 wages, UBIA). It does not matter to the recipient of the K-1 whether that determination was made using the safe harbor or based on facts and circumstances.

If you receive a K-1 from a passthrough entity engaged in real estate activities and there is no IRC §199A information reported (QBI, W-2 wages, UBIA), then the passthrough entity has made the determination that the real estate activity is not a trade or business.

MISCELLANEOUS ISSUES

ELECTION TO AVOID PARTNERSHIP TAX TREATMENT

A partnership, for income tax reporting purposes, includes a syndicate, group, pool, or joint venture. (IRC §761) However, if all the members of an unincorporated association so elect, they may exclude the organization from partnership treatment and report all income and make all applicable elections on the individual partners’ returns.

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Example of separate depreciation elections under IRC §761(a) election

Emma and Olivia pooled their money to purchase a rental property in 2021. They each contributed $200,000, and they agreed to hold title as tenants-in-common and split the income and expenses from the property 50/50.

Emma and Olivia make a valid IRC §761(a) election, so they each report 50% of the rental income and expenses on Schedule E of their respective returns.

In 2023, Emma and Olivia install new appliances in the rental property at a cost of $10,000. Because the IRC §761(a) election allows each owner to make their own elections, Emma can avail herself of bonus depreciation for her share of the cost of the appliances, and Olivia can elect out of bonus depreciation.

The bonus depreciation rate is 80% through December 31, 2023.

To qualify, the unincorporated association must be created:

- For investment purposes only and not for the active conduct of a trade or business (often referred to as an investing partnership);
- For the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted; or
- By dealers in securities for a short period for the limited purpose of underwriting, selling, or distributing a particular issue of securities.

Additionally, each member of the organization must be able to adequately determine their income without the computation of partnership taxable income. (IRC §761(a)) For this reason, the IRC §761 election is most commonly used for real estate investments.

Caution

A strict interpretation of the Internal Revenue Code seems to permit an IRC §761(a) election for any partnership (including LPs, LLPs, and LLCs). However, if state law in the state where the partnership or LLC was organized treats the entity as the owner of the property instead of treating each member or partner as co-owners, then an IRC §761(a) election may not be available.

This issue was addressed in a 2002 IRS Field Service Advice Memorandum 200216005 (regarding limited partnerships) and again in 2004 in Revenue Ruling 2004-33 (regarding a Delaware statutory trust (DST)), but the issue has not otherwise been addressed or tested by the IRS or the courts.

This is not an issue for general partnerships because they are not “organized” under state law.

Comment

Unincorporated associations participating in active trades or businesses do not qualify for an IRC §761(a) election.

Making the IRC §761(a) election

The qualifying syndicate, pool, joint venture, or similar organization must make an election under IRC §761(a) on a timely filed partnership income tax return. Form 1065, U.S. Return of Partnership Income, is required only for the year of the election.

The election is made by attaching a statement to Form 1065. The Form 1065 must contain only the following information:

- The name or other identification and the address of the organization;
- The names, addresses, and identification numbers of all the members of the organization;
- A statement that the organization qualifies under Treas. Regs. §1.761-2(a)(1) and either (2) or (3) (relating to whether the organization is an investing partnership and the rights of the members);
- A statement that all of the members of the organization elect that the organization be excluded from all of subchapter K; and
- A statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained).
(Treas. Regs. §1.761-2(b)(2)(i))

Relief available where IRC §761(a) election is not made

If a qualifying syndicate, pool, joint venture, or similar organization fails to make an IRC §761(a) election, it will nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of the organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable year of the organization. (Treas. Regs. §1.761-2(b)(ii))

Example of failure to make IRC §761(a) election

Roger and Jessica pooled their money to purchase a rental property in 2024. Roger contributed $250,000 and Jessica contributed $750,000 toward the purchase price of the property. They orally agreed to hold title as tenants-in-common and split the income and expenses from the property based on their initial contribution (25% Roger and 75% Jessica).

Roger and Jessica did not file Form 1065 in 2024, but they have each reported their share of the rental property's income and expenses on their respective Schedules E each year.

Roger and Jessica are deemed to have made the IRC §761(a) election because it can be shown from all the surrounding facts and circumstances (their oral agreement and their tax reporting history) that it was their intention from the outset to exclude their investment venture from subchapter K.

IDLE PROPERTY

Subject to the passive activity rules discussed above, taxpayers may continue to deduct their rental expenses necessary to manage and maintain the property when a rental house is vacant. This applies to "idle" periods such as:

- The period prior to the time the property owner begins to rent the property;
- Between tenants; or
- While the property owner is trying to sell the property.

In ***Bonds v. Comm.*** (TCS 2011-122), the taxpayer moved from Kansas City to Minnesota in 1988. From that time through 2005, she was able to rent out her former principal residence in Kansas City. In 2006 and 2007, the property was available for rent but was not rented due to various factors including a weak local economy and the property's location. The taxpayer continued to hold the

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property because she believed she could still sell it for a profit, but it was never actually put up for sale. The taxpayer did not use the property for personal purposes after her move to Minnesota. On her 2006 and 2007 returns, the taxpayer claimed Schedule E rental losses from expenses including mortgage interest, property taxes, depreciation, cleaning and maintenance, utilities, insurance, advertising, and auto travel to visit the property. There was no rental income in either year.

The Tax Court held that the taxpayer was entitled to deduct rental losses for 2006 and 2007, even though the property was not rented in those years, noting that holding property for the production of income can include income expected in future years, including an anticipated gain on sale. In 2006 and 2007, the taxpayer had reason to believe she could sell the property for a gain. The court also rejected the IRS's position that the taxpayer's rental losses were suspended by the passive activity loss (PAL) rules since she met the active participation requirement to currently deduct up to $25,000 of annual PALs from rental real estate.

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Part 2

Stan Pollock, CPA

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PART 2

LIKE-KIND EXCHANGES IN A NUTSHELL

IRC §1031 provides an exception to the general rule for recognition of gain or loss on the sale or exchange of property.

IRC §1031 allows taxpayers with business or investment property to "exchange" their property for new property without recognizing gain on the transaction. However, in order for taxpayers to take advantage of these tax-free exchanges, very specific requirements must be met.

IRC §1031 and the related regulations provide that no gain or loss shall be recognized on the:

- **Exchange** of
- **Business or investment** real property if the property is exchanged
- **Solely** for property of
- **Like kind**, which is to be
- **Held** either for productive use in a trade or business or for investment.

Generally, a like-kind exchange allows a taxpayer to defer tax on the sale of property leaving the taxpayer with more equity to reinvest and exploiting the time value of money.

Since a like-kind exchange defers the gain from the property, the 3.8% net investment income tax (NIIT) and alternative minimum tax will not apply to the deferred gain.

In addition, if the taxpayer continues their investment by not selling the replacement property or continuing to exchange properties until their death, they can avoid income taxes completely because the basis in the exchanged property is stepped up to fair market value at the taxpayer's death. (IRC §1014)

To the extent that property received is not solely of a like-kind of cash or other boot, gain is recognized. (IRC §1031(b)) Net relief of the transferor taxpayer's mortgage debt is considered boot received. (Treas. Regs. §1.1031(b)-1)

WHAT IS AN EXCHANGE?

To accomplish an exchange there must be a reciprocal exchange of properties. The simplest type of §1031 exchange is the simultaneous swap of one property for another. Deferred exchanges are more complex but allow more flexibility. They allow a taxpayer to dispose of property and subsequently acquire one or more other like-kind replacement properties. Deferred exchanges are discussed on page 2-20.

Generally, the same taxpayer that conveyed the relinquished property should receive the replacement property.

Single member LLCs

Since single member LLCs are disregarded entities for federal tax purposes, they may be used in exchanges without fear of violating the "same taxpayer" standard. The IRS has ruled in several letter rulings that an exchange is accomplished where a taxpayer conveys the relinquished property and an LLC owned 100% by the taxpayer takes title to the replacement property. (PLR 9807013; PLR 9911033; PLR 200118023)

TCJA CHANGES

Under the Tax Cuts and Jobs Act (TCJA), nonrecognition of gain or loss on like-kind exchanges under IRC §1031 is limited to real property not held primarily for sale for exchanges completed after 2017. (TCJA §13303; IRC §1031) A couple of common §1031 exchange scenarios that are no longer allowed are:

- Vehicle and other business equipment trade-ins, which could mean gain or loss would be reported; and
- Exchanges for art and other collectibles.

GENERAL REQUIREMENTS

Under IRC §1031, gain is not recognized if a taxpayer exchanges real property held for productive use in a trade or business or for investment (called the "relinquished property") solely for real property of a like-kind which is to be held either for productive use in a trade or business or for investment (the "replacement property").

To qualify, a taxpayer must:

- Identify the replacement property within 45 days of the date the relinquished property is sold; and
- Purchase the identified replacement property within the earlier of:
  - 180 days after the date on which the relinquished property is transferred; or
  - The due date (including extensions) for the transferor's return for the taxable year in which the relinquished property is sold.

If multiple properties are relinquished as part of an exchange and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date that any of the properties are transferred. (Treas. Regs. §1.1031(k)-1(b)(2))

If multiple replacement properties are identified within the 180-day period, the taxpayer must close on one of the properties identified during the 45-day period. The taxpayer cannot close on a different property.

Caution

If these deadlines are not met, then the like-kind exchange fails, and the gain becomes taxable.

Filing a tax return on time can make a like-kind exchange taxable. Prudent investors participating in an exchange in the fourth quarter of the year should extend the filing date of their tax return to maximize the replacement period to 180 days. A tax trap can occur by the 180 days "or, if earlier, the due date of the tax return" requirement.

Example of filing return

Joe, a calendar-year taxpayer, relinquishes his property as the first step of a like-kind exchange on December 31. Joe's 180 days end on June 29 of the next year.

Joe identifies the new property he will be purchasing on February 2, within the required 45-day period.

Joe needs his tax refund and files his return on April 15. This shortens the allowable exchange period from 180 days to 105 days.

Joe acquires the new property on April 30. Because Joe had not completed the exchange by April 15, his gain is taxable. Had he filed an extension and waited to file his return until the exchange was complete, his gain would have been deferred.

REVERSE EXCHANGES

In a reverse like-kind exchange, the replacement property is acquired before the relinquished property is transferred. This type of exchange is also known as a "reverse ***Starker***" exchange after an early court case. The regulations that provide the rules for deferred like-kind exchanges (see page 2-20) do not apply to reverse like-kind exchanges, but they do not prohibit reverse like-kind exchanges.

A reverse exchange typically uses an intermediary to hold title to the replacement property before the relinquished property is transferred to the intermediary in exchange for the replacement property (also referred to as "qualified exchange accommodation arrangements"). Another party then purchases the relinquished property from the intermediary. The intermediary, or "accommodation party," is treated as the owner of the replacement or relinquished property for federal income tax purposes.

Revenue Procedure 2000-37 contains safe harbor rules that allow these transactions with an intermediary to qualify as like-kind exchanges.

EXPLICITLY NONQUALIFYING PROPERTY

Deferral is not available for exchanges involving:

- Property held primarily for sale; or
- Foreign property.
  (IRC §1031(a)(2) and (h))

WHEN TO AVOID §1031 TREATMENT

There are circumstances in which a taxpayer may want to avoid §1031 treatment, such as when:

- The taxpayer needs cash;
- The taxpayer has an NOL carryover that may expire unused;
- The taxpayer has a charitable contribution carryover that may expire unused;
- The gain may be small in light of the extra costs and requirements for a §1031 exchange;
- The taxpayer does not plan to hold property of a like-kind exchange for very long. The principal value of utilizing IRC §1031 is the time value of money. If the time value of the money for a short holding period does not exceed the additional expenses incurred in doing an exchange, it may not be worth the process; and
- The property would be sold at a loss.

Comment

If IRC §1031 applies to a transaction, it must be applied. It is not an election. If the disposition of the property would result in a loss, the taxpayer may want to structure the transaction as a sale followed by a purchase, rather than an exchange.

Example of loss transaction

Daniel owns a rental property. He purchased it in 2008 for $770,000. As of 2024, it has an adjusted basis of $728,000 and a fair market value of $700,000.

Since he would have a loss if he sold this property, he should not do the §1031 exchange. If he did, the loss on the sale, and other loss carryovers, would be deferred into the new property.

DEFINING REAL PROPERTY FOR §1031 EXCHANGE TRANSACTIONS

Comment

We will dive into a bit of technical detail regarding the regulations here. However, for most taxpayers who own real property that has been subjected to a cost segregation study, they can breathe a sigh of relief because these regulations will allow them to treat most, if not all, of the segregated components of their property as real property for purposes of the like-kind exchange rules.

THE REGULATIONS

For purposes of applying the like-kind exchange rules under IRC §1031 and its regulations, the term "real property" includes:

- Land;
- Improvements to land;
- Unsevered natural products of land; and
- Water and air space superjacent to land.
  (Treas. Regs. §1.1031(a)-3(a)(1))

Comment

The regulations provide rules for defining real property but only for purposes of the like-kind exchange rules under IRC §1031 and its regulations. (Treas. Regs. §1.1031(a)-3(a)(6)) In other words, these rules do not apply for purposes of defining real property anywhere else within the Internal Revenue Code.

The term "improvements to land" means inherently permanent structures and the structural components of inherently permanent structures. (Treas. Regs. §1.1031(a)-3(a)(2)(i)) Further, the term "inherently permanent structures" means any building or other structure that is a distinct asset and is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time. (Treas. Regs. §1.1031(a)-3(a)(2)(ii)(A))

We will discuss the definition of "distinct asset" later.

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✐ Practice Pointer

The regulations provide a long list of inherently permanent structures that are too numerous to list here. They include in-ground swimming pools, telephone poles, gas lines, boat docks, etc. To determine whether a particular improvement upon land is an inherently permanent structure, practitioners should start by referencing Treas. Regs. §1.1031(a)-3(a)(2)(ii)(C) to determine if their property is specifically listed.

If property is not specifically listed in Treas. Regs. §1.1031(a)-3(a)(2)(ii)(C), then the determination of whether the property is an inherently permanent structure is based on the following factors:

- The manner in which the distinct asset is affixed to real property;
- Whether the distinct asset is designed to be removed or to remain in place;
- The damage that removal of the distinct asset would cause to the item or to the real property to which it is affixed;
- Any circumstances that suggest the expected period of affixation is not indefinite; and
- The time and expense required to move the distinct asset.
  (Treas. Regs. §1.1031(a)-3(a)(2)(ii)(C)(1)–(5))

Machinery

Machinery and equipment are generally not inherently permanent structures and not real property for purposes of the like-kind exchange rules. (Treas. Regs. §1.1031(a)-3(a)(2)(ii)(D)) However, if a building or inherently permanent structure includes property in the nature of machinery or equipment as a structural component, then the machinery is defined as real property if it serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of the space.

Example of machinery defined as real property

Miranda owns a two-story rental building in an area that contains many senior citizen renters. In order to attract more tenants, she installs a chair lift on the staircase to her rental property.

A chair lift is a piece of machinery, but it serves the permanent structure of the building and contributes to the use or occupancy of the rental property. As such, if Miranda were to relinquish her rental property in a like-kind exchange, then the chair lift is deemed to be part of the real property.

✐ Practice Pointer

Similar to the definition of "inherently permanent structure," the regulations provide a long list of structural components that are too numerous to list here. They include walls, partitions, elevators, floors, HVAC systems, etc. To determine whether a particular piece of machinery is part of a structural component, practitioners should start by referencing Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B).

If property is not specifically listed in Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B), then the determination of whether the component is a structural component is based on the following factors:

- The manner, time, and expense of installing and removing the component;
- Whether the component is designed to be moved;
- The damage that removal of the component would cause to the item or to the inherently permanent structure to which it is affixed; and
- Whether the component is installed during construction of the inherently permanent structure. (Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B)(1)–(4))

Unsevered natural products

Unsevered natural products of land, including growing crops, plants, timber, mines, wells, and other natural deposits, generally are treated as real property. (Treas. Regs. §1.1031(a)-3(a)(3)) Natural products and deposits stop being real property when they are severed, extracted, or removed from the land.

Distinct assets

A distinct asset must be analyzed separately from all other assets to which it relates to determine if the asset is real property (land, an inherently permanent structure, or a structural component of an inherently permanent structure). (Treas. Regs. §1.1031(a)-3(a)(4)) Buildings and other inherently permanent structures are distinct assets unto themselves. Additionally, an asset that is listed as a structural component under Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B) (walls, doors, HVAC systems, elevators, etc.) are also treated as distinct assts.

If an asset is not automatically determined to be a distinct asset because it is not a building, an inherently permanent structure, or specifically listed in Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B), then the following factors must be taken into account to determine whether the asset is a distinct asset:

- Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
- Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
- Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
- Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.
  (Treas. Regs. §1.1031(a)-3(a)(4)(ii)(A)–(D))

Comment

If a portion of the relinquished or replacement property is not real property, the exchange is treated as an exchange of both like-kind and non–like-kind property. The portion of the sales price allocable to the non–like-kind property is treated as a taxable sale.

Intangible assets

To the extent that an intangible asset derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of the property, the intangible asset is deemed to be real property for purposes of the like-kind exchange rules under IRC §1031 and its regulations. (Treas. Regs. §1.1031(a)-3(a)(5))

WHAT IS BUSINESS OR INVESTMENT PROPERTY?

Property that is not held for productive use in a trade or business cannot be either the relinquished property or the replacement property in an exchange. Issues arise regarding property held primarily for sale and when home offices, vacation homes, and property adjoining a residence are involved.

Property held for productive use in a trade or business may be exchanged for property held for investment and vice versa. (Treas. Regs. §1.1031(a)-1(a))

Primarily for sale

Stock in trade or other property held primarily for sale is specifically excluded from nonrecognition treatment. (IRC §1031(a)(2)(A))

In the context of real estate, this has sometimes led to the conclusion that a dealer cannot make tax-deferred exchanges. However, a taxpayer may be a dealer with respect to some properties and an investor with respect to others. Thus, the analysis must focus on the taxpayer's intent with respect to each specific property.

Personal residential properties

Exchanges involving a personal residence, second home, vacation home, or home office raise issues concerning the extent to which such properties qualify as relinquished or replacement properties. Clearly, though, such properties qualify only to the extent of the portions of the property held for productive use in a trade or business.

A taxpayer is deemed to use a dwelling unit as a residence if such unit is used for personal purposes for a number of days which exceeds the greater of:

- 14 days; or
- 10% of the number of days of the tax year for which the unit is rented at a fair rental. (IRC §280A(d))

Use by family members or any use without a fair rental is considered personal use. Neither a vacation home nor a second residence qualifies as investment property.

Conversion of replacement property to residential

If the taxpayer has personal-use residential property with significant built-in gain, the taxpayer might consider converting the use of the property to business property for a significant period and then exchanging the property for investment property. This would generally mean renting the property while following the IRC §280A limitations on personal use.

Unfortunately, there is no bright line test for "significant period."

The determination is made based on the intent of the taxpayer to use the property for qualifying purposes at the time of the exchange, and such intent is a question of fact for which the taxpayer bears the burden of proof. (***Bolker v. Comm.*** (1983) 81 TC 782; ***Click v. Comm.*** (1982) 78 TC 225))

Also see "Intent was to use replacement property as personal residence" on page 2-17.

IRC §§1031 and 121 on same sale

Revenue Procedure 2005-14 provides guidance as to when a homeowner may benefit from both the IRC §121 home-sale exclusion and a §1031 like-kind deferral. In these cases, the property must have been used consecutively or concurrently as a home and a business.

A taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the two-year use requirement if the residential and business portions of the property are within the same dwelling unit. (Treas. Regs. §1.121-1(e))

Computation of gain

For exchanges meeting the requirements of both IRC §§121 and 1031:

- **Apply sale-of-home rules before like-kind exchange rules:** The IRC §121 exclusion must be applied to the gain from the exchange before the application of IRC §1031 (amounts equivalent to boot that would result in gain recognition absent the application of IRC §121) (Rev. Proc. 2005-14, §4.02(1));
- **Depreciation recapture:** The IRC §121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. (IRC §121(d)(6)) However, IRC §1031 may apply to such gain (Rev. Proc. 2005-14, §4.02(2));
- **Treatment of boot:** In applying IRC §1031, cash or other non–like-kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property) is taken into account only to the extent the boot exceeds the gain excluded under IRC §121 with respect to the relinquished business property (Rev. Proc. 2005-14, §4.02(3)); and
- **Computation of basis:** In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under IRC §121 is treated as gain recognized by the taxpayer. Thus, under IRC §1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under IRC §121. (Rev. Proc. 2005-14, §4.03)

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Example of principal residence converted to rental

Anne buys a house for $210,000 that she uses as her principal residence from 2014 to 2022. From 2022 until 2024, Anne rents the house to tenants and claims depreciation deductions of $12,000 for the entire period.

In 2024, Anne exchanges the house, which has a FMV of $470,000 for $10,000 cash and a townhouse with a FMV of $460,000 that she intends to rent to tenants. Anne realizes gain of $272,000 on the exchange.

Amount realized	$470,000
Less adjusted basis ($210,000 – $12,000)	198,000
Realized gain ($470,000 – $198,000 basis)	272,000
Less gain excluded under IRC §121	250,000
Gain to be deferred under IRC §1031	$ 22,000

Because Anne owned and used the house as her principal residence for at least two years during the five-year period prior to the exchange, she may exclude gain under IRC §121. Because the house is investment property at the time of the exchange, she may also defer gain under IRC §1031.

Anne first applies IRC §121 to exclude $250,000 of the $272,000 gain before applying the nonrecognition rules of IRC §1031. Anne may additionally defer the remaining gain of $22,000, including the $12,000 gain attributable to depreciation under IRC §1031.

Although she receives $10,000 of cash (boot) in the exchange, Anne is not required to recognize gain on the $10,000 because the boot did not exceed the $250,000 exclusion amount.

WHAT IS LIKE-KIND?

Both the relinquished property and the replacement property must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character, or class. Quality or grade does not matter. (Treas. Regs. §1031(a)-1)

REAL PROPERTY

Most real property is like-kind to other real property. For example, the fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. (Treas. Regs. §1.1031(a)-1(b))

Leasehold interests

The regulations provide that a leasehold interest in real property with "30 years or more to run" may qualify as exchange property with a fee interest. (Treas. Regs. §1.1031(a)-1(c))

A leasehold interest in real property with a motel and a remaining term of 21 years was not considered like-kind with respect to ownership in two other real properties. (***VIP's Industries v. Comm.***, TCM 2013-157) However, the Tax Court stated that it wasn't deciding whether the 30-year rule in the regulations excludes all exchanges of leaseholds with terms of less than 30 years.

Caution

The courts have been inconsistent in ruling whether the 30-year leasehold term is a requirement or a safe harbor. (See ***Peabody Natural Resources v. Comm.*** (2006) 126 T.C. 261; ***Capri Inc. v. Comm.*** (1975) 65 T.C. 162) The prudent taxpayer may want to err on the side of caution.

Fractional interests

Individuals may exchange fractional interests in property but must be careful not to run afoul of the prohibition against exchanging partnership interests. In determining whether an interest in property is a partnership interest, federal tax law, not state law, is controlling.

Partnership interest under federal law

The distinction between co-ownership and a *de facto* partnership turns on the intent of the parties and the extent to which they conduct a joint business. Treas. Regs. §301.7701-1(a)(2) provides:

"A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. … Mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes."

The IRS has concluded that the ownership and operation of an apartment project does not constitute an active business so long as the owner furnishes only "customary" tenant services. (Rev. Rul. 73-374) Those services include the provision of heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas. In a separate ruling, the IRS indicated that the owner of an apartment building may arrange for the provision of laundry equipment and services by a third party and receive a fee based on a percentage of the gross laundry income without actively engaging in business. (PLR 8117040)

IRS issues guidelines

Although explicitly not a safe harbor, the IRS issued guidelines to help resolve the uncertainty regarding whether tenancy-in-common interests would be classified as partnership interests specifically with regard to like-kind exchanges. (Rev. Proc. 2002-22) In addition, the revenue procedure details guidelines for requesting private rulings of whether tenancy-in-common interests in real property will constitute partnership interests ineligible for §1031 exchanges.

According to the IRS, these guidelines are merely to assist taxpayers in preparing their requests for rulings, and the guidelines should not be taken as substantive rules or requirements. The IRS makes clear that even if all of the guidelines are satisfied in a request by a taxpayer for a private ruling, the IRS might still refuse to issue such ruling depending on the facts of the case. Nevertheless, tax practitioners have come to see the guidelines as a "safe harbor" for tenancy-in-common interests in like-kind exchanges.

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There are 15 specific guidelines. The key guidelines are:

- Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant-in-common under local law;
- There can be no more than 35 co-owners. A husband and wife are treated as a single person as are all persons who acquire interests from a co-owner by inheritance;
- The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any co-owner as a partner, or otherwise hold itself as a business entity;
- Unanimous decisions are required on any material matter; and
- All co-owners must share in all revenues generated by the property and all costs associated with the property *pro rata* based on their respective tenant-in-common interests.

Transferable development rights are like-kind to real property

The IRS determined that transferable development rights (TDRs) were like-kind to real property sold by a taxpayer and therefore qualified as a replacement property in a §1031 like-kind exchange. (PLR 202335002)

A transfer of development rights program allows landowners to sell development rights from their land to a developer that can use the rights to increase the density of development at another designated location. The seller of development rights still owns the land and can continue using it. However, an easement is placed on the land that prevents further development.

The taxpayer was approved to purchase TDRs from a city program to develop property into a public park. The taxpayer planned to sell one of its properties and acquire the TDRs in a reverse like-kind exchange. (A "reverse" exchange occurs when the taxpayer acquires the replacement property before transferring the relinquished property.) The TDRs would be used to increase the floor area at a second property already owned by the taxpayer beyond an amount permitted under zoning regulations.

Analysis of TDRs

Land development rights are real property for purposes of IRC §1031 (Treas. Regs. §1.1031(a)-3(a)(5)(i)), and TDRs are considered real property under the laws of the state where the taxpayer's properties were located.

The IRS likened the transaction to one described in Revenue Ruling 68-394, in which a taxpayer used part of the proceeds from land condemned for a state freeway to purchase the outstanding 45-year leasehold on adjacent land that the taxpayer owned but had leased to a second party to develop as a mobile home park.

Because the exchange of a fee interest in real property for a leasehold interest in real property with 30 years or more to run qualifies as a like-kind exchange (see Treas. Regs. §1.1031(a)-1(c)), Revenue Ruling 68-394 held that the acquisition of a 30-year or longer leasehold interest following the condemnation of unimproved real estate would also qualify as replacement property of like-kind, even though the leasehold interest was on property already owned by the taxpayer.

Therefore, in the PLR, the IRS held that the TDRs qualify as like-kind to the property the taxpayer sold for purposes of §1031, notwithstanding that the taxpayer intends to use the TDRs on land owned by the taxpayer prior to the acquisition of the TDRs.

Partnership interests

Partnership interests are explicitly nonqualifying for like-kind exchange treatment. On the other hand, there is no doubt that the partnership itself can engage in a qualifying like-kind exchange. However, as discussed below, there is a lot of gray area between these two types of exchanges.

DROP AND SWAP

A common issue that arises involves partnerships when some partners wish to engage in an exchange and others don't. One possible solution is the "drop and swap." In that scenario, the partnership distributes the property to the partners as tenants-in-common (the drop), where some partners can then exchange their tenancy-in-common interest in the property while others may cash out.

While drop and swap transactions are commonly used, the IRS will attack the strategy on two fronts:

1. **Step transaction:** The IRS may determine that the arrangement was designed solely to avoid taxation and disallow the exchange; and
2. **Investment:** They will assess whether the property is held long enough to be treated as an investment (see the upcoming discussion, "What does 'held' mean?").

How to accomplish the drop and swap

To accomplish the drop and swap, the entity converts the partnership interests to tenants-in-common interests by distributing the property to the partners. With title placed in the name of the individual investors, rather than the partnership, each investor is free to either "cash out" or make a like-kind exchange of their own using the equity obtained from the original property as payment.

Under Revenue Procedure 2002-22, the partnership may file an IRC §761(a) election, notifying the IRS that the property owners choose not to be taxed as a partnership.

The IRS considers an interest in a real estate partnership that has made an IRC §761(a) election (a "761 partnership") to be like-kind to an interest in real property because the election results in the partnership being disregarded for tax purposes. Once this election is made, the partners are considered to directly own *pro rata* interests in the property of the partnership.

✐ **Practice Pointer**

This is a transaction that requires advanced planning, as the investors must hold the property as tenants-in-common long enough to meet the "held for investment" criteria. There is no specific time period, but it is generally a minimum of two years — or more aggressively — a year and a day.

SWAP AND DROP

A partnership may do the reverse and make the exchange and then after waiting "long enough" elect out of the partnership treatment so as to avoid the step transaction treatment, drop title to the individual partners, or refinance the new property to acquire cash to redeem the partner(s) wanting to leave.

In PLR 200521002, the IRS indicated that a post-exchange distribution may occur relatively soon after the exchange without destroying the tax shield.

✐ **Practice Pointer**

These transactions are extremely complex and are frequently targeted for audit. We recommend the use of a tax attorney specializing in real estate to construct these types of transactions.

CASES

Transfer to LLC

The California State Board of Equalization unanimously held that an exchange of numerous taxpayers' interests in an apartment building for an ownership interest in a shopping mall and surrounding property was a valid like-kind exchange, even though the owners subsequently transferred the property to an LLC. The case involved a "swap and drop" transaction. (***Appeal of Rago Development Corp., et al.*** (June 23, 2015) 2015-SBE-001) The Board ruled that there was no question that the replacement property was held for investment purposes because all of the owners (at least those who were still alive) held on to their same interests in the LLCs for over 12 years after the initial exchange.

The replacement property, which consisted of four parcels in total, was initially held as a tenancy-in-common for seven months, during which period the taxpayers entered into leasing agreements, procured insurance, and underwent repair and remodeling activities. All of this demonstrated that the taxpayers incurred substantial economic risk during this seven-month period.

They claimed that under long-standing federal case rulings, the subsequent transfer of their interests in the real property to an LLC should not negate their like-kind exchange and deferment of gain under IRC §1031. (***Magneson v. Comm.*** (1985) 753 F.2d 1490; ***Maloney v. Comm.*** (1989) 93 TC 89); ***Bolker v. Comm.*** (Ninth Cir. 1985) 760 F.2d 1039; ***Wagensen v. Comm.*** (1980) 74 TC 653)

The FTB argued that a provision in the loan document for two of the four replacement parcels called for taxpayers to reorganize their tenancy-in-common interests into a single-asset entity within approximately seven months of acquiring the property.

However, the taxpayers countered that this did not negate their intent to hold the property for investment. Only two of the four loan documents contained the provision calling for the transfer of the property to the LLC, yet all four parcels were transferred to the newly formed LLC, and the taxpayers were not legally obligated to make the transfer.

In addition, for the seven months prior to the transfer, they negotiated leases, signed management contracts, entered into operating agreements, paid property taxes, acquired property and liability insurance, and filed federal and state returns as members of a tenancy-in-common. Therefore, the doctrine did not apply because the taxpayers bore a risk of economic change during this seven-month period, a period that was far longer than other cases in which courts have found the step-doctrine inapplicable.

The taxpayers successfully argued that under long-standing federal case law, there is no required holding period for replacement property, and "as long as taxpayers continue to hold replacement property for investment, a change in the mechanism of ownership that does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under IRC §1031."

Exchange with partnership

The California Office of Tax Appeals (OTA) held that a taxpayer properly received §1031 exchange treatment where immediately before the exchange the taxpayer received a distribution of the relinquished property from a general partnership, followed by an exchange of the distributed property into a replacement property. (***Appeal of Mitchell***, 2020-OTA-000.5, petition for rehearing denied 2020-0TA-001)

The decision is not precedential but is a major victory for California taxpayers that want to do "drop and swap" exchanges from partnerships and limited liability companies. Keep in mind, the ***Mitchell*** decision would apply only for California income tax purposes. The IRS is not bound to follow its precedent for federal taxes (although the reasoning in ***Mitchell*** may prove a persuasive argument to the IRS).

USING A DELAWARE STATUTORY TRUST (DST) AS PART OF AN EXCHANGE

It can be difficult for our clients to execute a successful §1031 like-kind exchange. Frequently taxpayers are unable to comply with the 45-day identification period and/or the 180-day closing period, not to mention the myriad other requirements.

That's why for many of our clients, the tenants-in-common §1031 exchange ("TIC §1031 exchange") became an attractive alternative in the 1990s and 2000s. However, although the IRS recognized the validity of TIC §1031 exchanges as long as certain conditions were satisfied, it is frequently difficult to obtain financing for such ventures. (Rev. Proc. 2002-22; PLR 201622008) An alternative to the TIC §1031 exchange is the Delaware statutory trust §1031 exchange ("DST §1031 exchange").

What is a DST?

DSTs are a form of business trust, which is essentially an unincorporated corporation. DSTs are formed as private governing agreements under which either:

- Property (real, tangible, and intangible) is held, managed, administered, invested, and/or operated; or
- Business or professional activities for profit are carried on by one or more trustees for the benefit of the trustor entitled to a beneficial interest in the trust property.
  (Tit. 12 Del. Code §3801)

Although a DST is formed in Delaware, it can operate anywhere. Other states also have enacted similar statutory business trust provisions, but the DST is by far the most popular. California recognizes business trusts, but it does not authorize the formation of business trusts by statute.

For DSTs holding real property, beneficiary-investors purchase interests in the DST, which holds title to property and guarantees the mortgage loan. Investment in the real estate is shared among many investors. Because the beneficiaries of the trust are considered the owners of the trust property, the DST does not run afoul of the §1031 partnership interest prohibition discussed above. Therefore, investing in a DST that holds real property will qualify as a replacement property in a like-kind exchange involving the sale of real property.

DST properties tend to be institutional grade commercial properties, e.g., apartment communities, office buildings, retail buildings, or shopping centers, thereby allowing the mom-and-pop investor to play with the big boys. An individual exchanging a house, condominium, small office/retail building

would not have funds to purchase such high-quality commercial properties without sharing the investment with other investors.

The DST has proven to be far more successful in terms of obtaining financing, making it the option of choice for many investors looking to make a §1031 exchange. Again, the IRS has recognized the validity of these transactions but has laid down very strict criteria as to what transactions will qualify. These criteria are laid out in Revenue Ruling 2004-86.

Two years after the IRS issued Revenue Procedure 2002-22 addressing TIC §1031 exchanges, the IRS also sanctioned the use of DST 1031s in Revenue Ruling 2004-86 as long as the DST does not violate specified prohibitions, commonly referred to as the "seven deadly sins." These prohibit the DST from the following activities:

1. Entering into new leases or renegotiating current leases;
2. Making additional capital contributions;
3. Renegotiating the current loan or obtaining a new loan;
4. Reinvesting the proceeds from any sale;
5. Capital expenditures beyond normal maintenance items;
6. Investing cash between distribution dates in anything other than short-term securities; and
7. Failing to distribute cash to the owners, other than required reserves.

To avoid the seven deadly sins and to make the venture more attractive, commercial leases involving DSTs usually have the trustee enter into a master lease agreement with a core tenant that then sublets the building or building units. The DST is the entity that obtains the financing, which makes this more attractive to lenders as they do not have to approve all the individual tenants-in-common owners for the mortgage.

Additionally, large reserves are put aside at the initial offering so that additional loans or financing are not required to cover additional costs. The properties invested in tend to be newer or recently remodeled so that large expenditures beyond normal maintenance are not required.

Pros and cons of TIC and DST §1031 exchanges

The following chart provides an overview of the advantages and disadvantages of TIC and DST §1031 exchanges.

Comparison of DST and TIC §1031 Exchanges		
	DST structure	**TIC structure**
IRS guidance	Rev. Rul. 2004-86	Rev. Proc. 2002-22
Number of investors	Unlimited, thereby making investments in larger properties more plausible	Unlimited (but if more than 35, then the tenancy-in-common interest is not deemed to be an interest in real property and is ineligible for §1031 exchange treatment)
Ownership	Percentage of beneficial ownership DST that owns real property	Undivided tenant-in-common interest in real property
Investors receive property deed	No	Yes
Investors form single member LLCs	One (the DST). Makes financing much more attractive to lenders	Each tenancy-in-common owner can form their own single member LLC to hold their interest
Major decisions regarding property	No voting rights. Trustee makes all decisions. Not appropriate for those who like more hands-on involvement	Equal voting rights and unanimous approval required. Essentially gives one tenant the veto power over all decisions
Number of borrowers	One (the DST). Makes financing much more attractive to lenders	Unlimited
Liability for DST obligations	None	Yes, unless a single member LLC is formed. If formed, California taxpayers must pay, at a minimum, $800 annual tax, not to mention the costs to establish the single member LLC
QBI	No	Maybe

WHAT DOES "HELD" MEAN?

IRC §1031 requires that property involved in an exchange be held for productive use in a trade or business or as an investment. Disputes have arisen between taxpayers and the IRS over the word "held" particularly when the replacement property is converted to personal use at the time of the exchange or thereafter.

There is no requirement that the replacement property or the relinquished property be held for any particular length of time, except in the case of related parties between exchanges and exchanges for the vacation home safe harbor. It is the taxpayer's intent at the time of the exchange that is controlling.

Because intent can only be derived based on facts and circumstances, the holding requirement has been the subject of much litigation.

"PRODUCTIVE USE" IN §1031 EXCHANGES

In two Chief Counsel Advice memorandums issued on consecutive days, the IRS dealt with the issue of "held for productive use in a trade or business or for investment" under IRC §1031.

CCA 201601011 stated that it is not appropriate to apply the hobby loss provisions under IRC §183 to determine whether a property is held for productive use in a trade or business for exchange purposes. Many businesses hold and use properties in a way that, if the use of that property were viewed as an activity, would not and could not generate profit. Nevertheless, the property itself is held for productive use in that business. As a result, a partnership's lack of intent to make an economic profit on an aircraft rental did not establish that the aircraft fails the productive use in a trade or business standard of IRC §1031.

Comment

Even though the property at issue in CCA 201601011 was not real estate (it was an aircraft), the analysis is still relevant because the "productive use" requirement still applies.

CCA 201605017 stated that some personal use of both the relinquished property and the replacement property in an exchange is permitted. The CCA concluded that if the examining agent determines that personal use was over 50%, then the Chief Counsel would agree that the relinquished property was not held for productive use in a trade or business. However, the productive use test is "intensely factual," and the CCA was emphatic that there is no general 50% personal use threshold.

INTENT WAS TO USE REPLACEMENT PROPERTY AS PERSONAL RESIDENCE

The productive use or investment requirement wasn't satisfied where the taxpayers moved into the replacement property two months after acquiring the property, and that move wasn't merely temporary until renters for the property could be found. (***Goolsby v. Comm.***, TCM 2010-64)

The acquisition of the replacement property was contingent on the sale of the taxpayers' former home. Before the exchange, the taxpayers' interactions with the qualified intermediary (QI) indicated that they were considering moving into the replacement property. The taxpayers began preparations for finishing the basement of the replacement property within two weeks of acquiring the replacement property. Also, before the exchange, the taxpayers failed to investigate the rental market or even look into whether the homeowners association allowed rentals, and made only minimal efforts (i.e., placed an advertisement in a neighborhood newspaper) to find a tenant after the exchange.

PERSONAL RESIDENCE, NOT B&B

Where taxpayers didn't prove that they intended to use a residence (the replacement property) received in an exchange as a "bed and breakfast," the productive use or investment requirement wasn't satisfied. (***Yates v. Comm.***, TCM 2013-28)

The evidence that supported the taxpayer's position included their own self-serving testimony and a provision in the contract that requested that the seller apply to the appropriate town board for permission to use the property as a bed and breakfast. However, there was no evidence that the seller ever made the request or that the taxpayers even inquired whether the request was made.

Furthermore, the sale was not explicitly conditioned upon the sellers successfully securing consent to use the replacement property as a bed and breakfast. The Tax Court characterized the provision in the contract as nothing more than a trivial addition inserted into the contract for the purpose of securing the taxpayers' nonrecognition treatment of the exchange. The fact that the taxpayers moved into the replacement property within four days of the closing and continued to live in the property created a clear presumption of nonbusiness intent.

TAXPAYERS DEFER GAIN ON PROPERTY THEY MOVED INTO

In this case, which includes a bit of family in-fighting, reality-TV-style, taxpayers were allowed to defer the gain on rental property even though they never rented, and in fact, moved into the newly acquired property. (***Reesink v. Comm.***, TCM 2012-118)

As the court noted, "In 1985 brothers Patrick and Michael Reesink purchased a six-unit apartment building (apartment building) on 38th Avenue, San Francisco, California, from their parents. Each acquired a 50% tenancy-in-common ownership interest in the building. And that concludes our record of civil behavior between the two brothers."

Various accusations arose between the brothers, including theft, attempted strangulation, and an attempt at poisoning "by pouring cleaning fluid into his drinking water," which resulted in Patrick suing Michael.

Pursuant to the settlement agreement, the brothers agreed to sell the apartment building and divide the net proceeds equally. In addition, the agreement instructed Michael to pay $60,000 from the proceeds to Patrick.

Property never rented

Patrick and Jill Reesink lived in the home they owned in San Francisco. Patrick and Jill used the proceeds from the sale of the apartment building to purchase a single-family residence in Guerneville, California (the Laurel Lane property), and treated the sale and purchase as a like-kind exchange. They posted flyers around town and posted signs on the property advertising the home for rent.

On a realtor's advice, they sought $3,000 per month. Potential renters visited the property but ultimately declined to rent it because it exceeded their budget. The Reesinks never lowered their monthly asking price nor found tenants for the property.

Patrick was disabled and Jill had never worked. With looming expenses and liabilities, they believed they had no choice but to sell their San Francisco residence because they needed the cash. After the sale, they moved into the Laurel Lane property.

The Reesinks engaged in extensive advertising efforts, showed the home to potential renters, and waited almost eight months before moving in. The court found the Reesinks' testimony credible. Richard Reesink, Patrick and Michael's brother, also testified that the Reesinks didn't intend to leave their personal residence until after the children finished high school, which they hadn't done at the time that they moved to the home.

Agreeing that the Reesinks had investment intent at the time of the exchange, the court allowed nonrecognition treatment.

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FAIR RENT MAKES §1031 EXCHANGE OK

A §1031 like-kind exchange was allowed when a taxpayer/property owner rented a house to his son at "fair rental value." (***Adams v. Comm.***, TCM 2013-7)

The taxpayer bought a house in San Francisco in 1963, lived in it for a number of years, and then rented it out for a number of years. He sold it in 2004 for $572,000, at which time he found a like-kind replacement property in Eureka, California, near where the taxpayer's son lived.

The IRS ruled that the exchange did not qualify under IRC §1031 because it was acquired for personal purposes (i.e., renting to family), but the Tax Court overruled, stating that the $1,200 per month was a fair rental value, especially since the son and his family did substantial repairs and renovations to the house.

TAXPAYER DIDN'T OWN THE PROPERTY

The ***Stringer*** case before the California Board of Equalization involved an attempted $3 million §1031 exchange in which the appellants never actually owned the relinquished property. (***Appeal of Scott L. Stringer and Irene Stringer*** (January 17, 2013) Cal. St. Bd. of Equal., Case No. 609814)

Stringer was a property developer, with the Board referring to him as an expert in the land entitlement process (the legal method of obtaining approvals for the right to develop property for a particular use).

The property at the heart of the case evolved through a series of events involving several other parties. They were "events" in the sense that three parcels of land were acquired, combined, and then carved into two parcels, with both owned by other parties working together with Stringer. One of the parcels was sold, with $3,677,435 of the sales price allocated to Stringer by the seller. He reported $677,435 as taxable income and asked the seller to retain $3 million, which was then used to purchase another property, thereby supposedly completing the exchange.

The FTB's contention was that the entire $3,677,435 represented taxable compensation to Stringer for his services and expertise in helping expedite the overall deal. Due to the terms of the deal, the Board found that Stringer never actually owned an interest in the property in question, but merely possessed an interest in the contractual and potential negotiating opportunities to buy the underlying parcel, stating that the option to acquire property does not equal ownership interest in the underlying property.

Stringer tried to support his case with the following example: A horse trainer is given a horse as a $10 payment for work done, trains the horse to increase its value, the horse wins the Kentucky Derby, and the horse is sold for $1,000,010, with the $1 million proceeds put into a like-kind exchange for another horse. He claimed the trainer, in the end, received $10 in ordinary income and another $1 million in deferred gain, which, he also claimed, was analogous to his fact pattern. The Board was unmoved by this homespun example, pointing out a huge hole in the analogy — the horse trainer actually owned the horse he exchanged.

Bottom line: One cannot execute a §1031 exchange with property one does not own.

DEFERRED EXCHANGES

The vast majority of like-kind exchanges are deferred exchanges, where a taxpayer sells one property and then acquires a replacement property (or properties) within 180 days. The 45-day identification and 180-day purchase rules are discussed on page 2-2.

Comment

Deferred exchanges are a hot audit target for both the IRS and California Franchise Tax Board. The audits focus on all aspects of the exchange, including the technical aspects of the exchange and the tax aspects. The technical aspects of the exchange are the duty of the exchange accommodator, such as whether written identification of replacement properties was made within prescribed time frames, etc.

It's good practice for tax professionals to request copies of all contracts and other documentation between the taxpayer and the accommodator. Keeping these documents in a file will help the practitioner respond to an audit more quickly and easily.

PENALTY FOR NONCOMPLIANCE WITH 45- AND 180-DAY RULE

If the 45- and 180-day rules are not strictly followed, any property received outside the dates is considered "not-like-kind" property. Therefore, the tax-free transaction is deemed a taxable sale and a subsequent purchase. (Treas. Regs. §1.1031(k)-1(a))

Once the old property is conveyed, the period for identifying the replacement property ends exactly 45 days later, and the period for receiving the property ends exactly 180 days later — no extensions are available.

✐ **Practice Pointer**

Note that there is an extension for postponements for certain taxpayers affected by Presidentially declared disasters or a military or a terrorist action, or certain taxpayers serving in combat zones and contingency operations. (IRC §7508A) Also see Revenue Procedure 2018-58.

There is no exception for a taxpayer who identifies a replacement property that becomes unavailable after the 45 days.

Example of losing property

Jason transfers his property to an accommodator on February 1. He properly identifies a replacement property on March 1. However, the replacement property burns down on April 1, and Jason is unable to complete the exchange.

Jason may not replace this property with a new property. Although the property was subject to a casualty loss, it was not destroyed as part of a Presidentially declared disaster.

HOW TO IDENTIFY THE REPLACEMENT PROPERTY

The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight 45 days after. (Treas. Regs. §1.1031(k)-1(b)(2)(i))

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MUST BE IN WRITING

The property must be designated as replacement property in writing, signed, and delivered to the person obligated to transfer the replacement property or to any other person involved in the exchange (other than the taxpayer or a "disqualified person"). In other words, the document can be delivered to any of the other parties to the exchange, an accommodator, an escrow agent, or a title company. A document signed by all parties prior to the end of the 45 days is also sufficient. (Treas. Regs. §1.1031(k)-1(c)(2))

A taxpayer can cancel an identification of replacement property at any time before the end of the 45-day identification period.

Practice Pointer

If the replacement property is purchased within 45 days of the sale of the relinquished property, then the 45-day identification period is automatically met. A written declaration of the replacement property is not necessary. (Treas. Regs. §1.1031(k)1-(c)(4)(ii))

Inability to find property is not an excuse

A taxpayer deposited the gross proceeds of the sale of her condominium with an accommodator, intending to purchase other property in a like-kind §1031 exchange. On October 30, 2001 (101 days later), she notified the qualified intermediary that she was unable to complete the exchange because the replacement properties had been sold to other parties and requested release of the funds. The court ruled the taxpayer had a taxable sale (or exchange) because she violated the 45-day rule. (***Stewart v. Comm.***, TCS 2006-37)

Practice Pointer

Taxpayers may want to consider postponing the sale of the relinquished property until they have identified and are in escrow on the replacement property. Many realtors advise clients to do this so that they don't lose out on the deferment if they are unable to meet these timing requirements. Given how tight the current market is in some areas, if sellers/purchasers can work around the timelines, it can prevent the cost of a failed exchange.

REPLACEMENT PROPERTY VALUES IN §1031 EXCHANGES

When executing a §1031 exchange, failing to find replacement property in time or identifying too many replacement properties or properties above a certain value will void the exchange, and the gain will be taxable.

Replacement values

A taxpayer can identify more than one replacement property, but there are rules regarding the number and the total value of those replacement properties.

Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is:

- Three properties without regard to the fair market values of the properties (the "three-property rule") (Treas. Regs. §1.1031(k)-1(c)(4)(i)(A)); or
- Any number of properties as long as their aggregate fair market value as of the end of the 45-day identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200% rule"). (Treas. Regs. §1.1031(k)-1(c)(4)(i)(B))

Named replacement value too high

In one case, taxpayers' exchange transaction failed because the FMV of the replacement properties violated the 200% value requirement. (***Appeal of Jinks*** (March 25, 2014) Cal. St. Bd. of Equal., Case No. 614126)

The taxpayers timely identified replacement properties within the 45-day period; however, the relinquished property was sold for $6.5 million, and the replacement properties (five, in total) were valued collectively at $17.4 million. One day after the 45-day period ended, the taxpayer submitted a revocation of two of the properties. The taxpayers argued that the FTB had arbitrarily placed values on the five properties to determine that the 200% rule had been violated but did not provide evidence of alternative FMVs.

Note: If the taxpayers had initially only identified three properties, the whole issue of FMV would not have come into play, but because they identified five, they were subject to the 200% limitation.

Caution

Stick to the three-property rule and avoid the 200% rule if possible because the fair market value of the replacement properties isn't likely to be known or easily proved (for example, offering prices may be all that are available for those properties). If the IRS successfully challenges the valuation under the 200% rule, the taxpayer could lose the tax-free exchange treatment.

Exceptions

If, at the end of the statutory 45-day identification period, a taxpayer has identified more than three properties that have an aggregate fair market value that exceeds the 200% rule, the taxpayer generally is treated as if no replacement property had been identified.

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However, there are two exceptions. Even if a taxpayer has violated both the three-property rule and the 200% rule, an appropriate identification is treated as having been made with respect to:

- Any replacement property actually received by the taxpayer before the end of the 45-day identification period; and
- Any replacement property identified by the taxpayer before the end of the 45-day identification period and received before the end of the exchange period, provided the taxpayer receives property amounting to at least 95% of the aggregate fair market value of all identified replacement properties before the end of the exchange period. This is known as the "95% rule." For this purpose, the fair market value of each identified property is determined as of the earlier of:
  - The date the property is received by the taxpayer; or
  - The last day of the exchange period.

  (Treas. Regs. §1.1031(k)1-(c)(4)(ii))

Example of 95% rule

Becky exchanged a building with a FMV of $1 million. Within the 45-day period, she identified four properties with FMVs as follows:

Property 1	$ 500,000
Property 2	750,000
Property 3	1,100,000
Property 4	250,000
Total (all properties)	$2,600,000

Within the 180-day period, she closed on all four of the properties. Although the aggregate FMV of all four properties is more than 200% of the FMV of the property relinquished, the FMV of the replacement properties is greater than 95% of the value of all properties named.

Assume instead she closes only properties 1, 2, and 3. She fails the 95% rule because the FMV of the properties she received is only 90.3% of the FMV of the properties named. ($2,350,000 ÷ $2,600,000 = 90.3%)

Multiple replacement properties

Failed to meet three-property rule

A taxpayer failed to complete a §1031 exchange because she did not meet the three-property rule for identifying multiple replacement properties. (***Appeal of Saxon***, 2024-OTA-095) The taxpayer entered into an exchange for the four residential real properties that were sold, after which the taxpayer identified five properties as replacement properties and ultimately acquired two of them.

The FTB disallowed the exchange because the taxpayer had not met the requirements for identifying multiple replacement properties.

The taxpayer and the FTB agreed that the 200% rule was not met. Regarding the three-property rule, the taxpayer argued that she had entered into three separate exchanges, and she had identified five properties for all three exchanges. However, the FTB argued that the exchange paperwork (escrow agreements, Forms 8824, the exchange agreement, etc.) did not support this argument or was not present in the record. The OTA agreed that the evidence pointed to a single exchange.

Therefore, the taxpayer was required to recognize $7.4 million in capital gain income, resulting in $958,769 in additional tax and a $191,753 accuracy-related penalty.

Reduction of debt

In a precedential decision, California taxpayers were liable for tax on net debt reduction following a §1031 exchange. (***Appeal of Troublefree, LLC***, 2024-OTA-078P) In that transaction, the taxpayer sold a commercial property in 2011 and acquired three replacement properties in 2012. The taxpayer started the transaction with $4.9 million of debt on the relinquished property and ended the transaction with $3 million of debt on the replacement properties.

The taxpayer argued that the reduction in debt should reduce the basis in the replacement properties, rather than constituting taxable boot. However, if consideration received by the taxpayer includes an assumption of debt, then the assumption of debt will be treated as if it were money or other non–like-kind property. (Treas. Regs. §1.1031(b)-1(c)) Also, if proceeds from the sale of relinquished property are used to pay off the taxpayer's debt (or debt that encumbers the relinquished property), the repayment would be treated as taxable boot. (***Barker v. Comm.*** (1980) 74 T.C. 555, 572)

Pertinent to this appeal, if a taxpayer is relieved of debt on the relinquished property but acquires replacement property that is subject to debt, then the debt on the replacement property also needs to be considered. (Treas. Regs. §1.1031(b)-1(c), (d)-2, and (k)-1(j)(3)) To determine the amount of mortgage boot, any debt assumed by the buyer on the relinquished property is offset by any debt assumed by the taxpayer on the replacement property.

Therefore, the taxpayers were required to recognize the $1.9 million mortgage debt reduction in 2011.

AVOIDING CONSTRUCTIVE RECEIPT

For purposes of the like-kind exchange rules, the taxpayer is treated as receiving money or other property when the money or other property is available to them. (Treas. Regs. §1.1031(k)-1(f)(2)) Once the taxpayer is treated as receiving the money or property, a taxable transaction has occurred.

To avoid constructive receipt, the funds from the "sale" of the taxpayer's property must be held in an account:

- The terms of which restrict the taxpayer's access to the funds; and
- By an individual or entity that is not under the control of the taxpayer.

The use of a qualified intermediary (QI) to facilitate a like-kind exchange qualifies as a safe harbor only if the agreement between the taxpayer and QI expressly limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the intermediary. (Treas. Regs. §1.1031(k)-1(g)(4)(ii))

Appeal of Korman (Cal. St. Bd. of Equal., Case No. 680322) is a 2015 BOE decision in which an exchange was declared invalid because the funds held by the QI were distributed to an LLC member who threatened to sue if he was not paid out for his LLC interest. The taxpayer argued that funds were only paid out due to the QI's fear of being sued and that the exchange still went through with the remainder of the proceeds from the relinquished property. The BOE said the LLC had constructive receipt of funds.

Who can be a QI?

A QI is a person who is not the taxpayer or a disqualified party and who enters into a written agreement with the taxpayer stating that the QI will perform specified duties. The QI:

- Acquires the property to be relinquished by the taxpayer;
- Transfers the relinquished property to the "buyer";
- Acquires the replacement property from the "seller"; and
- Transfers the replacement property to the taxpayer.
  (Treas. Regs. §1.1031(k)-1(g)(4)(iii))

A disqualified party is defined as:

- A person who is the agent of the taxpayer;
- A person who is related to the taxpayer; or
- A person who is related to the taxpayer's agent.
  (Treas. Regs. §1.1031(k)-1(k)(1))

The regulations specify that a person who has been the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first relinquished property is treated as an agent of the taxpayer. (Treas. Regs. §1.1031(k)-1(k)(2))

> ***Comment***
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> Based on the above, a tax professional cannot be their client's QI.

In addition, the general rules of agency apply, and the IRS has looked to the following factors to determine agency:

- The agent is operating in the name of the principal and on the principal's behalf;
- The agent has the power to bind the principal;
- The agent transmits money received to the principal; and
- The receipt of income is attributable to the services of the principal and the principal's employees, and to the principal's assets.
  (PLRs 200630005, 200803003, 200803014)

An individual is related to the taxpayer if the individual bears a relationship defined in IRC §267 or §707(b). However, in applying the rules of those sections, a 10% interest is disqualifying rather than the 50% described in those sections. As such, certain family members and certain entities in which the taxpayer has a direct interest of 10% or more or an indirect interest through family attribution are disqualified.

Repaying relinquished property debt in a §1031 exchange

A taxpayer who, through a qualified intermediary (QI), used proceeds from a relinquished property to pay a loan (that was secured by that property) was determined not to be in constructive receipt of the funds. (PLR 201648013) The repayment of relinquished property debt with those proceeds was treated as liability relief under the boot netting rules. (Treas. Regs. §1.031(b)-1(c))

Under IRC §1031(b), net relief of the transferor taxpayer's mortgage debt is considered boot received; when there are mortgages on both sides of the transaction, the mortgages are netted, and the difference becomes recognized gain (boot) to the party transferring the property with the larger mortgage. (Treas. Regs. §1.1031(d)-2)

The taxpayer in this situation operated a "like-kind exchange program" that followed the requirements of Revenue Procedure 2003-39, which provides that a taxpayer will not be in constructive receipt of funds from the sale of a relinquished property if the account used to hold those funds:

- Collects, holds, or disburses the proceeds from the relinquished property;
- Requires authorization from the QI to transfer funds out of the account; and
- Expressly limits the taxpayer's rights to those funds.

Revenue Procedure 2003-39 also provides that a taxpayer engaged in a like-kind exchange program is not in constructive receipt of funds from a relinquished property where an amount owed by the taxpayer to the buyer (other than a lease security deposit) is netted against the sale price of the relinquished property.

The taxpayer in this situation had a master exchange agreement that outlined such requirements. Plus, under that agreement, the transfer of a property to a buyer and the requirement to repay any outstanding loan were interdependent actions. Therefore, a property could not be transferred without the QI making a debt repayment out of the relinquished property proceeds.

CASES

Taxpayer must acquire replacement properties

A taxpayer was denied §1031 exchange treatment on the sale of three properties because he was unable to show that he had actually acquired replacement properties. (***Zurn v. Comm.***, TCM 2012-132) The taxpayer presented some documents that allegedly demonstrated he had acquired like-kind replacement properties. However, the documentation was inconsistent:

- He presented documentation of wire transfers, but the transfers appear to have never been completed;
- He also alleged to have acquired mortgages but had no proof of the mortgages; and
- He didn't report any income from the properties he allegedly acquired.

Failed §1031 exchange due to faulty escrow instructions

A taxpayer's escrow account did not expressly restrict access to and use of the funds in the account and therefore wasn't a qualified escrow account for like-kind exchange purposes. (***Crandall v. Comm.***, TCS 2011-14)

The court was not persuaded by the taxpayers' intent argument or the fact that they never actually used the proceeds in the account. The lack of required restrictive language meant that the taxpayers had constructive receipt of the funds, which is sufficient to void the nonrecognition exchange. The taxpayers had taxable gain.

Erroneous receipt of funds does not invalidate §1031 exchange

A like-kind exchange was not invalidated where a taxpayer immediately returned funds to an escrow agent who had accidentally wired him the money. (***Morton v. U.S.*** (April 27, 2011) U.S. Court of Federal Claims, Case No. 08-804C) A cofounder of the Hard Rock Cafe chain used an intermediary to exchange his company airplane under the pre-TCJA like-kind exchange rules. The intermediary inadvertently wired the funds from the sale of the plane to the taxpayer. The court disagreed with the IRS's argument that his receipt caused the exchange to be taxable. The court

noted that the taxpayer should not be punished for his agent's mistake, especially where the funds were returned immediately to the escrow account.

Lack of QI nullifies §1031 exchange

The Tax Court ruled that a taxpayer's sale and subsequent purchase of real property did not qualify as a like-kind exchange because the intermediary was not qualified. (***Blangiardo v. Comm.***, TCM 2014-110) The qualified intermediary was the taxpayer's son, an attorney. However, under Treas. Regs. §1.1031(k)-1(g)(4)(iii), family members including ancestors and lineal descendants are disqualified persons, and the regulation makes no exception based on profession.

COMPUTATION OF GAIN AND BASIS ON EXCHANGE

Gain must be recognized to the extent of cash or other boot received, and no loss from the exchange may be recognized to any extent. (IRC §1031(c))

BOOT

Boot includes the receipt of cash and non–like-kind property and the relief of liability associated with the mortgage.

Offsetting liabilities

The assumption of the taxpayer's mortgage by the acquiring party is considered boot. (IRC §1031(d)) However, if each party to a like-kind exchange assumes a liability of the other party, then liabilities are netted. (Treas. Regs. §1.1031(b)-1(c)) Generally, only the excess of liabilities transferred over liabilities assumed is boot. The liabilities relieved on the relinquished property can be offset by the liabilities taken on the replacement property.

Example of excess debt

Daryl and Jillian enter into a §1031 exchange agreement. Under the terms of the agreement, Daryl transfers a condo held for investment to Jillian. The condo has an FMV of $160,000 but is encumbered by a $40,000 mortgage. Jillian assumes the mortgage on the property as part of the transfer.

Jillian transfers a rental property that she owns to Daryl. The property transferred to Daryl has a FMV of $135,000 and is encumbered by a $15,000 mortgage. Daryl assumes the $15,000 mortgage as part of the transfer.

Mortgage assumed by Jillian	$40,000
Mortgage assumed by Daryl	($15,000)
Excess debt assumed by Jillian	$25,000

The $25,000 of excess debt assumed by Jillian is boot to Daryl.

Boot hiding in sales proceeds

Exchange expenses (closing costs such as brokerage commissions, attorney fees, and deed preparation fees) are subtracted from the consideration received to figure the amount of gain on a like-kind exchange. (Rev. Rul. 72-456) However, if the commissions would create a loss on the exchange, a deduction for a loss is disallowed. (IRC §1031(c))

Not all expenses on the escrow statements are exchange expenses. Expenses can fall into three categories:

- Cash in and cash out are ignored — examples include:
  - Deposit;
  - Cash back at close of escrow; and
  - Loan amounts.
- Income and expenses that belong on Schedules A, C, E, or F — examples include:
  - Rent prorations;
  - Tenant deposits;
  - Property tax prorations; and
  - Interest prorations; and
- Exchange expenses — examples include:
  - Escrow fees;
  - Real estate commissions;
  - Termite report; and
  - Title policies.

Example of exchange expenses

Beth exchanged a piece of raw land for a rental property. Here are details of the transaction:

	Land	**Rental Property**	**Reported On**
FMV	$100,000	$500,000	Form 8824
Cash paid into escrow		$200,000	Form 8824
Loan amount	$0	($300,000)	Form 8824
Loan origination fee		$3,000	Depreciation schedule
Real estate commission	$6,000	$0	Exchange expenses
Escrow fees	$500	$1,000	Exchange expenses
Title fees	$1,000		Exchange expenses
Prepaid rents		$8,000	Schedule E
Prepaid tenant deposits		$1,000	Schedule E
Prepaid property tax	$300		Schedule A
Accrued property tax		$3,000	Schedule E

BASIS OF PROPERTY RECEIVED

The basis of the property acquired is the same as the adjusted basis of the property relinquished, decreased or increased by the amount of any money or liabilities received or given and increased by the amount of any gain recognized.

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Example of an exchange with assumed liabilities

Anthony exchanges a building with a FMV of $820,000, an adjusted basis of $400,000, and a mortgage of $160,000, for a property with a FMV of $700,000, an adjusted basis of $100,000 and a mortgage of $90,000, which Anthony assumed.

Anthony also received $40,000 cash and incurred $10,000 of exchange expenses.

Step 1: Balance equities

	Given up	Received
FMV of like-kind property	$820,000	$700,000
Liabilities/mortgages	- 160,000	- 90,000
Total equity	$660,000	$610,000
Cash received to balance equities	$50,000	

Step 2: Boot received

Cash received to balance equities	$ 50,000
Net liabilities received	70,000
Exchange expenses	- 10,000
Boot received	$110,000

[1] From Step 1
[2] Liabilities given up less liabilities received

Step 3: Realized gain

FMV of like-kind property received	$700,000
Cash received	50,000
Liabilities given up	+160,000
Exchange price	$910,000
Adjusted basis of like-kind property given up	$400,000
Liabilities received	90,000
Exchange expenses paid	+ 10,000
Exchange costs	500,000
Realized gain (exchange price less exchange costs)	$410,000

Anthony must recognize gain of $110,000, which is the lesser of the gain realized or boot received.

Example of basis calculation

Returning to the previous example, Anthony's basis computation is:

Basis of property given up	$400,000
Gain recognized	100,000
Less boot received	(100,000)
Basis	$400,000

See the Tax Deferred Exchange Worksheets beginning on page 2-32.

Allocating basis

Basis allocation issues arise when there are exchanges of multiple properties. Generally, basis should be allocated based on the relative fair market values of the replacement properties.

Example of basis allocation

Warner exchanges one rental property for three. He gives a property with a fair market value of $400,000 plus $100,000 cash for three properties with combined fair market values of $500,000. The relinquished property had a basis of $200,000. Therefore, the basis to be allocated to the new properties is $300,000 ($200,000 basis of relinquished property plus $100,000 cash). The basis in the new properties is allocated as follows:

Property	FMV	% of total	Allocated basis
1	$100,000	20%	$ 60,000
2	150,000	30%	90,000
3	250,000	50%	150,000
Total	$500,000	100%	$300,000

Depreciating the replacement property

Generally, for MACRS property involved in an exchange, the basis of the replacement property is bifurcated into carryover basis and "excess" basis. (Treas. Regs. §1.168(i)-6)

Carryover basis: Depreciate the carryover basis over the remaining recovery period of the relinquished property using the same depreciation method as if it were a continuation of the relinquished property depreciation schedule.

Excess basis: Depreciate the excess basis as if it were a newly acquired property.

Example of depreciation

Henry exchanges residential rental properties under the following set of facts:

Relinquished property FMV	$1,000,000
Cost	$500,000
Accumulated depreciation	$150,000
Years of depreciation	10
Adjusted basis	$350,000
Exchange expenses	$80,000
Fair market value of new property	$1,200,000
Cash given	$200,000

Henry's basis in the new property is $630,000 (basis of original property of $350,000 plus $200,000 cash given plus $80,000 exchange expenses). Thus, he will depreciate:

- $350,000 original basis over the remaining life of the old property (17.5 years); and
- $280,000 new basis over 27.5 years as if it's a new asset newly placed in service.

Electing out

The regulations allow a taxpayer to elect out of the general rules and to treat the entire replacement property as a new asset. (Treas Regs. §1.168(i)-6) Taxpayers may want to elect out:

- To avoid the complexity of maintaining separate depreciation; and
- If the replacement property has a shorter life or more accelerated method of depreciation.

Depreciation suspended during deferred exchange

If replacement property is not acquired until after the disposition of the relinquished property, no depreciation is allowed during the period between the disposition of the relinquished property and the acquisition of the replacement property. (Treas. Regs. §1.168(i)-6(c)(5)(iv))

> 💣 **Caution**
>
> The rules regarding depreciation of property received in an exchange are complex and involve issues such as multiple properties, different periods and methods, different classes of property, and nondepreciable property such as land. Carefully review Treas. Regs. §1.168(i)-6.

Tax Deferred Exchange Worksheet - IRC 1031

Name Anthony Spidell | Date 06/12/2024

Description of like-kind property given up
Date property originally acquired | Date property actually transferred

Description of like-kind property received
Date property originally identified | Date property actually received

PART I - ADJUSTED BASIS OF PROPERTY GIVEN UP

		LIKE-KIND	UNLIKE-KIND
1.	Original cost or other basis	400,000	
2.	Improvements		
3.	Total (line 1 + line 2)	400,000	0
4.	Depreciation allowed or allowable		
5.	Casualty losses deducted		
6.	Investment/energy credits claimed		
7.	Deferred gain		
8.	Total (line 4 + 5 + 6 + 7)	0	0
9.	**ADJUSTED BASIS** (line 3 - line 8)	400,000	0

PART II - EQUITY BALANCING CALCULATION

		GIVEN UP	RECEIVED
1.	FMV of like-kind property	820,000	700,000
2.	FMV of unlike property/services		
3.	Total FMV of like and un-like property (line 1 + line 2)	820,000	700,000
4.	Liabilities/mortgages on like-kind property	160,000	90,000
5.	**EQUITY** in like and unlike property (line 3 - line 4)	660,000	610,000

PART III - BOOT RECEIVED

1.	Cash received (to balance equities)			50,000
2.	Cash paid (to balance equities)	0		
3.	Liabilities/mortgages given up		160,000	
4.	Liabilities/mortgages received	90,000		
5.	FMV of unlike property/services given up	0		
6.	Total (line 2 + 4 + 5)		90,000	
7.	Net liabilities/mortgages (line 3 - 6, but not < 0)			70,000
8.	FMV of unlike property/services received			0
9.	Expenses incurred for the exchange			10,000
10.	**TOTAL BOOT RECEIVED** (line 1 + 7 + 8 - 9, but not < 0)			110,000

Tax Deferred Exchange Worksheet - IRC 1031

Name: Anthony Spidell

PART IV - REALIZED GAIN (OR LOSS)

1.	FMV of like-kind property received	700,000	
2.	FMV of unlike property/services received		
3.	Cash received	50,000	
4.	Liabilities/mortgages given up	160,000	
5.	Exchange price (line 1 + 2 + 3 + 4)		910,000
6.	Adjusted basis of like-kind property given up	400,000	
7.	Adjusted basis of unlike property/services given up	0	
8.	Cash paid	0	
9.	Liabilities/mortgages received	90,000	
10.	Expenses incurred for exchange	10,000	
11.	Exchange costs (line 6 + 7 + 8 + 9 + 10)		500,000
12.	**REALIZED GAIN** (loss) on like and unlike (line 5 - line 11)		410,000

PART V - RECOGNIZED GAIN (OR LOSS)

UNLIKE PROPERTY

1.	FMV of unlike property/services given up			
2.	Adjusted basis of unlike property/services given up		0	
3.	**RECOGNIZED GAIN (LOSS)** on unlike property/services given up (line 1 - line 2)			0

LIKE-KIND PROPERTY

4.	Total boot received (line 10, Part III)		110,000	
5.	Realized gain (loss) (line 12, Part IV)	410,000		
6.	Recognized gain (loss) on unlike property (line 3, Part V)	0		
7.	Line 5 - line 6		410,000	
8.	**RECOGNIZED GAIN** on like-kind property (lesser of line 4 or 7 but not < 0)			110,000

Caution: If the property given up was used previously or partly as a home, see Property used as home in Form 8824 instructions and enter any Section 121 exclusion on the next screen. The exclusion amount will not be reflected in the calculations shown on this screen.

PART VI - BASIS OF PROPERTY RECEIVED

1.	Adjusted basis of like-kind property given up	400,000		
2.	Adjusted basis of unlike property given up	0		
3.	Cash paid	0		
4.	Liabilities/mortgages received	90,000		
5.	Expenses incurred for exchange	10,000		
6.	Recognized gain on like-kind property	110,000		
7.	Total (line 1 + 2 + 3 + 4 + 5 + 6)		610,000	
8.	Cash received	50,000		
9.	Liabilities/mortgages given up	160,000		
10.	Recognized (gain)/loss on unlike property	0		
11.	Total (line 8 + 9 +10)		210,000	
12.	Basis of all property acquired (line 7 - line 11)			400,000
13.	FMV of unlike property/services received			
14.	**BASIS** of like-kind property/services received (line 12 - line 13)			400,000

Caution: If the property given up was used previously or partly as a home, see Property used as home in Form 8824 instructions and enter any Section 121 exclusion on the next screen. The exclusion amount will not be reflected in the calculations shown on this screen. Refer to Line 25 on the next screen for the Basis of like-kind property received.

Form 8824 Reconciliation Worksheet

Name: Anthony Spidell

Form 8824, Part III - Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Description of like-kind property given up
Date property originally acquired | Date property actually transferred
Description of like-kind property received
Date property originally identified | Date property actually received

Form 8824 Line numbers		***Tax Def Worksheet Reference***			
Line 12	FMV of unlike property given up	(Part V, line 1)			
Line 13	Adjusted basis of unlike property given up	(Part V, line 2)		0	
Line 14	**RECOGNIZED GAIN** or (loss) on unlike property given up	(Part V, line 3)			0
	+ Cash received	(Part III, line 1)		50,000	
	+ FMV of unlike property received	(Part II, line 2b)			
	+ Liabilities/mortgages given up	(Part II, line 4a)	160,000		
	- Liabilities/mortgages received	(Part II, line 4b)	90,000		
	- Cash paid	(Part III, line 2)	0		
	- FMV of unlike property given up	(Part II, line 2a)			
	Net liabilities given-up by other party (but not less than zero)			70,000	
	Less: Expenses incurred for exchange	(Part III, line 9)		10,000	
Line 15	Total consideration received (not < 0)	(Part III, line 10)			110,000
Line 16	FMV of like-kind property received	(Part II, line 1b)			700,000
Line 17	Add lines 15 and 16				810,000
	+ Adj. basis of like-kind property given up	(Part I, line 9a)		400,000	
	+ Exchange expenses not used on line 15			0	
	+ Liabilities/mortgages received	(Part II, line 4b)	90,000		
	- Liabilities/mortgages given up	(Part II, line 4a)	160,000		
	+ Cash paid	(Part III, line 2)	0		
	+ FMV of unlike property given up	(Part II, line 2a)			
	Net paid to other party (but not less than zero)			0	
Line 18	Total consideration given up				400,000
Line 19	**REALIZED GAIN** or (loss) on like-kind property (line 17 - line 18) If the property given up was used previously or partly as a home, see Property used as home in Form 8824 instructions and enter any Sect 121 exclusion above.				410,000
Line 20	Smaller of line 15 (less any Sect 121 exclusion) or 19 (but less than zero)				110,000
Line 21	Ordinary income under recapture rules				
Line 22	Line 20 - line 21 (but not less than zero)				110,000
Line 23	**RECOGNIZED GAIN** on like-kind property (line 21 + line 22)				110,000
Line 24	Deferred gain or loss (line 19 - line 23)				300,000
Line 25	**BASIS** of like-kind property received (line 18 + 23 - 15 + any Sect 121 exclusion)				400,000

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Escrow Expense Worksheet

Name: Anthony Spidell

HUD Line #	EXPENSE DESCRIPTION	DISPOSITION EXPENSES	ACQUISITION EXPENSES
	EXCHANGE EXPENSES		
	Commissions:		
703	Broker's Commission	10,000	
	Loan Charges:		
803	Appraisal Fee		
804	Credit Report		
805	Lender's Inspection Fee		
806	Mortgage Insurance Application Fee		
807	Assumption Fee		
	Funding and Review Fee		
	Wire Fee		
	Payment Processing Fee		
	Flood Certification Fee		
	Escrow and Title Charges:		
1101	Settlement or Closing Fee		
1102	Abstract or Title Search		
1103	Title Examination		
1104	Title Insurance Binder		
1105	Document Preparation		
1106	Notary Fees		
1107	Attorney's Fees		
1108	Title Insurance		
	Demand Processing Fee		
	Messenger Fee		
	Recording and Transfer Fees		
1201	Recording Fees		
1202	City/county Tax/stamps		
1203	State Tax/stamps		
	Additional Settlement Charges		
1301	Survey		
1302	Pest Inspection		
	Expenses Outside of Escrow		
	Property Locating Fee		
	Intermediary Fee		
	Warehouse Fee		
	TOTAL	$ 10,000	0
	TOTAL EXCHANGE EXPENSES		$ 10,000
	NON-EXCHANGE EXPENSES		
801	Loan Origination Fee		
802	Loan Discount		
multiple	Mortgage and Hazard Insurance		
multiple	Property Taxes		
	Prepaid Interest		
	Prepayment Penalty		
	State Income Tax Withheld		
	Home Warranty		
	Loan(s) Payoff		
	Credit Card Payoff		
	TOTAL NON-EXCHANGE EXPENSES	$ 0	0
	GRAND TOTAL OF ESCROW EXPENSES		$ 10,000

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06-12-2024

RELATED-PARTY EXCHANGES

If a taxpayer exchanges property with a related party (as defined below), the original exchange will not qualify for tax deferral if either of the exchanged properties is sold or disposed of within two years of the transfer. Interestingly, the postponed gain becomes taxable at the time of the disqualifying disposition and all parties to an exchange are examined to determine if a party is "related."

It is important to note that exchanges between related parties may still use the tax-free benefits of IRC §1031, provided the two-year waiting period and other requirements listed are met. (IRC §1031(f) and (g))

Related parties include:

- **Family members:** Brothers, sisters, spouse, ancestors, and lineal descendants, as well as C or S corporations and over 50% shareholders, corporate controlled members, and grantors and fiduciaries of trusts. (IRC §267(b))
- **Partnership-partner:** The related-party definition also includes over 50% partner-to-partnership attribution rules. (IRC §707(b))

Exceptions to the two-year rule

Property acquired in a related-party like-kind exchange will retain like-kind exchange treatment if disposition within two years occurs:

- After the death of the taxpayer or the related party;
- In a compulsory or involuntary conversion (but only if the related-party like-kind exchange occurred before the threat or imminence of such conversion); or
- When the taxpayer can establish to the satisfaction of the IRS that neither the related-party like-kind exchange nor the disposition had tax avoidance as one of its principal purposes. (IRC §1031(f)(2))

The purpose of the related-party like-kind exchange rules

Because like-kind exchanges result in the substitution of basis of the exchanged property for the property received, related parties could engage in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale.

Basis shifting can also be used to accelerate loss on the retained property. Therefore, if a related-party exchange is followed shortly thereafter by a disposition of the property, the related parties can, in effect, "cash out" of the investment.

Filing requirements

If the exchange is made with a related party, both parties must file Form 8824, Like-Kind Exchanges, in the year of the exchange and for the two following years. (Form 8824 Instructions)

Example of related-party exchange

On July 1, 2023, brothers Joe and Mark exchanged Main Street (Joe's property) with a FMV of $100,000 and a basis of $90,000 for Park Avenue (Mark's property) with a FMV of $100,000 and a basis of $80,000. There are no mortgages or cash transactions. No gain is recognized by either brother.

On January 15, 2024, Joe disposes of Park Avenue for $105,000. Joe recognizes gain of $15,000 (sales price $105,000 – basis $90,000). Because the exchange is between related parties and does not meet the two-year holding period, Mark is taxable on the $20,000 of deferred gain on his exchange of Park Avenue.

Subsequent disposition does not disqualify related-party exchange

In a private letter ruling, the IRS held that the subsequent disposition of property received in a related-party exchange did not trigger gain recognition because the avoidance of federal income tax was not one of the principal purposes of the exchange or subsequent disposition. (PLR 200706001)

A taxpayer and her siblings inherited three parcels of land. The taxpayer did not want to divest herself of ownership in real estate. To accommodate her siblings' desire to sell, the parties agreed that the taxpayer would exchange her undivided 25% interest in Parcel #1 for a 100% unencumbered fee simple interest in Parcel #3. The parties agreed that the FMV of the 25% interest in Parcel #1 equaled the FMV of the 100% interest in Parcel #3. Following the exchange, the siblings sold Parcels #1 and #2.

Neither the exchange nor the subsequent disposition of Parcel #1 (a property received from a related party and sold within two years) is a disposition that caused recognition of gain to the taxpayer pursuant to the income recognition rule of IRC §1031(f) for exchanges between related persons.

There was no shifting of basis between properties because the respective per-acre basis in Parcels #1 and #3 were equivalent as a result of the step-up in basis that occurred when the taxpayer's father died owning the parcels. Accordingly, the transaction did not trigger deferred gain.

VACATION HOME SAFE HARBOR

Gain deferral on like-kind exchanges under IRC §1031 is normally not available to homes unless held for the production of income or as investment property. A vacation home does not qualify for like-kind exchange, even if one of the motives in acquiring the home was the prospect of appreciation. (***Moore v. Comm.***, TCM 2007-134) However, Revenue Procedure 2008-16 provides a safe harbor for when a second home will qualify as held either for productive use in a trade or business or for investment purposes.

The IRS will not challenge a property's qualification for §1031 treatment if it is:

1. **Relinquished property.** A dwelling unit that a taxpayer intends to be relinquished property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

    a. The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the qualifying use period); and
    b. Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:

        i. The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more; and
        ii. The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

    For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day), and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

2. **Replacement property.** A dwelling unit that a taxpayer intends to be replacement property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

    a. The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the qualifying use period); and
    b. Within the qualifying use period, in each of the two 12-month periods immediately after the exchange:

        i. The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more; and
        ii. The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

    For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place, and the second 12-month period begins on the day after the first 12-month period ends.

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Example of vacation home safe harbor

Albert owns a second residence that he has used as a vacation home. He purchased the property in 2019. From September 1, 2021, through August 31, 2022, he personally used the property for eight days and rented it at fair value for 26 days. From September 1, 2022, through August 31, 2023, he personally used the property 24 days and rented it at fair value for 260 days. On September 1, 2023, he exchanged the property for a new vacation home (no boot given or received).

The relinquished property qualifies for the safe harbor, because for each 12-month period in the 24 months preceding the sale, Albert rented the property for at least 14 days (26 for September 1, 2021, through August 31, 2022, and 260 for September 1, 2022, through August 31, 2023), and his personal use did not exceed the greater of 14 days or 10% of total usage (fewer than 14 days for September 1, 2021, through August 31, 2022, and less than 10% (24 ÷ 84 = 8.45%) for September 1, 2022, through August 31, 2023).

As long as Albert continues the same pattern of renting the replacement property for the period from September 1, 2023, through August 31, 2025, this exchange will meet the safe harbor and qualify as a §1031 exchange.

INVOLUNTARY CONVERSIONS — IRC §1033 EXCHANGES

Taxpayers may have so-called involuntary conversion gains when destroyed personal-use property is covered by insurance. Such gains are generally taxable unless sufficient expenditures are made to replace the destroyed property with similar property before the applicable deadline.

When insurance proceeds exceed the tax basis of destroyed property, a taxpayer has a potentially taxable profit. (IRC §1033(a)(2)) This is the case even if the insurance company doesn't fully compensate the client for the perceived pre-casualty value of the property. The gain is called an involuntary conversion gain because the casualty event causes the destroyed property to suddenly be converted into cash from insurance proceeds.

When the client has an involuntary conversion gain, it generally must be included in gross income for federal income tax purposes in the year during which the gain is realized (the year insurance proceeds resulting in gain are collected) unless the client:

- Makes a gain deferral election; and
- Makes sufficient expenditures to replace the property with similar property by the applicable deadline.

A taxpayer can elect to defer gains realized from involuntary conversions of property resulting from destruction (including hurricanes, wildfires, and other natural disasters), theft, seizure, condemnation, or threat thereof.

To completely defer the gain, the taxpayer must purchase replacement property (or stock in a corporation holding similar assets) that is similar or related in service or use to the original property that costs at least as much as the amount realized upon conversion (e.g., insurance proceeds). Note that there are special rules for farmers related to deferring crop and livestock income, which are not covered in these materials.

It is not necessary that the entire amount of the conversion proceeds received be used to acquire the replacement property. The taxpayer can still take out a mortgage to purchase the replacement

property. IRC §1033(a)(2) and Treas. Regs. §1.1033(a)-2 only state that gain must be recognized if the amount realized exceeds the cost of the replacement property, not that the amount realized must actually be invested in the replacement property.

Example of using a mortgage to acquire replacement property

Javier received $50,000 from his insurance company for the destruction of a piece of real estate with an adjusted basis of $20,000. He purchased a replacement piece of property by using $10,000 cash and assuming a $40,000 mortgage on the replacement property.

The replacement property's cost is at least equal to the proceeds; therefore, Javier does not have to recognize any gain on the transaction even though he did not use all of the insurance proceeds to purchase the replacement property.

The involuntary conversion rules do not affect losses. The taxpayer must recognize (or not recognize) a loss on an involuntary conversion under the rules that govern the transaction without regard to the rules for deferring gain on involuntary conversions.

REPLACEMENT PROPERTY

Replacement property must be similar or related in service or use ("similar-use property") to the involuntarily converted property to qualify for gain deferral. (IRC §1033(a)(2)) This is a functional rule, meaning the taxpayer-owner's end use of the replacement property must be substantially the same as the replaced property. It is a much more stringent rule than the like-kind requirement for like-kind exchanges. For example, the following replacements would probably not qualify as similar-use replacement property:

- Unimproved real estate replaced with improved real estate;
- Mobile home park replaced by a motel;
- Bowling alley replaced by a billiard center; and
- Rental building replaced with stock in a real estate investment trust.

The following replacements are examples of what probably would qualify:

- Farmland used to grow crops replaced with farmland used to grow fruit or raise livestock;
- Residential property in one U.S. city replaced with residential property in another U.S. city; and
- Two buildings used for a particular purpose replaced with one used for the same purpose.

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Comment

The rules for what qualifies as replacement property are less stringent when the involuntary conversion occurs in a federally declared disaster area (for example, hurricanes and other natural disasters).

The term "federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

The list of federally declared disaster areas is available at the Federal Emergency Management Agency website:

Website
www.fema.gov/disaster/declarations

The most recent tax relief provisions for taxpayers affected by disaster situations is available at:

Website
www.irs.gov/newsroom/tax-relief-in-disaster-situations

Real property located in the United States and real property located outside the United States are not property of a like kind for the purposes of IRC §1031. (IRC §1031(h))

Property used for farming purposes will qualify as similar or related to the use of livestock if it is not feasible for the taxpayer to reinvest the proceeds from involuntarily converted livestock due to drought, flood, other weather-related conditions, etc. (IRC §1033(f))

Property acquired from related person

Taxpayers cannot avoid gain recognition if the replacement property is acquired from a related person. (IRC §1033(i)) However, this related-party rule does not apply if:

- The gain realized from the involuntary conversion is $100,000 or less; or
- The related party acquired the replacement property from an unrelated party during the taxpayer's replacement period.

C corporations and partnerships with C corporation partners cannot acquire replacement property from related persons.

The IRC §§267(b) and 707(b)(1) definitions of related persons apply.

Example of related person limitation

Sharon wants to sell a small apartment building in Evanston, Illinois, and replace it with a commercial building in Denver, Colorado, that her brother Neil is selling. Under the related-party restrictions described above, she would be unable to defer the $300,000 gain from the sale of her apartment building because the replacement property is owned by her brother.

However, if Neil just purchased the commercial building the prior year from an unrelated party, Sharon would still be able to defer the gain from the like-kind exchange, provided that all the other requirements are met.

Condemned property

Real estate used in a business or held for investment that is condemned (or threat or imminence thereof) is deemed to be converted into similar-use property if it is replaced with like-kind property as defined under IRC §1031. (IRC §1033(g)) Consequently, such property may qualify for gain deferral even though the replacement property does not meet the stringent similar-use requirements discussed earlier.

For example, unimproved real estate replaced by improved real estate is not similar-use replacement property. It would, however, qualify for gain deferral under IRC §1033(g) because it is like-kind property. Conversely, replacement of real property not qualifying as like-kind may qualify under the similar-use test. For example, the use of condemnation proceeds (from land or land and building) to construct a building on land already owned by the taxpayer may not qualify as like-kind property but could qualify under the similar-use test (see Rev. Ruls. 67-255 and 71-41).

Corporate stock

A taxpayer can replace converted property with either qualifying property or stock in a corporation that owns qualifying property provided the taxpayer acquires control of the corporation. (IRC §1033(a)(2))

When corporate stock is purchased as the replacement property, the taxpayer's basis in the stock is its cost, decreased by the amount of gain not recognized. (IRC §1033(b)(2)) In addition, the basis of the replacement property owned by the corporation must also be reduced by the taxpayer's deferred gain. (IRC §1033(b)(3)) Thus, basis at both the shareholder and corporate levels is reduced for the same gain deferral.

REPLACEMENT PERIOD

The replacement period begins on the earlier of:

1. The date the property is disposed of (e.g., destroyed, stolen, condemned); or
2. The date of the threat or imminence of requisition or condemnation of the property.

It generally ends two years (three years for condemned real estate used in a business or held for investment and converted to like-kind property) after the close of the tax year any gain is realized. [IRC §1033(a)(2)(B) and (g)(4))

The replacement period to defer involuntary conversion gains from certain forced early sales of livestock due to drought, flood, or other weather-related conditions is four years, and property other than livestock can qualify as replacement property in certain circumstances.

The IRS is authorized to extend the replacement period even longer if regional weather-related conditions persist for more than three years. (IRC §1033(e)(2)(B) and (f); IRS Notices 2006-82 and 2002-43)

A four-year replacement period is available for a principal residence or any of its contents located in a federally declared disaster area. The taxpayer may apply to the IRS for an extension based on reasonable cause. The extension must be requested within the replacement period unless reasonable cause is shown for a later request. (Treas. Regs. §1.1033(a)-2(c)(3))

GAIN RECOGNITION

If property is converted only into similar-use property, nonrecognition is mandatory. (IRC §1033(a)(1)) If a taxpayer receives cash or property that is not similar-use, gain is recognized only to

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the extent the total of the cash and other nonsimilar property (proceeds) exceeds the cost of the replacement property, provided the taxpayer has timely replaced the property and elected the benefits of nonrecognition.

The election is made by including the appropriate portion of gain, if any, in gross income and excluding the deferred portion.

Example of gain on condemnation of real property

Carol, a calendar-year taxpayer, owns an office building with an adjusted basis of $175,000 on land that costs $30,000. The property was condemned and taken in return for a condemnation award of $250,000. She received the condemnation proceeds on March 18, 2024.

Because her real property was condemned, Carol can replace it with either similar-use or like-kind property. If Carol buys like-kind property costing at least $250,000 by December 31, 2027 (the end of the three-year replacement period), none of the $45,000 realized gain will be recognized. The basis of the replacement property will be its cost less the deferred gain of $45,000. If she does not reinvest by that date, the entire gain must be recognized.

If Carol acquires like-kind property for $180,000, the excess of the conversion amount ($250,000) over the cost of the replacement property is $70,000, and the entire $45,000 realized gain is recognized. The basis of the replacement property is $180,000 because there was no gain deferred.

If she acquires like-kind property for $230,000, the excess of the condemnation award over the cost of the new property is $20,000. In this situation, she recognizes only the $20,000, and the basis of the replacement property will be $205,000 ($230,000 cost – $25,000 deferred gain).

Alternately, if the award had been only $180,000, the loss of $25,000 (basis of $205,000 less award of $180,000) is recognized regardless of any replacement. IRC §1033 deferral applies only to gains.

If the taxpayer fails to replace the converted property within the allowable period or does so at a lower cost than anticipated at the time of the election, an amended return reporting the recognized gain must be filed for the tax year the gain was originally realized. (Treas. Regs. §1.1033(a)-2(c)(2)) Interest is owed on any additional tax resulting from the gain recognition.

INTERPLAY BETWEEN §§1033 AND 121

Under IRC §121(d)(5), the involuntary conversion (from destruction or condemnation) of a taxpayer's principal residence is treated as a sale of the residence eligible for the §121 gain exclusion if the taxpayer otherwise meets the requirements of those gain exclusion rules. This rule applies whether or not the involuntary conversion results from a federally declared disaster (see additional special rules for property damaged by federally declared disasters later in this chapter).

Any portion of the gain that cannot be excluded (for example, because it exceeds the $250,000 or $500,000 limitations) may be deferred under the involuntary conversion rules. In applying the §1033 involuntary conversion rules for any remaining gain, the amount realized from the conversion (insurance proceeds) is reduced by the gain excluded under IRC §121. (IRC §121(d)(5)(B))

Example of personal residence destroyed

In March 2024, fire destroys Dan's personal residence that had a basis of $70,000. Dan is single and owned and used this property as his principal residence for 10 years before its destruction.

Dan received $400,000 in insurance proceeds for the house. Therefore, Dan has a realized gain of $330,000 ($400,000 – $70,000). In November 2024, Dan buys a new house at a cost of $130,000.

The destruction of the residence is treated as a sale for purposes of the §121 gain exclusion rules, so Dan can exclude $250,000 of the realized gain.

In applying the §1033 involuntary conversion rules to the remaining gain, the amount realized is $150,000 ($400,000 – $250,000), the realized gain is now $80,000 (amount realized of $150,000 – basis of $70,000), but the recognized gain is only $20,000 ($150,000 amount realized – $130,000 cost of the new house).

The remaining $60,000 of gain is deferred, and Dan's basis in the new house is $70,000 ($130,000 cost – $60,000 gain not recognized).

✐ **Practice Pointer**

Whether the destruction of a taxpayer's principal residence has occurred for purposes of IRC §121(d)(5) is a question of fact. The IRS has ruled that when a residence is damaged as a result of a natural disaster and the cost to rebuild exceeds the property's original fair market value, the house is considered completely destroyed and is eligible for §121 treatment. (CCA 200734021)

Furthermore, when a residence is involuntarily converted and not rebuilt on the existing lot, a later sale of the lot is treated as part of the involuntary conversion (i.e., the residence and land are treated as a single involuntary conversion occurring on the date the dwelling was destroyed). Thus, gain from the sale of the land can be deferred if the §1033 deferral requirements are met. (Rev. Rul. 96-32)

Comment

Taxpayers may also continue to deduct mortgage interest on a destroyed residence during a reasonable period between the destruction of the residence and its sale or reconstruction and reoccupation. (Rev. Rul. 96-32)

PROPERTY DAMAGED BY FEDERALLY DECLARED DISASTERS

Taxpayers with property destroyed in federally declared disaster areas are subject to special relief provisions that broaden the scope of the normal involuntary conversion rules. (IRC §1033(h))

In addition, for taxpayers affected by disasters in federally declared disaster areas or by certain terrorist or military actions, the IRS can extend the normal deadline for many actions, including replacing damaged or destroyed property under IRC §1033. (IRC §7508A; Treas. Regs. §301.7508A-1; Rev. Proc. 2018-58)

Note, however, that postponements beyond the mandatory 60-day period under IRC §7508A are not automatic when a disaster occurs. Generally, the IRS will publish a notice or issue other guidance

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(including an IRS news release) authorizing the postponement. Such guidance will describe the acts postponed, the duration of the postponement, and the location of the covered disaster area.

Principal residences

The involuntary conversion rules for a disaster in a federally designated disaster area also apply to a taxpayer's principal residence. (IRC §1033(h)(1))

When a taxpayer's principal residence (or any of its contents) is located in a disaster area and is involuntarily converted as a result of a federally declared disaster, no gain is recognized on the receipt of insurance proceeds for "unscheduled" personal property that was part of the contents of such residence. This rule applies regardless of the taxpayer's basis in the unscheduled personal property or how the insurance proceeds are used. (IRC §1033(h)(1)(A)(i); Rev. Rul. 95-22) (**Note:** Scheduled personal property is a supplemental insurance policy that extends coverage beyond the standard protection provided in a homeowner's insurance policy. By purchasing a scheduled personal property policy, owners can ensure full coverage of expensive items, such as jewelry, in the event of a claim.)

Any insurance proceeds for the residence or its separately scheduled contents can be treated as a common pool of funds. The taxpayer can elect to recognize gain only to the extent that the funds exceed the cost of replacing the residence and its contents. Any type of replacement contents (whether separately scheduled or unscheduled) qualifies for this purpose. Insurance proceeds for separately scheduled property (e.g., jewelry, art) do not have to be used to purchase the same type of property. (IRC §1033(h)(1)(A)(ii); Rev. Rul. 95-22)

The taxpayer must make the replacement within four years (as opposed to the normal two-year period for involuntary conversion replacements) after the close of the year gain is first realized. (IRC §1033(h)(1)(B))

Example of personal residence and contents destroyed in disaster

Cole's personal residence and contents are totally destroyed by a hurricane in September 2023. His residence was subsequently included in a location that was designated as a federally declared disaster area. Cole received the following insurance proceeds:

- $300,000 as compensation for destruction of the residence;
- $35,000 for the unscheduled household contents;
- $7,000 for scheduled jewelry; and
- $3,000 for scheduled musical instruments.

In March 2026, Cole spends $300,000 to replace the previously destroyed residence and $50,000 to furnish the new home ($40,000 for general furnishings and $10,000 for a painting).

Cole recognizes no gain upon receipt of the $35,000 for the destruction of the unscheduled personal property, regardless of how he uses or spends this money.

Because Cole spent $350,000 within the four-year statutorily prescribed replacement period under IRC §1033(h)(1)(B) for disasters to purchase a replacement dwelling and contents, which is in excess of the $310,000 common pool of funds he received from insurance ($300,000 for the residence + $10,000 for scheduled personal property ($7,000 + $3,000)), Cole will not be required to recognize any gain upon the destruction of the residence and its contents.

Trade or business or investment property

No gain is recognized if property held for use in a trade or business or for investment is involuntarily converted as a result of being in a federally declared disaster area and is replaced with tangible property used in a trade or business. (IRC §1033(h)(2)) This rule applies even if the replacement property is not similar-use to the converted property.

Example of gain deferral for dissimilar and unrelated-use property

Sue's Diner was destroyed by a flood. The diner is located in a federally declared disaster area. Sue decides not to reopen the diner and uses the insurance proceeds to purchase a bowling alley before December 31 at the end of the two-year period following the disaster. She recognizes no gain on the transaction because the new property is trade or business property (treated as being similar-use to the property destroyed in the federally declared disaster).

Property lost in the involuntary conversion can be either business or investment property, but the replacement property must be "of a type held for productive use in a trade or business." (IRC §1033(h)(2))

Example of gain deferral denied for investment replacement property

Assume the same facts as the previous example, except Sue uses the insurance proceeds to purchase valuable works of art for investment because the art is not held for productive use in a trade or business. She cannot defer the gain on the conversion of the diner.

Variation: If Sue had lost the artwork in a federally declared disaster and purchased the diner with the insurance proceeds, the gain deferral provisions should apply because she replaced investment property with business property.

DEFERRING THE GAIN

To defer the gain, attach a statement to the year of the gain. The statement should include:

- The date and details of the casualty;
- The insurance or other reimbursement received from the casualty or theft;
- How the gain was computed;
- If the replacement property is purchased in the same year, information regarding the replacement property, the postponed gain, the basis adjustments, and any recognized gain; and
- If the replacement property has not yet been purchased, a statement indicating that the taxpayer will be purchasing replacement property within the specified replacement period. When the property is actually purchased, attach another statement to the return for the year in which the property is acquired, with detailed information concerning the replacement property.

An amended return must be filed and any additional tax paid for the tax year of the gain if:

- Replacement property is not acquired within the replacement period, including extensions; or
- The replacement property was timely purchased but at a cost less than the amount received from insurance or other reimbursements.

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REPORTING CASUALTY LOSSES TO BUSINESS OR INCOME-PRODUCING PROPERTY

Gains from income-producing property or gains/losses from a trade or business property or rental or royalty property are reported in Section B of Form 4684, Casualties and Thefts, and then transferred to Form 4797, Sales of Business Property. Deferred gains under IRC §1033 are reported by attaching a statement to the return, as described under "Deferring the gain," above.

Example of involuntary conversion of rental property

In Year 1, Debbie and Marty purchased a duplex in Napa as rental property for the lump sum of $700,000. The purchase price was allocated between the land ($300,000) and the building ($400,000) for purposes of determining basis.

In Year 3, the building was completely destroyed by wildfire. At the time of the casualty, the adjusted basis of the land is $300,000, the adjusted basis of the building is $390,000.

The fair market value of the land and building immediately before the casualty is $350,000 and $425,000, respectively, and immediately after the casualty is $350,000 and $0, respectively.

In Year 3, insurance proceeds of $450,000 are received to cover the loss to the building. Because the property is used for trade or business purposes rather than personal purposes, the amount of the casualty loss must be determined by considering the separate fair market value and adjusted basis of each single, identifiable item of property damaged or destroyed.

The amount of the casualty loss deduction is calculated as follows:

Building: adjusted basis	$390,000
Casualty loss before reimbursement	(390,000)
Less: reimbursement	– 450,000
Casualty gain on building	$ 60,000

If Debbie and Marty decide to sell the Napa property and reinvest in another rental property in Lake County, they can defer reporting the casualty gain on their return.

Treatment of the land

Whether the sale of the land can qualify as part of the involuntary conversion when an investment/business property is destroyed is dependent on whether:

- The properties qualify as "one economic property unit";
- The unavailability of suitable nearby property of like kind; and
- The proceeds of the voluntary sale must be used to acquire like-kind property.

In PLR 8132121, a taxpayer had a three-unit rental on land located in a resort community. The taxpayer had purchased the property for $66,160 in 1972, and the property was destroyed by a gas explosion in 1979. In 1972, the land was worth $30,000, and in 1980 it sold for $165,000. The taxpayer only received $51,790 in insurance proceeds and due to the escalating cost of building in the area, the taxpayer could not afford to rebuild in the area.

The IRS ruled that the taxpayer could treat the destroyed building and the land as "one economic property unit." The IRS also accepted the taxpayer's contentions that due to the escalating land and building costs in the area, he could not afford to purchase a like-kind property in the area, and that similar property in another resort community in another state qualified as like-kind property. Therefore, the replacement property could be purchased with the tax-deferred gain from the insurance proceeds and land sale.

In PLR 9143056, the IRS held that an individual who owned a four-family apartment building that was destroyed by fire was able to treat the sale of the land as an involuntary conversion as well. The taxpayer showed that the rental building and the land constituted one economic unit of rental real estate and that rebuilding was not an economically feasible option.

The taxpayer provided cost estimates for replacing the destroyed building with a similar structure and evidence that the current rental charges in the city in which the building was located would not economically support a building costing that much.

In PLR 9334007, a taxpayer had a residential rental unit, which was a single-family dwelling that was destroyed by a tornado. The taxpayer had purchased the property decades earlier, and therefore the property's adjusted basis was negligible. The taxpayer received insurance proceeds in one tax year and claimed an involuntary conversion for the gain from these proceeds. The taxpayer later determined that to rebuild on the land would be economically impractical because the area around the property was being developed into high-priced residential subdivisions, and if he were to rebuild a property similar to what was destroyed, it would be far out of character in terms of size, price, and quality of other residences in the area.

The IRS agreed and found that the land and building constituted one economic unit, it was not feasible to find a replacement property in the area, and that the land could not practically have been used without replacement of the residential rental unit. Therefore, the taxpayer was allowed to treat the sale of the land in a subsequent year as a voluntary conversion.

If the sale of the land qualifies as an involuntary conversion, gain from the sale proceeds qualify for deferral as long as it is sold within the allowed conversion period (two years generally, three years for certain property held for productive use in a trade or business or for investment, four years for a principal residence destroyed in a disaster). (Rev. Rul. 96-32)

CALIFORNIA LIKE-KIND EXCHANGES

REAL PROPERTY LIMITATION

Applicable to exchanges completed after January 10, 2019, California generally conforms to the TCJA amendment limiting deferral of income to those like-kind exchanges involving real property for both corporate and personal income taxpayers. (R&TC §§18031.5, 24941.5) However, for California purposes, this limitation only applies to personal income taxpayers with federal adjusted gross income of $250,000 or more ($500,000 or more if filing MFJ, HOH, or surviving spouse).

California conforms to the 45- and 180-day rules for delayed exchanges. The taxpayer must make a valid federal extension of time to file if the 180-day period ends after the original due date of the return, even though California allows automatic extensions. (IRC §1031(a)(3)(B))

OUT-OF-STATE EXCHANGE

If a taxpayer has a qualified exchange of property located in California for property located either inside or outside California, the gain is not recognized. This applies whether the taxpayer exchanging the property is a resident of California or a nonresident of California.

When the out-of-state property is sold in a fully taxable transaction, the entire gain is taxable to a resident. If the taxpayer is a nonresident when the replacement property is sold, the taxpayer is taxed on the lesser of the deferred gain on the property or the actual gain.

WHEN AND HOW TO FILE FORM FTB 3840

All taxpayers must file Form FTB 3840, California Like-Kind Exchanges, if they exchange a California property for a non-California property in a tax-deferred §1031 exchange. The return must be filed in the year of exchange and every year thereafter until the deferred tax is paid. (R&TC §18032(a)) If the taxpayer does not have a filing requirement, the form should be filed as a stand-alone form, which is due on the extended due date of the income or franchise tax return (October 15 for most calendar-year individual taxpayers). If filing the form with a return, the form may be e-filed. However, stand-alone forms may not be e-filed.

FAQs

When must the form be filed?

Form 3840 must be filed in the year the like-kind exchange occurs and every year thereafter for as long as the gain or loss is deferred, and continues until:

- The property has been disposed of in a fully taxable transaction;
- The property is transferred through inheritance, eliminating the deferred California-source gain or loss; or
- The replacement property is donated to a nonprofit organization.

Does Form 3840 have to be filed if the taxpayer is not required to file a California tax return?

Yes. If a taxpayer does not file a California return, the taxpayer must file Form 3840 separately as a California information return. The due date is the same due date that would apply if the property owner would have been required to file a California return. Form 3840 should be signed and mailed to the address included in the form instructions.

See "What happens if a taxpayer fails to file Form 3840?" below for the consequences of failing to file the information return.

Does a taxpayer who converts an out-of-state replacement rental property to personal use still need to file the form?

Yes. A conversion to personal use is not considered a disposition in a fully taxable transaction. The taxpayer must continue to file Form 3840 until one of the events listed in the first FAQ occurs.

Does a person who receives an out-of-state replacement property as a gift need to file Form 3840?

Yes, a taxpayer who receives a replacement property as a gift rather than as an inheritance (e.g., a parent gifts a property to their child with the property's carryover basis) must continue to file

Form 3840 until the property is otherwise disposed of. We recommend that the giftee attach a statement to Form 3840 stating that the property was received as a gift and that the giftor filed a final Form 3840 with a statement attached stating that the property was gifted to the giftee.

Does a California resident have to file Form 3840 if they exchange an out-of-state property for another out-of-state property?

No. Form 3840 should only be filed if a taxpayer exchanges a California property for an out-of-state property.

Who is responsible for filing the form?

Knowing which parties must file Form 3840 will help avoid forgetting to file it. Here are some tips as to who files the form:

- **Multiple owners:** Each owner must complete Form 3840 to report their proportionate share of the gain in the year of sale and subsequent years.
- **Owned by an entity:** If the property is owned by a passthrough entity, only the entity must file Form 3840. If the entity liquidates and the property is passed to the owners, the filing requirement passes to the partners/members/shareholders who now own the property.
- **SMLLC:** If the property is owned by a single member LLC, the taxpayer files Form 3840 with the individual return.
- **Divorcing taxpayers:** If a married couple divorces, whichever spouse receives the property is the taxpayer required to file Form 3840. If both spouses own the property, each must file Form 3840.
- **Death of owner:** If the owner of the property dies, and the property has a fully stepped-up basis, there is no gain to report. In this situation, a final Form 3840 is filed, stating that the owner is deceased, and the property was transferred to a beneficiary. However, if the property was co-owned, the surviving co-owner must continue to file Form 3840 for the portion they owned prior to inheritance.
- **Property exchanged again:** Replacement property must be tracked and identified if that property is disposed of in a subsequent exchange for property outside of California until the gain is fully recognized. See the next question for more details.

How should Form 3840 be completed when the taxpayer purchased multiple replacement properties?

If a property is exchanged for multiple out-of-state replacement properties, different reporting rules apply depending on the disposition of the replacement property:

- **Property sold at a loss:** If a replacement property is sold at a loss, the taxpayer should exclude the property from the list of properties on Form 3840 and attach a statement noting that the property was sold at a loss. The taxpayer must also report the loss on their California return; or
- **Property exchanged again:** If one of the replacement properties is exchanged again, that original replacement property should be removed from the Form 3840 filed in relation to the original exchange. A statement should be attached explaining that one of the original replacement properties was exchanged for a new replacement property, and that a new Form 3840 is being submitted with details concerning the second exchange. The new Form 3840 should have the "Initial FTB 3840" box checked on Question B and should list the property exchanged in the subsequent exchange as the relinquished property. The portion of the original deferred gain relating to that property should be reflected on the second Form 3840.

The taxpayer will continue to file multiple Forms 3840 in future years.

How should Form 3840 be completed if a taxpayer exchanges the replacement property for another property in a subsequent like-kind exchange?

If an out-of-state replacement property is later exchanged for another property as part of a tax-deferred exchange, the taxpayer is still required to file Form 3840 because the gain or loss deferral continues. When the taxpayer does a second exchange and relinquishes out-of-state property #1 for out-of-state property #2, the taxpayer must file a "final" Form 3840 for the first exchange and file an "initial" Form 3840 to track the new exchange.

What happens if a taxpayer fails to file Form 3840?

According to the Form 3840 instructions, if a taxpayer fails to file Form 3840, the FTB may issue a Notice of Proposed Assessment on the amount of income deferred, essentially accelerating the gain recognized on the deferred exchange into the year the form was not filed.

However, that's a little misleading. The law only allows the FTB to accelerate this gain recognition in a tax year if the taxpayer fails to file Form 3840 **and** also fails to file a California return for that year. (R&TC §18032(b)) This means that California taxpayers who file a return but fail to file Form 3840 would not be subject to this accelerated gain recognition.

Should a taxpayer file an amended return if they forgot to attach Form 3840 to the return?

The FTB strongly encourages taxpayers to submit Form 3840 with an amended return. This will ensure that the form is associated with the taxpayer's return because Form 3840 generally is required to be filed with the California tax return for taxpayers who have a California filing requirement. If it's filed separately, there will more likely be an inquiry from the FTB concerning the transaction.

If no return was required, the taxpayer should mail Form 3840 to the address listed in the form instructions.

Note: While Form 3840 may be included in an e-filed California return, the taxpayer may not e-file Form 3840 as a stand-alone form. Either way, the form is due by the extended due date of the return.

INVOLUNTARY CONVERSIONS

California conforms to the federal law that allows a taxpayer who receives insurance proceeds from an involuntary conversion in a Presidentially declared disaster to reinvest the proceeds in any tangible property held for productive use in a trade or business, without recognizing gain. (IRC §1033; R&TC §§18031, 24949.5)

Any tangible property of a type held for productive use in a trade or business, including inventory, will be treated as similar or related in service or use to business or investment property that is located in a disaster area and is involuntarily converted as a result of a federally declared disaster. (IRC §1033(h)(2)) The replacement property is not required to be located in the federally declared disaster area, nor must it be used in the same type or line of business.

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Part 3

Renée Rodda, J.D.

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PART 3

INTRODUCTION

The General Business Credit (GBC) is not a single credit. Rather it is the sum of over 30 credits that a business can claim against a portion of its tax liability. In any given year, the GBC can be comprised of unused GBC carryforwards, the current-year GBC, and carrybacks. (IRC §38(a))

Each of the individual credits is computed separately on the form applicable to that individual credit, and then all available credits are compiled and reported on Form 3800, General Business Credit, to determine the amount of combined credit that can be claimed as a GBC.

The GBC is nonrefundable, and limitations apply as to the total amount that may be claimed in any given year. IRC §§38 and 39 govern the computation of the GBC, including:

- The limits on how much of the GBC can be claimed against a taxpayer's tax liability;
- Carrybacks and carryforwards; and
- The order in which each of the 30-plus credits may be claimed.

Taxpayers that are unable to use the total credits available by the end of the carryover period can claim a deduction for the amount of specified unused credits.

This chapter will provide an overview of the mechanics of claiming the GBC and an in- depth discussion of the more common credits taken by your clients.

CREDITS COMPRISING THE GENERAL BUSINESS CREDIT

The following chart lists the credits that make up the GBC, the applicable IRC section, and the form on which the credit is computed. (IRC §38(b)) As discussed in more detail on page 3-9, the credits are claimed on Form 3800 in the order they are listed in the chart. The credits in bold are the credits most likely to apply to our clients and which we discuss in more detail throughout these materials.

Credits Comprising the General Business Credit		
Name of credit	**IRC section**	**Form number**
Investment Tax Credit, comprised of: **Rehabilitation Credit** **Energy Investment Credit** Qualifying Advanced Coal Project Credit Qualifying Gasification Project Credit Qualifying Advanced Energy Project Credit Qualifying Therapeutic Discovery Project Credit (carryover only) Advanced Manufacturing Investment Credit Clean Electricity Investment Credit (for post-2024 tax years)	§§46, 49, 50 §47 §48 §48A §48B §48C Former §48D §48D §48E	3468
Work Opportunity Credit	§51	5884
Alcohol Fuels Credit	§40	6478
Research Credit	§41	6765
Low-Income Housing Credit	§42	8586
Enhanced Oil Recovery Credit (**n**ot available during the 2022 and 2023 tax years)	§43	8830
Disabled Access Credit	§44	8826
Renewable Electricity Production Credit	§45	8835
Empowerment Zone Employment Credit	§1396	8844
Indian Employment Credit	§45A	8845
Employer Social Security Credit (aka the FICA Tip Credit)	§45B	8846
Orphan Drug Credit	§45C	8820
New Markets Tax Credit	§45D	8874
Small Employer Pension Plan Startup Costs Credit	§45E	8881
Employer-Provided Child Care Credit	§45F	8882
Railroad Track Maintenance Credit	§45G	8900
Biodiesel Fuels Credit	§40A	8864
Low Sulfur Diesel Fuel Production Credit	§45H	8896
Marginal Oil and Gas Well Production Credit	§45I	8904
Distilled Spirits Credit	§5011	8906
Advanced Nuclear Power Facility Production Credit	§45J	7213
Nonconventional Source Production Credit	§45K	Expired
		(continued)

Credits Comprising the General Business Credit (continued)		
Name of credit	**IRC section**	**Form number**
New Energy Efficient Home Credit	§45L	8908
Alternative Motor Vehicle Credit (for vehicles placed in service prior to 2022)	§30B	8910
Alternative Fuel Refueling Property Credit	§30C	8911
Mine Rescue Team Training Credit	§45N	8923
Agricultural Chemicals Security Credit	§45O	Expired
Differential Wage Payment Credit	§45P	8932
Carbon Dioxide Sequestration Credit	§45Q	8933
New Clean Vehicle Credit	§30D	8936
Small Employer Health Insurance Credit	§45R	8941
Paid Family and Medical Leave Credit	§45S	8994
Retirement Auto-Enrollment Credit	§45T	8881
Zero-Emission Nuclear Power Production Credit (post-2023 tax years)	§45U	Not available
Sustainable Aviation Fuel Credit	§40B	Not available
Clean Hydrogen Production Credit	§45V	7210
Qualified Commercial Clean Vehicle Credit	**§45W**	**8936**
Advanced Manufacturing Production Credit	§45X	7207
Clean Electricity Production Credit (post-2024 tax years)	§45Y	Not available
Clean Fuel Production Credit	§45Z	Not available
Military Spouse Retirement Plan	**§45AA**	**8881**

LIMITATIONS

In addition to the passive activity credit limitations discussed starting on page 1-14, the GBC is subject to an annual income limitation.

For noncorporate taxpayers, the amount of the GBC that can be claimed in a tax year is limited to the excess (if any) of the taxpayer's net income tax over the greater of:

- The taxpayer's tentative minimum tax; or
- 25% of the taxpayer's net regular tax liability in excess of $25,000. The $25,000 figure may be modified for MFS taxpayers, trusts and estates, and members of controlled groups (see IRC §38(c)(6)).
  (IRC §38(c))

"Net income tax" is the sum of the taxpayer's regular tax liability plus its alternative minimum tax (AMT) liability less most personal income tax credits (IRC §§21–30D) and the Foreign Tax Credit. "Net regular tax liability" is the taxpayer's regular tax liability reduced by specified personal income tax credits (IRC §§21–30D). (IRC §38(c))

Comment

Key things to keep in mind for noncorporate taxpayers:

- If a taxpayer is subject to the AMT, the taxpayer cannot claim the GBC in the current year, with exceptions for certain credits (discussed below);
- The GBC cannot offset more than 75% of the taxpayer's net income tax; and
- Taxpayers with regular tax liability of $25,000 or less are not subject to the limitation unless they are subject to the alternative minimum tax.

For corporate taxpayers, the amount of the credit is limited to 25% of net income tax in excess of $25,000. (IRC §38(c)(6)(E))

Example of GBC income limitation

Planetarius, Inc. is a C corporation and has General Business Credits equal to $175,000, $210,000 in net income tax, and $150,000 in tentative minimum tax.

Planetarius is limited to claiming $163,750 in General Business Credits for the tax year computed as follows:

Regular tax liability	$210,000
Threshold	- 25,000
Regular tax liability in excess of $25,000	185,000
Credit limitation percentage (corporation)	× 25%
Amount of credit limitation	$ 46,250
Regular tax liability	$210,000
Credit limitation	- 46,250
Maximum GBC allowed	$163,750

Because Planetarius's threshold limitation of $163,750 is greater than its TMT of $150,000, the amount of GBC Planetarius can claim in the tax year is $163,750.

The remaining $11,250 ($175,000 GBC - $163,750 limitation) of unused credit is subject to the carryback and carryforward rules discussed below.

Limitation for specified credits

The limitation discussed above is modified for the specified credits listed below by treating the tentative minimum tax as "0." This means noncorporate taxpayers can claim some of the credits that make up the GBC against both their regular tax liability and their AMT.

In addition, the limitation based on 25% of a portion of the taxpayer's tax liability is computed separately for these specified credits. The specified credit limitation is computed after the taxpayer's tax liability is reduced by all the other nonspecified GBC credits (see example below).

The specified credits are:

- Biofuel Producer Credit (IRC §40);
- Research Credit for an eligible small business as defined in IRC §38(c)(5), essentially nonpublicly traded corporations, partnerships, and sole proprietors whose average annual gross income for the preceding three taxable years does not exceed $50 million. (IRC §41);
- Low-Income Housing Credit (IRC §42);
- Renewable Electricity Production Tax Credit (PTC) for the four-year period after the facility is originally placed in service. (IRC §45) **Note:** The Renewable Electricity Production Tax Credit can be claimed over a ten-year period;
- FICA Tip Credit (IRC §45B);
- Railroad Track Maintenance Credit (IRC §45G);
- Small Employer Health Care Credit (IRC §45R);
- Employer Paid Family and Medical Leave Credit ((IRC §45S);
- Energy Credit (IRC §48);
- Rehabilitation Credit (IRC §47); and
- Work Opportunity Credit (IRC §51).

Example of GBC income limitation for specified credits

Lil's Restaurant, a Schedule C business, has:

Regular income tax liability	$35,000
Tentative minimum tax (TMT)	$50,000
AMT	$15,000
Nonspecified GBC	$5,000
Specified credits	$20,000
Non-GBC credits	$0

Nonspecified GBC credit limitation

Lil's cannot claim the GBC during the current year for its nonspecified GBC credits because its net income does not exceed its TMT, discussed above. Remember, the GBC can only be claimed up to the amount of Lil's net income, in excess of its TMT or the 25% income limitation component.

For Lil's, the GBC income limitation is computed as follows:

Regular tax liability	$35,000
AMT	15,000
Net income tax	$50,000
(A) TMT	$50,000
(B) Credit limitation*	$2,500
Net income tax in excess of the greater of (A) or (B)	$0

* ($35,000 regular tax - $25,000 threshold) × 25%

Lil cannot claim the GBC for these credits during the tax year because its TMT is the same as its "net income," and therefore no GBC is allowed.

(continued)

Example of GBC income limitation for specified credits (continued)

Specified GBC credit limitation

However, Lil's can claim the GBC for its specified credits because the GBC limitation is computed separately using the modified specified credit limitation formula.

For its specified credits for the current year, Lil's computation of its GBC is computed as follows:

Regular tax liability	$35,000
TMT	0
Net income tax liability	$35,000
(A) TMT	$0
(B) Credit limitation*	$2,500
Net income tax in excess of the greater of (A) or (B)	$32,500

* ($35,000 regular tax - $25,000 threshold) × 25%

CARRYBACKS AND CARRYFORWARDS

The amount of the GBC **allowed** in a tax year is equal to the sum of the following amounts (applied in the order listed here):

- The business credit carryforwards carried to the taxable year;
- The amount of the current-year business credit; and
- The business credit carrybacks carried back to the taxable year.
  (IRC §38(a))

However, the amount of GBC that can be **claimed** in the tax year cannot exceed the limitations described above.

Generally unused credits must first be carried back one year and then carried forward 20 years. However, beginning with the 2023 tax year, a three-year carryback period applies for applicable credits that can be treated as a tax payment by tax-exempt entities and government organizations (discussed on page 3-13).

Example of applying carryforwards and carrybacks

In 2023, ABC Corp. had a tax liability of $80,000. The $80,000 was partially offset by unused business credit carryforwards of $35,000 from 2021, and $10,000 from 2022, resulting in a 2023 net income tax liability of $35,000.

In 2024, ABC had an unused GBC of $40,000, which it carried back to 2023. ABC now has a credit carryforward from 2023 equal to $5,000 that may be carried forward until used, up to a maximum of 20 years.

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Practice Pointer

In general, no part of the unused credit for any year attributable to any credit can be carried back to any tax year before the first tax year for which that credit was first allowable. For example, the Qualified Commercial Clean Vehicle Credit can only be claimed for vehicles placed in service after 2022 and therefore cannot be carried back to the 2022 tax year.

However, this general rule does not apply to unused credits listed in IRC §6417(b), which may be carried back three tax years. As discussed in more detail below, IRC §6417 allows certain tax-exempt entities and governmental agencies to claim certain tax credits as a tax payment (see page 3-13).

ORDERING RULES

Taxpayers with more than one credit that exceeds the limitation must apply the credits in the order listed in the chart starting on page 3-2.

Carryovers from earlier years are applied prior to the current-year credits, and the ordering rules apply within each tax year.

Example of applying ordering rules

Tasty Goods, Inc. is a restaurant chain that has $35,000 of tax liability and $48,000 of GBC credits comprised of the following credits:

Work Opportunity Credit	$25,000
Small Employer Health Insurance Credit	$5,000
Disabled Access Credit	$5,000
Qualified Commercial Clean Vehicle Credit	$10,000
FICA Tip Credit	$3,000

Applying the ordering rules in the chart starting on page 3-2, the credits that can be claimed during the tax year are:

Work Opportunity Credit	$25,000
Disabled Access Credit	$5,000
FICA Tip Credit	$3,000
Small Employer Health Insurance Credit	$2,000

The remaining $3,000 of the Small Employer Health Insurance Credit and the $10,000 Qualified Commercial Clean Vehicle Credit must either be carried back to the prior year and/or carried forward.

Note: The Qualified Commercial Clean Vehicle Credit was first available in 2023. So, if this was the 2023 taxable year, then the credit could not be carried back to a year before 2023.

Example of applying ordering rules for multiyear carryovers

Revving Up, Inc. began its operations in 2022 and had NOLs in 2022 and 2023. During those years, it incurred a $10,000 Disabled Access Credit in 2022 and a $30,000 Rehabilitation Credit in 2023 that it was unable to claim.

In 2024, it generated taxable income but is limited to $75,000 in GBC that it could claim. It also generated a $50,000 Research Credit and a $20,000 Energy Investment Credit.

On its 2024 return, Revving Up may claim the GBC for the following credits:

Disabled Access Credit (2022 carryover)	$10,000
Rehabilitation Credit (2023 carryover)	$30,000
Energy Investment Credit (2024)	$20,000
Research Credit (portion of 2024's $50,000)	$15,000

The remaining $35,000 of the Research Credit will be carried forward to 2025.

Note: Oldest carryovers are claimed first. The 2024 Energy Investment Credit is applied prior to the 2024 Research Credit because it is above the Research Credit in the chart starting on page 3-2.

Claiming the carryback

Taxpayers can either claim the carryback on an amended return or by filing:

- Form 1139, Corporation Application for Tentative Refund; or
- Form 1045, Application for Tentative Refund.

✐ **Practice Pointer**

Forms 1139 and 1045 must generally be filed by the end of the tax year following the tax year in which the credit arose. They are filed with the IRS Service Center where the taxpayer files their return. The IRS must act on these applications within 90 days.

Credit recaptures

If a credit is subject to recapture, amended returns do not need to be filed. The amount of the credit carryforward is reduced by the amount of the recapture. (Instructions to Form 3800)

DEDUCTION FOR UNUSED CREDITS

Taxpayers unable to use up all of their available qualified business credit(s) may be able to claim a deduction for the unused credit at the end of their 20-year carryover period. (IRC §196) The deduction is generally claimed in the year following the end of the carryover period.

Comment

This deduction is an attempt to make taxpayers somewhat "whole." Most credits prohibit a taxpayer from claiming a deduction for expenses for which a credit is claimed. The IRC §196 deduction allows them to claim deductions for expenses for which they were not able to claim the credit. Unfortunately, most taxpayers must wait 21 years to claim the deduction.

QUALIFIED BUSINESS CREDITS

A deduction may only be claimed for the following unused credits:

- Investment Tax Credit for property that had an IRC §50(c) basis adjustment;
- Work Opportunity Credit;
- Alcohol Fuels Credit;
- Research Credit, unless the taxpayer made an IRC §280C(c) election to reduce the credit;
- Enhanced Oil Recovery Credit;
- Empowerment Zone Employment Credit;
- Indian Employment Credit;
- FICA Tip Credit;
- New Markets Credit;
- Small Employer Pension Plan Start-Up Costs Credit;
- Biodiesel Fuels Credit;
- Low Sulfur Diesel Fuel Production Credit;
- Energy Efficient Home Credit; and
- Small Employer's Health Care Credit.
  (IRC §196(c))

ACCELERATED DEDUCTION

The deduction may be claimed earlier than the end of the 20-year carryover period if:

- The taxpayer dies; or
- Ceases to exist.
  (IRC §196(b))

In such instances, the taxpayer may claim the deduction in the year the taxpayer dies or ceases to exist. This can be especially important for taxpayers selling their business who have yet to claim all of their unused GBC because they may offset gains from the sale of the business with this increased deduction.

CLAIMING THE GBC

As discussed above, taxpayers must first compute the source credit on the applicable credit form, and then the credit is bundled with the other General Business Credits on Form 3800.

Partnerships and S corporations must always complete and attach the source forms for the various component credits to their entity income tax returns.

All other filers whose only source for a credit is from a partnership, S corporation, estate, trust, or cooperative or who received the credit as a transfer from an unrelated eligible taxpayer can report most component credits directly on Form 3800. However, the source forms must still be attached to the taxpayer's return if the taxpayer is:

- Claiming the Investment Tax Credit (Form 3468) or the Biodiesel Fuels Credit (Form 8864);
- An estate or trust and the source credit must be allocated to beneficiaries; or
- A cooperative and the source credit can or must be allocated to patrons.

FORM 3800 REVISIONS

Form 3800 underwent a major revision beginning with the 2023 tax return. The form was expanded from three parts to six parts to accommodate the IRA ’22 provisions that allow taxpayers to transfer credits and certain eligible taxpayers to claim credits as a tax payment and to simplify how the various credits are reported.

The six parts of Form 3800 are:

- **Part I:** Current Year Credit for Credits Not Allowed Against Tentative Minimum Tax. This part has not been significantly modified;
- **Part II:** Allowable Credit, which computes the amount of the allowable credit for the year based on the taxpayer’s income limits, passive income, etc., has not undergone any significant changes;
- **Part III:** Current Year General Business Credits has undergone a major redesign. Now, instead of having to complete a separate Part III if they had a credit from both passive and nonpassive activities, or if they received the same credit from more than one passthrough entity, Part III has been revised to include 10 columns so taxpayers can indicate whether:
  - An applicable entity is electing to treat the credit as a tax payment and for how much;
  - The taxpayer is transferring the credit and how much is being transferred; and
  - Whether the credit is related to passive or nonpassive activities;
- **Part IV (new):** This part breaks out accrued credits and carryovers;
- **Part V (new):** This part is used to break down an aggregate current-year credit amount reported in Part III if the credit amount includes credits from more than one tax year, from more than one passthrough entity, or from both passive and nonpassive activities. It also is used to report credit transfer amounts and elective tax payments; and
- **Part VI (new):** This part is used to provide similar information as that provided in Part IV, but the information pertains to accrued carrybacks and carryovers.

MONETIZING SPECIFIED ENERGY CREDITS

The Inflation Reduction Act of 2022 enacted two new provisions (IRC §§6417 and 6418), which, beginning with the 2023 tax year, allow certain taxpayers to either apply certain energy-related tax credits as tax payments (primarily for certain tax-exempt and governmental entities) or sell certain energy credits. (IRC §6417; Treas. Regs. §1.6417-0 et seq.; IRC §6418; Treas. Regs. §1.6418-0 et seq.)

Comment

Energy credit marketplaces are beginning to pop up. A simple Google search for selling energy credits will produce multiple companies advertising themselves as marketplaces for managing and brokering the acquisition and sale of eligible energy credits.

According to one recent article, in the first six months since the IRS released guidance as to transferring credits, deals totaling up to $9 billion in credit sales were negotiated. Buyers paid an average of 92 to 94 cents on the dollar for credits. Crux, an online platform for transferring tax credits, and other companies like it say they charge fees ranging from less than 1% to 3% of the value of the credits, which can only be sold once. (Binnie, Isla (January 16, 2024) “US energy tax credit trading grows to as much as $9 billion, study funds” *Reuters*. Available at: www.reuters.com/business/energy/us-energy-tax-credit-trading-grows-much-9-billion-study-finds-2024-01-16/)

REGISTRATION

The IRS has opened an online registration tool for eligible taxpayers that want to monetize their energy credits. (IR-2023-249) Registration is required before any qualifying business, tax-exempt organization, or government or tribal entity can monetize their energy credits.

Once an entity registers through the IRS's registration tool, which can be found at the link below, the entity must receive a registration number from the IRS before monetizing their energy credits.

Entities should register after the energy property or facility has been placed in service, but the IRS recommends registering at least 120 days prior to filing the entity's income tax returns for the year. The 120-day lead time is so the IRS has plenty of time to review the registration information provided and obtain additional information if needed. The registration number must be included on the entity's income tax return.

The registration website is:

Website
www.irs.gov/credits-deductions/register-for-elective-payment-or-transfer-of-credits

Practice Pointer

We have gone through the registration process already and would like to share some of our observations:

- Taxpayers may require more than one registration number. Be sure to review the form instructions for the particular energy credit being claimed to determine how many registration numbers will be required;
- The registration process was easy, and practitioners can do it on their client's behalf after logging in using their ID.me account;
- The registration process requires that you provide a client's bank account and routing numbers even though this is just an early registration process. Obtain this information ahead of time if you don't have it already;
- The registration process requires that you input the latitude and longitude of the facility where the energy property is placed in service. This is easy to do using a Google search of the facility's physical address;
- The registration process asks for documents to be uploaded related to the facility but provides no direction regarding the nature of the documents. The registration process can be completed without uploading any documents, but a notice during the registration process states that the IRS's processing time will be longer if no documents are uploaded; and
- When submitting the registration, we were met with a warning stating that there may be an error and requesting that we double-check our input. After double-checking all input, including entity name and EIN, we found no errors and resubmitted the registration successfully. So, a potential matching error on the IRS's end does not appear to prevent you from submitting the registration, despite an initial error message.

ELIGIBLE CREDITS

The credits that may be transferred include, but are not limited to, the:

- IRC §45 Renewable Electricity Production Tax Credit;
- IRC §45Y Clean Electricity Production Tax Credit for facilities placed in service after 2024;
- IRC §48 Energy Investment Credit (often referred to as the business solar credit); and
- IRC §48E Clean Electricity Investment Credit for facilities placed in service after 2024.

For a complete listing of the applicable credits, see IRC §6418(f)(1)(A).

ELIGIBLE TAXPAYERS

Taxpayers eligible to transfer the credit include any person subject to any internal revenue tax, other than government agencies, Indian tribes, or tax-exempt entities (as discussed below, these latter entities can treat these credits as tax payments).

This means taxpayers subject to a U.S. employment tax or an excise tax, such as partnerships and S corporations, can transfer the credit even if the taxpayer is not subject to an income tax or corporate tax. (Treas. Regs. §1.6418-1(b))

Limitations

The eligible taxpayer cannot transfer credits to related taxpayers (within the meaning of IRC §267(b) or §707(b)(1)) and cannot transfer the credit for noncash consideration, such as various price reductions for products or services.

A credit can only be sold/transferred once. (IRC §6418(a) and (e)(2))

ELIGIBLE CREDIT AMOUNT

Taxpayers can transfer the entire credit or a portion of the allowable credit. Eligible taxpayers can sell credits to multiple transferees as long as the total credit transferred does not exceed the amount of the eligible credit determined with respect to the eligible credit property. (Treas. Regs. §1.6418-2(a)(2))

Taxpayers cannot transfer the "bonus" portion of a credit (e.g., the component attributable to a taxpayer meeting the wage and apprenticeship requirements) separately from the base portion of the credit.

MAKING THE ELECTION

An irrevocable election must be made on an original or superseding return filed by the extended due date for the return for the taxable year for which the credit is determined. (IRC §6418(d); Treas. Regs. §1.6418-2(f)) For S corporations and partnerships, the election is made at the entity level.

A separate transfer election must be made for each credit or portion of credit transferred with respect to a single eligible credit property and for each year the credit is available.

Both the eligible taxpayer and the transferee taxpayer must each attach a transfer election statement to each of their returns. Details of what must be included in the election statement are outlined in Treas. Regs. §1.6418-2(b)(5).

CLAIMING THE CREDIT

The transferred credit is claimed in the first taxable year of the transferee taxpayer ending with, or after, the taxable year of the transferor with respect to which the credit was determined. (IRC §6417(d)(6); Treas. Regs. §1.6418-5) The credit is claimed on Form 3800.

Excessive credits

Transferee taxpayers that claim too much of a credit are liable for the amount of the excessive payment plus, absent reasonable cause, an additional amount equal to 20% of the excessive payment. (Treas. Regs. §1.6418-5(d) and (e))

CREDIT RECAPTURE

For transferred eligible credits under IRC §48, §48E, or §48C, or transferred carbon sequestration tax credits under IRC §45Q, the proposed regulations provide that the transferee bears the financial responsibility for a recapture event. Remember, these credits are subject to a five-year recapture provision if the property is disposed of or taken out of service. (Treas. Regs. §1.6418-2(d)(1))

CREDITS TREATED AS TAX PAYMENTS FOR TAX-EXEMPT ORGANIZATIONS AND GOVERNMENTAL AGENCIES

In addition to the credit transfer rules discussed above, the IRS has also issued proposed regulations regarding the election available to tax-exempt organizations and governmental agencies and their instrumentalities that allows them to treat the various energy credits as elective tax payments, applicable beginning with the 2023 tax year. (REG-101607-23; Prop. Treas. Regs. §1.6417-0 et seq.) The election applies to any entity exempt under IRC §501(a), which includes charitable and religious organizations. Any elective tax payments made in excess of amounts the entity may owe will be refunded to the taxpayer.

Comment

The purpose of IRC §6417, which allows certain entities to elect to treat some energy credits as tax payments, is to benefit tax-exempt entities. Income tax credits provide little or no benefit to tax-exempt organizations because they don’t typically have any income tax liabilities.

By allowing these entities to elect to treat the credits as a tax payment under IRC §6417, they can now receive the same monetary benefit of energy credits that for-profit taxpayers receive.

Comment

These rules apply to the same credits available for credit transfers. However, the election for tax-exempt organizations and governmental agencies also applies to the IRC §45W Commercial Clean Vehicle Credit. (Prop. Treas. Regs. §1.6417-1(b))

The irrevocable election and the elective tax payment is made on the entity’s timely filed (including extensions), original annual tax return. (Prop. Treas. Regs. §1.6417-2(b)) Form 990-T, Exempt Organization Business Income Tax Return, should be used for all entities not otherwise required to file a return.

The rules clarify that the credit amounts may be reduced for investment credit property purchased, constructed, erected, etc., with certain tax-exempt income such as various grants and forgiven loans provided to invest in qualified property.

Additional information

The IRS has issued FAQs regarding these elective pay provisions as well. They are available at:

Website
www.irs.gov/credits-deductions/
elective-pay-and-transferability-frequently-asked-questions-elective-pay

INVESTMENT TAX CREDIT

The Investment Tax Credit is the sum of the following tax credits:

- Rehabilitation Credit (see page 3-19);
- Energy Investment Credit (see page 3-22);
- Qualifying Advanced Coal Project Credit (IRC §48A);
- Qualifying Gasification Project Credit (IRC §48B);
- Qualifying Advanced Energy Project Credit (IRC §48C) Note: Taxpayers must apply to the Department of Energy to be awarded this credit (see www.energy.gov/infrastructure/qualifying-advanced-energy-project-credit-48c-program);
- Qualifying Therapeutic Discovery Project Credit (carryfoward only);
- Advanced Manufacturing Investment Credit (IRC §48D); and
- For property placed in service after 2024, Clean Electricity Investment Credit ((IRC §48E); see page 3-30).
  (IRC §46)

INVESTMENT CREDIT PROPERTY

Investment credit property is any depreciable or amortizable property that qualifies for one of the credits listed above.

Ineligible property

The credit cannot be claimed for property that is:

- Used mainly outside the United States (except for property described in IRC §168(g)(4) such as transportation property, satellites, etc.);
- Used by a governmental unit or foreign person or entity unless the property is leased for under six months, or for buildings leased to such entities or persons for which a Rehabilitation Credit is claimed;
- Used for lodging or in the furnishing of lodging unless an exception applies under IRC §50(b)(2) such as transient lodging and any energy property (see page 3-23);
- Property used by a tax-exempt organization unless it is used predominantly in an unrelated trade or business; or
- Certain MACRS business property to the extent it has been expensed under IRC §179.
  (IRC §50(b); Instructions to Form 3468)

AT-RISK LIMITATION

The Investment Tax Credit is generally determined based on a percentage of the taxpayer's basis in the investment credit property. However, under the IRC §49 at-risk limitation rules, the credit may be limited if:

- The taxpayer borrowed against the property and is protected against loss; or
- If they borrowed money from a person who is related or who has an interest (other than as a creditor) in the business activity.

The cost or basis must be reduced by the amount of the nonqualified nonrecourse financing related to the property as of the close of the tax year in which the property is placed in service. If, at the close of a tax year following the year property was placed in service, the nonqualified nonrecourse financing for any property has increased or decreased, then the credit base for the property changes accordingly. The changes may result in an increased credit or a recapture of the credit in the year of the change.

Example of at-risk limitation rules

Jessie purchases a historic building for $1 million with the intention of rehabilitating it and claiming the Rehabilitation Tax Credit (discussed below). The rehabilitation costs are expected to be $800,000. Jessie funds the purchase and rehabilitation with $500,000 of her own money and $1.3 million through a nonrecourse loan.

The maximum Rehabilitation Credit is 20% of the qualified rehabilitation expenditures. In this case, the credit would be $160,000 (20% of $800,000).

However, the at-risk rules limit Jessie's ability to claim the credit. The amount she is considered "at-risk" for is limited to the amount of her personal investment and any recourse debt, which in this case would be the $500,000 (her own money) because the $1.3 million loan is nonrecourse.

As a result, Jessie's Rehabilitation Credit is limited to $100,000 (20% of her at-risk amount of $500,000), even though the total credit based on the rehabilitation expenditures would have been $160,000.

If the nonrecourse loan were instead a recourse loan, Jessie's at-risk amount would be $1.8 million ($500,000 personal investment + $1.3 million recourse loan), and she would be able to claim the full $160,000 Rehabilitation Credit.

Qualified nonrecourse financing

Taxpayers who are engaged in the activity of holding real property are considered to be at risk with respect to the taxpayer's share of qualified nonrecourse financing that's secured by the real property. (IRC §465(b)(6)(A); Treas. Regs. § 1.465-27(a))

If Jesse's loan of $1.3 million had been classified as qualified nonrecourse financing, then she would have been able to claim the maximum Rehabilitation Credit because she would be deemed to be at risk for greater than the rehabilitation costs of $800,000.

BASIS ADJUSTMENTS

Basis adjustment to energy property within the Energy Investment Tax Credit

If a business receives an Investment Tax Credit for investment credit property, the basis of the property must be reduced by the amount of the credit claimed (only 50% of the credit claimed for Energy Credit property). (IRC §50(c))

Example of basis adjustment

Penco, Inc., a C corporation, is a manufacturer and owns a factory with an adjusted basis of $7 million. Penco purchases and installs solar panels on its factory on August 4, 2024, at a cost of $230,000 and receives an Investment Tax Credit of $69,000 ($230,000 × 30%).

The new basis of Penco's building is $7,195,500 calculated as follows:

Adjusted basis before solar panels	$7,000,000
Plus solar panel installation (capital improvement)	230,000
Less 50% of credit	(34,500)
New basis	$7,195,500

Comment

Most tax credits require taxpayers to reduce their basis (or reduce a deduction) by 100% of the credit claimed in order to prevent taxpayers from realizing a double benefit. However, the Investment Tax Credit only requires taxpayers to reduce their basis by 50% of the credit claimed.

This provision gives taxpayers a double benefit for 50% of their Investment Tax Credit as an incentive to invest in eligible energy property.

Adjustment in basis of interest in partnership or S corporation

The adjusted basis of a partner's interest in a partnership or a shareholder's stock in an S corporation must also be adjusted to take into account the entity's basis adjustments in the investment credit property held by the partnership or S corporation. (IRC §50(c)(5))

Example of partner/shareholder basis adjustment

In the above example, assume Penco is an S corporation with two shareholders, Mary and Amanda. Mary owns 25% of Penco's issued and outstanding shares, and Amanda owns 75%. Mary and Amanda would each reduce the basis of their Penco stock as follows:

Mary:
$34,500 downward basis adjustment × 25% = $8,625

Amanda:
$34,500 downward basis adjustment × 75% = $25,875

Mary's and Amanda's K-1s from Penco should provide them with the information necessary to make their basis adjustments.

If Penco is a partnership, then Mary and Amanda would make the adjustments to their outside basis in the partnership in the same way pursuant to Treas. Regs. §1.704-1(b)(2)(iv)(j).

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Recapture of reductions

For purposes of IRC §§1245 and 1250, any reduction in basis due to the Investment Tax Credit is treated as a deduction allowed for depreciation. (IRC §50(c)(4)(A))

For purposes of IRC §1250(b), the determination of what would have been a depreciation adjustment under the straight-line method is made as if there had been no reduction. (IRC §50(c)(4)(B))

Basis adjustments where credits are recaptured

If any amount of the credit is recaptured (discussed below) with respect to any investment property the basis of which was reduced, the basis of the property (immediately before the event resulting in recapture) is increased by an amount equal to such recapture amount.

The downward basis adjustments made by S corporation shareholders and partnership partners must be restored to the extent credits are recaptured.

SPECIAL RULES FOR CERTAIN TAX-FAVORED ORGANIZATIONS

Special rules apply to certain tax-favored organizations, including regulated investment companies (RICs), public utilities, certain cooperative organizations, religious organizations, and others. Detailed discussions of specialized industries are beyond the scope of this course but are mentioned here to make the practitioner aware that if their client is a business that receives tax-favored treatment, then they should be aware that their solar credits may be limited. (IRC §50(d))

CREDIT BASE AND AT-RISK RULES

Special rules reduce the credit base of investment credit property and subject such property to at-risk rules under IRC §49. However, energy property, including solar property, is excluded from these rules.

CLAIMING THE CREDIT

The Investment Tax Credit is claimed on Form 3468, Investment Credit. Taxpayers complete a separate Form 3468 to claim a credit for each investment property and any unused Investment Tax Credit amount from cooperatives.

The credit is normally claimed for the year the property is placed in service. However, a taxpayer can elect to claim the credit for qualified progress expenditures before the property is placed in service.

Qualified progress expenditure property

Qualified progress expenditure property is any property that is being constructed by or for the taxpayer and which:

- Has a normal construction period of two years or more; and
- It is reasonable to believe that the property will be new Investment Tax Credit property in the hands of the taxpayer when it is placed in service.

Qualified progress expenditures for:

- Self-constructed property means the amount that is properly chargeable (during the tax year) to a capital account with respect to that property; or
- Non–self-constructed property means the lesser of:
  - The amount paid (during the tax year) to another person for the construction of the property; or
  - The amount that represents the proportion of the overall cost to the taxpayer of the construction by the other person, which is properly attributable to that portion of the construction that is completed during the tax year.

CREDIT RECAPTURE

The Investment Tax Credit is subject to recapture if the taxpayer disposes of investment credit property before the end of five full years after the property was placed in service (recapture period). (IRC §50(a)(1))

Recapture also applies if:

- The taxpayer changes the use of the property before the end of the recapture period so that it no longer qualifies as investment credit property;
- The business use of the property decreases before the end of the recapture period so that it no longer qualifies (in whole or in part) as investment credit property;
- Any building or property for which the credit was claimed for qualified progress payments will no longer be a qualified rehabilitated building when placed in service;
- Before the end of the recapture period, the taxpayer's proportionate interest is reduced by more than one-third in an S corporation, partnership, estate, or trust that allocated the cost or basis of property to the taxpayer for which the taxpayer claimed a credit;
- The taxpayer returns leased property (on which they claimed a credit) to the lessor before the end of the recapture period; and
- A net increase in the amount of nonqualified nonrecourse financing occurs for any property to which the IRC §49(a)(1) at-risk rules applied.
  (IRC §50(a)(1))

The recapture percentage is 100% if the property ceases to be investment credit property within the first full year after being placed in service and is reduced 20% per year thereafter. (IRC §50(a)(1)(A)); IRS Notice 2013-12) The following table sets forth the recapture percentage during the year in the five-year recapture period the property is disposed of or ceases to be investment credit property (IRC §50(a)(1)(B)):

Recapture Percentage	
If the property ceases to qualify within:	**The recapture percentage is:**
One full year after the property is placed in service	100%
The second full year	80%
The third full year	60%
The fourth full year	40%
The fifth full year	20%

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Unused credit carryovers must be adjusted

Unused Investment Tax Credits may be carried back one year and forward twenty years. If the investment credit property is disposed of or otherwise ceases to be investment credit property, then any carrybacks or carryforwards resulting from recaptured credits must be adjusted.

The basis of the investment credit property is increased by the amount of any recaptured credit.

Example of credit recapture

ABC Inc. purchases a piece of equipment for $1 million on January 15, 2022, and claims an Investment Tax Credit of $100,000 (assuming a 10% credit rate). The company plans to use this equipment in its manufacturing process for the next five years, which is the recapture period for this particular type of equipment.

However, on January 14, 2024, ABC Inc. sells the equipment to another company for $750,000. Since ABC Inc. did not hold the equipment for the full five-year recapture period, a portion of the Investment Tax Credit claimed is subject to recapture.

The recaptured amount is calculated by determining the difference between the credit claimed and the credit that would have been allowed for the actual duration of use. In this case:

Original credit claimed	$100,000
Recalculated credit ($100,000 × (2 years ÷ 5 years))	- 40,000
Recaptured amount ($100,000 - $40,000)	$ 60,000

ABC Inc. will need to add $60,000 to its tax liability in the year of the sale (2024) to account for the recaptured portion of the Investment Tax Credit.

Exceptions to recapture

Recapture doesn't apply if:

- The transfer is due to the taxpayer's death;
- The transfer is incident to divorce under IRC §1041. However, a later disposition by the transferee is subject to recapture to the same extent as if the transferor had disposed of the property at the later date;
- A corporate IRC §381(a) transaction occurs (relating to certain acquisitions of the assets of one corporation by another corporation); or
- A mere change in the form of conducting a trade or business (e.g., entity elects or revokes S corporation status) if:
  - The property is retained as investment credit property in that trade or business; and
  - The taxpayer retains a substantial interest in that trade or business.

(Form 3468 Instructions)

REHABILITATION CREDIT

Taxpayers may claim a credit for a portion of their qualified rehabilitation expenditures made for any qualified rehabilitated building. (IRC §47) The Rehabilitation Credit is part of the Investment Tax Credit and is also commonly referred to as the Historic Preservation Tax Credit.

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An IRS webpage and FAQs with detailed discussion of this credit is available at:

Website
www.irs.gov/businesses/small-businesses-self-employed/rehabilitation-credit

CREDIT AMOUNT

The credit is equal to 20% of the qualified rehabilitation expenditures and is claimed ratably over a five-year period, beginning with the year the property is placed in service (earlier if the taxpayer elects to take the credit for qualified progress payments under IRC §47(d)) (see page 3-17).

Example of claiming the credit

Charlie incurs $50,000 of qualified rehabilitation expenditures in 2023 and 2024. The building is placed in service in 2024. Charlie is eligible for a Rehabilitation Credit equal to $10,000. He would claim a $2,000 credit each year for a period of five years starting with the 2024 tax year, subject to the Investment Tax Credit limitations discussed beginning on page 3-14. No credit can be claimed during the 2023 tax year, even though Charlie incurred expenses during the 2023 tax year.

WHO CAN CLAIM THE CREDIT

Taxpayers that own an interest in a qualified rehabilitated building directly or through a passthrough entity, or are lessees of the building in certain cases, are eligible to claim the Rehabilitation Credit and generally include:

- Individuals;
- Corporations;
- Partners, shareholders, and beneficiaries of a passthrough entity; and
- Estates and trusts.

A passthrough entity is not eligible to claim the Rehabilitation Credit. A passthrough entity can allocate qualified rehabilitation expenditures to its partners, shareholders, or beneficiaries. A partner, shareholder, or beneficiary may claim the Rehabilitation Credit provided all requirements are met.

Lessees of qualified rehabilitated buildings may qualify for the Rehabilitation Credit if the lessor that owns a building elects to treat a lessee of the building (or a portion of the building) as having purchased the building solely for purposes of the Rehabilitation Credit. The lessee of the building (or a portion of the building) is allowed to take the qualified rehabilitation expenditures into account for claiming the Rehabilitation Credit provided certain requirements are met. Treas. Regs. § 1.48-4(a)(1) provides the requirements for the time and manner for making an election to treat the lessee as having purchased the building for purposes of the Rehabilitation Credit.

In the case of a long-term lease, the lessee's expenditures may be qualified rehabilitation expenditures, and the lessee can claim a Rehabilitation Credit even without the lessor's election provided certain requirements are met. However, if on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than the recovery period determined under IRC §168(c), then the lessee's expenditures are not included as qualified rehabilitation expenditures. The recovery period for residential rental property is 27.5 years, and the recovery period for nonresidential real property is 39 years.

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QUALIFIED REHABILITATED BUILDING

A qualified rehabilitated building is a building that meets all of the following requirements.

- The building must be a certified historic structure. A certified historic structure is any building:
  - Listed in the National Register of Historic Places; or
  - Located in a registered historic district.
- Certification requests are made through the taxpayer's State Historic Preservation Officer on National Park Service (NPS) Form 10-168, Historic Preservation Certification Application. The request for certification should be made prior to physical work beginning on the building.
- The building must be substantially rehabilitated. A building is considered substantially rehabilitated if the taxpayer's qualified rehabilitation expenditures during a self-selected 24-month period (60 months for phased rehabilitations) that ends with or within the taxpayer's tax year are more than the greater of:
  - $5,000; or
  - The taxpayer's adjusted basis in the building and its structural components.
- Depreciation must be allowable with respect to the building. Depreciation isn't allowable if the building is permanently retired from service.
- The building must have been placed in service before the beginning of rehabilitation. This requirement is met if the building was placed in service by any person at any time before the rehabilitation began.

QUALIFIED REHABILITATION EXPENDITURES

In general, the term "qualified rehabilitation expenditure" means:

- Any amount properly chargeable to a capital account;
- That is incurred by the taxpayer;
- For property for which depreciation is allowable under I.R.C §168, which is:
  - Nonresidential real property;
  - Residential real property;
  - Real property which has a class life of more than 12.5 years; or
  - An addition or improvement to the property describe above; and
- That is made in connection with the rehabilitation of a qualified rehabilitated building.

Practice Pointer

The Energy Credit (discussed below) cannot be claimed for the portion of the basis of property that is attributable to qualified rehabilitation expenditures. (IRC §48(a)(2)(B))

Nonqualified expenditures

Examples of nonqualified expenditures include:

- Acquisition costs;
- Enlargement costs; and
- Expenditures for work done on property related to the building, such as sidewalks, parking lots, and landscaping.

CLAIMING THE CREDIT

The credit is computed on Form 3648, Part VII, reported on Form 3800, Part III, line 4k, and may be claimed against AMT.

Additional information

The IRS has a list of Rehabilitation Credit FAQs available at:

Website
www.ftb.ca.gov

ENERGY INVESTMENT CREDIT

IRC §48 provides for credits of up to 30% (plus additional bonus credits) for expenditures on nonresidential energy property that produces renewal energy. The business energy credit is frequently referred to as the Energy Investment Credit and is available only for construction of energy properties that begins prior to January 1, 2025, when the IRC §48E Clean Electricity Investment Credit will kick in (see page 3-30).

Planning Pointer

Key things to keep in mind:

- The IRC §48 Energy Investment Credit is only available for property the construction of which begins prior to January 1, 2025. Property for which construction commences after 2024 may be eligible for the IRC §48E Clean Electricity Investment Credit discussed beginning on page 3-30;
- Property that qualifies for the Rehabilitation Credit cannot also qualify for the Energy Credit (IRC §48(a)(2)(B));
- For certain property (e.g., solar and wind facilities), taxpayers must choose between claiming the Energy Investment Credit and the Production Tax Credit for the same property. See page 3-46 for a discussion of factors to consider when determining which credits to choose; and
- The credit cannot be claimed for property for which the taxpayer receives a §1603 American Recovery and Reinvestment Act grant from the Treasury Department.

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ENERGY PROPERTIES

Energy properties include the properties as defined in IRC §48(c), but only if they meet certain general qualifications discussed below.

> ***Comment***
>
> While many of the energy-related business credits only benefit large energy-related companies, this credit and the Production Tax Credit discussed on page 3-46 may provide the impetus for smaller startup companies (e.g., wind and solar production companies) to form.

> ***Comment***
>
> The focus of this discussion is for our clients that may qualify for the Energy Investment Credit for making their buildings or facilities more energy efficient. This material will not delve into the details that are more applicable to energy companies and alternative energy generators.

Energy properties include:

- Geothermal energy property;
- Solar energy property to generate electricity, or solar energy property to illuminate;

> ***Solar energy property defined***
>
> Solar energy property for purposes of the Energy Investment Credit is equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat (other than to heat a swimming pool). (IRC §48(a)(3)(A)(i)) Such property includes:
>
> - Solar panels;
> - Storage devices;
> - Power conditioning equipment;
> - Transfer equipment; and
> - Parts related to the functioning of those items (e.g., solar cells or other collectors).
>
> However, solar energy property used to generate electricity only includes equipment up to (but not including) the stage that transmits or uses electricity. (Treas. Regs. §1.48-9(d)(3))

- Qualified fuel cell property;
- Qualified microturbine property;
- Combined heat and power system property;
- Qualified small wind energy property, which is property that uses a wind turbine that has a nameplate capacity of not more than 100 kilowatts that is used to generate electricity;

> ***Comment***
>
> How much a 100 kilowatt wind turbine can support can vary depending on a property's electricity usage and the amount of wind in an area, but to put this in perspective, according to energy.gov it would take a 1.5-kW wind turbine to meet the average needs of a typical home in a location with an annual average wind speed of 14 mph. (https://windexchange.energy.gov/small-wind-guidebook#size)

- Waste energy recovery property;
- Geothermal heat pump system property, which is equipment that uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure;
- Energy storage technology property (see below for definition);
- Qualified biogas property;
- Microgrid controllers property;
- Qualified investment credit facility; and
- Clean hydrogen production facility treated as energy property.

Energy storage technology property defined

Energy storage technologies placed in service after 2022 now qualify for the Energy Investment Credit. This includes but is not limited to batteries, as long as the property has a nameplate capacity of not less than 5 kilowatt hours.

Modifications to existing storage systems

Modifications to energy storage technology property with a capacity of less than 5 kilowatt hours to bring it up to a capacity of at least 5 kilowatt hours also qualifies for the credit, even if it was installed prior to 2022. However, the basis of the existing property prior to the modification will not be included in the calculation of the credit.

Thermal energy storage property

Thermal energy storage property is property comprising a system that:

- Is directly connected to a heating, ventilation, or air conditioning system;
- Removes heat from, or adds heat to, a storage medium for subsequent use; and
- Provides energy for the heating or cooling of the interior of a residential or commercial building.

Thermal energy storage property doesn't include a swimming pool, combined heat and power system property, or a building or its structural components.

GENERAL QUALIFICATION CRITERIA FOR ENERGY PROPERTY

Construction or original use

Only energy property that the taxpayer constructs, reconstructs, erects, or acquires for original use, or that is acquired by the taxpayer if the original use of the property commences with the taxpayer, is eligible for the credit. (IRC §48(a)(3)(B))

Must be depreciable or amortizable property

In order to qualify as "energy property," the property must be subject to the allowance for depreciation (or amortization in lieu of depreciation). (IRC §48(a)(3)(C))

No credit for lease unless capital lease

The requirements that the property be subject to the allowance for depreciation removes leased solar energy property from the credit. However, a lease treated as a capital lease would qualify because the property would be subject to the allowance for depreciation.

Depreciable life for solar property

Solar property falls under the five-year property classification under IRC §168 (MACRS) and is bonus depreciation eligible. (CCA 201032038; IRC §168(e)(3)(B)(vi)(I))

Property must meet performance and quality standards

The energy property must meet quality performance standards (if any) that have been prescribed by the IRS and are in effect at the time of the acquisition of the property. (IRC §48(a)(3)(D)) The IRS works with the Department of Energy to develop standards that change as technology changes. Practitioners should advise their clients to verify that the property they seek to install meets all current government standards.

AMOUNT OF THE CREDIT

The base amount of the Energy Investment Credit is generally 6% of the basis of the energy project. (IRC §48(a)(2)(A)(i)(II)) Additional limits may also apply depending on the type of property involved.

The credit is increased five times and becomes a 30% "bonus credit rate" if:

- Construction of the facility began prior to January 30, 2023 (IRS Notice 2022-61);
- The project is small enough to be exempt from the wage and apprenticeship requirements (IRC §48(a)(9)(B)(i)); or
- Certain wage and apprenticeship requirements are met (IRC §48(a)(9)(A)(i)).

An "energy project" is a project consisting of one or more energy properties that are part of a single project. (IRC §48(a)(9)(A)(ii))

Additional amounts may also be claimed if the taxpayer meets the domestic content requirements or is in an energy community or low-income community. See page 3-28.

Old phaseouts retroactively repealed

Taxpayers may claim the full 30% credit if the property is placed in service after 2021.

Under pre-Inflation Reduction Act law, the amount of the Energy Investment Credit was phased down to 26% for solar energy property, qualified fuel cell property, and qualified small wind property if the construction began after 2019 and the property was placed in service prior to 2026. The credit was scheduled to be further reduced to 22% if the construction began after 2022. The Inflation Reduction Act limits the application of the 26% rate to those properties that were placed in service prior to 2022.

Additional limits

The following properties have additional credit amount limits:

- Qualified fuel cell property: capped at $1,500 for each 0.5 kilowatt of capacity; and
- Microturbine property: The base percentage for the credit is 2%, and the "bonus" percentage is 10%. In addition, the credit is capped at $200 for each kilowatt of capacity.

Small projects

If the facility upon which the energy property is constructed has a maximum net output of electrical or thermal energy of less than 1 megawatt, then the taxpayer can claim the bonus credit rate of 30% without having to meet the wage and apprenticeship requirements put in place by the Inflation Reduction Act. (IRC §48(a)(9)(B)(i))

The average home in the United States requires 1,223 watts of power. (www.forbes.com/home-improvement/home/how-many-watts-run-house/) In other words, 1 megawatt of output is the equivalent of over 800 average homes.

Practice Pointer

The vast majority of solar projects, including those for most residential rental and even commercial buildings, are unlikely to be constructed on buildings whose electricity output is greater than 800 average homes. As such, most taxpayers can claim the 30% bonus credit rate without having to comply with the Inflation Reduction Act's wage and apprenticeship requirements.

Wage and apprenticeship requirements

Projects that don't qualify for the exceptions listed above must meet certain prevailing wage and apprenticeship requirements in order to qualify for the 30% bonus credit rate.

The IRS has issued final regulations related to the increased tax credit or deduction amounts for clean energy facilities and projects if taxpayers satisfy certain prevailing wage and registered apprenticeship requirements.

The final regulations include rules that:

- Require prevailing wage rates to be determined by the Department of Labor;
- Incentivize contemporaneous compliance with the wage and apprenticeship requirements;
- Implement recordkeeping requirements;
- Guarantee that taxpayers with projects covered by "qualifying project labor agreements" will not be penalized; and
- Clarify the apprenticeship requirements by defining what constitutes a request for qualified apprentices, what constitutes a response, and when the good faith effort exception applies.

The IRS has updated the following publications and FAQs:

Website

Publication 5855, Prevailing Wage & Registered Apprenticeship Overview:
www.irs.gov/pub/irs-pdf/p5855.pdf

Publication 5983, Inflation Reduction Act Prevailing Wage and Apprenticeship Requirements:
www.irs.gov/pub/irs-pdf/p5983.pdf

FAQs:
www.irs.gov/credits-deductions/frequently-asked-questions-about-the-prevailing-wage-and-apprenticeship-under-the-inflation-reduction-act

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The final regulations are available at:

Website
www.federalregister.gov/public-inspection/2024-13331/increased-amounts-of-credit-or-deduction-for-satisfying-certain-prevailing-wage-and-registered

Prevailing wages

Taxpayers satisfy the prevailing wage requirements by paying at least the prevailing wages for the geographic area and type(s) of construction applicable to the facility on which work is being performed, including all labor classifications for the construction, alteration, or repair work that will be done on the facility by laborers or mechanics.

The prevailing wage rates are published by the Secretary of Labor at:

Website
www.sam.gov

If the Secretary of Labor has not published a prevailing wage determination for the geographic area and type of construction for the facility on www.sam.gov (or if one or more labor classifications for the project are not listed), then the taxpayer must contact the Department of Labor Wage and Hour Division via e-mail and request the correct prevailing wage rate for the worker(s) at issue.

When e-mailing the Department of Labor Wage and Hour Division, the taxpayer must provide the following information to the department for each classification that is not listed:

- Type of facility;
- Facility location;
- Proposed labor classifications;
- Proposed prevailing wage rates;
- Job description and duties; and
- Any rationale for the proposed classifications.

The e-mail address is:

E-mail
iraprevailingwage@dol.gov

"Wages" includes amounts paid to all individuals performing services for the taxpayer, contractor, or subcontractor in exchange for remuneration, regardless of whether the individual would be characterized as an employee or independent contractor for other federal tax purposes.

When calculating whether prevailing wages are paid, taxpayers include any *bona fide* fringe benefits defined under 29 CFR §5.2(p).

Apprenticeship requirement

In order to satisfy the apprenticeship requirements, taxpayers must:

- Satisfy the apprenticeship labor hour requirements;
- Satisfy the apprenticeship participation requirements; and
- Comply with the same general bookkeeping requirements that apply to the prevailing wage requirement under IRC §6001 and Treas. Regs. §1.6001-1 et seq.

If a taxpayer cannot satisfy either the apprenticeship labor hour requirements or the participation requirements, then the taxpayer is deemed to have met the requirements if they meet the good faith effort exception. (IRC §45(b)(8)(D)(ii)) Under the good faith exception, the taxpayer must:

- Request qualified apprentices from a registered apprenticeship program, as defined in IRC §3131(e)(3)(B); and
- Either:
    - The request must have been denied (for purposes other than the taxpayer's failure to meet the requirements of the apprenticeship program's established standards); or
    - The registered apprenticeship program fails to respond to the taxpayer's request within five business days from the date the registered apprenticeship program received the taxpayer's request.

Under the apprenticeship labor hour requirement, the taxpayer must ensure that at least the applicable percentage of the total labor hours for the project is performed by qualified apprentices. The applicable percentages are:

- 12.5% for projects which begin in 2023; and
- 15% for projects that begin after December 31, 2023.

Under the apprenticeship participation requirement, each taxpayer, contractor, or subcontractor who employs four or more individuals to perform construction, alteration, or repair work with respect to the facility for which an applicable credit or deduction is claimed must employ at least one qualified apprentice. (IRC §45(b)(8)(B))

Comment

Certain provisions of the Inflation Reduction Act, such as IRC §§45, 45Y, and 48, require prevailing wages to be maintained for any alterations or repairs on a facility for which enhanced credits were claimed for up to 10 years.

Additional bonus credits

Taxpayers can qualify for up to three bonus credit increases if certain conditions are met. These bonuses involve:

- Up to a 10% increase if certain domestic content requirements for steel, iron, and manufactured products are met (see IRC §45(b)(9) and IRS Notice 2023-38);
- Up to a 10% increase if the project is located in an energy community (e.g., a brownfield site, or certain areas with high unemployment rates if the area has significant tax revenues or employment related to the fossil fuel industry, and census tracts in which a coal mine has been closed); and
- Up to 20% for certain solar and wind facilities placed in service in connection with low-income communities.

BEGINNING OF CONSTRUCTION

The IRS allows two methods to establish the beginning of construction:

- The physical work test; and
- The 5% safe harbor.
  (IRS Notice 2018-59)

A taxpayer is deemed to have begun work on the earliest date the taxpayer satisfies either test.

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The physical work test

A taxpayer satisfies the physical work test when physical work of a significant nature begins. This test focuses on the nature of the actual work performed, not the amount or the cost, and both off-site and on-site work may be taken into account. However, it does not include preliminary activities, even if the cost of the preliminary activities will be included in the depreciable basis of the property. Notice 2018-59 does not otherwise define "work of a significant nature."

The 5% safe harbor test

A taxpayer satisfies the 5% safe harbor test if:

- A taxpayer pays or incurs 5% or more of the total cost of the energy property; and
- Thereafter, the taxpayer makes continuous efforts to advance toward completion of the energy property.

All costs that will be part of the depreciable basis of the business solar property are taken into account to determine whether the 5% test is met.

Continuity requirement

Once a taxpayer meets either the physical work test or the 5% safe harbor test, the taxpayer must make continuous progress toward completion of the project. Whether a taxpayer meets the continuity requirement is based on all the facts and circumstances including, but not limited to:

- Paying or incurring additional amounts included in the total cost of the energy property;
- Entering into binding contracts for the manufacture, construction, or production of components of property or for future work to construct the energy property;
- Obtaining necessary permits; and
- Performing physical work of a significant nature.

Disruptions to the continuity requirement that are beyond the taxpayer's control are not an indication that the taxpayer has failed to satisfy the continuity requirement.

Continuity requirement safe harbor: The continuity requirement itself has a safe harbor. If the taxpayer places the business solar property in service by the end of the calendar year that is no more than four calendar years after the calendar year during which construction of the energy property began (referred to as the continuity safe harbor deadline), the energy property is deemed to satisfy the continuity requirement.

Example of continuity safe harbor

ABC, Inc. satisfied the physical work test and the 5% safe harbor test (and therefore began construction) on August 18, 2023. The continuity safe harbor deadline for ABC, Inc.'s solar project is December 31, 2027.

As long as the solar project is completed by December 31, 2027, then ABC, Inc. has satisfied the continuity requirement.

Notice 2018-59 does not address what happens if the continuity requirement is disrupted. Presumably, if the continuity requirement is disrupted, the taxpayer would then be required to determine a new construction begin date.

CLAIMING THE ENERGY INVESTMENT CREDIT

The credit is calculated on Form 3468, Part VI, and then reported on Form 3800, Part III, line 4a as part of the General Business Credit. The Energy Investment Credit can be claimed against AMT.

New Clean Electricity Investment Credit

Applicable to property placed in service after 2024 (including expansions and incremental production increases), the IRC §48 Energy Investment Credit is replaced with a new IRC §48E Clean Electricity Investment Credit. (IRA ’22 §13702) The IRS has issued proposed regulations regarding IRC §48E in REG-119283-23.

Only U.S. facilities for which the greenhouse gas emissions rate is less than zero qualify for the new credit. The IRS is directed to publish tables with greenhouse emissions rates for different categories of facilities.

Like the Energy Investment Credit, the Clean Electricity Investment Credit:

- Is equal to 6% of the basis of the property (30% in cases of small facilities or taxpayers that meet the wage and apprenticeship requirements);
- Additional credit is available for facilities located in an energy community or low-income community and for facilities that qualify for a domestic content bonus credit;
- Credits are reduced for projects financed with tax-exempt bonds;
- The credit is subject to recapture if greenhouse emission standards are not met; and
- The credit can be treated as a tax payment or transferred to an unrelated taxpayer.

The amount of the credit is subject to phaseout beginning in 2032, or earlier if the Treasury Secretary determines that specified reductions of greenhouse gas emissions from the production of electricity in the U.S. have been met.

Taxpayers are ineligible for the credit if they claim or previously claimed other energy credits for the same facility, including, but not limited to, the IRC §45 Production Tax Credit, the IRC §48 Energy Investment Credit, or the new IRC §45Y Clean Electricity Production Credit.

WORK OPPORTUNITY TAX CREDIT

The Work Opportunity Tax Credit (WOTC) is available to employers that hire and employ individuals to work in their trade or business prior to January 1, 2026, if the employee is part of a target group of individuals who have faced significant barriers to employment. (IRC §51) Even tax-exempt entities may be entitled to the credit under specified circumstances.

Household employees ineligible

Because the credit can only be claimed for employees working in an employer’s trade or business, the credit cannot be claimed for household employees.

The credit is jointly administered by the IRS and the U.S. Department of Labor.

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ELIGIBLE EMPLOYEES

An employer may claim the WOTC for an individual who is certified as a member of any of the following targeted groups:

- Qualified veterans (e.g., those whose family received SNAP (food stamps), were unemployed for a specified period, or are entitled to service-connected disability compensation);
- Long-term unemployment recipient (unemployed for at least 27 weeks and received unemployment for at least a portion of this period);
- Ex-felons hired within one year after conviction or release;
- Recipients of Temporary Assistance for Needy Families (TANF; a welfare program for families);
- Residents of empowerment zones or rural renewal counties (see Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, Instructions for a listing of these communities), which includes summer youth employees living within an empowerment zone;
- Individuals referred to an employer following completion of a rehabilitation plan or program;
- Recipients of SNAP benefits (aka food stamps); and
- Supplemental security income (SSI) recipients.

Tax-exempt employers

Tax-exempt entities can only claim the credit for wages paid to qualified veterans.

Rehires and related individuals ineligible

An employer cannot claim the WOTC for employees who are rehired, nor can they claim the credit for amounts paid to persons related to the employer. (IRC §51(i)(1)(A); Treas. Regs. §1.51-1(e)(1))

A "related person" includes but is not limited to children, siblings, parents, but not spouses. It also includes biologically unrelated individuals who live with the employer and individuals who are related to a shareholder/partner who owns more than 50% of the entity.

Prescreening and certification

To qualify for the credit, the employer must prescreen the employee prior to hiring them and receive certification from the state workforce agency that the employee is a member of a targeted group. This is done by filing Form 8850 with the state workforce agency. The employer and potential employee must both complete and sign Form 8850 no later than the day the job offer is made.

State workforce agencies

The name, address, phone and fax numbers, and e-mail address of the WOTC coordinator for the various state workforce agencies is available on the DOL's website at:

Website
www.dol.gov/agencies/eta/wotc/contact/state-workforce-agencies

CREDIT AMOUNT

In general, the WOTC is equal to 40% of up to $6,000 of wages paid (up to $24,000 for certain qualified veterans) to an individual who:

- Is in their first year of employment;
- Is certified as being a member of a targeted group; and
- Performs at least 400 hours of services for that employer.

This means the maximum tax credit is generally $2,400.

The WOTC for long-term family assistance recipients can be claimed for two years of employment, is based on $10,000 of wages (rather than $6,000), and is equal to 50% of the wage base.

A 25% rate applies to wages for individuals who perform fewer than 400 but at least 120 hours of service for the employer.

NO DOUBLE BENEFIT

No deduction can be claimed for wages for which the credit was claimed.

In addition, wages used to calculate the WOTC cannot be used to calculate other wage-based credits.

> ✐ **Practice Pointer**
>
> Employers can still claim multiple wage-based credits for the same employee as long as the "wage base" is not the same. For instance, if an employer claims the WOTC for $6,000 of wages paid to an employee, they can also claim a Disaster Employee Retention Credit for the $4,000 of remaining wages.

CLAIMING THE CREDIT

For-profit businesses compute the credit on Form 5884, Work Opportunity Credit, and report the credit on Form 3800, Part III, line 4b. The WOTC can be claimed against AMT.

Eligible tax-exempt employers can claim the WOTC only against payroll taxes. The credit is computed on Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans.

CREDIT FOR INCREASING RESEARCH ACTIVITIES

Taxpayers may claim a credit for their qualified research expenses. (IRC §41) While the GBC credit limitations and carryover rules apply, there are unique provisions for the Research Credit that are applicable to eligible small businesses as to how the credit is calculated and applied (see the discussion starting on page 3-36).

There are also special credits for basic research payments to universities and energy consortium payments that are beyond the scope of this discussion.

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The credit can be claimed for either:

- In-house research expenses, including wages paid to employees engaging in qualified research and those directly supervising or supporting the research activities and costs of supplies used in the research; or
- Research that is contracted out to another party.
(IRC §41(b))

ELIGIBILITY CRITERIA

To qualify for the Research Credit, a business must engage in qualified research activities for the taxpayer's trade or business. Qualified research activities are defined as activities that meet the following four-part test:

- **IRC §174 test:** The expenditures connected with the research must be specified research expenses treated as depreciable/amortizable expenses under IRC §174;
- **Technological in nature:** The research must be undertaken for the purpose of discovering technological information;
- **Business component test:** The taxpayer must intend that the information to be discovered be useful in the development of a new or improved business component (e.g., product, process, computer software, technique, formula or invention) that the taxpayer holds for sale, lease or license or uses in its trade or business;
- **Process of experimentation:** Substantially all of the research activities must constitute elements of a process of experimentation such as modeling, simulation, systematic trial and error, or other methods for a purpose relating to a new or improved function, performance, reliability, or quality. This test requires the use of the scientific method; simple trial and error is not sufficient.
(IRC §41(d))

Trade or business requirement

In ***Sonntag v. Comm.*** (TCS 2022-3), a taxpayer was denied business expense deductions for "research expenses" that included the cost of Lana Del Rey concert tickets, a portion of his cable TV bill, Spotify and iTunes subscriptions, and Netflix streaming services. The taxpayer was in the music entertainment business and ran a recording studio called Shed Studios out of a shed in his backyard. The Tax Court held that the expenses, most of which were unsubstantiated, were primarily for personal enjoyment or personal use instead of for a trade or business.

Ineligible activities

Certain activities are specifically excluded from the definition of qualified research expenses, such as:

- Research related to style, taste, cosmetic, or seasonal design factors;
- Research conducted after the beginning of commercial production;
- Adaptation of existing products or processes;
- Surveys or studies related to efficiency, management functions, market research testing or development, routine data collection, or quality control;
- Research conducted outside the U.S., Puerto Rico, or any U.S. possession;
- Research in the social sciences, arts, or humanities; and
- Any research to the extent funded by any grant, contract, or another person.
(IRC §41(d)(3)(B) and (d)(4)

IRC §174 TEST

The heart of the IRC §174 test is whether the cost incurred by the taxpayer was in connection with the taxpayer's trade or business and whether the activities were "intended to discover information that would eliminate uncertainty concerning the development or improvement of a product." (Treas. Regs. §1.174-2(a)(1))

TECHNOLOGICAL INFORMATION TEST

In order for an activity to be qualified research, it must be undertaken for the purpose of discovering technological information. (IRC §41(d)(1)(B)) Under the regulations, information is technological if "the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." (Treas. Regs. §1.41-4(a)(4))

BUSINESS COMPONENT TEST CASES

Construction designs

In ***Harper v. Comm.*** (TCM 2023-57), the Tax Court rejected the IRS's motion for summary judgement and ruled that a trial was necessary to determine if a construction company was eligible to claim the Research Credit for its various research activities undertaken as part of its construction of numerous military installations.

Although the Tax Court did not actually yet rule on the merits of the case, the ruling is important in that:

- The Tax Court held that a taxpayer's designs can qualify under the business component requirement, which is not solely limited to products produced by a taxpayer. This is important for those businesses involved in the construction and engineering fields; and
- It shows that the Tax Court is not interpreting the business component requirement for qualified research expenses as narrowly as the IRS.

In the ***Harper*** case, the IRS disallowed the taxpayers' over $800,000 in Research Credits claimed over a two-year period on the basis that the taxpayers did not have qualified research expenses because the expenses failed to meet the business component requirement.

The taxpayers' construction company specialized in military design-build projects, and during the tax years at issue they were involved in 53 separate projects, including building aircraft hangers, living quarters, medical clinics, training facilities, etc. As part of these projects, the taxpayers developed conceptual and development designs incorporating various alternatives in building materials, building orientation, equipment designs, piping and duct routing, etc.

The following table summarizes the IRS's arguments and the Tax Court's rejection of these arguments.

Summary of *Harper* Case	
IRS's arguments	**Tax Court's reasons for rejecting arguments**
The buildings and facilities constructed by the taxpayers never belonged to the taxpayers, yet only these structures were "new and improved."	The record showed that the taxpayers engaged in lengthy, multistep processes of conceptual design and development for each project, resulting in novel ideas and iterative improvements to them. Case law establishes that the development of a new or improved business component only can provide some level of functional improvement
The taxpayers' designs were not "products" but rather "tangible manifestations of construction services."	The designs do not have to be products. The business component definition also includes processes, techniques, or inventions. (***Northwest Corp. v. Comm.*** (1998) 110 TC 454; ***Union Carbide Corp. v. Comm.***, TCM 2009-50)
Neither the taxpayers' designs nor the facilities constructed were ever held for sale by the taxpayers.	It was unclear from the record who owned the facilities prior to completion and whether the processes, techniques, and potential inventions developed by the taxpayers were used in the taxpayers' business. This is an issue to be resolved at trial.
The taxpayers did not "use" their designs in the sense intended by IRC §41 because they were not used in a "meaningful way" in the taxpayers' day-to-day operations.	The taxpayers used their designs in the construction process, and there is nothing in the statute that requires that the taxpayer's use be "habitual use."

We will have to wait until the Tax Court's actual decision after trial to determine not only if the taxpayers' activities satisfy the business component credit, but also whether the taxpayers' activities meet the various other tests and/or whether the activities involve any of the excluded activities listed on page 3-33.

PROCESS OF EXPERIMENTATION TEST

To qualify as a process of experimentation, substantially all of the activities must constitute elements of a process of experimentation for purposes for a qualified purpose, which relates to**:**

- A new or improved function;
- Performance; or
- Reliability or quality.
  (IRC §41(d)(1)(C)) and (d)(3))

The regulations define a process of experimentation as a "process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." (Treas. Regs. §1.41-4(a)(5)(i))

The process of experimentation test must involve a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense. (***Union Carbide Corp. & Subs. v. Comm.***, TCM 2009-50) For example, the regulations explain that the evaluation of products available from vendors is not a process of experimentation.

Substantially all

The "substantially all" requirement is satisfied if at least 80% of the taxpayer's research activities are for a qualified purpose. Therefore, research with respect to a taxpayer's business component can be qualified research if at least 80% of the research activities are for a qualified purpose and 20% or less of the research activities are for a nonqualified purpose (style, taste, cosmetic, or seasonal design factors).

When evaluating whether the 80% rule is satisfied, the taxpayer's research activities must be measured on a cost or other consistently applied reasonable basis. The "substantially all" requirement is applied separately to each business component, so it's possible that the taxpayer could have one business component fail the 80% test and another succeed. (IRC §41(d)(1)(C); Treas. Regs. §1.41-4(a)(6))

Practice Pointer

It's important to remember that a taxpayer may not qualify to claim the Research Credit for one business component but may do so for another component. This is especially important when looking at the "process of experimentation test," which looks at whether "substantially all" of the activities constitute a process of experimentation.

For instance, a taxpayer's activities in looking at providing a new software suite for one of its accounting firm clients might not qualify as qualified research expenses for the whole suite because a significant portion of the work might be considered an "adaptation." However, if one of the software programs contained in the suite involves developing a new software program to successfully integrate a new AI generative system to review returns, this "business component" of the software suite may qualify.

If any portion of a taxpayer's qualified research expenses are related to style, taste, cosmetic, or seasonal design factors, a taxpayer may document that expenses related to these factors make up no more than 20% of the total research expenses for each component of the Research Credit. (TAM 202327015)

Production expenses

In ***Intermountain Electronics, Inc. v. Comm.*** (March 14, 2024) U.S. Tax Court, Dkt. No. 11-19-19, the Tax Court held that its prior ruling in ***Little Sandy Coal Co. v. Comm.*** (TCM 2021-15) did not stand for the proposition that production expenses are automatically excluded from the Research Credit calculation and therefore rejected the IRS's motion for summary judgment. The Tax Court held that a taxpayer must show that the production expenses were part of an evaluative process to address uncertainty relating to the development of custom equipment. The Tax Court's ruling allows the taxpayer to provide such evidence at trial.

The ***Intermountain*** case involved expenses incurred by a company that designs, engineers, and manufactures electrical distribution and control equipment in creating custom products for its customers. The IRS had taken the position that the taxpayer's pilot models automatically fail the "substantially all" requirement of the process of experimentation test and were not specified research or experimental expenditures that qualify as an IRC §174 research expenditure.

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CALCULATION METHODS

There are two primary methods for calculating the Research Credit:

- The Regular Research Credit; and
- The Alternative Simplified Credit (ASC).
  (IRC §41(c))

Regular Research Credit

The regular Research Credit is generally equal to 20% of the excess of the taxpayer's qualified research expenses (QREs) for the taxable year over a base amount. (IRC §41(a))

The base amount is equal to the lesser of:

- The taxpayer's average annual gross receipts for the four preceding tax years by a fixed-base percentage; or
- 50%of the qualified research expenses for the credit year.

For non-startup businesses the fixed-base percentage is equal to the taxpayer's aggregate qualified research expenses for the four preceding taxable years divided by the aggregate gross receipts for such taxable years.

Example of Research Credit calculation

ChemCo is a chemical manufacturing company that has a large research and development department. Its gross receipts for the last four years are:

Year 1	$ 5,000,000
Year 2	4,200,000
Year 3	4,800,000
Year 4	6,200,000
Total	$20,200,000

In Year 5, ChemCo incurred $600,000 of qualified research expenses. Assume ChemCo's fixed-base percentage is 9.0%. ChemCo calculates its R&D credit as follows:

A	Qualified research expenses	$600,000
B	Fixed base percentage	9%
C	Average annual gross receipts ($20,200,000 ÷ 4 preceding years)	$5,050,000
D	B × C	$454,500
E	A – D	$145,500
F	A × 50% limitation	$300,000
G	Smaller of E or F	$145,500
H	R&D credit (G × 20%)	$29,100

"Startup" companies

For startup companies (generally those formed after the mid to late 1980s), the fixed-base percentage amount is set at 3% for the startup's first five years it has qualified research expenses, reduced incrementally thereafter as specified under IRC §41(c)(3)(B)(i).

Alternative simplified credit

The alternative simplified credit (ASC) is equal to 14% of the excess of the taxpayer's QREs for the taxable year over 50% of the average QREs for the three preceding taxable years. (IRC §41(c)(4)) If the taxpayer has no QREs in any of the three preceding taxable years, the ASC rate is reduced to 6%.

Taxpayers may choose between the regular Research Credit and the ASC on an annual basis, depending on which method provides the greater benefit.

Regular Research Credit method vs. ASC

The ASC method is frequently easier to calculate, as information regarding gross receipts and base amounts is not required and therefore may be the calculation method of choice for taxpayers with inadequate records. The ASC method would also likely be the preferred approach in instances when the taxpayers' research expenses have declined from previous years.

However, in certain scenarios the credit may be larger if the regular Research Credit calculation method is used, especially when the taxpayer's base amounts are low. This is especially true for startup companies.

Taxpayers should run the numbers to determine which method is more beneficial, as the example below illustrates

Example of regular Research Credit vs. ASC calculations

Ingenuity, Inc. has $120,000 in current-year qualified research expenses and had an average of $100,000 in qualified research expenses for the prior three years. Its base amount is $10,000.

If Ingenuity uses the ASC method, its current year Research Credit is equal to $9,800 computed as follows: $120,000 – ($100,000 × 50%) × 14%.

If it uses the regular Research Credit method, its current-year Research Credit is equal to $22,000 (20% × ($120,000 - $10,000)).

Ingenuity can claim a higher Research Credit using the regular Research Credit method than the ASC method.

SMALL BUSINESS PAYROLL TAX OFFSET

Qualified small businesses may offset the Research Credit against the employer portion of payroll taxes. A qualified small business is defined as a corporation, partnership, or sole proprietorship with:

- Gross receipts of less than $5 million for the current taxable year; and
- No gross receipts for any taxable year preceding the five-taxable-year period ending with the current taxable year.

The payroll tax credit is elected by completing the appropriate portion of Form 6765, Credit for Increasing Research Activities, and attaching the completed form to the business's timely filed (including extensions) income tax return for the taxable year to which the election applies.

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✐ **Practice Pointer**

An election cannot be made on an amended return.

The qualified small business can first claim the payroll tax credit on its employment tax return for the first quarter that begins after it files the income tax return reflecting the payroll tax election on Form 6765.

Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, must be attached to the employment tax return and is used to determine the amount of the payroll tax credit that can be used in the current quarter.

Amount of payroll credit

The maximum amount of Research Credit that a qualified small business can elect to apply against its payroll tax liability was increased by the Inflation Reduction Act from $250,000 to $500,000 for tax years beginning after December 31, 2022. (IRA ’22 13902)

The IRA also modified IRC §3111(f) to allow a portion of the payroll tax credit to apply against the employer’s portion of Medicare tax, as imposed by IRC §3111(b). The payroll tax credit is first used to reduce the employer’s share of Social Security tax up to $250,000 per quarter, and any remaining credit reduces the employer’s share of Medicare tax for the quarter.

For older elections that are carried over into 2023, the carryover amount can now be applied against the employer’s share of Social Security tax (up to $250,000) and then to the employer’s share of Medicare tax for employment tax returns.

For both new elections and carryover elections, a payroll tax credit in excess of the employer’s share of Social Security tax and the employer’s share of Medicare tax shown on an employment tax return may be carried over to the next period’s employment tax return.

QUALIFIED RESEARCH EXPENSES (QREs)

QREs are the expenses that form the basis for the Research Credit calculation. These include:

- Wages paid to employees engaged in qualified research activities;
- Supplies used in qualified research activities, including tangible property other than land or depreciable property;
- Contract research expenses paid to third parties for performing qualified research on behalf of the taxpayer, generally limited to 65% of the actual expenses incurred; and
- Basic research payments made to qualified educational institutions and scientific research organizations, up to 75% of the actual expenses incurred.

Comment

Expenses related to the development of computer software, including software developed for internal use, can qualify for the Research Credit if they meet the four-part test mentioned earlier.

SUBSTANTIATION AND RECORDKEEPING

To claim the research credit, taxpayers must maintain contemporaneous documentation to substantiate their qualified research activities and QREs. At a minimum this documentation should include:

- Project descriptions and descriptions of the business components involved;
- Research activities performed and the individuals involved;
- Time and expenses allocated to each research project; and
- An explanation of how each project meets the four-part test for QREs. This is especially critical regarding the process of experimentation test. Documentation of what the research is trying to establish and what steps were taken to eliminate various approaches to achieve this result and why is key.

COORDINATION WITH RESEARCH DEDUCTION

Taxpayers must reduce their IRC §174 specified research expenses (SRE) by the amount of any Research Credit claimed. (IRC §280C(c)(1)) If, however, the Research Credit for the year exceeds the allowable SRE deduction for the year, then the capitalized SRE expenditures must be reduced by the excess.

Example of Research Credit interplay

High Tech, Inc. is a calendar-year C corporation. For the 2024 taxable year, it incurred $2 million of SRE expenditures and claimed a Research Credit of $150,000. High Tech's SRE expenditure amount that must be amortized over five years is $2 million, and its current-year SRE deduction is $200,000.

Because High Tech's Research Credit of $150,000 does not exceed its SRE deduction for the year ($200,000), High Tech must reduce its current-year deduction by the amount of the credit claimed. The amount of its 2024 deduction is calculated as follows:

SRE expenditures incurred during the year	$2,000,000
Amortization period	÷ 60
Monthly deduction	33,333
Deductible months in 2024	× 6
Amortization deduction in 2024	$ 200,000

If, however, High Tech's current-year Research Credit exceeds its $200,000 SRE amortization deduction, then High Tech must reduce its amortizable SRE expenditures before calculating the current-year deduction.

Assume High Tech's Research Credit is $225,000, so its credit is $25,000 greater than its SRE expenditure amortization deduction ($225,000 credit, less $200,000 current-year amortization deduction). The calculation to reduce its amortization of SRE expenditures is calculated as follows:

SRE expenditures incurred during the year	$2,000,000
Excess R&D credit over current-year deduction	(25,000)
Amortizable SRE	1,975,000
Amortization period	÷ 60
Monthly deduction	32,917
Deductible months in 2024	× 6
Amortization deduction in 2024	$ 197,500

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ELECTION TO TAKE A REDUCED RESEARCH CREDIT (IRC §280C ELECTION)

Taxpayers that claim the Research Credit must reduce their deductible research expenses by the amount of the credit claimed. (IRC §280C(c)(1)) However, taxpayers can make an irrevocable election to reduce the amount of their credit claimed by the corporate tax rate of 21% in exchange for not reducing their deductible/amortizable research expenses. (IRC §280C(c)(2)) The election is commonly known as the §280C election.

The §280C election is made by checking a box on Form 6765, Credit for Increasing Research Activities, on a timely filed income tax return, including extensions.

Example of Research Credit and §280C election

Maya is the sole shareholder of an S corporation manufacturing business. The corporation's net income before deducting research expenses is $5 million in 2023, its SRE expenditures under IRC §174 are $815,000, and it calculates a Research Credit of $72,000.

The following calculation compares the tax burden to Maya if she does not claim any Research Credit, if she claims the Research Credit without the §280C election, and if she claims the credit with the §280C election.

	Without R&D Credit	With R&D Credit (no §280C election)	With R&D Credit (and §280C election)
Net income (without current-year R&E)	$5,000,000	$5,000,000	$5,000,000
SRE deduction (amortizable portion of R&E)[1]	- 81,500	- 9,500	- 81,500
Net ordinary income to S corp. shareholder	4,918,500	4,990,500	4,918,500
Shareholder's tax rate	× 37%	× 37%	× 37%
Tax burden before Research Credit	1,819,845	1,846,485	1,819,845
Research Credit	- N/A	- 72,000	- 56,880[2]
Net tax burden to Maya	$1,819,845	$1,774,485	$1,762,965

[1] For taxable years beginning after December 31, 2021, taxpayers must capitalize and amortize their SRE expenditures under IRC §174 over 60 months, starting with the midpoint of the year the expenditures were incurred. For taxable years beginning before January 1, 2022, taxpayers were allowed to deduct all their IRC §174 research expenses in the year incurred

[2] $72,000 credit × 79% = $56,880 allowable credit, which represents a 21% reduction in the credit pursuant to the §280C election. In exchange for making the election, the corporation is not required to reduce its deductible research expenses

Practice Pointer

The reduced credit rate of 21% applies no matter what type of taxpayer makes the election (C corporation, S corporation, partnership, etc.). As the example illustrates, if a taxpayer's marginal tax rate is higher than 21%, then they will benefit from making a §280C election.

C corporations that pay a flat tax rate of 21% will see neither a benefit nor an increase in their tax burden by making a §280C election. But an S corporation shareholder in the 37% marginal income tax bracket will benefit if their S corporation makes the election.

Most states don't allow Research Credits for state income tax purposes, and they use federal income as a starting point to calculate state income taxes. Because the §280C election allows taxpayers to not reduce their deductible SRE expenditures, taxpayers will typically end up with lower state income tax liabilities as well.

Protective elections

Many taxpayers fail to claim Research Credits on their originally filed return and only claim them by filing amended returns later. Taxpayers that do not claim Research Credits on their originally filed income tax returns can preserve their §280C election by filing Form 6765 with all zeroes but checking the election box on the form for the §280C election. (Treas. Regs. §1.280C-4(a))

The §280C election is irrevocable, so a taxpayer that makes a protective election but whose marginal tax rate is less than 21% (and therefore won't benefit from the election) cannot choose to reverse their decision on their amended return.

RESEARCH CREDIT REFUND CLAIMS

In a Chief Counsel Memorandum, the IRS outlines the requirements a refund claim related to an IRC §41 Research Credit must meet in order to be considered a valid claim. (Chief Counsel Memorandum 20214101F) The originally scheduled effective dates for these new requirements were delayed until January 10, 2024. (IR-2021-203)

The requirements are extensive, and some tax commentators have questioned whether the Chief Counsel's position is valid. However, taxpayers that do not want their claims rejected up front should familiarize themselves with these new requirements.

These refund claims will take a lot more preparation time because they will require taxpayers to attest to, and provide detailed facts in support of, their positions taken on the refund claim.

FAQs available

The IRS has posted a set of FAQs regarding Research Credit refund claim requirements available at:

Website
www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions

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Why is this so important?

According to the memorandum, if the taxpayer does not provide the detailed information required, then the claim should be rejected due to not meeting the specificity requirements of Treas. Regs. §301.6402-2(b)(1). If a claim is "rejected" for technical grounds verses being "disallowed" based on substantive grounds, the courts will not have jurisdiction to hear an appeal.

In fact, the memorandum advises IRS staff to make sure to review the claim to see if it should be rejected for not meeting these new requirements before any audit or other substantive review is undertaken. This would be done to prevent taxpayers from arguing that the IRS waived its objection to the validity of the claim or treated the claim as an "informal refund claim" that could later be perfected after the statute of limitations period has expired.

What must be included in the claim?

To be considered valid, a refund claim for a Research Credit must, at a minimum:

- Identify all the business components to which the Research Credit claim relates for that year;
- For each business component, identify all:
  - Research activities performed;
  - Individuals who performed each research activity; and
  - The information each individual sought to discover; and
- Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year (this may be done using Form 6765, Credit for Increasing Research Activities).

The memorandum provides detailed analysis of what is required for each of these requirements.

IRS waives certain requirements

On June 18, 2024, the IRS announced that effective for claims postmarked as of June 18, 2024, it is waiving the requirement that taxpayers provide the following two items of information with their refund claim involving the Research Credit:

- The names of the individuals who performed each research activity; and
- The information each individual sought to discover.

While the IRS is waiving the requirement of providing these two items of information at the time a refund claim involving the Research Credit is filed with the IRS, this information may be requested if a refund claim involving the Research Credit is selected for examination.

The taxpayer must also provide a sworn declaration verifying that the facts provided are accurate. In most cases, the signature on Forms 1040X or 1120X will satisfy this requirement.

Comment

Regarding what to include in a refund claim, while the items listed in the last bullet are already required to be provided on Form 6765 when claiming the credit on the original return, the items in the first two bullets are not. This means taxpayers claiming the credit on a refund claim must provide more information than what is currently required on the original return.

Is supporting documentation required?

A taxpayer does not have to provide supporting documentation at the time they file the claim. However, they should state the supporting facts in a written statement attached to the claim rather than through the production of documents.

If a taxpayer voluntarily provides documents with the claim, the taxpayer must specifically identify where in the documents the facts responsive to each of the facts listed above can be found. Similarly, if the taxpayer has prepared a credit study, the taxpayer does not need to attach it to the taxpayer's claim. If the taxpayer does attach a credit study, the taxpayer must identify the specific facts contained in the study that the taxpayer contends meet the foundational information requirements stated above.

More changes to come?

On June 21, 2024, the IRS released a second draft of Form 6765 that incorporates similar requirements as outlined above. (IR-2024-171) This latest draft form was modified to address comments received to the initial draft form released in late 2023 and provides relief from some of the more onerous requirements for qualified small business taxpayers as well as those taxpayers with $50 million of gross receipts that have $1.5 million or less of qualified research expenditures.

The form's revised Section G, Business Component Information, will be optional for all filers for the 2024 tax year, but will be required for all other taxpayers (other than those noted above) beginning with the 2025 tax year (processed in 2026).

Additional information is available in IR-2024-171.

DISABLED ACCESS CREDIT

Eligible small businesses can claim a credit for a portion of their costs incurred to come into compliance with the Americans with Disability Act. (IRC §44)

ELIGIBLE SMALL BUSINESS

For purposes of this credit, an eligible small business is a business:

- With gross receipts (reduced for returns and allowances) for the preceding taxable year of $1 million or less; or
- That employed 30 or fewer full-time employees during the preceding year. A full-time employee is an employee that is employed at least 30 hours per week for 20 more calendar weeks in the taxable year. A full-time equivalency test does not apply for purposes of this credit.
  (IRC §44(b))

Controlled group rules apply for purposes of determining whether a business qualifies as an eligible small business that can claim the credit. (IRC §44(d)(2)) This means that if controlled group members have gross receipts and employees combined that exceed these thresholds, both entities are ineligible to claim the credit even if one or both would qualify as an eligible small business individually.

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CREDIT AMOUNT

The amount of the credit is equal to 50% of the eligible expenditures incurred during the taxable year in excess of $250 but below $10,250. This means the maximum credit that can be claimed in a tax year is $5,000. (IRC §44(a)) The limitation is applied at both the partnership/S corporation level as well as the partner/shareholder level.

All members of a controlled group, within the meaning of IRC §52(a), and all persons under common control (as defined in IRC §52(b)) are treated as one person for purposes of the credit.

Example of computing credit for controlled group

B-One Corp. and B-Two, LLC are members of a controlled group under the tax rules. In the current tax year, B-One spends $8,000 on installing ramps and widening doorways to improve accessibility for disabled individuals in their office building. B-Two spends $5,000 on similar qualifying expenses to improve accessibility in their retail store location.

The Disabled Access Credit has an overall limit of $10,250 in a single year for all members of a controlled group. Because the combined expenditures of B-One and B-Two exceed this limit, the credit must be apportioned between the two entities.

The total qualifying expenditures are $13,000 ($8,000 + $5,000). B-One's expenditures represent about 61.5% of the total ($8,000 ÷ $13,000), while B-Two's expenditures account for the remaining 38.5% ($5,000 ÷ $13,000).

Therefore, B-One can claim approximately $6,303.75 (61.5% × $10,250) of the total credit, and B-Two can claim the remaining $3,946.25 (38.5% × $10,250).

ELIGIBLE EXPENDITURES

The credit can only be claimed for eligible access expenditures, which include amounts paid or incurred to:

- Remove architectural, communication, physical, or transportation barriers to make the business accessible but only if the facility in which the barriers were removed was placed in service before November 6, 1990;
- Provide qualified interpreters or other effective methods of making aurally delivered materials available to individuals with hearing impairments;
- Provide qualified readers, taped texts, and other effective methods of making visually delivered materials available to individuals with visual impairments;
- Acquire or modify equipment or devices for individuals with disabilities; or
- Provide other similar services, modifications, materials, or equipment.
  (IRC §44(c))

The amounts must also be reasonable and necessary to accomplish the purposes outlined above.

DENIAL OF DOUBLE BENEFIT

Taxpayers cannot claim any other deduction or credit for expenses for which the Disabled Access Credit was claimed. Nor can the adjusted basis of the property be increased by the amount for which the credit was claimed. (IRC §44(d)(7)

☑ Planning Pointer

Taxpayers that may not be able to take full advantage of the credit due to the GBC limitation and ordering rules may want to consider claiming the IRC §190 current expense deduction for removing barriers incurred by a trade or business to make their facilities more accessible to handicapped or elderly individuals.

Under IRC §190, taxpayers can deduct up to $15,000 in qualified architectural barrier removal expenses rather than capitalizing and depreciating such expenses. The deduction is available regardless of whether the taxpayer owns or leases the facilities.

CLAIMING THE CREDIT

The credit is computed on Form 8826, Disabled Access Credit. Partnerships and S corporations, report the credit on Schedule K. All taxpayers report the amount on Form 3800, Part III, line 1e.

RENEWABLE ELECTRICITY PRODUCTION TAX CREDIT

The IRC §45 Renewable Electricity Production Tax Credit (aka the Production Tax Credit) is a per kilowatt-hour (kWh) tax credit for electricity generated by solar and other qualifying technologies for the first 10 years of a system's operation. The electricity must be sold to an unrelated buyer.

Comment

For the first four years after a qualified facility is placed in service, the General Business Credit tax liability limitation discussed on page 3-3 is calculated separately, and the credit may be claimed against both regular and AMT liabilities.

The Production Tax Credit was generally extended by the Inflation Reduction Act of 2022 for three years to apply to facilities that begin construction before January 1, 2025. (IRA '22 §13101; IRC §45) Facilities that begin construction after 2024 will likely qualify for the new IRC §45Y Clean Electricity Production Tax Credit discussed on page 3-48.

ELIGIBLE FACILITIES

The Production Tax Credit is available for a range of renewable energy facilities, including:

- Solar and wind energy facilities;
- Closed-loop biomass facilities;
- Open-loop biomass facilities;
- Geothermal energy facilities;
- Landfill gas facilities;
- Trash facilities;
- Qualified hydropower facilities; and
- Marine and hydrokinetic renewable energy facilities.

Each type of facility must meet specific requirements to qualify for the Production Tax Credit. For example, wind energy facilities must have a nameplate capacity of at least 100 kilowatts, and

closed-loop biomass facilities must use organic material planted exclusively for the purpose of being used at a qualified facility.

CREDIT AMOUNTS

The Production Tax Credit is a per-kilowatt-hour (kWh) tax credit for electricity generated by qualified renewable energy facilities. For facilities placed in service after 2021, the "base" credit is reduced from 1.5 cents to 0.3 cents per kilowatt hours of electricity produced and is adjusted for inflation.

The credit amount varies depending on the type of facility and the year in which it was placed into service. As of 2023, the Production Tax Credit base rates for facilities placed in service after 2022 are as follows:

- $0.055/kWh for solar, wind energy, closed-loop biomass, geothermal energy, qualified hydropower, marine and hydrokinetic renewable energy facilities; and
- $0.03/kWh for open-loop biomass, landfill gas, and trash facilities.
  (IRC §45(a))

These rates are adjusted annually for inflation.

Like the Energy Investment Credit, for facilities placed in service after 2021, the base credit is multiplied by five if:

- Construction of the facility began before January 29, 2023;
- The facility has a maximum net output of less than one megawatt; or
- The facility satisfies prevailing wage and apprenticeship requirements (see page 3-26).
  (IRC §45(b)(6))

Credit bonuses are also available if the facility satisfies the domestic content test (10% bonus) or is located in an energy community (10%). (IRC §45(g)(9)) See page 3-28 for more details concerning these bonus credits.

Comment

The exemption from the reduced rate for a facility that has a maximum net output of less than 1 megawatt may exempt many businesses from the reduction.

The credit is reduced for projects financed with tax-exempt bonds. (IRC §45(b)(3))

Curing wage requirement failures

Unlike the Energy Investment Credit, a taxpayer claiming the Production Tax Credit may cure the prevailing wage requirement and still claim the bonus credit rate in a taxable year if the taxpayer:

- Pays the worker the difference between the wages paid and the prevailing wage, plus interest (three times this sum if intentional disregard of the requirement); and
- Pays the Secretary of the Treasury $5,000 ($10,000 if intentional disregard of the requirement) per underpaid worker.
  (IRC §45(b)(7)(B))

These payments must be paid within 180 days of notification by the Secretary of the Treasury of the failure. If not, the taxpayer will be ineligible for the bonus credits.

Curing apprenticeship requirement failures

A taxpayer may also "cure" the apprenticeship wage requirements by paying the Treasury Secretary a penalty equal to $50 ($500 if intentional) multiplied by the total labor hour requirements that were not met. (IRA '22 §13101(f); IRC §45(b)(8)(D)(i)(II)(bb))

New Clean Electricity Production Tax Credit

Applicable to electricity generation facilities placed in service after 2024, the IRC §45C Renewable Electricity Production Tax Credit is replaced with a new IRC §45Y Clean Electricity Production Tax Credit. (IRA '22 §13701) Only U.S. facilities for which the greenhouse gas emissions rate is less than zero qualify for the new credit. The IRS is directed to publish tables with greenhouse emissions rates for different categories of facilities.

Like the Renewable Electricity Production Tax Credit, the Clean Electricity Production Tax Credit:

- Is based on the number of kilowatt hours of electricity produced;
- Is equal to 0.3 cents per kilowatt hour (1.5 cents for small facilities or if the taxpayer meets the prevailing wage and apprenticeship requirements). Both amounts are adjusted for inflation;
- Additional credit is available for facilities located in an energy community and for facilities that qualify for a domestic content bonus credit;
- Credits are reduced for projects financed with tax-exempt bonds; and
- Tax-exempt entities and government/Indian tribe organizations can treat the credit as a tax payment or transfer the credit to an unrelated taxpayer.

The amount of the credit is subject to phaseout beginning in 2032 or earlier if the Treasury Secretary determines that specified reductions of greenhouse gas emissions from the production of electricity in the U.S. have been met.

Taxpayers are ineligible for the credit if they claim or previously claimed other energy credits for the same facility, including, but not limited to, the IRC §45 Renewable Electricity Production Tax Credit, the IRC §48 Energy Credit, or the new IRC §48E Clean Electricity Investment Credit.

CLAIMING THE CREDIT

The Production Tax Credit is computed on Form 8835, Renewable Electricity Production Credit, and reported on Schedule K for partnership and S corporations and on Form 3800, Part III, line 4e for all other taxpayers.

INVESTMENT TAX CREDIT VS. PRODUCTION TAX CREDIT

As can be seen from the discussions above, taxpayers may be able to choose either the Investment Tax Credit or Production Tax Credit for many energy-related investments. This means taxpayers must choose which credit will provide them with the most bang for the buck.

The Investment Tax Credit is an upfront credit, while the Production Tax Credit is claimed over a 10-year period. But the credit amounts generated in the first year the credit is available may not be the determinative factor.

It's important to remember that given how the General Business Credit operates, it may not be advantageous for a taxpayer to receive a large credit upfront if they don't have the income to offset

the credit or if they will lose out on claiming other credits if they generate a large upfront Investment Tax Credit.

As can be seen from the following chart, taxpayers only must make a choice between the two credits for projects involving solar and wind, municipal solid waste, geothermal, or tidal technologies and/or facilities.

Which Projects Qualify for Which Credit?		
Investment Tax Credit or Production Tax Credit	**Investment Tax Credit**	**Production Tax Credit**
• Solar and wind technologies • Municipal solid waste • Geothermal (electric) • Tidal	• Energy storage technologies • Microgrid controllers • Fuel cells • Geothermal (heat pump and direct use) • Combined heat and power • Microturbines	• Biomass • Landfill gas • Hydroelectric • Marine • Hydrokinetic

The following table is a summary prepared by the U.S. Department of Energy, comparing the credit amounts of the Investment Tax Credit versus the Production Tax Credit.

Summary of Investment Tax Credit (ITC) and Production Tax Credit (PTC) Values Over Time

			Start of Construction						
			2006 to 2019	2020 to 2021	2022	2023 to 2033	The later of 2034 (or two years after applicable year[a])	The later of 2035 (or three years after applicable year[a])	The later of 2036 (or four years after applicable year[a])
ITC	**Full rate** (if project meets labor requirements[b])	Base Credit	30%	26%	30%	30%	22.5%	15%	0%
		Domestic Content Bonus				10%	7.5%	5%	0%
		Energy Community Bonus				10%	7.5%	5%	0%
	Base rate (if project does not meet labor requirements[b])	Base Credit	30%	26%	6%	6%	4.5%	3%	0%
		Domestic Content Bonus				2%	1.5%	1%	0%
		Energy Community Bonus				2%	1.5%	1%	0%
	Low-income bonus (1.8 GW/yr cap)	<5 MW projects in LMI communities or Indian land				10%	10%	10%	10%
		Qualified low-income residential building project / Qualified low-income economic benefit project				20%	20%	20%	20%
PTC for 10 years ($2022)	**Full rate** (if project meets labor requirements[b])	Base Credit			2.75 ¢	2.75 ¢	2.0 ¢	1.3 ¢	0.0 ¢
		Domestic Content Bonus				0.3 ¢	0.2 ¢	0.1 ¢	0.0 ¢
		Energy Community Bonus				0.3 ¢	0.2 ¢	0.1 ¢	0.0 ¢
	Base rate (if project does not meet labor requirements[b])	Base Credit			0.55 ¢	0.55 ¢	0.4 ¢	0.3 ¢	0.0 ¢
		Domestic Content Bonus				0.1 ¢	0.0 ¢	0.0 ¢	0.0 ¢
		Energy Community Bonus				0.1 ¢	0.0 ¢	0.1 ¢	0.0 ¢

a "Applicable year" is defined as the later of (i) 2032 or (ii) the year the Treasury Secretary determines that there has been a 75% or more reduction in annual greenhouse gas emissions from the production of electricity in the United States as compared to the calendar year 2022.

b "Labor requirements" entail certain prevailing wage and apprenticeship conditions being met.

For many of our clients, the big question will be whether to claim the Investment Tax Credit or the Production Tax Credit for solar systems that are being installed. The DOE provides the following guidance:

The ITC is an upfront tax credit that does not vary by system performance, while the PTC can provide a more attractive cash flow, as the tax credits are earned over time. Whether to choose the ITC or the PTC depends largely on the cost of the project, the amount of sunlight available, and whether it is eligible for any bonus tax credits.

In general, large-scale photovoltaic (PV) projects will receive more value if they opt for the PTC in sunny places, while projects located in less sunny areas, that incur high installation costs, or that qualify for bonus tax credits, are more likely to benefit from the ITC.

Smaller-scale PV projects and concentrating solar-thermal power (CSP) projects generally receive more value utilizing the ITC, particularly if they can utilize a low-income bonus, which is not available with a PTC. However, as installed PV and CSP system costs reduce over time (or generate more electricity), the PTC may become more attractive for all sectors.

Example of Investment Tax Credit and Production Tax Credit comparisons

PowerUp, Inc. began construction of a solar energy system in 2023 and placed it in service in 2024. The 500-kW system cost $1 million and has a capacity factor of 20% in the first year.

Below is a comparison of the Investment Tax Credit and Production Tax Credit with bonus depreciation factored in.

Investment Tax Credit calculation

The Investment Tax Credit is a maximum 30% so could generate a credit of $300,000 if all requirements for the bonus credit are satisfied. This results in the property's tax basis being reduced from $1 million to $850,000 (remember, for the Investment Tax Credit, the basis is only reduced by 50% of the credit claimed).

Because the property is placed in service in 2024, the bonus depreciation rate is 60%, resulting in $510,000 in bonus depreciation ($850,000 × 60%).

Solar property is depreciated over five years, so PowerUp would also be able claim an additional $68,000 in depreciation each year over the five-year period (($850,000 - $510,000) ÷ 5).

PowerUp would receive a $121,380 tax reduction from the depreciation deductions in 2025 (21% tax rate × $578,000 in depreciation deductions).

Therefore, assuming the General Business Credit limits don't apply, PowerUp can potentially receive up to $421,380 in total reduction in tax liability for 2024.

Production Tax Credit calculation

A 500-kW solar photovoltaic property that commenced construction in 2023 is eligible for a 2.75 cent/kWh Production Tax Credit for the first ten years of a project. A first-year capacity factor of 20% would mean it generates 876,000 kWh in Year 1 (500 kW × 24 hours/day × 365 days/year × 20% = 876,000).

Therefore, in Year 1 it generates $24,090 in tax credits (876,000 × $0.026/kWh = $24,090).

Because the business is claiming the Production Tax Credit instead of the Investment Tax Credit, its depreciable basis for the system is not reduced, and therefore PowerUp could claim $600,000 in bonus depreciation, and the remaining $400,000 would be depreciated over five years, resulting in an additional $80,000 per-year depreciation deduction. The net impact of the depreciation deductions would result in a $142,800 reduction in tax liability ($680,000 × 21%).

Bottom line, PowerUp would receive a total reduction in tax liability equal to $166,890 when the Production Tax Credit and depreciation deductions are combined.

FICA TIP CREDIT

Employers in the food and beverage industry may be eligible to claim a credit for the employer's share of Social Security taxes (6.2%) and Medicare taxes (1.45%) paid on certain tips. The credit may

be claimed for these payroll taxes paid on behalf of employees who received tips for providing, delivering, or serving food or beverages for consumption.

CREDIT AMOUNT

The credit is equal to the full amount of the employer's share of payroll taxes paid on the employee's tips, as long as the employee receives a wage (excluding the tips) of at least $5.15 an hour. The $5.15 figure is the federal minimum wage rate in effect on January 1, 2007, the last time the FICA Credit Tip minimum wage standard was increased.

If the employer pays wages (excluding tips) of less than $5.15 per hour, the credit cannot be claimed on the payroll taxes paid on the tips used to bring the employee up to the $5.15 per hour rate.

Example of credit computation

Alice worked 1,000 hours at Hal's Restaurant and received $4,500 in tips in 2024. She received $3,750 in wages (excluding tips) from Hal's at the rate of $3.75 an hour.

If Alice had been paid $5.15 an hour, she would have received wages, excluding tips, of $5,150.

For credit purposes, Hal's would compute the credit as follows:

Tips received	$4,500
Federal minimum wage less wages actually paid ($5,150 - $3,750)	1,400
	3,100
Employer's share of payroll taxes	× 7.65%
Total credit	$ 240

Comment

Although most states require a minimum wage for tipped employees that exceeds the 2007 $5.15 federal minimum wage per-hour requirement, many states do not. Examples include Alabama, Louisiana, Mississippi, South Carolina, and Tennessee. (www.paycor.com/resource-center/articles/minimum-wage-tipped-employees-by-state/)

CLAIMING THE CREDIT

The credit is computed on Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips, in the year the employer's payroll taxes are paid. The credit may be claimed on an original or amended return.

✐ **Practice Pointer**

Employees may fail to report or underreport their tips. Should the IRS uncover this, they will send the employer an IRC §3121(q) Notice and Demand. The year the Notice and Demand is issued is the year the employer is obligated to pay the payroll tax. Therefore, for unreported tips, the credit is claimed in the year the IRC §3121(q) Notice and Demand is made and not the year in which the unreported tips were received by the employee. (Rev. Rul. 2012-18)

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NEW MARKETS TAX CREDIT

The New Markets Tax Credit is designed to encourage investment in low-income communities in the United States. (IRC §45D) This is done by providing credits to taxpayers who make qualified equity investments in qualified community development entities, which are usually nonprofit loan funds, community development organizations, or private financial institutions.

Qualified community development entities must be certified by the Community Development Financial Institutions Fund and must apply to the fund each year to receive credit allocations. Once the community development entity wins an allocation, it raises private investments by offering investors the allocated credits and then uses those investments to finance projects and businesses in low-income communities.

Locating qualified community development entities to invest in

The Community Development Financial Institutions Fund has an interactive tool on its website that allows taxpayers to locate all the qualified community development entities by state and service area. The tool is available at:

Website
www.cdfifund.gov/awards/nmtc

Comment

According to the Tax Policy Institute, over $40 billion in New Markets Tax Credits have been awarded over a 20-year period from 2003 to 2023.

CREDIT AMOUNTS

The total credit is equal to 39% of the original investment amount and is claimed over a seven-year period. The credit is equal to:

- 5% of the investment for each of the first three years; and
- 6% of the investment for each of the remaining four years.

QUALIFIED EQUITY INVESTMENT

To be eligible for the New Markets Tax Credit, investments must be made in the form of a qualified equity investment in a certified community development entity. A qualified equity investment is an interest in a qualified community development entity in the form of stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership if:

- The taxpayer acquired the investment solely for cash at its original issue (or from a taxpayer for whom the investment was a qualified equity investment). The cash may be from borrowed funds, including a nonrecourse loan (Rev. Rul. 2003-20 and Rev. Rul. 2010-17);
- Substantially all (at least 85%) of the cash is used to make qualified low-income community investments. The 85% requirement is reduced to 75% for the seventh year of the seven-year credit period; and
- The investment was designated as a qualified equity investment or a non-real estate qualified equity investment (e.g., investing in a low-income community businesses) by the community development entity on its books and records for purposes of the New Markets Tax Credit.

CREDIT RECAPTURE

The credit is subject to recapture if at any time within seven years from the date of the original issuance of the qualified equity investment:

- The entity ceases to be a qualified community development entity;
- Substantially all of the proceeds of the investment cease to be used to make qualified low-income community investments; or
- The investment is redeemed or otherwise cashed out by the entity.

Exception from recapture

If a community development entity fails to use substantially all of the proceeds of a qualified equity investment to make qualified low-income community investments, the community development entity may avoid recapture of the credit if it corrects the failure within six months after the date it becomes aware (or reasonably should have become aware) of the failure. Only one correction is permitted for each qualified equity investment during the seven-year credit period.

CLAIMING THE CREDIT

The credit is computed on Form 8874, New Markets Tax Credit, and reported on Schedule K for partnerships and S corporations and on Form 3800, Part III, line 1i for all other taxpayers.

The credit can be claimed against AMT.

CREDIT FOR SMALL EMPLOYER PENSION PLAN STARTUP COSTS

The Small Employer Pension Plan Startup Costs Credit is a tax credit available to small businesses (100 employees or fewer) that set up and begin contributing to an employer-sponsored retirement plan. (IRC §45E) The credit can be claimed for three consecutive years.

In addition, beginning with the 2023 tax year, employers can also claim a credit for employer contributions.

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CREDIT AMOUNT

The maximum plan startup credit is equal to 100% of an employer's pension plan startup costs for employers with up to 50 employees (prior to the 2023 tax year, the maximum credit was 50% of qualified costs). (IRC §45E(e)(4)) The 50% credit limit still applies to employers of between 51 and 100 employees.

However, the credit is limited to the greater of:

- $500; or
- The lesser of:
  - $250 for each non-highly compensated employee eligible to participate in the plan; or
  - $5,000.

Employees counted

Only those employees who are paid at least $5,000 of compensation in the prior year are included in the 50/100 employee threshold. (IRC §45E(c)(1))

In addition, the SIMPLE rules governing eligible employers apply. For purposes of the 100-employee limitation, you must take into account all employees employed at any time during the calendar year, including those employees who have not met the plan's eligibility requirements.

ELIGIBLE EMPLOYER

An employer is ineligible if the employer, or any member of any controlled group including the employer (or any predecessor of either) established or maintained a qualified employer plan under which contributions were made, or benefits accrued, for substantially the same employees.

Comment

Employers that participate in CalSavers or other state-mandated Roth IRA retirement plan are not eligible for the Small Employer Pension Plan Startup Costs Credit. This is because CalSavers is merely a Roth IRA account set up through the CalSavers program that accepts only employee contributions.

However, employers that subsequently offer a retirement plan other than CalSavers, such as a 401(k), SEP IRA, or SIMPLE plan, can qualify for the credit.

QUALIFIED STARTUP COSTS

Qualified startup costs are any of the employer's ordinary and necessary expenses related to:

- Establishing or administering the plan; or
- Educating the employees concerning the plan.

An eligible employer plan is a qualified employer plan (as defined in IRC § 4972(d)) with at least one employee eligible to participate in the plan who is not a highly compensated employee. All eligible employer plans of the same employer are treated as one eligible employer plan.

ADDITIONAL CREDIT FOR SMALL EMPLOYER CONTRIBUTIONS

Beginning with the 2023 tax year, small employers can also claim a credit for plan contributions made to a defined contribution plan, SEP or SIMPLE, up to a $1,000 maximum credit per employee. (IRC §45E(f))

Contributions made for employees who receive wages in excess of $100,000 (increased for inflation beginning in any taxable year beginning in a calendar year after 2023) are excluded from the calculation of the additional credit. (IRC §45E(f)(2)(C)) The credit also does not apply to elective deferrals as defined in IRC §402(g)(3) or to defined benefit plans.

The applicable percentage is equal to:

- 100% for the first and second taxable years after the plan is established;
- 75% for the third taxable year after the plan is established;
- 50% for the fourth taxable year after the plan is established;
- 25% for the fifth taxable year after the plan is established; and
- 0% thereafter.
  (IRC §45E(f)(3))

Previously, the applicable percentage was 100% for only the first taxable year.

The credit is phased out for employers with 51 to 100 employees by 2% for each employee for the preceding taxable year in excess of 50 employees. (IRC §45E(f)(2))

Example of employer contribution credit

ABC, Inc. is an employer with 65 employees and established a small employer pension plan (a 401(k)) in 2024. Seven of the employees are paid salaries and wages greater than $100,000, so there are 58 employees eligible for the credit (65 total employees minus 7 whose compensation is greater than $100,000).

Under the terms of the 401(k) plan, ABC made employer contributions totaling $90,000 for each of its first five years (not including those employees whose salary and wages are greater than $100,000). At least $1,000 was paid on behalf of each of the 58 eligible employees.

ABC's Small Employer Contributions Credit is calculated as follows for 2024:

	Years 1–2 (2024–25)	**Year 3 (2026)**	**Year 4 (2027)**	**Year 4 (2028)**
Employer contribution[1]	$58,000	$58,000	$58,000	$58,000
Credit percentage	× 100%	× 75%	× 50%	× 25%
Base credit amount	$58,000	$43,500	$29,000	$14,500
Employees in excess of 50	15	15	15	15
Reduction percentage	× 2%	× 2%	× 2%	× 2%
Total reduction percentage	30%	30%	30%	30%
Total reduction[2]	$17,400	$13,050	$ 8,700	$ 4,350
Credit[3]	$40,600	$30,450	$20,300	$10,150

[1] Limited to $1,000 per eligible employee
[2] Base credit × reduction percentage
[3] Base credit – total reduction

In its first five years, ABC is able to claim tax credits totaling $142,100 to subsidize its employer contributions to its new 401(k) plan.

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Creating a new plan

The Small Employer Pension Plan Startup Costs Credit is designed to provide a credit for employers that start new retirement plans for their employees. However, the language of IRC §45E(c)(2) is a bit more nuanced.

It provides that the term "eligible employer":

"…shall not include an employer if, during the 3-taxable year period immediately preceding the 1st taxable year for which the credit under this section is otherwise allowable for a qualified employer plan of the employer, the employer or any member of any controlled group including the employer (or any predecessor of either) established or maintained a qualified employer plan ***with respect to which contributions were made, or benefits were accrued, for substantially the same employees as are in the qualified employer plan*** *[emphasis added]."*

The quoted and emphasized language above raises an interesting question: Can an employer that already has a retirement plan in place create a new retirement plan and still claim the credit? Consider the following example.

Example of creating a new plan

RamCo started a SIMPLE IRA for its employees 10 years ago, but only four out of its 25 employees contribute to it.

RamCo decides to start a 401(k) in 2024 and provides a more favorable employer matching program than it offered in its SIMPLE IRA plan. Due to the more favorable matching, all 25 employees decide to participate in the new 401(k).

Can RamCo claim the Small Employer Pension Plan Startup Costs Credit? It would seem that this scenario runs contrary to the purpose of IRC §45E, but what does it mean for a plan to include "substantially the same employees" as an existing plan? IRC §45E provides no further guidance nor has the IRS.

We know of at least one employer in this scenario whose national payroll company believes that they do qualify.

Employers that join existing plans

When an employer joins an existing multiple employer plan, the first year the taxpayer joins the plan becomes the first of the five years the employer is eligible to claim the credit. (SECURE 2.0 Act §111; IRC §45E(d)(3)(A)) Previously, the credit was only available for the first three years of the plan's existence, which prevented employers that joined an existing multiple employer plan from claiming the credit for the full three years (if at all).

✐ **Practice Pointer**

This SECURE 2.0 Act provision is applied retroactively, so employers that were not eligible under the original SECURE Act provision can file amended returns for any open tax years and claim the expanded Credit for Small Employer Pension Plan Startup Costs due to the retroactive nature of this provision.

SOLO PLANS

Qualifying retirement plans must have at least one participant, but one-participant plans where the one participant is a highly compensated employee are excluded. (IRC §45E(d)(1)(B)) Highly compensated employees include anyone who was a 5% owner at any time during the current taxable year or the preceding taxable year. (IRC §414(q)(1))

Because of this limitation, one-participant retirement plans where the owner is the only participant do not qualify for the credit.

NO DOUBLE BENEFIT

The employer's income tax deduction for contributions to the retirement plan must be reduced by the amount of the credit claimed. (SECURE 2.0 Act §102(c); IRC §45E(e)(2))

CLAIMING THE CREDITS

The credits are calculated using Form 8881, Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation, and reported on Schedule K for partnerships and S corporations and on Form 3800, Part III, line 1j for all other taxpayers.

The credit can be claimed against a taxpayer's AMT.

For purposes of the credit for startup costs, the credit may be claimed for three years. The first credit year is generally the taxpayer's tax year that includes the date that the plan becomes effective with respect to the eligible employer. However, taxpayers can elect to have the preceding tax year be the first credit year and claim the credit for qualified startup costs paid or incurred during that tax year.

Comment

Note that while the original credit that can be claimed for a small employer's startup costs can only be claimed for three years, the additional credit for small employer contributions can be claimed for four years.

CREDIT FOR EMPLOYER-PROVIDED CHILD CARE FACILITIES AND SERVICES

Employers who provide child care services to their employees may claim a credit of up to $150,000 annually. (IRC §45F)

ELIGIBLE EXPENSES

To be eligible for the credit, an employer must have paid or incurred qualified child care expenditures during the tax year to provide child care services to its employees.

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Qualified child care expenditures are:

- Acquisition, construction, rehabilitation, and/or expansion costs related to depreciable/amortizable property used as the taxpayer's qualified child care facility. The property cannot be used as the principal residence of the taxpayer or a taxpayer's employee;
- Qualified child care facility expenditures, which are operating expenses made by the taxpayer, including amounts paid to support child care workers through training, scholarship programs, and providing increased compensation to employees with higher levels of child care training; and
- Qualified resource and referral expenditures, which include amounts paid or incurred under a contract provide child care resource and referral services to employees of the taxpayer.

Practice Pointer

Qualified child care facility expenditures do not include expenses over the fair market value of such care.

Qualified child care facility

A qualified child care facility is a space that meets the requirements of all applicable state and local laws and regulations. This includes the licensing of the facility as a child care facility.

The facility must also meet these conditions:

- The principal use of the facility must be to provide child care assistance (unless the facility is also the principal residence (within the meaning of IRC §121) of the person operating the facility);
- Enrollment in the facility must be open to employees of the taxpayer during the taxable year;
- If the facility is the taxpayer's principal trade or business, at least 30% of the enrollees of the facility must be dependents of employees of the taxpayer; and
- The use of the facility (or the eligibility to use the facility) must not discriminate in favor of highly compensated employees (within the meaning of IRC §414(q)).

CREDIT AMOUNT

The credit is 25% of the qualified child care facility expenditures plus 10% of the qualified child care resource and referral expenditures paid or incurred during the tax year, up to a $150,000 maximum per year.

For purposes of figuring the credit, all members of a controlled group of corporations (as defined in IRC §52(a)) and all members of a group of businesses under common control (as defined in IRC §52(b)) are treated as a single taxpayer.

NO DOUBLE BENEFIT

Taxpayers must reduce, by the amount of associated expenses for which the credit was claimed, the basis of the qualified child care facility and any other deductions or credits that could be claimed for those expenses.

CLAIMING THE CREDIT

The credit is computed on IRS Form 8882, Credit for Employer-Provided Child Care Facilities and Services, and reported on Schedule K for partnerships and S corporations and on Form 3800, Part III, line 1k for all other taxpayers.

CREDIT RECAPTURE

Taxpayers must recapture part or all of the credit if, before the tenth tax year after the tax year in which the qualified child care facility is placed in service, the facility ceases to operate as a qualified child care facility or there is a change in ownership of the facility. However, a change in ownership will not require recapture if the person acquiring the interest in the facility agrees, in writing, to assume the recapture liability. (IRC §45F(d))

The amount of the recapture depends on the year in which the recapture event occurs as follows:

- 100% for years 1 through 3;
- 85% for Year 4;
- 70% for Year 5;
- 55% for Year 6;
- 40% for Year 7;
- 25% for Year 8; and
- 10% for years 9 and 10.

Recapture is not required if the facility's operations cease as a result of a casualty loss if the facility is restored or replaced within a reasonable period as established by the Secretary.

✎ **Practice Pointer**

Any recapture tax is reported on the line of the taxpayer's tax return where other recapture taxes are reported (or, if no such line, on the "total tax" line). The recapture tax may not be used in figuring the amount of any credit or in figuring the alternative minimum tax.

NEW ENERGY EFFICIENT HOME CREDIT

Many tax professionals are asking whether clients engaged in home construction or remodeling can claim the business solar energy credit. Even if they could, the credit would be subject to recapture if the home is sold within five years, so it is not really a viable option.

However, the IRA '22 did reinstate, expand and extend (through 2032) the IRC §45L New Energy Efficient Home Credit available to eligible contractors or manufacturers that construct or substantially reconstruct or rehabilitate new energy efficient homes, allowing contractors to claim up to $5,000 per home.

QUALIFICATIONS

To qualify the contractor must:

- Construct or substantially reconstruct a qualified home;
- Own the home and have a basis in it during construction; and
- Sell or rent it to a person for use as a residence.
  (IRC §45L(a), (b))

In addition, the home must be:

- A single family (including manufactured homes) or multifamily home, as defined under certain Energy Star program requirements;
- Located in the United States;
- Purchased or rented for use as a residence; and
- Certified to meet applicable energy saving requirements based on home type and acquisition date.

CREDIT AMOUNTS

Single-family homes

For homes acquired after 2022 the credit amounts are:

- $2,500 for single-family homes that are eligible to participate in the:
  - Energy Star Residential New Construction Program that meet the single-family home requirements but are not certified as a Zero Energy Ready Home; or
  - Energy Star Manufactured New Homes Program that meet the single-family home requirements but are not certified as a Zero Energy Ready Home; and
- Increased to $5,000 if the eligible single-family and manufactured new homes are certified as a Zero Energy Ready Home under the Department of Energy's Zero Energy Ready Home program as in effect on January 1, 2023 (or any successor program).
(IRC §45L(a)(2)(A))

Note: A Zero Energy Ready Home is a high-performance home that is so energy efficient that a renewable energy system could offset most or all the home's annual energy use. (www.energy.gov/eere/buildings/zero-energy-ready-home-program)

Multifamily homes

A contractor or manufacturer may claim a base credit of $500 for each multifamily dwelling unit eligible to participate in the Energy Star Multifamily New Construction Program that meets the specified national and local requirements. The credit is increased to $1,000 if the unit is certified as zero energy ready under the Department of Energy's Zero Energy Ready Home Program. (IRC §45L(a)(2)(B))

These base credit rates are increased to bonus credit rates of $2,500 and $5,000 if the contractor or manufacturer ensures that any laborers and mechanics employed by the contractor or manufacturer or any other contractor or subcontractor is paid prevailing rates for construction, alteration, or repair of a similar character in the locality where the residence is located.

Contractors and manufacturers may "cure" any failure to satisfy the prevailing wage rate requirement in a manner similar to that described under the Renewable Electricity Production Tax Credit on page 3-46.

CLAIMING THE CREDIT

The credit is computed on Form 8908, Energy Efficient Home Credit, and is claimed in the year the home is acquired or leased by an individual from the contract for use as a residence. The credit is reported on Schedule K for partnerships and S corporations and on Form 3800, Part III, line 1p for all other taxpayers.

NO DOUBLE BENEFIT

For both single and multifamily homes, the credit cannot be claimed for expenses used in calculating the IRC §47 Rehabilitation Credit or the IRC §48 Energy Credit. (IRC §45L(f))

In addition, the property's basis must generally be reduced by the amount of credit claimed. (IRC §45L(e))

ALTERNATIVE FUEL VEHICLE REFUELING PROPERTY CREDIT

IRC §30C provides a credit of 30% of the cost of qualified alternative fuel vehicle refueling property placed in service prior to January 1, 2033. Alternative fuel includes electricity and fuel that contains specified percentages of ethanol, natural gas, biodiesel, kerosene, etc. The credit is only available for alternative fuel vehicle refueling property installed by a business or at a taxpayer's principal residence.

Comment

Taxpayers that install electric charging stations in their business or homes can claim this credit. However, as discussed below, starting in 2023, it is only available if the property is placed in service in low-income or rural census tracts (aka eligible census tract).

QUALIFIED PROPERTY

Qualified alternative fuel vehicle refueling property is any property (other than a building or its structural components), including bidirectional charging equipment, used for either of the following:

- To store or dispense an alternative fuel (defined below) other than electricity into the fuel tank of a motor vehicle propelled by the fuel, but only if the storage or dispensing is at the point where the fuel is delivered into that tank; or
- To recharge an electric vehicle, but only if the recharging property is located at the point where the vehicle is recharged.

In addition, the following requirements must be met to qualify for the credit:

- The refueling property is placed in service during the tax year;
- The original use of the property began with taxpayer;
- The property is predominantly used in the United States;
- If the property isn't business/investment use property, the property must be installed on property used as the taxpayer's main home; and
- The property must be located in an eligible census tract (use the tools outlined in the instructions to Form 8911, Alternative Fuel Vehicle Refueling Property Credit, to determine if the property is located in an eligible census tract).

Sellers of the new refueling property to tax-exempt organizations or governmental entities may also claim the credit under specified conditions.

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Alternative fuel

The following are alternative fuels:

- Any fuel at least 85% of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, and/or hydrogen;
- Any mixture which consists of two or more of the following: biodiesel, diesel fuel, or kerosene, and at least 20% of the volume of which consists of biodiesel determined without regard to any kerosene in such mixture;
- Electricity; and
- For fuel produced after December 31, 2024, certain transportation fuel.

CREDIT AMOUNT

The part of the credit attributable to business/investment use is treated as a General Business Credit. Any part of the credit not attributable to business/investment use is treated as a personal credit.

For business and investment property, the credit for each item of property is 6% (30% if a certain project meets the wage and apprenticeship requirements outlined on page 3-26) of the property's cost, up to a maximum credit of $100,000.

For personal use property, the credit for each item of property is generally 30% of the property's cost, up to a $1,000 maximum credit.

> ✐ **Practice Pointer**
>
> Each property's cost must first be reduced by any IRC §179 expense deduction taken for the property.

CREDIT RECAPTURE

The credit must be recaptured if, at any time before the end of the property's recovery period:

- The property ceases to qualify as alternative fuel vehicle refueling property;
- The property is no longer used 50% or more in a trade or business;
- The property is used in a manner described in exceptions to the Investment Tax Credit (e.g., used predominantly outside the U.S. or to furnish lodging, etc.); or
- The taxpayer sells or disposes of the property and knows or had reason to know that it would be used in one of the recapture events outlined above.

The amount of credit to be recaptured is based on the number of years left in the property's recovery period.

CLAIMING THE CREDIT

The credit is computed on Form 8911, Alternative Fuel Vehicle Refueling Property Credit.

CREDIT FOR SMALL EMPLOYER HEALTH INSURANCE PREMIUMS

Qualified small employers, including nonprofits, who cover at least 50% of their full-time employee's health insurance premium costs purchased through the Small Business Health Options Program (SHOP marketplace) can claim a credit for a portion of the premiums for two consecutive tax years. (IRC §45R)

Comment

This credit was enacted as part of the Affordable Care Act in 2010, so most existing employers who qualified have already claimed it. However, this credit may be a boon for new businesses or small businesses that are first offering health insurance to their employees. It's important to remember that to qualify, the business must enroll through the SHOP Marketplace (e.g., Health Care Exchange such as Covered California). For more information see:

Website
www.healthcare.gov/small-businesses/get-coverage/

Employers can still claim the credit if the business is in an area where there are no SHOP plans available. See IRS Notice 2018-27 for details.

ELIGIBLE BUSINESSES

To qualify, the business must:

- Have fewer than 25 full-time equivalent (FTE) employees;
- Pay an average employee salary of about $62,000 (2023) per year or less (adjusted for inflation);
- Pay at least 50% of their FTE employees' premium costs; and
- Offer SHOP coverage to all FTE employees.

Comment

The business is not required to offer health insurance to dependents or employees working fewer than 30 hours per week to qualify for the credit.

Household employers

Household employers who otherwise qualify are eligible for the credit. (IRS FAQ 9 at: www.irs.gov/newsroom/small-business-health-care-tax-credit-questions-and-answers-who-gets-the-tax-credit)

Hawaii employers

According to the Form 8941 Instructions, employers in Hawaii can't participate in the SHOP Marketplace or claim the credit for insurance premiums paid for health plan years beginning after 2016.

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Nonprofits

A tax-exempt organization described in IRC §501(c) and exempt from tax under IRC §501(a) and otherwise meets the definition of an eligible small employer may qualify for the credit.

Counting full-time employees

Self-employed individuals, including sole proprietors and partners, 2% shareholders of an S corporation, and 5% owners of the employer (within the meaning of IRC §416(a)(1)(B)(i)) are not treated as employees for purposes of the credit. In addition, any individual who bears any relationship to any such owner or shareholder described in IRC §152 is not treated as an employee. This would include a parent, child, sibling, etc.

The number of FTE employees is determined by dividing the total number of hours worked during the year by 2,080. The result is rounded down. Hours worked by any one employee in excess of 2,080 are not counted for purposes of determining the number of FTE employees (wages for work performed in excess of 2,080 hours are counted for purposes of average annual wages).

Example of computing FTEs

Busy Bees, Inc. has 10 employees who work 40 hours per week, each working 2,080 hours or more each year. In addition, it has 10 part-time employees who work 10 hours per week, each working 520 hours each year.

Total full-time hours (10 × 2,080)	20,800
Total part-time hours (10 × 520)	5,200
Total hours	26,000
	÷ 2,080
	12.5
FTE employees (rounded down)	12

Seasonal workers, as the term is defined by the Department of Labor, are not counted for purposes of FTE employees or annual average wages unless the worker works for the employer for more than 120 days during the year. An employee includes a leased employee within the meaning of IRC §414(n).

Average annual wages defined

Average annual wages are determined by dividing the aggregate amount of wage paid to qualifying employees during the year by the number of FTE employees.

The amount is rounded down to the nearest $1,000.

"Wages" has the meaning given that term for FICA purposes under IRC §3121(a).

Qualifying plan defined

A plan qualifies if it is a qualifying "contribution arrangement." A contribution arrangement is qualifying if it requires the employer to make nonelective contributions on behalf of every employee who enrolls in the employer plan:

- In an amount that is at least 50% of the premium cost; and
- Is a uniform percentage for all employees.

A nonelective contribution is any contribution other than an employer contribution under a salary reduction arrangement. Therefore, any amount contributed under a cafeteria plan within the meaning of IRC §125 is not treated as an employer contribution for purposes of the credit.

Exceptions to premium contribution uniformity requirement

An arrangement that requires an employer to pay a uniform premium for each enrolled employee (aka composite billing) and offers different tiers of coverage (for example, employee-only, dependent, and family coverage) can be a qualifying arrangement even if it requires the employer to pay a uniform percentage that is less than 50% of the premium cost for employees not enrolled in employee-only coverage.

In addition, an arrangement that requires an employer to pay a separate premium for each employee based on age or other factors (aka list billing) can be a qualifying arrangement even if it requires the employer to pay a uniform percentage that is less than 50% of the premium cost for some employees.

CREDIT AMOUNT

The maximum credit is 50% (35% for nonprofits) of premiums paid for employers with 10 or less employees up to the amount of net premiums paid.

Net premiums

Net premium payments are employer premium paid minus the amount of any state tax credits or subsidies paid.

Reductions

The maximum credit is phased down by the sum of formulas based on:

- Number of FTE employees in excess of 10; and
- Average annual wages in excess of $25,000, adjusted for inflation ($30,700 for 2023 and $32,400 for 2024).

For employers with 10 or more employees, the credit is reduced by the sum of:

- The initial credit amount multiplied by a fraction, the numerator of which is the total number of employees in excess of 10 and the denominator of which is 15; and
- The initial credit amount multiplied by a fraction, the numerator of which is the average annual wages in excess of $32,400 (2024) and the denominator of which is $32,400 (2024).

Example of reduced credit calculation

In 2024 M&P, LLC is a qualifying small employer that had 16 employees and average annual wages of $35,000. They paid $40,000 in qualifying health care premiums.

Initial credit amount (50% × $40,000)	$20,000
Phaseout for number of employees ($20,000 × (16 - 10) ÷ 15)	8,000
Phaseout for excess wages ($20,000 × ($35,000 - $32,400) ÷ $32,400)	- 1,605
Credit	$10,395

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Credit estimator

Healthcare.gov provides a Small Business Health Care Tax Credit Estimator for employers to use to estimate the amount of credit they may be entitled to:

Website
www.healthcare.gov/shop-calculators-taxcredit

Tax-exempt employers

The credit is refundable for tax-exempt employers but is limited to the amount of the tax-exempt employer's payroll taxes withheld during the calendar year in which the taxable year begins.

What premiums count?

The credit can only be claimed for the share of premiums paid by the employer, so if an employer pays 80% of the premiums and the employee pays 20%, the credit may only be claimed for the 80% paid by the employer.

In addition, the employer's premium payments used for purposes of computing the credit are limited by the average premium in the small group market in the rating area in which the employee enrolls for coverage through a SHOP exchange (Treas. Regs. §1.45R-3(b); Prop. Treas. Regs., §§1.45R-1(a)(1), 1.45R-1(3)(b))

So even if an employer pays $150 per employee for health insurance premiums, if the average premium in the small group market in the business's locale is $120, the employer's credit would be limited to $60 per employee.

The average annual premiums for a tax year are found in the instructions to Form 8941, Credit for Small Employer Health Insurance Premiums.

The table below addresses whether certain payments are included in the employer's health insurance premium costs eligible for the credit.

Amounts Includable in an Employer's Health Insurance Premiums for Purposes of the Credit*

Description	**Includable in premiums for purposes of the credit?**
State subsidies or credits received by employer	Yes. Does not reduce the amount employer's payments eligible for the credit even if paid directly by the state to the insurer
Wellness program costs paid by employer	Yes
Tobacco surcharges paid due to employee's use of tobacco	No
Dependent coverage (not to be confused with family coverage)	Yes
Employee's share of premiums paid through salary reduction arrangement under a cafeteria plan	No

* Form 8941 Instructions

NO DOUBLE BENEFIT

The amount otherwise deductible by the employer as health insurance premiums must be reduced by the amount of any credit allowed.

CLAIMING THE CREDIT

The credit is calculated on Form 8941, Credit for Small Employer Health Insurance Premiums, and may be claimed against AMT. Partnerships and S corporations report the credit on Schedule K, and all other taxpayers report the credit on Form 3800, Part III, line 4h. Tax-exempt small employers report the credit on Form 990-T, Part III, line 6f.

The credit can be claimed for two consecutive years only, with the first year being the year the taxpayer attaches Form 8941 to their tax return.

PAID FAMILY AND MEDICAL LEAVE CREDIT

Eligible employers that provide paid family and medical leave (PFML) to their eligible employees can claim a credit for wages paid while the employees are on leave, applicable to pre-2026 tax years. (IRC §45S)

Comment

The credit cannot be claimed for any leave paid by a state or local government or that is required by state or local law. (IRC §45S(c)(4))

Additional information

The IRS has issued FAQs concerning this credit available at:

Website
www.irs.gov/newsroom/
section-45s-employer-credit-for-paid-family-and-medical-leave-faqs

QUALIFIED EMPLOYERS

Employers must have a written policy in place that meets certain requirements, including providing:

- At least two weeks of paid family and medical leave (annually) to all qualifying employees who work full time (prorated for employees who work part time); and
- The paid leave is not less than 50% of the wages normally paid to the employee.

Interplay with short-term disability programs

Paid leave allowed under an employer's short-term disability program, whether self-insured by an employer or through a short-term disability insurance policy, may be characterized as family and medical leave if it meets the requirements under the law. (IRS FAQs)

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QUALIFIED EMPLOYEES

A qualifying employee is any employee under the Fair Labor Standards Act who has been employed by the employer for at least one year and who, for the preceding year, had compensation of not more than a certain amount ($81,000 for 2023).

QUALIFIED PAID FAMILY LEAVE

For purposes of this credit, paid family and medical leave is limited to leave for the following reasons:

- Birth of an employee's child and to care for the child;
- Placement of a child with the employee for adoption or foster care;
- To care for a seriously ill spouse, child, or parent;
- A serious health condition that makes the employee unable to perform their work;
- Any qualifying exigency due to an employee's spouse, child, or parent being on covered active duty (or having been notified of an impending call or order to covered active duty) in the Armed Forces; or
- To care for a service member who is the employee's spouse, child, parent, or next of kin.

CREDIT AMOUNT

The credit is generally equal to a percentage of the amount of wages paid to a qualifying employee while on PFML for up to 12 weeks per taxable year. The minimum percentage is 12.5% and is increased by 0.25% for each percentage point by which the amount paid to a qualifying employee exceeds 50% of the employee's wages, with a maximum of 25%. In certain cases, an additional limit may apply.

Example of calculating the credit

Kinder, Inc. has a PFML written policy in place that pays qualified employees up to 75% of wages for a 12-week period.

Marta, who makes $60,000 per year ($1,154 per week), takes the full 12 weeks of PFML. The credit is computed as follows.

The 75% of PFML provided means Kinder may claim an additional credit above the 12.5% base amount equal to 6.25% (0.25% × 25%), resulting in a total credit percentage of 18.75%.

The total credit equals $2,596 ($1,154 × 12 weeks × 18.75%).

NO DOUBLE BENEFIT

A wage deduction cannot be claimed for any wages used to calculate the credit. In addition, wages do not include any amount taken into account for purposes of determining any other business-related tax credit.

Caution

The credit must be claimed unless the taxpayer makes an election out.

CLAIMING THE CREDIT

The credit is computed on Form 8994, Employer Credit for Paid Family and Medical Leave, and reported on Schedule K for partnerships and S corporations and on Form 3800, Part III, line 4j for all other taxpayers.

The credit can be claimed against AMT.

RETIREMENT AUTO-ENROLLMENT CREDIT

Small employers may claim a credit of $500 per year for three taxable years if they adopt an automatic enrollment contribution arrangement feature to a qualified plan. (IRC §45T)

ELIGIBLE SMALL EMPLOYERS

Small employers are defined as those with no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. (IRC §408(p)(2)(C)(i)(I)) Even sole proprietors are eligible employers. (Notice 98-4, Q&A B-1)

An employer who satisfies this requirement for at least one year and then subsequently fails the small employer requirement will be treated as a small employer for a two-year grace period following the last year the employer qualified. (IRC §408(p)(2)(C)(i)(II)) However, if the employer fails the small business definition due to acquisition, disposition, or similar transaction, then the two-year grace period does not apply.

✎ Practice Pointer

There is nothing in the law that says there must be more than one employee. So, sole shareholders/proprietors can qualify for this credit for putting themselves on auto-enrollment.

ELIGIBLE PLANS

A qualified employer plan is essentially a defined contribution plan where the employee contributions are automatically taken out of their wages at a uniform rate unless they opt out or choose a different rate. (IRC §45T(b)(1)) This would include automatic contributions taken from SIMPLE IRAs and 401(k) plans but excludes governmental plans under IRC §414(d) and plans maintained by tax-exempt employers. (IRS Notice 2020-68)

CLAIMING THE CREDIT

The credit is claimed beginning with the first taxable year for which the employer includes an eligible automatic enrollment arrangement as part of its 401(k) or SIMPLE IRA plan. (IRC §45T(b))

The credit is computed on Form 8881, Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation.

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QUALIFIED COMMERCIAL CLEAN VEHICLE CREDIT

The Qualified Commercial Clean Vehicle Credit is available for qualified vehicles purchased after December 31, 2022, and before 2033. (IRA '22 §13403; IRC §45W) The taxpayer must use the vehicle for a business purpose. (FAQs About Qualified Commercial Clean Vehicle Credit, Topic G, Q&A 1)

Comment

The IRS has issued guidance regarding this new credit in IRS Notice 2023-9 and in FAQs available at:

Website
www.irs.gov/pub/taxpros/fs-2023-08.pdf

Comment

As we discuss in more detail below, business taxpayers have a choice between claiming the IRC §30D Cleave Vehicle Credit and the Qualified Commercial Clean Vehicle Credit for vehicles purchased for business use. If the IRC §30D credit is claimed for the vehicle (or a portion of the vehicle's cost if used both for personal and business use), then the credit claimed for the business use is subject to the General Business Credit limitations and reported on Form 3800.

CREDIT AMOUNT

The Qualified Commercial Clean Vehicle Credit is equal to the lesser of:

- 15% of the vehicle's basis (30% if the vehicle is not powered by a gasoline or diesel internal combustion engine); or
- The excess of the vehicle's purchase price over the cost of a comparable vehicle in terms of size and use, which is powered solely by a gasoline or diesel internal combustion engine. This is referred to as the vehicle's "incremental cost."
(IRC §45W(b))

The credit is capped at $40,000 ($7,500 for vehicles with a gross vehicle weight rating of less than 14,000 pounds).

Comment

Unlike the Clean Vehicle Credit, the Qualified Commercial Clean Vehicle Credit cannot be transferred to the dealer at the time of purchase. However, tax-exempt entities can treat the seller as the purchaser.

Incremental costs

The IRS has stated that it will accept a taxpayer's use of $7,500 as the incremental cost for all street vehicles (other than compact car plug-in hybrid electric vehicles (PHEVs)) with a gross vehicle weight rating of less than 14,000 pounds when calculating the IRC §45W credit for 2023 and 2024. (Notices 2023-9 and 2024-5)

For PHEVs and vehicles with a gross weight of 14,000 pounds or more, the IRS will allow taxpayers to use the figures contained in the Department of Energy's (DOE's) incremental cost analysis as a safe harbor. The DOE's analysis is available at:

Website
www.energy.gov/eere/vehicles/articles/
2022-incremental-purchase-cost-methodology-and-results-clean-vehicles

QUALIFIED COMMERCIAL CLEAN VEHICLE

A qualified commercial clean vehicle is a vehicle that:

- Is made by a qualified manufacturer (one that registers with the Secretary of the Treasury and discloses specified information to the IRS, including the vehicle's VIN);
- Is acquired for use or lease by the taxpayer and not for resale;
- Either is:
  - A motor vehicle under Title II of the Clean Air Act; or
  - A mobile machinery under IRC §4053(8);
- Either is:
  - Propelled to a significant extent by an electric motor that draws electricity from a battery with a minimum capacity of 15 kilowatt hours (seven kilowatt hours for vehicles that weigh less than 14,000 pounds) and is capable of being recharged from an external source of electricity; or
  - A fuel cell vehicle as defined under IRC §30B; and
- Is subject to depreciation.

More vehicles qualify than under the Clean Vehicle Credit

For a vehicle to qualify for the Clean Vehicle Credit under IRC §30D, the vehicle must have its critical material and battery components sourced from the United States or a country in which the United States has a free trade agreement in affect. In addition, the vehicle's final assembly point must be in North America.

The Qualified Commercial Clean Vehicle Credit does not contain the critical material or battery component sourcing rules.

Further, because the Qualified Commercial Clean Vehicle Credit can be claimed for vehicles used in a trade or business with a gross vehicle weight of less than 14,000 pounds, many vehicles that would qualify for the Clean Vehicle Credit except for the fact that either their critical components are not sourced in the U.S. or a qualifying country or the vehicle's final assembly point is not in North America can qualify for the Qualified Commercial Clean Vehicle Credit.

In addition, taxpayers do not have to meet the AGI limits to qualify to claim the credit.

See the discussion on page 3-74 dealing with vehicles that can qualify for a credit under both IRC §§30D and 45W.

> ***Comment***
>
> The credit is subject to recapture if the vehicle is no longer qualified (e.g., does not continue to be used in a trade or business). (IRC §§30D(f)(5), 45W(d)(1))
>
> The Inflation Reduction Act provision requiring recapture leaves the details of this provision up to the Department of the Treasury to issue regulations. As of publication, no such regulations have been issued.

Leased vehicles

Lessees of a clean vehicle cannot claim the credit. (FAQs About Qualified Commercial Clean Vehicle Credit, Topic G, Q&A 5)

Used vehicles

Technically, a taxpayer can claim the Qualified Commercial Clean Vehicle Credit under IRC §45W for used vehicles, but only if neither the Clean Vehicle Credit under IRC §30D or the Qualified Commercial Clean Vehicle Credit under IRC §45W has already been claimed for the vehicle.

> ***Comment***
>
> It seems unlikely that a taxpayer will actually be able to claim the Qualified Commercial Clean Vehicle Credit for a used vehicle. First, it's very unlikely that the taxpayer who purchased the vehicle new would forego claiming the credit, which is required in order to claim the credit for a used vehicle. Second, there isn't a mechanism in place for taxpayers to look up the used vehicle VIN number to determine whether a previous credit has been claimed for the vehicle.

OTHER ISSUES

Also, like the Clean Vehicle Credit, when claiming the Qualified Commercial Clean Vehicle Credit:

- Taxpayers must provide the vehicle identification number (VIN) on the tax return for the year the credit is claimed;
- The vehicle's basis must be reduced by the amount of the credit claimed;
- Tax-exempt entities that purchase a qualified vehicle may elect to have the seller treated as the taxpayer for purposes of the credit;
- The credit cannot be claimed for vehicles used predominantly outside the U.S.;
- Only one credit may be claimed per vehicle; and
- The vehicle must meet applicable air quality and motor vehicle safety standards.

No double benefit

The Qualified Commercial Clean Vehicle Credit cannot be claimed for a vehicle for which the taxpayer claimed the Clean Vehicle Credit under IRC §30D.

Any other deduction or credit allowed for the vehicle must be reduced by the amount of the Qualified Commercial Clean Vehicle Credit.

CLAIMING THE QUALIFIED COMMERCIAL CLEAN VEHICLE CREDIT

Starting with the 2023 taxable year, Form 8936, Clean Vehicle Credits, is used to compute all three clean vehicle credits under IRC §§30D, 45W, and 25E. The Qualified Commercial Clean Vehicle Credit is reported on Schedule K for partnerships and S corporations and on Form 3800, Part III, line 1aa for all other taxpayers.

Splitting Clean Vehicle Credit

When splitting the Clean Vehicle Credit between business and personal use, the credit is first reported on Form 8936, then the personal use portion of the credit carries directly to Schedule 3 (Form 1040), and the business use portion of the credit carries to Form 3800, General Business Credit.

INTERSECTION OF IRC §§30D, 45W, AND 25E FOR BUSINESS AUTOS

Prior to the Inflation Reduction Act, there was only one clean vehicle credit available to individuals and businesses and that was the New Qualified Plug-In Electric Drive Motor Vehicle Credit under IRC §30D (renamed the Clean Vehicle Credit by the Inflation Reduction Act). The introduction of the Qualified Commercial Clean Vehicle Credit under IRC §45W by the Inflation Reduction Act creates a scenario where many new cars are eligible for both credits, and taxpayers must choose which credit to claim.

The decision will come down to understanding the limitations applicable to each credit to help your clients avoid the limitation maze.

BUSINESS VEHICLES UNDER IRC §30D

Prior to the Inflation Reduction Act, the Qualified Plug-in Electric Drive Motor Vehicle Credit could be claimed for either a personal use vehicle or a vehicle subject to an allowance for depreciation (i.e., a business use vehicle). (IRC §30D(c)(1)) However, if the credit was claimed for a business vehicle, then the credit was claimed as part of the General Business Credit under IRC §38 and not part of the regular plug-in vehicle credit under IRC §30D(a). IRC §30D(c)(1) was left unchanged by the Inflation Reduction Act and remains in effect.

If, in the year a vehicle is placed in service, it has a combination of business and personal use, then the business and personal use must be split based on the personal versus business use percentages (usually using mileage in the year the vehicle is placed in service). Business use is reported on Form 8936, Clean Vehicle Credits, Part II, and the business portion of the credit is treated as part of the General Business Credit and carries to Form 3800. The personal use portion of the vehicle credit is reported on Form 8936, Part III and carries to Form 1040, Schedule 3.

Because IRC §30D(c) was left unchanged by the Inflation Reduction Act, taxpayers who purchase qualifying vehicles that are placed in service and are subject to an allowance for depreciation can still claim the Clean Vehicle Credit. This is significant because many cars are now eligible for both the Clean Vehicle Credit under IRC §30D and the new Qualified Commercial Clean Vehicle Credit under IRC §45W. Taxpayers cannot claim both credits for the same vehicle — they must choose wisely.

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Proposed regulations: mixed business and personal use for IRC §30D credit

The entire IRC §30D credit must be claimed as an IRC §38 General Business Credit if a vehicle is used 50% or more for business in the year it is placed in service. (Treas. Regs. §1.30D-1(b)(1)(i)) A Clean Vehicle Credit under IRC §30D(a) cannot be claimed by an individual taxpayer in this situation.

Example of clean vehicle with 50% or more business use

Kristin has a side hustle working as an Uber driver. She reports her income and expenses from Uber on Schedule C. Kristin purchased a new qualifying clean vehicle in 2024, and all requirements for claiming the Clean Vehicle Credit have been met (such as the vehicle MSRP, her AGI, etc.).

Using a mileage log, Kristin determines that she used her new car 50% for business and 50% for nonbusiness in 2024.

When Kristin files her 2024 income tax return, she must report the vehicle on Form 8936, and then the entire credit will be reported on Form 3800 as a General Business Credit and is subject to all limitations applicable to the General Business Credit.

If the vehicle is used less than 50% for business, then, just as before the Inflation Reduction Act, the credit must be split based on the business and personal use: The credit for the business use portion of the vehicle must be claimed as a General Business Credit under IRC §38, and the credit for the personal use portion of the vehicle is claimed as a Clean Vehicle Credit under IRC §30D(a). (Treas. Regs. §1.30D-1(b)(2))

Example of clean vehicle with less than 50% business use

Assume the facts are the same as the prior example, except that Kristin uses her new clean vehicle 49% for her Uber side hustle and 51% for nonbusiness purposes (once again, based on her mileage log).

When Kristin files her 2024 income tax return, she must report the vehicle on Form 8936, but 51% of the credit will flow directly to Form 1040, Schedule 3, and 49% of the credit must flow through the General Business Credit on Form 3800 and run through the limitation maze of the General Business Credit before the credit ultimately ends up on Kristin's Form 1040, Schedule 3.

Comment

The proposed regulations, as illustrated in the examples above, contain a somewhat strange rule that if a Clean Vehicle Credit is used 50% or more for business, then the entire Clean Vehicle Credit must be claimed as a General Business Credit.

This special rule in the regulations only applies to the Clean Vehicle Credit under IRC §30D. The regulations do not allow a taxpayer to treat a qualifying clean vehicle that is used only 50% for business as if it was a 100% business-use vehicle when it comes to deducting business mileage, depreciation issues, etc.

Partnerships and S corporations claiming Clean Vehicle Credit under IRC §30D

Under IRC §30D(f)(10), applicable to vehicles placed in service after December 31, 2022, taxpayers are ineligible for the Clean Vehicle Credit if their modified AGI exceeds the following amounts in both the current and the prior tax year:

- $300,000 for MFJ;
- $225,000 for HOH; or
- $150,000 for all other taxpayers.
  (IRA '22 §13401(f); IRC §30D(f)(10))

Modified AGI is the taxpayer's AGI, increased for any foreign income exclusion claimed under IRC §911, §931, or §933.

The AGI limitation under IRC §30D(f)(10) generally does not apply to C corporations or other taxpayers that do not calculate an adjusted gross income under IRC §62. (Treas. Regs. §1.30D-4(b)(5)(i))

However, in the case of partnerships and S corporations where the Clean Vehicle Credit is claimed by individuals who are direct or indirect partners or shareholders, the modified AGI limits do apply to those partners and shareholders when the credit passes through to them. (Treas. Regs. §1.30D-4(b)(5)(ii))

Example of reporting Clean Vehicle Credit purchased by a partnership

The KR Partnership is owned by Kiko (60%) and Radesh (40%), who both file their personal tax returns as single individuals. KR purchased a qualifying clean vehicle in 2024 and will claim the credit under IRC §30D. The vehicle qualifies for the maximum $7,500 credit.

Kiko's AGI for 2024 is $180,000 and Radesh's AGI is $130,000.

The partnership must first report the purchase of the vehicle on Form 8936, Clean Vehicle Credits, in Part II and will carry the $7,500 credit to Schedule K, line 15P (Other Credits). For an S corporation, this will be Schedule K, line 13P.

Kiko's Schedule K-1, line 15P will report $4,500 of the credit ($7,500 × 60% ownership) and Radesh's Schedule K-1, line 15P will report the remaining $3,000.

On their personal income tax returns, Kiko and Radesh each must determine whether they qualify to claim the credit based on their own AGI. Kiko cannot claim any portion of the $4,500 credit allocated to him because his AGI is over $150,000. Radesh's AGI is less than the $150,000 limit for 2023, so he will report the credit on Form 3800, General Business Credit, at Part III, line 1y. Assuming his General Business Credits are not limited, then the $3,000 credit will flow from Form 3800 to Schedule 3, line 6a.

The business choice

For purposes of qualified commercial clean vehicles under the 14,000-pound gross vehicle weight rating (GVWR), a qualified commercial vehicle means any vehicle that meets the vehicle requirements of IRC §30D(d)(1)(C). That subsection defines an eligible vehicle, but it does not include the following limitations:

- Critical mineral and battery component sourcing;
- MSRP limitations; and
- AGI limitations.

What this means is that taxpayers who purchase a new clean vehicle with a GVWR of under 14,000 pounds for their business can choose between the credit available under IRC §30D or IRC

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§45W. Both credits will be claimed as part of the General Business Credit under IRC §38, but the limitations discussed here will affect the tax professional's strategic decision to determine under which code section (and on which IRS form) to claim the credit.

Comparison of IRC §§30D and 45W Credits		
Point of consideration	**IRC §30D**	**IRC §45W**
Calculation of credit	Credit is either $3,750 or $7,500 based on battery capacity and sourcing of material and battery components — use Department of Energy website to determine available credit based on make and model (https://fueleconomy.gov/feg/tax2023.shtml)	Lesser of: • 15% of vehicle basis (30% if not powered at all by gas or diesel engine); or • Excess of vehicle's purchase price over cost of comparable gas or diesel vehicle (see IRS Notice 2023-9)
Apportionment of credit for mixed personal/business credit	Credit apportioned between personal and business credit if business use less than 50% Treated as 100% business credit if business use is 50% or more	No apportionment required but must be a business-use vehicle
Critical material and battery component sourcing limitation	Subject to limitation for vehicles delivered after April 17, 2023	Not subject to limitation
Vehicle MSRP limitation	Subject to limitation	Not subject to limitation
Taxpayer modified AGI limitation	• C corporations (and other taxpayers that do not calculate an AGI) are not subject to limitation; • Partners and S corporation shareholders are subject to limitation when credit passes through to them; and • Individual taxpayers are subject to limitation	Not subject to limitation
Credit claimed at point of sale	Yes, starting in 2024. This allows taxpayers to transfer the credit to the dealer who can then discount the price of the car	No
Recapture of credit claimed for business vehicle if vehicle sold or no longer used for business	Yes (but regulations containing details of recapture have not yet been issued)	Yes (but regulations containing details of recapture have not yet been issued)
IRS form to claim the credit	Form 8936	Form 8936 (use Form 8936-A for fiscal years beginning in 2022)

As should be obvious from the chart, because the Qualified Commercial Clean Vehicle Credit under IRC §45W contains fewer limitations, it will generally be preferrable over the Clean Vehicle Credit under IRC §30D. However, tax professionals must evaluate the calculation of each credit to determine which provides a greater benefit. Consider the following examples.

Example of IRC §30D providing a greater credit

Joe's Pool Cleaning, a Schedule C business, purchased a new plug-in hybrid vehicle for its business in 2024 at a cost of $35,000. According to the Department of Energy website, the credit under IRC §30D for the vehicle is $7,500. Joe's modified AGI is under the threshold, and he is eligible to claim the IRC §30D credit.

Under IRC §45W, the credit is only $5,250 (15% of the vehicle's basis because the car is powered by a hybrid gas-electric engine). In this scenario, it is more advantageous for Joe to claim the Clean Vehicle Credit under IRC §30D (using Form 8936).

Example of IRC §45W providing a greater credit

Assume the facts are the same as the previous example, except that Joe's AGI is too high to claim the Clean Vehicle Credit under IRC §30D. In this scenario, Joe should claim the $5,250 Qualified Commercial Clean Vehicle Credit under IRC §45W (using Form 8936-A).

MILITARY SPOUSE RETIREMENT PLAN CREDIT

Small employers (100 employees or less) that offer an "eligible defined contribution plan" that allows military spouses accelerated access to eligibility for an employer's retirement plan or accelerated vesting in employer contributions may claim a credit of up to $500 per covered military spouse, effective for taxable years beginning after December 29, 2022. (IRC §45AA)

All persons treated as a single employer under IRC §414(b), (c), (m), or (o) are treated as an employer for purposes of this credit. (IRC §45AA(f))

Comment

This credit is designed to incentivize employers to offer retirement plans to military spouses who, because of their spouse's military assignments, often do not remain employed long enough to become eligible for their employer's retirement plan or to vest in employer contributions.

The spouse must be married to the active-duty military service member on the date that the spouse is first hired by the employer. An employer can rely on the employee's certification to that effect as long as it contains the spouse's name, rank, and service branch. (IRC §45AA(d))

The employer cannot claim the credit for benefits provided to a highly compensated employee, as defined in IRC §414(q) (e.g., a 5% owner or an employee who received more than $150,000 (2023) in the previous year). (IRC §45AA(d)(2))

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CREDIT AMOUNT

The credit is capped at $500 per military spouse and is equal to the sum of:

- $200 per military spouse employee who participates in the employer's defined contribution plan during the taxable year; and
- Employer contributions of up to $300 per such employee made during the taxable year.

The credit can only be claimed on behalf of a military spouse employee for three succeeding years beginning with the first year the employee became eligible to participate in the plan. (IRC §45AA(a))

ELIGIBLE DEFINED CONTRIBUTION PLAN

An eligible defined contribution plan is a defined contribution plan (as defined in IRC §414(i)) that:

- Makes military spouse employees immediately eligible for plan participation within two months of hire;
- Upon plan eligibility, makes the miliary spouse eligible for any matching or nonelective contribution that they would have been eligible for otherwise at two years of service; and
- Makes the military spouse 100% immediately vested in all employer contributions.

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Part 4

Mike Giangrande, J.D., LL.M.

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PART 4

ROTH IRAs

CONTRIBUTIONS

For taxpayers with AGI not exceeding certain amounts, Roth IRA contributions, which are not deductible, are allowable up to the lesser of $7,000 for 2024 or the taxpayer's earned income. (IRS Notice 2023-75) The maximum contribution amounts to traditional and Roth IRAs are aggregate, so the allowable contribution to any traditional or Roth IRA is reduced by the amount the taxpayer contributes to another traditional or Roth IRA for the same taxable year.

Consistent with general IRA rules, joint-filing couples may contribute up to $7,000 each to a Roth IRA, provided the couple's combined earned income is at least equal to the amount contributed.

Taxpayers age 50 and older can make an additional catch-up contribution of $1,000 to their IRAs. Under the SECURE 2.0 Act, the catch-up contributions are indexed for inflation starting in 2024. (IRC §219(b)(5)(C)) However, the inflation adjustment for 2024 was low enough that the catch-up remains at only $1,000 for 2024.

CalSavers

The CalSavers program is a California state-administered Roth IRA retirement plan. It requires certain employers who do not have an employer-sponsored retirement plan to withhold from their employees and contribute that withholding to the CalSavers program. The initial default withholding rate is 5% and increases by 1% each year, up to 8%. Employees have the option to elect different withholding rates or can opt out altogether.

Because the CalSavers program is a Roth IRA, contributions to the program count toward the employee's aggregate annual IRA contribution limit ($7,000 in 2024 or $8,000 for taxpayers age 50 and older).

Employer-sponsored retirement plans, such as Roth 401(k)s, allow employees to contribute to the plan regardless of their AGI. CalSavers is not an employer-sponsored retirement plan, so taxpayers who participate in the program but whose AGI is over the Roth IRA AGI limit are subject to the federal 6% excise tax for excess contributions. However, a taxpayer can recharacterize a Roth IRA contribution to a traditional IRA contribution by the due date of the taxpayer's return for the year.

Adjusted gross income limitation

The maximum contribution that can be made to a Roth IRA is phased out based on the taxpayer's AGI, adjusted annually for inflation.

Roth IRA AGI Limits	
Filing status	**2024 (Notice 2023-75)**
Single, HOH, or MFS and did not live with spouse at any time during the year	$146,000–$161,000
MFJ	$230,000–$240,000
MFS and lived with spouse at any time during the year	$0–$10,000

Practice Pointer

Unlike a traditional IRA that has a limitation on the ability to make deductible contributions based on whether the individual or spouse is a participant in an employer-sponsored retirement plan, a Roth IRA has a limitation based only on the amount of earned income and the taxpayer's AGI.

Roth IRA does not have an age limit

Roth IRAs, like traditional IRAs, have no age limit for contributions. Any individual with earned income and whose AGI is below the top of the phaseout range detailed above can contribute to a Roth IRA. (IRC §§219(d)(1), 408A(c)(4))

California conformity

California conforms to IRC §408A and automatically conforms to any federal Roth IRA rules. (R&TC §§17501–17509, 23701)

DISTRIBUTIONS

Roth IRA distributions are not taxable as long as the taxpayer has satisfied the five-year rule. (IRC §408A(d))

Roth IRAs are also not subject to required minimum distribution (RMD) rules. (IRC §408A(c)(4))

Five-year rule for Roth IRAs

Roth earnings are taxable if withdrawn within five years from the beginning of the tax year for which the taxpayer first established **any** Roth IRA account (Roth IRA, SIMPLE Roth IRA, or SEP Roth IRA), even if the distribution:

- Occurs after the taxpayer reaches age 59½ or is disabled;
- Is used by a first-time homebuyer (up to $10,000); or
- Is made to the deceased taxpayer's heirs or estate.

Meeting the holding period

Each taxpayer has only one five-year holding period, and it begins on the first day of the taxable year for which the first contribution to any Roth IRA is made. (IRC §408A(d)(2)(B); Treas. Regs. §1.408A-6, Q&A2)

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If a taxpayer inherits a Roth IRA after the owner's death, the five-year holding period carries over from the Roth IRA owner to the beneficiary and is determined independently from any of the beneficiary's own Roth IRA accounts. (Treas. Regs. §1.408A-6, Q&A7(b)) However, if a surviving spouse elects to treat a Roth IRA inherited from their predeceased spouse as the surviving spouse's own Roth IRA, then the five-year period ends at the earlier of either the survivor's or the decedent's five-year holding period.

A calendar-year taxpayer can start the five-year period by making a contribution any time between January 1 Year 1 and April 15 Year 2, and the start date will be January 1 Year 1. So, if a taxpayer made a contribution on April 15 for the previous tax year, the five-year period begins on January 1, Year 1, meaning the holding period actually is less than five years in this situation. (Treas. Regs. §1.408A-6, Q&A2)

Example of five-year holding period

Marianne does not have a Roth IRA, nor has she had one at any time. She makes a Roth IRA contribution of $7,000 on June 15, 2023; Marianne's five-year holding period begins on January 1, 2023, and ends on December 31, 2027.

Marianne makes later Roth IRA contributions of $7,000 in both years 2024 and 2025. If she withdraws $20,000 from the Roth IRA in 2028, the entire distribution will be a tax-free qualified distribution because the holding period requirement for the Roth IRA will have been met when the distribution is made.

The initial contribution to a Roth IRA does not start the five-tax-year period if the contribution is:

- A corrective distribution under IRC §408(d)(4) (a corrective distribution is treated as if it was never contributed) (Treas. Regs. §1.408A-6, Q&A2); or
- Revoked within seven days. (Treas. Regs. §1.408-6(d)(4)(ii)(A))

PLANNING OPPORTUNITIES

Roth conversions

You may want to convert a traditional IRA to a Roth IRA because, in so doing, all future earnings will be tax-free. But there is a cost: The amount of the conversion, less any basis, is taxable income in the year of conversion. Additionally, a partial conversion from the traditional IRA to a Roth IRA requires an allocation of the basis.

Whether a Roth conversion is beneficial requires an analysis of many factors. The following chart can help you evaluate the facts and circumstances applicable to your client and help determine whether a Roth conversion is in your client's best interest.

Roth Conversion Considerations	
Factor	**Description**
Taxpayer's age	The younger the taxpayer, the longer tax-free Roth earnings will compound.
Funds available to pay tax liability on conversion	Taxpayers who are able to use non-IRA funds to meet the tax liability caused by the conversion won't have to reduce their IRA funds because of the conversion.
Current tax rate vs. anticipated tax rate in retirement	Taxpayers in a higher tax rate today than their expected tax rate in retirement will pay more taxes on their conversion versus taking non-Roth taxable distributions in retirement. Taxpayers in a lower tax rate today than their expected tax rate in retirement will pay fewer taxes on their Roth conversion than if they keep the funds in their non-Roth accounts and take distributions in retirement.
Current tax attributes	Taxpayers with carryovers that may expire, such as charitable contribution carryovers, or who have nonrefundable credits that won't be fully utilized due to low taxable income can benefit by making a taxable Roth conversion, thereby unlocking the carryovers or nonrefundable credits.
Inheritance	Inherited Roth IRAs are subject to specific distribution rules, but like Roth IRAs in the original owner's hands, distributions from an inherited Roth IRA are tax-free (providing the five-year rule has been met). Taxpayers who want to leave tax-free money to their beneficiaries may prefer converting retirement funds to a Roth IRA.
Stock market	A stock market decline may provide an opportunity for a Roth IRA conversion. For example, let's say a taxpayer's traditional IRA was worth $100,000, but due to a market decline, it is now worth $80,000. The taxpayer can convert the traditional IRA to a Roth IRA and pay tax on $80,000. When the market recovers and the Roth IRA's value returns to $100,000 — the taxpayer will have made $20,000 tax-free.

Example of Roth conversion analysis

Tim is 45 years old and has $200,000 in a traditional IRA that he is considering converting to a Roth IRA. For Tim, the following factors apply:

- Number of years until retirement: 20
- Anticipated number of retirement years: 20
- Current marginal tax rates: 22% federal and 9.3% state
- Anticipated marginal tax rates in retirement: 24% federal and 9.3% state
- Tim has outside funds available to pay tax liability on the conversion.

Based on this information, Tim's estimated federal and state tax liability on conversion is $58,500. The Roth conversion is estimated to provide an advantage to Tim of $218,425.

The advantage of the ability to pay the tax liability on conversion without having to use IRA funds cannot be overstated. Assume all other facts are the same, except that Tim does not have funds outside of his IRA to pay the $58,500 tax liability on conversion. In this alternate scenario, the estimated benefit of converting his IRA to a Roth IRA falls from $218,425 down to $27,228.

Why Convert a Traditional IRA to a Roth IRA?

Name: Tim Smith

Amount to be converted to New Roth IRA	$	200,000
Amount of Nondeductible Contributions included in above	$	0
Deduct Federal/State Taxes from amount to be converted?		No

Subject to Early Withdrawal Penalty? No

	Rollover Period	Accumulation Period	Distribution Period
Number of Years		20	20
Annual Investment Rate of Return		8.00%	5.00%
Federal Tax Rate	22.00%	22.00%	24.00%
State Tax Rate	9.30%	9.30%	9.30%
State Tax as an Itemized Deduction?	Yes	Yes	Yes
Combined Federal and State Tax Rate	29.25%	29.25%	31.07%
Federal/State Income Taxes Due at Conversion	$	58,500	

		Traditional IRA	Roth IRA
Value at Start of Distribution Period	$	932,191	932,191
Future Value of Taxes Saved (after taxes)		175,941	N/A
Total Value at start of Distribution Period	$	1,108,132	932,191
After-tax IRA Distributions	$	1,031,212	1,496,028
After-tax Distribution of Taxes Saved	$	246,391	N/A
Total Value of After Tax Distributions	$	1,277,603	1,496,028

This analysis shows the advantage of converting to a Roth IRA is $ 218,425

Why Convert a Traditional IRA to a Roth IRA?

Name: Tim Smith

Amount to be converted to New Roth IRA	$	200,000
Amount of Nondeductible Contributions included in above	$	0
Deduct Federal/State Taxes from amount to be converted?		Yes

Subject to Early Withdrawal Penalty? No

	Rollover Period	Accumulation Period	Distribution Period
Number of Years		20	20
Annual Investment Rate of Return		8.00%	5.00%
Federal Tax Rate	22.00%	22.00%	24.00%
State Tax Rate	9.30%	9.30%	9.30%
State Tax as an Itemized Deduction?	Yes	Yes	Yes
Combined Federal and State Tax Rate	29.25%	29.25%	31.07%
Federal/State Income Taxes Due at Conversion	$ 58,500		

		Traditional IRA	Roth IRA
Value at Start of Distribution Period	$	932,191	659,525
Future Value of Taxes Saved (after taxes)		0	N/A
Total Value at start of Distribution Period	$	932,191	659,525
After-tax IRA Distributions	$	1,031,212	1,058,440
After-tax Distribution of Taxes Saved	$	0	N/A
Total Value of After Tax Distributions	$	1,031,212	1,058,440

This analysis shows the advantage of converting to a Roth IRA is $ 27,228

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05-03-2024

Comparison Chart of Allowable Rollovers

Rollover From		Rollover To							
		IRA	**SEP-IRA**	**SIMPLE IRA**	**Roth IRAs (traditional, SEP and SIMPLE)**	**457(b)**	**403(b)**	**Qualified Plan**	**Designated Roth Account***
Rollover From	**IRA**	Yes	Yes	Yes, after two years	Yes, must include in income	Yes, must have separate accounts	Yes	Yes	No
	SEP-IRA	Yes	Yes	Yes, after two years	Yes, must include in income	Yes, must have separate accounts	Yes	Yes	No
	SIMPLE IRA	Yes, after two years	Yes, after two years	Yes	Yes, after two years. Must include in income	Yes, after two years. Must have separate accounts	Yes, after two years	Yes, after two years	No
	Roth IRAs (traditional, SEP, and SIMPLE)	No	No	No	Yes	No	No	No	No
	457(b)	Yes	Yes	Yes, after two years	Yes. Must include in income	Yes	Yes	Yes	Yes, must include in income, must be an in-plan rollover
	403(b)	Yes	Yes	Yes, after two years	Yes. Must include in income	Yes, must have separate accounts	Yes	Yes	Yes, must include in income, must be an in-plan rollover
	Qualified Plan	Yes	Yes	Yes, after two years	Yes. Must include in income	Yes, must have separate accounts	Yes	Yes	Yes, must include in income, must be an in-plan rollover
	Designated Roth Account	No	No	No	Yes	No	No	No	Yes, if a direct trustee-to-trustee transfer

Warning: The comparison chart shows general information that may not be applicable to all plans. Not all accounts allow rollover contributions. (Treas. Regs. §1.402(a)(31)-1, Q&A 13) Check with your pension administrator for additional requirements. A trustee-to-trustee transfer is required in some instances. A 60-day rollover rule may apply. (www.irs.gov/retirement-plans)

* Roth 401(k), Roth 403(b), Roth 457(b)

Partial conversions

Taxpayers can choose to convert only part of a traditional IRA to a Roth. In that case, the distribution ordering rules come into play, and all of the taxpayer's traditional IRAs and the total basis in all the IRAs are combined. (IRC §408(d)(2))

The amount of basis considered converted is the percentage of the total basis that bears the same ratio as the amount converted bears to the total value of all of the taxpayer's traditional IRAs.

Example of partial Roth IRA conversion

Bo has a traditional IRA with a balance of $350,000 and a SEP IRA with a balance of $100,000. Bo's traditional IRA has a basis of $36,000 due to nondeductible contributions he has made over the years. He wants to convert his entire SEP IRA to a Roth IRA.

Bo must treat his traditional IRA and SEP IRA as one IRA under the aggregation rules of IRC §408(d)(2) when calculating the taxable portion of his conversion.

Bo must report $92,000 as taxable income, calculated as follows:

Basis in all non-Roth IRAs	$36,000
FMV of all non-Roth IRAs at date of conversion	÷450,000
Percentage of total non-Roth IRA balances allocated to basis	8%

Roth conversion amount	$100,000
Percentage of total non-Roth IRA balances allocated to basis*	× 8%
Total basis allocated to Roth conversion	$ 8,000
* Calculated in prior step	

Roth conversion amount	$100,000
Total basis allocated to Roth conversion*	- 8,000
Taxable Roth conversion	$ 92,000
* Calculated in prior step	

After the partial conversion, Bo's traditional IRA's basis will be $28,000 ($36,000 basis before the conversion, less $8,000 of basis utilized to reduce the taxable portion of the conversion). This calculation is reported on Form 8606, Nondeductible IRAs.

Backdoor Roth conversions

The "backdoor" Roth conversion strategy allows high-income individuals to make a nondeductible contribution to a traditional IRA and then convert the traditional IRA to a Roth IRA. The IRA aggregation rules under IRC §408(d)(2) discussed immediately above come into play when considering a backdoor Roth IRA strategy.

Example of simple backdoor conversion

Gail is 51 years old and a participant in her employer's retirement plan. Her AGI is too high to make either a deductible IRA contribution or a direct Roth IRA contribution.

Gail's only retirement funds are held in her employer's defined contribution retirement plan (that is not a SIMPLE IRA) and in her Roth IRA.

For the 2024 taxable year, Gail contributed $8,000 to a traditional IRA ($7,000 contribution limit for 2024, plus $1,000 catch-up contribution for taxpayers age 50+).

Immediately after contributing the $8,000 to her traditional IRA, she converted the $8,000 to her Roth IRA in a nontaxable event.

Even though Roth conversions are taxable events, Gail's $8,000 traditional IRA contribution was not deductible for her, thus giving Gail $8,000 of basis in the IRA. So, when she immediately converted the $8,000 to her Roth IRA, she was able to utilize the $8,000 basis to offset the taxable conversion.

California conformity

California conforms to IRC §408A and automatically conforms to any federal changes including the Roth recharacterization repeal. (R&TC §§17501–17509, 23701) The TCJA repealed the provision in IRC §408A(d) that allowed taxpayers to make Roth IRA contributions during the year and then recharacterize them as traditional IRA contributions at tax time.

Prior to the TCJA, taxpayers could make Roth conversions during the year, then recharacterize some or all of them back to traditional IRA contributions by the due date of the taxpayer's return by April 15 of the following year — after the taxpayer had a chance to calculate the optimal Roth conversion amount.

The TCJA's repeal of the recharacterization provision does not preclude an individual from making a contribution to a traditional IRA and converting the traditional IRA to a Roth IRA by the end of the taxable year.

Mega backdoor Roth

The mega backdoor Roth strategy works similarly to a backdoor Roth IRA strategy. In a mega backdoor Roth strategy, a taxpayer uses after-tax (nondeductible) contributions to a 401(k) plan instead of nondeductible contributions to a traditional IRA.

In order to take advantage of a mega backdoor Roth strategy, the taxpayer must be a participant in a 401(k) that allows participants to make after-tax contributions.

Comment

Most people, even many tax professionals, think that the maximum employee deferral contributions that can be made to a 401(k) plan in 2024 is $23,000 ($30,500 for taxpayers age 50 and over). This is not true. These dollar amounts are only the maximum pre-tax contributions a participant can make as an employee deferral. Any contributions in excess of these limits are after-tax (i.e., nondeductible) contributions.

401(k) plan participants can only contribute more than the pre-tax contribution limits if their employer plan allows it. Many large employer 401(k) plans contain the requisite provisions in their 401(k) plan to allow for mega backdoor Roth contributions, but most employees do not understand them.

Occasionally, a taxpayer is a participant in a 401(k) plan that does not allow after-tax contributions, but the taxpayer manages to contribute more than the pre-tax limits — usually due to a clerical error. In this scenario the 401(k) plan will typically distribute the excess contribution back to the participant, which will trigger a Form 1099-R.

Required employer plan provisions

For the mega backdoor Roth strategy to work, in addition to allowing contributions beyond the pre-tax contribution limits, the 401(k) plan must also allow the taxpayer to make either:

- In-plan Roth conversions (converting after-tax 401(k) contributions into the employer's Roth 401(k)); or
- In-service withdrawals (which allows the employee to roll over or convert 401(k) funds into an IRA while still employed).

Contribution limits

The total employer and employee contribution limits for a 401(k) is limited to the lesser of 100% of the employee's compensation or $69,000 for 2024 ($76,500 for taxpayers age 50 and over).

✎ Practice Pointer

Employees who take advantage of after-tax contributions must be careful not to contribute the maximum $69,000 ($76,500 for taxpayers age 50 and over) with employee contributions alone because these limits include employer matching and profit sharing contributions as well.

If the employee uses their own deferral contributions to reach the $69,000/$76,500 limit, then there is no more room in the bucket for employer matching or profit sharing contributions.

Example of mega backdoor Roth strategy

Hank is over age 50 and works for an employer whose plan allows for after-tax contributions as well as in-plan Roth conversions. Hank's employer offers both a traditional 401(k) and a Roth 401(k).

Hank wants to contribute $55,500 into his 401(k) for the year. He should maximize his Roth 401(k) contributions first, then make the rest of his employee deferrals as after-tax contributions into the non-Roth 401(k). His $55,500 total contributions will be broken out as follows:

Direct Roth 401(k) contributions	$30,500
After-tax traditional 401(k) contributions	25,000
Total	$55,500

Hank can then engage in an in-plan Roth conversion and convert his $25,000 of after-tax contributions, plus related earnings, into the company's Roth 401(k). The conversion is a taxable event, but because he has $25,000 of basis, his only taxable income from the conversion will be from any earnings in the account prior to the conversion.

As an added benefit, IRS Notice 2014-54 allows Hank to peel off the earnings from his after-tax 401(k) contributions and roll them over into a traditional IRA (if his employer plan allows it). This will allow Hank to escape any tax on his conversion because the earnings are treated as a direct trustee-to-trustee rollover from a traditional 401(k) to a traditional IRA.

Employer matching contributions

Employer matching contributions can be included as part of the backdoor Roth conversion strategy.

Prior to 2023, employer matching contributions could only be made as non-Roth contributions. So, if a taxpayer contributed to an employer's Roth 401(k) for example, then the employer's matching contributions had to be made into a traditional 401(k). Thanks to the SECURE 2.0 Act, employers can offer employees the option to receive their matching contributions as Roth contributions. Employer Roth matching contributions are discussed in more detail at page 4-16.

Basis and aggregation rules

The aggregation rules under IRC §408 that require taxpayers to treat all their IRAs as one do not apply to employer-sponsored plans (401(k)s, 403(b)s and 457(b)s). With employer-sponsored plans, each account stands on its own.

However, if a taxpayer has an employer-sponsored plan containing pre-tax and post-tax contributions, then the basis allocation rules still apply if the taxpayer only makes a partial mega backdoor Roth conversion.

Example of partial mega backdoor Roth conversion

Brenda has a traditional 401(k) with her current employer that has a balance of $75,000 and a 401(k) with a prior employer. Brenda's 401(k) with her current employer has a basis of $15,000 due to nondeductible contributions she has made. She wants to convert $50,000 of her 401(k) with her current employer as part of her mega backdoor Roth strategy.

Brenda does not factor in her prior employer's 401(k) into her conversion calculation because the aggregation rules under IRC §408 that apply to IRAs do not apply to employer-sponsored plans.

Brenda must report $40,000 as taxable income, calculated as follows:

Basis in 401(k) to be converted	$15,000
FMV of 401(k) to be converted	÷75,000
Percentage of basis in 401(k)	20%
Roth conversion amount	$50,000
Percentage of basis in 401(k)	× 20%
Total basis allocated to Roth conversion	$10,000
* Calculated in prior step	
Roth conversion amount	$50,000
Total basis allocated to Roth conversion	- 10,000
Taxable Roth conversion	$40,000
* Calculated in prior step	

After the partial conversion, Brenda's 401(k)'s basis will be $5,000 ($15,000 basis before the conversion, less $10,000 of basis utilized to reduce the taxable portion of the conversion).

Qualified charitable distributions (QCDs)

Taxpayers may exclude up to $105,000 in 2024 in "qualified charitable distributions" (QCDs) from their AGI. (IRC §408(d)(8))

QCDs are:

- Made directly by the IRA trustee to a charitable organization; and
- Made on or after the date the taxpayer reaches age 70½.

☑ Planning Pointer

QCDs can be made from Roth IRAs, but we do not recommend it. Because Roth IRA distributions are already tax-free as long as the five-year rule has been met, and Roth IRAs are not subject to the RMD rules, there is no tax benefit from using a Roth IRA for QCDs.

ROTH SEP AND SIMPLE IRAs

The SECURE 2.0 Act authorizes SIMPLE IRAs and SEP IRAs to accept Roth contributions beginning with the 2023 taxable year. (SECURE 2.0 Act §601; IRC §§402(h)(1)(C), 408A(f))

Roth SEP IRA and Roth SIMPLE IRA plans must contain the following important features:

- Employer contributions are treated as taxable compensation to the employee;
- If Roth employer contributions are offered by the employer, the employee must be given the option to opt out and therefore receive their employer contributions as traditional (nontaxable) contributions; and
- Like traditional SEP IRA and SIMPLE IRAs, Roth employer contributions must be 100% vested immediately.

Year of employee's income inclusion

When an employer makes a Roth SEP IRA or Roth SIMPLE IRA contribution on behalf of an employee, the employer's contribution is reported in the employee's taxable income for the taxable year that includes the date on which the contribution is made. (Notice 2024-2, Q&A K-4) It does not matter that the employer matching contribution or nonelective contribution is treated as if it were made for the prior taxable year of the employer pursuant to IRC §404(h)(1)(B) or §404(m)(2)(B).

Report on Form 1099-R (not W-2)

The employer must report its Roth SEP IRA and Roth SIMPLE IRA contributions on Form 1099-R in the same manner as the reporting that would have applied if the employee had engaged in a Roth conversion. (Notice 2024-2, Q&A K-5) The employer's contributions are not reported on Form W-2.

Employer contributions to an employee's Roth SEP IRA or Roth SIMPLE IRA are not subject to Social Security, Medicare, or FUTA taxes. (Notice 2024-2, Q&A K-6) However, employees should consider adjusting their income tax withholding or consider making estimated tax payments to account for the additional taxable income generated from employer Roth contributions.

Example of employer Roth SEP IRA contributions

Quinn is an employee of SmallCo, which offers a Roth SEP IRA to its employees. Quinn has elected to receive his employer's SEP contributions as Roth contributions. On March 10, 2024, SmallCo made a Roth SEP IRA contribution of $5,000 for Quinn for the 2023 taxable year.

SmallCo must deduct the $5,000 contribution it made for Quinn on its 2023 income tax return and must report the $5,000 on Form 1099-R issued to Quinn for the 2024 taxable year.

If Quinn is under age 59½, then SmallCo should use code 2 in Box 7 (early withdrawal, exception applies) of the Form 1099-R. If Quinn is age 59½ or older, then it should use code 7 in Box 7 (normal distribution).

Quinn should consider increasing his 2024 withholding, or he should make an estimated tax payment to account for the additional $5,000 of taxable income he must recognize in 2024.

Employer contributions to a Roth SIMPLE IRA are reported in the same manner.

Planning for Roth SEP IRAs and Roth SIMPLE IRAs

The new Roth SEP IRAs and Roth SIMPLE IRAs are a great option for employers who want to provide more retirement options for their employees.

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Roth accounts may be more beneficial for employees on the lower end of the income scale over the long run because:

- The contributions are taxable at a lower tax rate today;
- Roth accounts do not have RMD requirements in retirement;
- Roth accounts are tax-free if the five-year rule is met (see page 4-2), so distributions in retirement won't increase the taxpayer's AGI. If the taxpayer remains on the low end of the income scale in retirement, the tax-free nature of their Roth distributions may reduce the taxable portion of the employee's Social Security benefits.

For employees on the higher end of the income scale, utilizing Roth accounts may allow them to invest in Roth accounts where their AGI is too high to allow direct Roth IRA contributions.

Planning for one-participant SEP IRAs of self-employed taxpayers

Taxpayers who have self-employment income and no employees may find Roth SEP IRAs particularly attractive.

Traditional SEP IRA contributions reduce the taxpayer's qualified business income and reduce their IRC §199A deduction. Roth SEP IRA contributions made on behalf of the self-employed taxpayer are not deductible and therefore don't reduce qualified business income.

Self-employed taxpayers can find themselves in a position where they have positive self-employment income, but zero income tax liability due to excess personal deductions or losses from a spouse's business. Taxpayers in this situation receive no benefit from traditional SEP IRA contributions because traditional SEP IRA contributions are deductible on Schedule 1 and do not reduce self-employment income.

As such, the taxpayer receives no benefit of the deduction and also does not get to increase their basis in their IRA for the contribution. Taxpayers in this situation benefit greatly by using a Roth SEP IRA. Consider the following example.

Example of Roth SEP IRA for self-employed taxpayer

Alisha is a sole proprietor and made $150,000 from her business in 2023. Alisha's husband Nate is also self-employed and had a terrible year in his business, which had losses of $100,000. After itemized deductions, Alisha and Nate's taxable income was $0, although they still owe self-employment tax on Alisha's positive self-employment income.

Nate's business has recovered in 2024, and the couple has a filing extension until October 15, 2024. Alisha wants to make a $20,000 SEP IRA contribution for the 2023 taxable, which she can make by the extended filing deadline.

With their 2023 income tax liability of $0, Alisha and Nate will receive no benefit of a traditional SEP IRA contribution. Remember, SEP IRAs made on behalf of a self-employed taxpayer are deductible on Schedule 1 and can reduce income tax but not self-employment taxes.

Alisha is better off opening a new Roth SEP IRA and making her $20,000 contribution into that account. Doing so will allow her to reap the benefits of making a contribution to a Roth account (tax-free earnings and no RMD requirements) and will not reduce whatever §199A deduction she qualifies for.

California conformity

California automatically conforms to any provision that impacts retirement plan qualifications and benefit limitations and to Roth tax treatment. (R&TC §§17501, 24601)

ROTH 401(k), 403(b) AND 457(b)

Roth employer matching

Employers offering 401(k), 403(b), and 457(b) defined contribution plans can now provide participants with the option of receiving matching contributions on a Roth basis (after-tax) thanks to the SECURE 2.0 Act. (IRC §414(v)(2)(B)(ii))

Similar to the Roth SEP IRA and Roth SIMPLE IRA provisions previously discussed:

- Employer nonelective or matching contributions made on a Roth basis are includable in the employee's taxable income;
- Employees must elect to receive their employer's contributions on a Roth basis;
- Employers are not required to offer their contributions on a Roth basis;
- Employer nonelective and matching contributions are not taxable as wages to the employee and are therefore not reported on the employee's W-2. Instead, they are reported on Form 1099-R to the employee (Notice 2024-2, Q&A L-9); and
- The Form 1099-R must be issued to the employee for the taxable year in which the contribution is allocated to the employee's account.
- (Notice 2024-2, Q&A L-2)

The provision allowing for Roth employer matching will provide a new planning avenue for clients with regard to their employer retirement plans. For example, many employers offer both a traditional and a Roth 401(k), where employees can choose whether their deferred compensation is contributed to the traditional 401(k) (pre-tax), the Roth 401(k) (post-tax), or some combination of the two. In either scenario, however, before the SECURE 2.0 Act, all employer matching contributions and nonelective contributions had to be into the traditional 401(k) (or 403(b) or 457(b)).

Now, employees will have the option (if the employer's plan allows it) to have the employer's matching and elective contributions be into the Roth 401(k) (or 403(b) or 457(b)) as well.

No more RMDs for employer-sponsored Roth accounts

Roth IRAs do not have an RMD requirement while the account owner is alive; however, employer-sponsored Roth accounts such as Roth 401(k)s did have an RMD requirement while the account owner was alive through the 2023 taxable year. (IRC §401(a)(9)(A) and (B))

The SECURE 2.0 Act removed the RMD requirement for employer-sponsored Roth accounts starting with the 2024 taxable year. (SECURE 2.0 Act §325; IRC §402A(d))

California conformity

California automatically conforms to any provision that impacts retirement plan qualifications and benefit limitations and to Roth tax treatment. (R&TC §§17501, 24601)

Planning Pointer

Participants in non-Roth employer-sponsored retirement plans (401(k)s, 403(b)s, 457(b)s, pension, profit sharing, stock bonus plans) must begin taking distributions at a specified age (their RMD age). The RMD age is age 73 for taxpayers born in 1951 through 1959 and age 75 for taxpayers born after 1959.

Taxpayers who are still working are not required to begin taking distributions from their current employer's retirement plan until April 1 of the year following the year the taxpayer retires or is otherwise separated from employment. (IRC §401(a)(9)(C)(i); Treas. Regs. §1.401(a)(9)-2, Q&A2)

This rule delaying RMDs for taxpayers who are still working does not apply to IRAs, plans sponsored by prior employers, SEP IRAs, SIMPLE IRAs, or if the taxpayer owns more than 5% of the business. (IRC §401(a)(9)(C)(ii); Treas. Regs. §1.408-8, Q&A2 and 3)

The "more than 5% owner" rule applies to taxpayers if they directly or constructively own more than 5% of any of the employers maintaining the plan at issue ending within the calendar year the taxpayer reaches their RMD age. (IRC §401(a)(9)(C)(ii))

INVESTMENT ANALYSIS

Most tax professionals are not professional financial planners. We certainly have a greater understanding of investments than most, but clients generally do not pay their tax professionals to manage their investment accounts. Likewise, our malpractice insurance generally does not cover investment activities performed on behalf of our clients. However, effective investment planning must contain a heavy dose of tax planning and advising, which is where tax professionals come into play.

We may not help our clients pick stocks or find real estate opportunities, but we can help them strategize the direction of their investment dollars to help leverage the Internal Revenue Code for their advantage.

U.S. DOL releases final fiduciary rule

On April 23, 2024, the U.S. Department of Labor (DOL) released the Retirement Security Rule, which redefines who qualifies as a fiduciary under the Employee Retirement Income Security Act (ERISA).

In short, the new rule provides that anyone who holds themselves out as a trusted advisor when providing investment advice is classified as an investment advice fiduciary, which means that they must put the investor's interests ahead of their own.

The new rule would not apply to tax professionals merely providing tax advice regarding investment alternatives, especially where the tax professional's compensation is not dependent on whether a client chooses one investment over another.

The final security rule can be found in the Federal Register here:

Website
www.govinfo.gov/content/pkg/FR-2024-04-25/pdf/2024-08065.pdf

CASH FLOW INVESTMENTS

Investments designed to produce cash flow for our clients generally include investments that pay regular interest, dividends, or produce positive rental income year over year. Examples of cash flow investments include:

- High-yield savings accounts;
- Short-term certificates of deposit;
- Money market funds;
- Private loans;
- Municipal bonds;
- Short-term Treasury bonds;
- Annuities (contains aspects of cash flow and growth investments);
- Real estate (contains aspects of cash flow and growth investments);
- Dividend stocks; and
- Real estate investment trusts (REITs).

Stocks that pay regular dividends (also known as "dividend stocks") are shares of stock in companies that are consistently profitable and that have committed to paying a portion of their profits to shareholders. Of course, any corporation can pay dividends, but it's those whose boards of directors have agreed to pay regular dividends where the stocks are typically known as "dividend stocks."

GROWTH INVESTMENTS

Growth investments are designed for income deferral and/or to take advantage of long-term capital gains rates. Examples of growth investments include:

- Growth stocks;
- Real estate (contains aspects of cash flow and growth investments);
- Long-term Treasury bonds;
- Long-term certificates of deposit; and
- Annuities (contains aspects of cash flow and growth investments).

Growth stocks are shares of stock in companies that generally do not pay dividends because earnings are reinvested in the company. Growth stocks should have anticipated growth rates that are significantly higher than dividend stocks and are more common in younger companies and companies investing in new technologies and industries.

✏ **Practice Pointer**

Growth stocks generally carry a larger risk than dividend stocks because investors are buying into what they expect the company will be worth down the road due the reinvestment of its profits, the raising of new capital, and the company's investments into new technologies, industries, or processes.

Comment

The lists of investments above are not exhaustive, and there are variations and derivatives of these. For example, taxpayers can invest in mutual funds that contain a combination of dividend stocks, growth stocks, and municipal bonds, or they can invest in publicly traded partnerships that pay a combination of ordinary income and investment income.

CASH FLOW VS. GROWTH INVESTMENTS

Tax now or tax later

Clients who need a regular stream of income from their investments, such as many retirees, may prefer cash flow investments. Conversely, clients who are still working may prefer growth investments, which will enable them to build their investment portfolio without generating taxable income today.

The chart on page 4-23 summarizes the various investments identified above and the timing and character of the taxable income generated from the investment.

Ordinary income vs. long-term capital gain

Gain or loss from the sale of capital assets held more than one year is treated as a long-term capital gain or loss. (IRC §1222(3) and (4)) Property held one year or less is treated as short-term. (IRC §1222(1) and (2))

Long-term capital gains (as well as qualified dividends) are taxed at preferential tax rates that are lower than the ordinary income tax rates as detailed in the following chart.

Individual Long-Term Capital Gains Rates (IRC §1(h))	
Rate	**Taxable income breakpoint (2024) (Rev. Proc. 2023-34)**
0%	Single: $47,025 MFS: $47,025 MFJ: $94,050 HOH: $63,000 Estates and trusts: $3,150
15%	Single: $518,900 MFS: $291,850 MFJ: $583,750 HOH: $551,350 Estates and trusts: $15,450
20%	No breakpoint

Investment income other than long-term capital gains and qualified dividends is taxed at ordinary income tax rates, which can be as high as 37% for federal purposes in 2024.

Taxpayers almost always prefer to be taxed at the lower long-term capital gain rates than the higher ordinary income tax rates. Often, clients who favor “safe” investments will invest in interest paying investments, such as certificates of deposit and money market funds that generate taxable income at ordinary income rates.

Those taxpayers who prefer "safe" investments may consider dividend stocks whose dividends are generally classified as qualified dividends and are therefore taxed at long-term capital gain rates.

Corporations whose stocks are known as dividend stocks are some of the most well-established and well-recognized companies in North America. Clients looking to reduce their tax rate may see such companies as less risky and may be willing to venture into the stock market in exchange for lower tax rates.

Special considerations for municipal bonds and Treasury bonds

Interest on municipal bonds is typically tax-exempt for federal income tax purposes, and residents in the state that issued the bond are also typically not subject to state income tax on the interest income. Municipal bonds often have a lower rate of return in exchange for their tax-free treatment.

✐ Practice Pointer

Even though interest on municipal bonds is tax-free, that doesn't mean municipal bonds are free from tax consequences altogether. Other tax consequences include:

- Interest from specified activity bonds are not exempt from AMT;
- Bonds sold at a higher price than their acquisition cost give rise to capital gains; and
- Interest on municipal bonds is included in modified adjusted gross income (MAGI) when calculating:
    - The taxable portion of Social Security benefits; and
    - The Medicare premium surcharge.

Treasury bonds are taxable by the federal government but are not taxable for state income purposes. As such, taxpayers in high tax states may prefer Treasury bonds over out-of-state municipal bonds.

Election to recognize interest income annually: Interest on Treasury bonds compounds and is added to the value of the bond. The interest is not actually paid nor included in the taxpayer's gross taxable income until the earlier of when the bond matures or is cashed out.

Instead of recognizing interest income all at once when the bond matures, taxpayers can make an irrevocable election to report interest income from Treasury bonds on the accrual method and recognize interest income as it is earned each year. (IRC §§454(a) and (c)) Taxpayers who make the election to accrue interest on Treasury bonds must apply the accrual rule for all Treasury bonds owned by them in the year they make the election and all future years.

The election to use the accrual method is beneficial where the taxpayer:

- May not have a filing requirement due to low income but is likely to have a filing requirement later;
- Is in a low tax bracket now but may be in a higher bracket later; or
- Has sufficient investment deductions to offset the additional investment income now.

Education planning with Series I and EE bonds: Series I and EE savings bonds contain an education exclusion that permits qualified taxpayers to exclude from their gross income all or a part of the interest paid on redemption of their bonds when the bond owner pays qualified higher education expenses at an eligible institution. (IRC §135) See page 4-31 for a more complete discussion of this topic.

Real estate investment trusts: From an investor perspective, a REIT is a mutual fund for real estate. REITs give investors the opportunity to own real estate indirectly through the purchase of interests in a trust that owns and operates real property or owns mortgages on real property.

One of the advantages of a REIT for an individual investor is diversification in real estate holdings. The price tag on most real estate is high, so if an investor wanted to create a diversified portfolio of real estate holdings, a large amount of capital would be required. By purchasing an interest in a REIT, the investor can achieve diversification while participating in the investment returns that real estate offers.

REITs themselves are exempt from tax at the entity level if they:

- Derive a minimum of 75% of their income from real estate; and
- Distribute at least 90% of their income in the form of cash dividends to their owners on an annual basis.

Provided that these requirements are met, the owners of interests in the REIT report their proportionate share of the REIT's income on their individual income tax returns for the year in a manner similar to owners of mutual funds.

REIT dividends do not represent distributions of earnings from a corporation that pays an entity-level tax, and therefore are not classified as qualified dividends. As such, REIT dividends are typically taxed as ordinary income. However, to the extent that a REIT has invested in shares of a company that pays qualified dividends, those qualified dividends can be passed through to the REIT's owners and reported as qualified dividends on the owners' personal income tax returns.

REIT dividends are classified as qualified business income and are therefore eligible for the IRC §199A deduction.

Lastly, when an interest in a REIT is sold, the owner realizes capital gain or loss, which can be classified as either short-term or long-term, depending on how long the taxpayer owned their interest in the REIT.

Net investment income tax

Tax professionals cannot ignore the net investment income tax (NIIT) when evaluating investment income alternatives for their clients. The NIIT is an additional 3.8% tax imposed on an individual for the lesser of:

- Net investment income; or
- The excess of modified adjusted gross income for the taxable year, over the threshold amount.
  (IRC §1411(a)(1))

The threshold amounts are:

NIIT Threshold Amounts	
Filing status	**NIIT threshold**
MFJ and qualifying widow(er)	$250,000
MFS	$125,000
Single and HOH	$200,000
The NIIT thresholds are not adjusted annually for inflation.	

For estates and trusts, the net investment income tax is imposed on the lesser of:

- The undistributed net investment income; or
- The excess of modified adjusted gross income over the dollar amount at which the highest tax bracket begins for an estate or trust for the tax year ($14,450 for 2023 and $15,200 for 2024).

Modified adjusted gross income, for purposes of the NIIT, is generally defined as the taxpayer's adjusted gross income for regular income tax purposes increased by the foreign-earned income exclusion (but also adjusted for certain deductions related to the foreign-earned income).

"Net investment income" is defined as gross income from interest, dividends, annuities, royalties, and rents, other than such income that is derived in the ordinary course of a trade or business not described in IRC §1411(c)(2). (IRC §1411(c)(1))

The net investment income tax applies to income derived in the ordinary course of business if that business is a passive activity with respect to the taxpayer. (IRC §1411(c)(2))

A passive activity is described as any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate. (IRC §469(c)(1)) To qualify for the ordinary course of business exception, the taxpayer must directly conduct the trade or business through a disregarded entity owned by the taxpayer or through a passthrough entity such as a partnership or S corporation. (Treas. Regs. §1.1411-4(b)) Since a C corporation is neither, the dividend income received by a taxpayer is always classified as investment income.

Planning for the NIIT

Minimizing the NIIT can be accomplished by keeping the following in mind:

- The NIIT is applied against net capital gains, so consider harvesting capital losses before the end of the year to offset capital gains;
- Tax-exempt income is not subject to the net investment income tax, such as interest on municipal bonds;
- Income, gains, and losses are not factored into the NIIT calculation if they are derived in the ordinary course of a trade or business in which the taxpayer is a nonpassive participant; and
- Deductions that are allocable to items of gross investment income are deductible on Form 8960, Net Investment Income Tax — Individuals, Estates, and Trusts. These deductions include investment interest expense, investment advisor fees, expenses related to rent and royalty income, tax preparation fees, fiduciary fees (in the case of an estate or trust), and state and local income taxes. However, the deductions must be otherwise deductible on the income tax returns, so, for example, investment advisor fees are classified as 2% miscellaneous itemized deductions and are not deductible from 2018 through 2025. As such, investment advisor fees are not currently deductible on Form 8960.

Chart of investment income timing and income characterization

Investment Income Timing and Income Characterization		
Investment	**Timing of income inclusion**	**Income characterization**
Bank interest (high-yield savings, regular savings, interest checking, etc.)	Interest income is generally paid monthly	Ordinary income when paid
Certificates of deposit	Interest compounds regularly and is paid when the CD matures. CDs of one year or less can provide a stream of interest income, while long-term CDs can provide long-term compounding at fixed rates	Ordinary income when the CD matures
Money market funds	Interest is generally paid monthly	Ordinary income when paid
Private loans	Interest is paid according to the terms of the loan	Ordinary income when interest is paid
Municipal bonds	Interest is paid according to the terms of the bond — most commonly semiannually	Tax-exempt at the federal level, and residents in the state that issued the bond are also typically not subject to state income tax
Treasury bonds	Interest compounds regularly and is paid on the earlier of when the bond matures or is redeemed	Ordinary income at the federal level and not subject to state income tax
Annuities	Income is recognized when payments are received by the owner	Ordinary income when distributions are received. Each annuity payment is considered a partially tax-free return of basis and partially ordinary income, using an inclusion/exclusion ratio (See discussion below)
Stocks	Dividends are recognized when received Capital gains (losses) are recognized when the stock is sold	Regular dividends are taxable as ordinary income Qualified dividends are taxable as long-term capital gains Capital gains (losses) on the sale of stock can be short-term (if the stock was held for one year or less) or long-term (if the stock was held for more than one year)
		(continued)

Investment Income Timing and Income Characterization (continued)		
Investment	**Timing of income inclusion**	**Income characterization**
Real estate investment trusts (REITs)	Income is recognized when dividends are paid	Ordinary income when paid
Real estate	Net rental income is recognized as earned Capital gains (losses) are recognized when the real estate is sold in a taxable transaction. IRC §1031 allows real estate to be exchanged in a tax-free transaction, thus deferring the recognition of taxable income if all requirements are met	Net rental income is taxed as ordinary income as earned Capital gains (losses) on the sale of real estate can be short-term (if the stock was held for one year or less) or long-term (if the stock was held for more than one year). Any depreciation recapture is subject to ordinary income tax rates

ANNUITIES

Annuity contracts are not specifically defined by the Internal Revenue Code. An annuity contract must be purchased from an insurance company and can provide either a fixed benefit or a variable benefit depending on the performance of the investment.

Annuities are typically purchased with after-tax dollars. Similar to an IRA or other designated retirement account, income and gains generated within the annuity are not taxable as earned. Instead, the taxable event occurs when the taxpayer receives distributions from the annuity.

The taxable portion of annuity distributions are taxed as ordinary income and are subject to the net investment income tax. It does not matter whether the growth inside the annuity was generated with capital gains or qualified dividends.

The timing of the recognition of gross income from an annuity depends on whether the taxpayer annuitizes the contract, surrenders the contract, or simply takes distributions as needed from the contract.

COMMON TYPES OF ANNUITIES

Fixed period annuities

Fixed period annuities pay defined amounts to the taxpayer at regular intervals (such as monthly or annually) for a specified length of time.

Variable annuities

Variable annuities make payments to the taxpayer that can vary in amount for either a specified length of time or for life. The payments received from the annuity can depend on different variables, but they are most typically dependent on the earnings of the annuity's investments.

Single life annuities

Single life annuities pay defined amounts to the taxpayer at regular intervals for life. Payments from a single life annuity end on the taxpayer's death.

Joint and survivor annuities

Joint and survivor annuities pay the first annuitant a defined amount at regular intervals for that person's life. After the first annuitant's death, a second annuitant (usually a spouse) receives a defined amount at regular intervals for the survivor's life. The amount paid to the second annuitant may or may not differ from the amount paid to the first annuitant.

NONTAXABLE PORTION OF ANNUITY PAYMENTS

Generally, each part of every payment received from an annuity contains a nontaxable return of invested capital, and the remainder is taxable income. There are two methods to calculate the nontaxable portion of each annuity payment:

- The General Rule, which is based on the ratio of the taxpayer's investment in the annuity contract to the total expected return from the contract; and
- The Simplified Method.

✐ **Practice Pointer**

The details and variations of the General Rule and the Simplified Method calculations are typically calculated by the insurance company that issues the annuity because they need to report the taxable portion of the annuity payments on Form 1099-R.

We have only included a discussion of the General Rule here to help tax professionals gain an understanding of the topic, but it's not necessary to perform these calculations. When performing tax planning for clients who have annuities, it's best to request that the client obtain information regarding the taxable portion of annuity payments directly from the insurance company that issued the annuity.

The basics of the General Rule

Under the General Rule, the amount of each payment that is a nontaxable return of invested capital is determined using the exclusion ratio in the following formula:

Investment in the contract
÷ Expected total return
Exclusion ratio
× Distributions (payments received)
Exclusion amount

The investment in the contract is the total amount of after-tax dollars invested in the contract. The expected return is the total amount of dollar distributions expected under the contract. For fixed period annuities, the expected return is equal to the periodic payments made by the annuity multiplied by the total amount of expected payments, as illustrated in the next example.

For single life and joint and survivor annuities, the expected return is equal to the annual payments expected made by the annuity, multiplied using a life expectancy factor. The life expectancy factors are published in tables in IRS Publication 939.

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Example of calculating annuity exclusion ratio for a fixed period annuity

Jessie invested $100,000 in an annuity contract. The insurance company agreed to pay her $1,389 per month for 15 years. Her expected return is $250,000 (15 years × 12 months × $1,389 per month).

Using the formula above, Jessie's exclusion ratio is 40% (0.40), and the amount of each payment that is treated as a tax-free return of capital is $556 until Jessie recovers her entire investment in the contract.

Investment in the contract	$100,000
Expected total return	÷250,000
Exclusion ratio	40%
Distributions (payments received)	× 1,389
Exclusion amount	$ 556

Once Jessie recovers all of her investment in the contract, 100% of any additional annuity payments are includible in her taxable income.

Investment in the contract

Determine the taxpayer's net investment in the annuity contract by adding the total:

- Premiums;
- Contributions; or
- Other amounts paid for the annuity (including employer contributions if they were includible in the annuitant's taxable income).

Do not include amounts for health and accident benefits or deductible voluntary employee contributions that were used for the taxpayer's investment in the annuity.

From the total costs paid for the annuity contract, subtract:

- Refunded premiums, rebates, dividends, or unrepaid loans that weren't included in the annuitant's taxable income when received. Only count amounts received by the later of the annuity start date or the date on which the annuitant received their first payment from the annuity contract;
- Any additional premiums paid for double indemnity or disability benefits; and
- Any other tax-free amounts received by the annuitant under the annuity contract before the later of the annuity start date or the date on which the annuitant received their first payment from the annuity contract.

Refund features

If the annuity contains a refund feature, the net investment in the contract is reduced by the value of the refund feature. The value of the refund features is determined by using Tables III or VII in IRS Publication 939.

An annuity contract is deemed to have a refund feature if:

- The expected return of the annuity depends entirely or partly on the life of one or more individuals;
- The contract provides that payments will be made to a beneficiary or the estate of an annuitant on or after the death of the annuitant if a specified amount or a stated number of payments hasn't been paid to the annuitant(s) before death; and
- The payments are a refund of the amounts the taxpayer paid for the annuity contract.

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UNRECOVERED BASIS ON DEATH

Taxpayers who die before recovering their entire investment in their annuity contract can deduct the unrecovered investment on their final income tax return as a miscellaneous itemized deduction not subject to the 2% floor. (IRC §72(b)(3)(A)) For example, if Jessie from the example above died after only recovering $75,000 of the total $100,000 she invested in her annuity contract, then the remaining $25,000 is deductible as a non-2% miscellaneous itemized deduction on her final income tax return.

QUALIFIED VERSUS NONQUALIFIED ANNUITIES

Annuities can be either qualified or nonqualified. Qualified annuities are those that are purchased with pre-tax dollars, which means they are annuities that are purchased in connection with a qualified retirement plan.

Nonqualified annuities are annuities that are purchased with after-tax dollars. Most annuities are nonqualified annuities.

Annuities and the net investment income tax

The taxable portion of distributions from nonqualified annuities are subject to the net investment income tax.

Distributions from qualified annuities are not subject to the net investment income tax.

PLANNING WITH ANNUITIES

Pros and cons of annuities

Annuities can be advantageous because they:

- Grow tax-deferred;
- Provide a regular stream of income once the annuity start date begins. If the annuity is a life annuity, then payments continue until death;
- Can provide a guaranteed rate of return (for a fixed rate annuity); and
- Can offer survivor benefits.

The downfalls of annuities include:

- They can contain higher expenses and commissions than other investments;
- Because annuities are contracts between the annuitant and an insurance company, it can be difficult or expensive to move out of the annuity; and
- Annuities, particularly fixed rate annuities, are generally tied to interest rates, which generally provide a lower rate of return over other investments.

Qualified longevity annuity contracts (QLACs)

Qualified longevity annuity contracts (QLACs) are investment vehicles that allow taxpayers to remove assets from their IRA and hold them until later retirement years. (Treas. Regs. §1.401(a)(9)-6, Q&A 17)

The cornerstone of the QLAC is the removal of RMD requirements for assets placed in a QLAC. They make it easier for retirees to address the risk of outliving their assets by using a limited portion of their retirement savings to purchase a policy in a retirement plan that will provide guaranteed income for life starting at an advanced age.

Distributions from the QLAC must commence no later than age 85 (although the contract may specify an earlier age).

Example of stretching IRA

Paul is 74 years old and his IRA contains $1.5 million. Paul's RMD is $58,824 ($1,500,000 ÷ 25.5 life expectancy factor). Paul receives Social Security benefits and other sources of passive income, so he does not need his RMD to meet his living expenses.

He put $200,000 in a QLAC, which reduced his current-year RMD by $7,843 ($200,000 ÷ 25.5 life expectancy factor).

In addition to reducing his RMDs, if the annuity pays 6% over the next 11 years, Paul's $200,000 will be worth over $386,000 when he is 85 years old and must begin drawing on the annuity.

Maximum QLAC investment

The premiums paid for all QLAC contracts for the benefit of any individual cannot exceed $200,000 (indexed for inflation starting in 2025). (SECURE 2.0 Act §202)

Eligible accounts

QLACs may be purchased under:

- Defined contribution plans (401(k)s, 403(b)s, 457(b)s, SIMPLE IRAs);
- Traditional IRAs;
- IRC §403(b) plans; and
- Governmental IRC §457(b) plans.

QLACs cannot be purchased with funds from an inherited IRA.

QLAC requirements

Under a QLAC, a plan may provide that if the purchasing retiree dies before (or after) the age when the annuity begins, the premiums they paid but have not yet received as annuity payments may be returned to their accounts.

QLAC planning with Form 1098-Q, Qualified Longevity Annuity Contract Information

Form 1098-Q is an annual information statement prepared by the issuer of a qualified longevity annuity contract (QLAC).

Form 1098-Q is very similar to Form 5498, IRA Contribution Information. Where Form 5498 can help provide information to taxpayers and tax professionals regarding their IRA accounts, Form 1098-Q also provides information that can be helpful for tax planning.

Form 1098-Q provides the taxpayer with the following:

- **Box 1a:** The amount of the taxpayer's monthly annuity on the annuity's start date;
- **Box 1b:** The annuity's start date;
- **Box 2:** Whether the annuity can be accelerated to a date before the date shown in Box 1b;
- **Box 3:** The total premiums paid for the annuity; and
- **Box 4:** The fair market value of the annuity as of December 31 of the reporting year.

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The information contained in Boxes 1a and 1b is helpful for income and estimated tax planning as the taxpayer gets closer to the annuity start date.

Box 2 may be checked, indicating whether the annuity start date can be accelerated, which can come into play if the taxpayer cannot wait until the annuity start date to access their money. The QLAC contract will dictate the terms of annuity acceleration, but Box 2 tells the taxpayer that there may be an acceleration option available to them.

Box 3 indicates whether the taxpayer has maximized their QLAC contributions or can contribute more. Taxpayers can move up to $200,000 from their IRA into a QLAC. If the sum of Box 3 on all QLAC contracts owned by the taxpayer is less than $200,000, then the taxpayer can still make additional QLAC investments if they want.

Brief history of Form 1098-Q: Form 1098-Q first came about in 2014 — the same year QLACs were created. Annuity rates are highly dependent on interest rates, and interest rates from 2014 until early 2022 were at historic lows. (https://tradingeconomics.com/united-states/interest-rate) As such, the rate of return on annuity investments in general, including QLACs, was not very good.

Now that interest rates are much higher than they were even two years ago, and the fact that the SECURE 2.0 Act increased the maximum allowable QLAC investment to $200,000, more taxpayers are investing in them.

Charitable gift annuities

In addition to annuities purchased through insurance companies, taxpayers can purchase annuities from charitable organizations that offer them. Charitable gift annuities provide an upfront charitable contribution deduction when the annuity is purchased equal to the amount paid for the annuity, less the present value of anticipated annuity payments to be received by the taxpayer.

Charitable gift annuities typically make fixed annuity payments to the taxpayer for their life (or for the joint lives of married taxpayers). When the taxpayer dies, the remaining annuity funds remain with the charitable organization.

✎ Practice Pointer

Charities usually have minimum age and gift amounts that vary from charity to charity.

Taxpayers who are interested in charitable gift annuities should work with their charity of choice to plan for the annuity. The charity's actuarial professionals will determine the charitable contribution amount and the annuity payouts based on the taxpayer's life expectancy.

Using QCDs to purchase charitable gift annuities

The qualified charitable distribution (QCD) rules allow taxpayers to give up to $105,000 to charity directly from their IRA in 2024. QCDs are discussed in more detail on page 4-13.

The SECURE 2.0 Act allows for one-time qualified charitable distributions from IRAs of up to $53,000 for 2024 to be contributed into charitable gift annuities, charitable remainder unitrusts, and charitable remainder annuity trusts, applicable to distributions made in taxable years ending after December 29, 2022. (SECURE 2.0 Act §307; IRC §408(d)(8)(F))

The election is only available if the annuity or trust is funded exclusively by qualified charitable distributions, and in the case of the charitable gift annuity, if the annuity commences fixed payments of 5% or greater not later than one year from the date of funding.

The $53,000 contributed to the split entity trusts/annuities described above counts toward the taxpayer's overall $105,000 qualified charitable distribution limitation.

PLANNING FOR THE NEXT GENERATION

Planning for the next generation includes both estate and gift planning strategies as well as helping the next generation get a financial head start. We'll discuss both here.

The younger a taxpayer begins investing, the greater the benefit they will receive from compounding investment returns. The best way to start a taxpayer investing young is when they receive financial education at home and when their parents or grandparents can help them at the youngest age possible.

INVESTING FOR COLLEGE

§529 plans

§529 college savings plans work similar to Roth IRAs: Taxpayers make contributions of after-tax dollars, and the funds in the account grow tax-deferred. If distributions from the college savings account are used for a quailed purpose, then none of the distributions are taxable, not even the earnings. If distributions from the account are not used for a qualified purpose, then the portion of the distributions allocated to earnings is taxable and subject to federal penalties equal to 10% of the taxable portion of the distribution.

Distributions from §529 accounts can be used to repay up to $10,000 of student loans per lifetime, per person (the beneficiary and siblings).

§529 Distributions		
	Postsecondary (college) and registered apprenticeships	**K–12**
Tuition	No limit	Limited to $10,000 annually
Fees, books, supplies, and equipment required for enrollment or attendance	Eligible expenses	Not eligible expenses (§529 distributions used for these purposes are taxable)
Expenses for special needs services of beneficiary in connection with enrollment or attendance	Eligible expenses	Not eligible expenses
Expenses for the purchase of computer or peripheral equipment, software, internet access and related services, if used during enrollment at education institution	Eligible expenses (but not for software designed for sports, games, or hobbies unless it is predominantly educational in nature; for example, if student is studying video game development)	Not eligible
Student loan repayments	N/A	N/A

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California partial conformity

California generally conforms to the IRC §529 provisions. However, California does not conform to the SECURE 2.0 provision that allows taxpayers to make a tax-free rollover into a Roth account. Therefore, any earnings included in the distributions are taxable and subject to penalties on the California return.

California also does not allow §529 distributions to be used for K–12 education.

California residents who use distributions from §529 accounts for K–12 education are subject to California's 2.5% early withdrawal penalty on the earnings withdrawn from the account. (R&TC §§17024.5, 17140, 17140.3)

Direct payments of college tuition

Taxpayers who make tuition payments for another person directly to a qualified educational organization may exclude those payments from gift tax and reporting no matter their amount, and they do not count toward the taxpayer's annual exclusion or lifetime credit. (IRC §2503(e); Treas. Regs. §25.2503-6(b)(2)) The unlimited exclusion is not permitted for amounts paid for books, supplies, dormitory fees, or similar expenses that do not constitute direct tuition costs.

A qualified educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are conducted. (IRC §170(b)(1)(A)(ii))

☑ Planning Pointer

Making gifts by directly paying tuition may be a better alternative than gifting into a §529 college savings account. For example, grandparents, aunts, and uncles often want to give gifts that will be used for education. But what if the recipient will be drawing from their §529 account within a couple of short years? A gift made into a §529 account isn't likely to see much appreciation before it is spent.

In this scenario, it may be better to preserve the annual gift tax exclusion amount and simply wait to make a tuition payment directly to the educational institution.

In addition to gifts of education tuition, direct payments of medical expenses to a medical care provider can be made gift-tax free. (IRC §2503(e); Treas. Regs. §25.2503-6(b)(3))

The medical gift does not count against the annual gift tax exclusion or the lifetime gifting credit, so the donors reduce their estate and retain the ability to make additional gifts.

This exclusion applies regardless of the relationship between the person making the payments and the individual on whose behalf the payments are made. This exclusion is available in addition to the annual gift tax exclusion. (Treas. Regs. §25.2503-6(a)) However, the payments must be made for medical care as it is defined under the IRC §213(d) medical expense deduction rules. This includes the costs of dental treatment, drugs and medicines, nursing, and certain transportation and travel.

Series I and EE bonds to pay for college

Series EE and I savings bonds have an education exclusion that permits qualified taxpayers to exclude from their gross income all or a part of the interest paid on redemption of their bonds when

the bond owner pays qualified higher education expenses at an eligible institution. (IRC §135) The exclusion is calculated on Form 8815, Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989, and reported on Schedule B (Form 1040), line 3.

"Qualified higher education expenses" include tuition and fees required for enrollment or attendance as well as contributions to a Coverdell education savings account (Coverdell ESA) or a qualified tuition program (QTP), such as a §529 college savings account.

The income exclusion is available if all of the following apply:

- The bonds were cashed in the same tax year for which the exclusion is claimed;
- The qualified higher education expenses were paid for by the taxpayer, spouse or dependents;
- The taxpayer's filing status can't be married filing separate;
- The taxpayer's modified AGI was less than:
    - $111,800 if filing single, head of household, or qualifying widow(er); or
    - $175,200 if married filing joint; and
- The taxpayer was at least 24 years old when their savings bonds were issued.

The age requirement for the interest income exclusion can be confusing. It's the taxpayer claiming the exclusion who must have been at least 24 years old when their savings bonds were issued.

Example of interest exclusion age requirement

Mel owns two Series I Treasury bonds with a face value of $10,000 each. The first bond was purchased by Mel's parents on his behalf before he was 24 years old, and he purchased the other one when he was 25 years old.

Mel is 35 years old now. He redeemed the bonds and contributed the proceeds into a §529 college savings account for his daughter.

Mel can exclude the interest income from the bond he purchased when he was age 25 from his gross income, but he cannot exclude the interest income from the bond that his parents purchased for him when he was under the age of 24. Mel will report the interest income exclusion on Form 8815.

INVESTING FOR YOUNG ADULTS

Roth conversions of leftover §529 funds

Individuals who have maintained §529 accounts for at least 15 years can make a direct trustee-to-trustee rollover from the §529 plan to the beneficiary's Roth IRA effective for distributions made after December 31, 2023. (SECURE 2.0 Act §126; IRC §§408A(e)(1)(C), 529(c)(3)(E)) The exclusion only applies to the amount contributed to the §529 plan (and earnings attributable thereto) before the five-year period ending on the date of the distribution.

Comment

It is hoped that this will encourage individuals who might have been concerned about leftover funds being trapped in §529 accounts and being subject to penalties to continue to make contributions to §529 plans to pay for escalating education costs.

Limitations

Rollovers from §529 plans to a taxpayer's Roth IRA count toward the taxpayer's annual IRA contribution limits ($7,000 for 2024 for taxpayers under age 50; $8,000 for those age 50 or older). (IRC §529(c)(3)(E)(ii)) However, the Roth contribution AGI limitation does not apply to these rollovers.

Rollovers from a §529 plan are subject to an aggregate lifetime limit of $35,000 per beneficiary.

Example of rollover from §529 account to Roth IRA

Teresa's parents opened a §529 college savings account for her on her 10th birthday with $10,000. They contributed an additional $10,000 on each birthday until she turned age 18 ($10,000 × 9 years = $90,000). When she started college, her account balance was $150,000 after factoring in investment growth.

Teresa attended a state school with lower tuition costs and graduated from college at 22 years old. The balance of her §529 account was $42,000 when she graduated, comprised of $26,000 of contributions and $16,000 of earnings.

If Teresa withdraws the balance of her account, she will have $16,000 of taxable income that is also subject to a 10% penalty for not using the §529 funds for eligible expenses.

Alternately, the SECURE 2.0 Act allows Teresa to make annual trustee-to-trustee Roth IRA rollovers, up to $35,000 over her lifetime.

She cannot roll over the entire $35,000 at once because the rollovers are subject to the regular annual IRA contribution limits ($7,000 for 2024). The maximum IRA contribution limit is reduced if Teresa makes other IRA contributions or does not have sufficient earned income.

However, the AGI limitation for Roth contributions is not taken into account. So, if Teresa works at a high paying job out of college, she can still make the Roth IRA contributions from her §529 account.

Additionally, because Teresa's parents started her account at age 10, she must wait until age 25 to make the rollover contributions. The SECURE 2.0 Act requires that her account be at least 15 years old.

Direct Roth IRA funding for young adult workers

The greatest benefits of compound investment growth are realized when investing is done early and often. For young adults, especially teenagers, the most significant obstacle to investing in an IRA is a lack of earned income. But once the youngster starts their first job, helping them contribute to a Roth IRA can give them the type of retirement investment head start we all wish we had growing up.

Due to a young worker's low tax bracket, Roth IRAs provide the greatest benefit. In fact, many teenagers and young adults who are dependents have earned income that does not exceed their standard deduction and therefore pay no federal income tax. Roth IRA distributions later in the child's life will likely occur when they are in a federal tax bracket above 0%.

Example of child's Roth IRA

Luke is 13 years old and started his first job working as a youth soccer referee. Luke earned $3,000 in 2024 and expects to earn about that same amount until he is 18.

Each year his parents fund a Roth IRA with $3,000 (equal to his earned income). Assuming a growth rate of 7%, Luke will have over $21,000 in his Roth IRA at age 18. With no additional contributions after age 18, the account will top $535,000 when he turns age 65, assuming the same 7% annual rate of return.

Even better, if Luke were to continue contributing just $3,000 per year until age 65, assuming the same rate of growth, his Roth IRA will be worth over $1.6 million. That's not too bad for only $3,000 per year.

Taxable investments for kids

Taxpayers who want to get an even earlier start on investing (before their children or grandchildren have earned income) can invest in taxable investments. Taxable investments don't have the same tax-deferred growth feature of IRAs, but the investments can still benefit from compound growth.

The downfall of investment accounts for kids is that if earnings reach a fairly low threshold, the kiddie tax rules come into play. Before the threshold is reached, the child will benefit from what is most likely a very low (or no) tax rate.

Kiddie tax rules

Children who meet the following listed requirements must attach Form 8615, Tax for Certain Children Who Have Unearned Income, to their income tax return. If the requirements are met, the child's unearned income is taxed at their parents' highest marginal income tax rate. All of the following conditions must be met:

- The child's unearned income was more than $2,600 in 2024;
- The child meets one of the following age requirements:
  - Under age 18 at the end of the tax year;
  - At least age 18 at the end of the tax year and didn't have earned income that was more than one-half of the child's support; or
  - Was a full-time student at least age 19 and under age 24 at the end of the tax year and didn't have earned income that was more than one-half of the child's support;
- At least one of the child's parents was alive at the end of the tax year;
- The child is required to file a tax return for the year; and
- The child didn't file a joint return for the year.
  (IRC §1(g)(2))

Which parent's tax rate applies?

In the case of parents who are not married, the tax rate of the custodial parent is used to determine the kiddie tax. (IRC §1(g)(5)(A))

In the case of married taxpayers filing separately, the parent with the greater taxable income is the one whose tax rate applies to determine the kiddie tax. (IRC §1(g)(5)(B))

Parents' election to report child's interest and dividends

Instead of filing Form 8615 and attaching it to their child's income tax return, parents can elect to report their child's income on their own return using Form 8814, Parents' Election to Report Child's Interest and Dividends. Parents are eligible to make the election if their child meets all of the following conditions:

- At the end of the tax year the child was under age 19 (or under age 24 if a full-time student);
- The child's gross income was less than $14,600 for the 2024 tax year;
- The child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends);
- No estimated tax payments were made for the child for the tax year, and no overpayments from the previous tax year (or from any amended return) were applied to the current tax year under the child's name and Social Security number;
- No federal income was withheld from the child's income under the backup withholding rules;
- The child is required to file a federal return unless this election is made;
- The child does not file a joint return for the tax year; and
- The parent is qualified to make the election because they are either the custodial parent, the parent with higher taxable income when the parents' filing status is married filing separate, or both the child's parents file a joint return.

California conformity

California conforms to the kiddie tax rules currently in effect. (R&TC §17041)

Planning to limit the kiddie tax

Taxpayers can limit the kiddie tax bite by making investment decisions that will reduce the child's unearned income, including:

- Deferring capital gains to the following year or until the child is old enough that the kiddie tax rules no longer apply to them;
- Defer gifts of income-producing property until the dependent is old enough to not be subject to the kiddie tax rules;
- Utilize tax-deferred investments, such as U.S. savings bonds or certificates of deposit or Treasury that won't mature in the current year;
- If the child has earned income, invest in a Roth IRA so the account appreciation is not taxable; and
- Consider putting investment dollars into a §529 college savings account, which will grow tax-deferred and the earnings will never be taxed if used for qualifying expenses.

GIFTING

Annual gifting

For 2024, the annual gift tax exclusion is $18,000. (Rev. Proc. 2023-34) Taxpayers can gift up to the annual gifting limit to as many recipients as they want without triggering the need to file a gift tax return (Form 709) or reducing their unified exclusion.

The 2024 unified exclusion amount is $13.61 million. (Rev. Proc. 2023-34) The TCJA drastically increased the unified exclusion, but only temporarily. For taxpayers who die after December 31,

2025, the TCJA's increased unified exclusion is scheduled to be reduced to $5 million (plus inflation from 2011). This means that the 2026 unified exclusion is expected to be roughly one-half of the 2025 inflation-adjusted exclusion (which won't be released until fall 2024).

Taxpayers who are expected to have taxable estates when they die can engage in an annual gifting strategy. For older taxpayers, an annual gifting strategy, where the taxpayer makes gifts up to the annual gift tax limit to multiple beneficiaries, can help save significantly on estate taxes.

Example of annual gifting strategy

Ann is 85 years old and has a gross estate valued at $8 million today. Ann has three children and seven grandchildren. Ann's estate consists of two homes and investments.

Ann is in good health and expects to live another 10 years. Her annual expenses are $200,000 per year (including state and federal income taxes, living expenses, etc.), and her estate is expected to grow at a rate of 5% per year.

Based on her spending and the rate of growth of her estate, Ann's gross estate is expected to be $10.5 million when she dies. In other words, it's growing faster than she is spending it.

Ann's husband died before the deceased spouse unused exclusion (DSUE) became available, and she has never made any taxable gifts during her life.

Assuming the unified exclusion is $8 million when Ann dies, she will have a taxable estate of $2.5 million ($10.5 million value on death, minus $8 million unified exclusion). A taxable estate of $2.5 million translates to an estate tax liability of $945,000.

If Ann were to take advantage of annual gifting and make the maximum annual gift of $18,000 to each of her children and grandchildren, then she can make annual gifts of $180,000 per year ($18,000 x 10 total children and grandchildren). That translates to $1.8 million over 10 years.

If Ann's taxable estate on her death is reduced to $700,000 ($2.5 million before annual gifting, minus $1.8 million of annual gifting), then her estate tax is reduced to $229,800. That's a tax savings of $715,200. In other words, it only cost her $1,084,800 to transfer $1.8 million of wealth to her children and grandchildren ($1.8 million gifted less $715,200 tax savings).

We kept the math simple for this example, but in reality, with annual gifting, Ann's estate won't grow as fast because she is reducing the value of her estate each year, so the compound effect will actually reduce her taxable estate more than what's shown here. Additionally, the annual gift tax exclusion is adjusted each year for inflation, so she will be able to gift more than $18,000 per year to each child and grandchild over the 10-year period.

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Unified Estate and Gift Tax Rate Chart					
If the taxable estate is …		Tentative tax is …			Of excess over …
Over	But not over				
$0	$10,000	$0	+	18%	$0
$10,000	$20,000	$1,800	+	20%	$10,000
$20,000	$40,000	$3,800	+	22%	$20,000
$40,000	$60,000	$8,200	+	24%	$40,000
$60,000	$80,000	$13,000	+	26%	$60,000
$80,000	$100,000	$18,200	+	28%	$80,000
$100,000	$150,000	$23,800	+	30%	$100,000
$150,000	$250,000	$38,800	+	32%	$150,000
$250,000	$500,000	$70,800	+	34%	$250,000
$500,000	$750,000	$155,800	+	37%	$500,000
$750,000	$1,000,000	$248,300	+	39%	$750,000
$1,000,000		$345,800	+	40%	$1,000,000

§529 superfunding

Taxpayers can make yearly contributions up to the annual gift tax limit ($18,000 in 2024) without the need to file gift tax returns; however, there is an option to place up to five years' worth of the annual gift limit in a §529 account in one year and spread that contribution across five years. This amount is $90,000 using the 2024 gift limit ($18,000 × 5). Taxpayers can make this election for as many separate people for whom §529 plan contributions were made.

There is no immediate federal tax benefit for making contributions to a §529 plan, but certain states offer either a credit or a deduction from income. A chart of states that offer either a credit or a deduction can be found at:

Website
www.caltax.com/files/2023/529plans.pdf

Gift tax return requirement

If a taxpayer makes the election to treat up to $90,000 (for 2024) of a contribution to a §529 plan as being contributed ratably over a five-year period, then the taxpayer must file a gift tax return in the year of the gift. There is generally no gift tax return requirement in years 2 through 5 if the taxpayer otherwise did not make any reportable gifts. If the election applies to a portion of a larger contribution (for example, if the taxpayer contributed $120,000 to a §529 plan), a gift tax return is required in all years to report the excess of the five-year amount. (Instructions to Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return)

Example of filing gift tax returns

In 2024, Xavier contributed $120,000 to a §529 plan for the benefit of his son, and he elects to treat $90,000 of it as being contributed ratably over a five-year period ($18,000 2024 gift tax exclusion × five years = $90,000).

For 2024, he must file Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, to report a $30,000 taxable gift to his son as well as the $90,000 excludable gift.

In 2025, Xavier gives a gift of $20,000 cash to his niece.

For 2025, Xavier must file Form 709 to report the $20,000 gift to his niece ($18,000 of which is the annual gift tax exclusion (assuming the 2025 exclusion is also $18,000)), and so he will also report a $18,000 gift to his son (the one-fifth portion of the 2024 superfunding that is treated as made in 2025).

Xavier doesn't make any taxable gifts in 2026, 2027, or 2028. He is not required to file Form 709 in those years to report the one-fifth portion of the §529 plan contribution because he is not otherwise required to file Form 709.

Superfunding of a §529 college savings account can be performed more than once for the same beneficiary, but the taxpayer must wait out the first five-year period before engaging in another §529 superfunding transaction for the same beneficiary.

Lifetime gift vs. inheritance

As clients get older, they typically give greater consideration to transferring assets to their heirs in the most tax-efficient manner. The natural question arises: Should gifts be made during life or transferred after death?

Lifetime gifts

The benefits of lifetime gifts include:

- The ability to use the annual gift tax exclusion ($18,000 in 2024);
- The donor is still alive to see their heirs enjoy their inheritance;
- For taxpayers with large estates, lifetime gifts in excess of the reduced lifetime exclusion scheduled to take effect in 2026 generally won't be adversely affected by the reduced exclusion; and
- Gifting assets with high expected appreciation will remove the assets from the donor estate, thus allowing the growth to occur in the beneficiary's hands.

The disadvantages of lifetime gifts include:

- The recipient takes a transferred basis; and
- Gifts in excess of the donor's annual gift tax exclusion reduce the donor's unified exclusion.

Inheritance

The single biggest benefit to holding assets and leaving them to heirs after death is that assets that are includible in the decedent's gross estate receive a basis step-up for the recipients.

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Deciding whether lifetime gifts or inheritance makes more sense

There is no one-size-fits-all answer to whether it makes more sense to make lifetime gifts or hold assets and let them pass at death. However, the following tips are helpful when evaluating a client's situation:

- Avoid lifetime gifts of appreciated assets if you don't expect the taxpayer to have a taxable estate. With estate taxes removed from the equation, the greatest benefit is achieved by allowing the taxpayer's heirs to receive a basis step-up on the assets.
- Taxpayers with taxable estates should use annual gifting to reduce the size of their taxable estate without reducing their unified exclusion. Annual gifting strategies are discussed on page 4-35.
- Taxpayers with large taxable estates should take advantage of the higher lifetime exclusion in effect through 2025. Utilizing their entire exclusion by making taxable gifts now generally won't harm them when the lifetime exclusion is cut in half in 2026, although some taxable gifts can be clawed back.

Basis step-up rules

The basis step-up rules provide that when a taxpayer acquires property from a decedent, the basis of the property in the taxpayer's hands is the fair market value of the property at the date of the decedent's death. (IRC §1014(a)(1))

Generally, the property must be acquired from a decedent, and the property must be includible in the decedent's gross estate. Getting a little more technical, there are seven types of property that are considered to have been acquired from or to have passed from the decedent, listed in IRC §1014(b). For brevity, we will not cover these rules in detail here, but they cover specific situations that may provide unique challenges when determining whether property is actually acquired from a decedent.

Alternate valuation date election

Generally, the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death or, if the decedent's executor so elects, at the alternate valuation date prescribed in IRC §2032.

IRC §2032 allows the value of a decedent's gross estate to be determined by valuing all the property included in the gross estate as follows:

- In the case of property distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death, the property is valued as of the date of distribution, sale, exchange or other disposition; and
- In the case of property not distributed, sold, or otherwise disposed of within six months after the decedent's death, the property is valued as of the date that is six months after the decedent's date of death.
  (IRC §2032(a))

The alternate valuation date election is an irrevocable election that must be made on an estate tax return (Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return). (IRC §2032(d)(1)) The election can be made on an amended Form 706, but only if the election is made no more than one year after the due date of the Form 706, including extensions. (IRC §2032(d)(2)) Additionally, the alternate valuation date election is only available if the election will decrease both:

- The value of the decedent's gross estate; and
- The sum of the estate tax and generation-skipping transfer taxes.
  (IRC §2032(c))

Assets held in trust

Taxpayers often hold their assets in a trust. Whether assets held in a trust receive a basis step-up upon the trust grantor's death depends on whether the assets are includible in the grantor's gross estate. Assets that are not includible in the grantor's gross estate are deemed to have not been acquired from the decedent, as is required by IRC §1014(a), and therefore will not benefit from the step-up in basis. (H.R. Rep. No. 83-1337 at 4407-08 (March 9, 1954); ***Collins v. United States*** (1970) 318 F. Supp. 382)

Irrevocable trusts

One of the key reasons taxpayers will create irrevocable trusts during their life is to remove assets from their gross estate. As such, once the taxpayer dies the assets in the irrevocable trust do not receive a basis step-up. The IRS's most recent ruling in this area dealt with intentionally defective grantor trusts (IDGTs). (Rev. Rul. 2023-02) An IDGT is an irrevocable trust set up during the grantor's life, but for income tax purposes the trust is still treated as a disregarded entity.

The IRS ruled that taxpayers do not receive a step-up in basis on assets held in an irrevocable trust if the assets are not includible in the taxpayer's gross estate. This is true even if the assets are held in an IDGT where the taxpayer must report the income and expenses from the trust on their personal income tax return.

Why set up a defective grantor trust?

The IDGT strategy is frequently used in situations where an individual:

- Wants to transfer assets/income to their beneficiaries and out of their estate for estate tax planning purposes; but
- Does not want the income to be taxed to the trust or the beneficiaries (thereby providing a double benefit to their beneficiaries).

Fortunately, as the law currently stands, this can be done because the estate tax laws and income tax laws treat grantor trusts differently under certain scenarios.

If the grantor of the trust retains the right to substitute the assets of the trust (e.g., exchange real property for stocks), this does not change the "irrevocable" nature of the trust for estate tax purposes. The gift of "an asset" is still treated as a completed gift. However, retaining the right of substitution results in the trust being "defective" and treated as a grantor trust under IRC §§671–679 for income tax purposes, meaning the income will be taxed to the grantor and not the trust or beneficiaries.

Because the gift is considered complete when the assets are transferred to the trust, the assets do not qualify for a step-up in basis when the grantor dies (unless the trust assets are otherwise includible in the decedent's gross estate). This is because the property was not transferred to the beneficiaries nor the estate by bequest, devise, or inheritance, nor does it fit within any of the other types of property eligible for a step-up in basis under IRC §1014(b).

Trusts that become irrevocable upon death

Revocable trusts, often referred to as "living trusts," generally allow the grantor to make unlimited changes to the trust, including the ability to revoke the trust altogether. A revocable/living trust becomes irrevocable upon the death of its grantors, and the assets of the trust are includible in the grantor's gross estate. As such, assets held in a revocable/living trust receive a basis step-up on the grantor's death.

A-B trusts

A common structure for revocable/living trusts of married couples is to use an "A-B" trust. In an A-B trust, upon the death of the first spouse, the trust is split in two with the deceased spouse's assets going into a "B" or "bypass" trust and the surviving spouse's assets going into an "A" or "survivor's" trust.

The B trust becomes irrevocable upon the deceased spouse's death, and the A trust continues as the surviving spouse's revocable/living trust.

The B trust assets receive a basis step-up, and the A trust assets do not unless the assets are community property assets. All community property assets receive a full basis step-up upon the death of the first spouse.

When the surviving spouse dies, the assets in the A trust receive a basis step-up, but the assets in the B trust do not. Even in community property states, the assets in the B trust do not receive a basis step-up on the second spouse's death.

Community property

Under community property rules, each spouse owns an undivided interest in all of the assets of the "community" (i.e., the marriage or, in some states, registered domestic partnership). Community property is generally defined as assets derived from the time, effort, and skill of the community.

Because each spouse owns an undivided interest in all of the assets, then all of the community assets are deemed includible in the decedent's gross estate. Therefore, all community assets receive a full basis step-up on the first spouse's death.

There are only nine community property states in the United States. They are:

- Arizona;
- California;
- Idaho;
- Louisiana;
- Nevada;
- New Mexico;
- Texas;
- Washington; and
- Wisconsin.

Unified exclusion

Under the TCJA, beginning after December 31, 2017, the unified exclusion amount was doubled from $5 million (adjusted for inflation after 2011) to $10 million, which is also indexed for inflation. (IRC §2010(c)(3)) The 2024 exclusion amount is $13.61 million. (Rev. Proc. 2023-34)

The exclusion amount will revert back to $5 million (plus inflation from 2011) for taxpayers dying after December 31, 2025.

Planning for a reduced exclusion

Because the unified exclusion is scheduled to revert back to $5 million (plus inflation from 2011) after 2025, the IRS issued final regulations in 2019 to provide an anti-clawback rule so that individuals taking advantage of the increased gift and estate tax exclusion amounts currently in

effect will not be adversely impacted when the exclusion amount is reduced. (IR-2019-189; Treas. Regs. §§20.2010-1, 20.2010-3; T.D. 9884)

The potential problem: The temporary increase in the unified estate exclusion amount contained in the TCJA generated questions about what will happen if individuals made gifts in excess of $5 million but die after 2025 when the exclusion amount is decreased.

For purposes of calculating estate tax at an individual's death, lifetime exclusion gifts are added back into the estate, and the estate tax is based on the total of the gifts plus any remaining assets.

Example of taxable estate

Annie made lifetime gifts of $10 million to her children, filed gift tax returns when required, and applied $10 million of her exclusion amount to those gifts. As a result, no gift tax was paid on any of the transfers.

At Annie's death in 2024, she had $5 million in assets remaining. Her estate tax will be $501,800.

Lifetime gifts	$10,000,000
Remaining assets at death	5,000,000
Taxable estate	15,000,000
Exclusion amount	(13,610,000)
Subject to estate tax	1,390,000
Estate tax	$ 501,800

If the individual dies after the exclusion is reduced, under this basic calculation, the decreased exclusion amount could greatly increase the estate tax liability.

Example of death after exclusion reduced

Assume the facts are the same as the previous example, except that at Annie's death, the lifetime exclusion is $7 million ($5 million with an estimated adjustment for inflation). Without regard to the relief provided in the regulations, her estate tax would be $3,145,800 million.

Lifetime gifts	$10,000,000
Remaining assets	5,000,000
Taxable estate	15,000,000
Exclusion amount	(7,000,000)
Subject to estate tax	8,000,000
Estate tax	$ 3,145,800

The fix provided in the regulations: The final regulations issued in 2019 provide a special rule that allows the estate to compute its estate tax credit using the higher of the exclusion applicable to gifts at the time the gifts are made or the exclusion applicable on the date of death. (Treas. Regs. §20.2010-1(c))

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Example of death after exclusion reduced, with regulations fix

Once again, assume the facts are the same as the previous example, except that Annie's estate applies the fix provided in the regulations. Remember, at Annie's death, she has $5 million in assets remaining, and the lifetime exclusion is $7 million. Her estate tax will be $1,945,800.

Lifetime gifts*	$10,000,000
Remaining assets	5,000,000
Taxable estate	15,000,000
Exclusion amount*	(10,000,000)
Subject to estate tax	5,000,000
Estate tax	$ 1,945,800

* Higher of the exclusion applicable to gifts at the time the gifts were made ($10 million) or the exclusion applicable at the time of death ($7 million)

Without the fix provided in the regulations, it's possible that taxpayers could end up with a tax liability greater than the assets remaining in their estate, as the following example illustrates.

Example of estate tax greater than assets

Jane made a gift of $11 million to her daughter in 2020, when the exclusion amount was $11.58 million. She applied $11 million of her exclusion amount to the gift, and no gift tax was paid on the transfer.

Jane dies in 2026, when the exclusion amount is reduced to $7 million, and she has $2 million of assets remaining in her estate. Without the fix provided in the regulations her estate tax would be $2,345,800.

Lifetime gifts	$11,000,000
Remaining assets	2,000,000
Taxable estate	13,000,000
Exclusion amount	(7,000,000)
Subject to estate tax	6,000,000
Estate tax (40%)	$ 2,345,800

The result would be an estate tax liability that exceeds the assets remaining in the estate.

Applying the exclusion amount used during her lifetime reduces the estate tax lability to $745,800.

Proposed regulations limit 2019 relief

The IRS has issued a proposed regulation (REG-118913-21) that provides an exception to the gift and estate tax basic exclusion amount special anti-clawback rule discussed immediately above. (T.D. 9884; Treas. Regs. §20.2010-1(c)) Unfortunately, the proposed regulations apply limitations that were not originally anticipated. This could create significant estate tax liabilities for some advanced gifting strategies.

Exceptions to the rule: It was clear the anti-clawback rule applies to completed gifts made during the donor's lifetime. However, the IRS stated at the time the 2019 final regulations were

adopted that it would provide additional guidance that would provide exceptions to the anti-clawback rules where a donor makes a gift during their lifetime but still retains significant beneficial use, enjoyment, or control of the transferred property.

The 2022 proposed regulations officially create the IRS's exceptions to the anti-clawback rule. The proposed regulations provide that the anti-clawback rules do not apply to various transfers includable in the decedent's gross estate, including but not limited to:

- The following transfers includible in the decedent's gross estate, even if a charitable deduction or spousal deduction was claimed:
  - Near-death transfers (made within three years of the decedent's death) (IRC §2035);
  - Transfers with a retained life estate (IRC §2036);
  - Transfers taking effect at death or conditioned upon surviving the decedent (IRC §2037);
  - Revocable transfers (IRC §2038); and
  - Life insurance policies on the decedent's life over which the decedent retained certain incidents of ownership (IRC §2042);
- Transfers made by an enforceable promise (e.g., a promissory note) to the extent they remain unsatisfied at death; and
- Transfers of certain applicable retained interests in:
  - Corporations or partnerships (e.g., intrafamily equity interest transfers where the decedent still retains certain rights, such as determining whether a distribution will be made); or
  - Certain trusts (e.g., grantor retained annuity trusts and qualified personal residence trusts).

The exceptions to the anti-clawback rule apply even if transfers described above are actually "completed" within 18 months of the donor's date of death, meaning that the decedent no longer had the use, enjoyment, or control of the property during the last 18 months of their life. In this case, the basic exclusion amount in effect on the decedent's date of death will apply.

Example of treatment of gift of promissory note

In 2022, Alberto made a completed gift of a promissory note of $9 million to his daughter Mikhaila, which was unpaid at the time of Alberto's death.

Alberto died after 2025. At the time of his death, the basic exclusion amount is $6.8 million. The exclusion applied on his estate tax return is limited to $6.8 million, even though at the time the promissory note was issued the exclusion amount was $12.06 million.

Exceptions to the exception: The anti-clawback rules will still apply, even to the type of transfers described above, to:

- Gifts that are not material, meaning that the taxable amount is 5% or less of the total amount of the transfer, valued as of the date of the transfer; and
- Transfers, relinquishments, or eliminations made within the last 18 months of the decedent's life if the transfer, relinquishment, or elimination occurred as a result of the termination of a durational period described in the original transfer by either the mere passage of time or the death of any person (e.g., the complete transfer will occur at the end of a five-year period or the death of the decedent's spouse).

Effective date: The proposed regulations are applicable to the estates of decedents dying on or after April 27, 2023.

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GLOSSARY

Active participation: a rental activity participation standard that is more easily satisfied than material participation. In order to meet the active participation standard, the taxpayer must simply participate in the rental activity in a significant way, including making decisions or arranging for others to provide services

Aggregation election: an election by a real estate professional to treat all rental real estate interests as a single activity; also known as grouping

Alternative minimum tax (AMT): an income tax that ensures that individuals and corporations that benefit from various exclusions, credits, and deductions will pay at least some tax. The AMT is assessed on an adjusted amount of taxable income above a specified threshold

Annuity: an investment product sold by a financial institution, typically an insurance company, whereby funds provided by an individual are contractually provided to the insurance company, and then the money is paid back to the individual in incremental amounts over a future time period that is predetermined by the insured. Annuity contracts are designed to provide a guaranteed stream of future income and are generally considered to be a low-risk investment

Applicable financial statement (AFS): one that is submitted to the SEC or is subject to a certified audit

Augusta Rule: aka Master's Rule; a special tax code rule that allows for a home to be rented out for 14 days or less without having to be reported as income. The name refers to Augusta, Georgia, where it was first implemented during the Masters Golf Tournament

Backdoor Roth: an IRA transaction whereby taxpayers who are ineligible to make a Roth contribution can make a nondeductible contribution to a traditional IRA and then convert the contribution to a Roth IRA

Betterment: amelioration of a preexisting material condition, whether or not known when the property was acquired; the amelioration of a material condition that arose during production of a unit of property; a material addition to space or capacity; or a material increase in productivity, efficiency, strength, quality, or output of a unit of property. Amounts paid for a betterment must be capitalized

Biomass: organic matter utilized as fuel for the generation of electricity

Bonus depreciation: for assets whose original use commences with the taxpayer, an added amount of depreciation that can be deducted, always in the first year that the depreciable item is placed in service

Boot: in a §1031 exchange, the fair market value of other property or the cash received by the taxpayer in the exchange transaction

Brownfield site: specified contaminated real property

Bypass trust: a type of irrevocable trust most commonly used to pass assets from parents to children when the second parent dies. The use of a bypass trust allows a first spouse to die to carve out the amount equal to the applicable exclusion amount and place it in a trust that is not included in the survivor's estate. Also known as a credit shelter trust, exemption trust, decedent's trust, or B trust

CalSavers: previously known as California Secure Choice Retirement Program; a state-sponsored retirement program for private-sector employees, which currently requires private employers with five or more employees who don't offer a retirement plan to enroll their employees in a CalSavers account unless the employee opts out. As of December 1, 2025, employers with one or more employees will be required to enroll their employees if they don't offer a retirement plan

Capital lease: akin to financed purchases, where the lease term spans over the course of most of the asset's useful life

Capitalization: a method in accounting whereby a cost is recorded as an asset, not an expense. In this way, companies can acquire assets with a long lifespan and spread out the cost over an extended period of time

Certificate of deposit: a type of savings account that pays a fixed interest rate, usually higher than a regular savings account, on money held for a predetermined period. Funds in a CD must remain untouched during the term of the fixed period

Clean Electricity Investment Credit: replaces the IRC §48 Energy Investment Credit for property placed in service after 2024 (including expansions and incremental production increases). Only U.S. facilities for which the greenhouse gas emissions rate is less than zero will qualify for this credit

Clean Electricity Production Tax Credit: replaces the Renewable Electricity Production Tax Credit for electricity generation facilities placed in service after 2024. Only U.S. facilities for which the greenhouse gas emissions rate is less than zero will qualify for this credit

Clean Vehicle Credit: formerly known as the Qualified Plug-In Electric Drive Motor Vehicle Credit, which was amended by the Inflation Reduction Act of 2022. Provides a credit for electric vehicles including passenger vehicles and light trucks, although multiple factors apply

Community property: a form of joint ownership of property by a husband and wife; both real and personal property, wherever situated, acquired by a married person during marriage while domiciled in the state. Each spouse can manage, direct, and control community property

Constructive receipt: a doctrine under which an individual is considered to have received income when the economic value is within the taxpayer's control, not just when payment is in hand

Cost segregation study: segregates the components of real property into its shorter depreciable-life components

Coverdell IRA: a tax-advantaged education savings account (ESA) set up to cover future education expenses of a designated beneficiary, including tuition, books, uniforms, etc., for elementary, secondary, and college education

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Delaware statutory trust (DST): a legally recognized trust set up as a private governing agreement under which property is held and managed or for-profit business activities are carried on by one or more trustees for the benefit of the trustor. The trust is not necessarily established in the state of Delaware. Also referred to as an unincorporated business organization trust (UBOT)

***De minimis* safe harbor election:** allows taxpayers to write off or expense certain tangible personal property items that would otherwise have to be capitalized and depreciated over several years. Taxpayers can expense purchases of items costing up to $500, or $5,000 for those with an applicable financial statement

Depreciation: an annual allowance that reflects the reduction in the value of an asset due to wear and tear, deterioration, or obsolescence, resulting in an income tax deduction in order to recover the costs or other basis of specific property

Drop and swap: a like-kind exchange transaction where a partnership distributes property to partners as tenants-in-common (the drop), which allows some partners to exchange their tenants-in-common interest in the property, while others may cash out (the swap)

DST §1031: allows a trustee to enter into a master lease agreement with a core tenant who then sublets the building or building units. There can be an unlimited number of investors, but the DST is the entity that obtains the financing. The trustee makes all the decisions regarding the property

Energy Efficient Home Credit: available to eligible contractors or manufacturers that substantially reconstruct or rehabilitate new energy efficient homes, allowing contractors to claim up to $5,000 per home

Energy Star certified: a government-backed designation signifying energy efficiency

ERISA: the Employee Retirement Income Security Act under which individual retirement accounts were established in 1974

General Business Credit: made up of over 30 separate business credits that are calculated and reported on their own IRS forms. The credits are then combined on Form 3800, General Business Credit, and are subject to limitations on the aggregate credit

Grantor retained annuity trust (GRAT): an irrevocable trust where the grantor retains the right to receive for a specified term an annuity based on a specified sum or a fixed percentage of the value of the assets transferred to the trust

Grantor trust: a trust where the grantor effectively retains control over the assets in the trust, which will cause the existence of the trust to be ignored for income tax purposes. Also known as a living trust

Inherently permanent structure: for purposes of IRC §1031, any building or other structure that is permanently affixed to real property and that will typically remain affixed for an indefinite time period

Intentionally defective grantor trust (IDGT): a trust that is irrevocable for estate and gift tax purposes, but the grantor retains certain powers so that the trust is treated as a grantor trust for income tax purposes. The grantor, not the beneficiary, is taxed on all trust income even though the grantor is not entitled to any trust distributions

Investment Tax Credit: the sum of eight various credits, including the Energy Investment Credit and the Rehabilitation Credit. Investment credit property is any depreciable or amortizable property that qualifies for one of these credits

IRA: individual retirement account that allows a person to save for retirement on a tax-deferred basis. With a traditional IRA, permissible contributions may be deducted on an individual tax return, and earnings grow tax-deferred until they are withdrawn. With a Roth IRA, after-tax contributions are made that may be withdrawn at retirement tax-free

IRC §179 depreciation deduction: allows a taxpayer to elect to deduct the cost of certain types of property as an expense on their tax return rather than being required to capitalize and depreciate the property cost

IRC §199A deduction: a small business tax deduction under the TCJA. With respect to a trade or business, it is the actual deduction after subjecting the combined tentative deduction to the taxable income limitation and adding in any deductible amount with respect to co-ops, REITs, and PTPs

IRC §481(a) adjustment: computed as of the beginning of the taxable year of accounting method change. The adjustment reflects the cumulative difference between the present and the proposed methods and is used to prevent amounts of income or expense from being duplicated or omitted when the change is made. All IRC §481(a) adjustments are aggregated in the year of change

IRC §761(a) election: an election made to secure exclusion from all of subchapter K whereby each member of the organization is able to adequately determine their income without the computation of partnership taxable income

IRC §1031 exchange: provides an exception to taxation on gain upon the sale of business or investment property, allowing taxpayers to postpone paying taxes if the proceeds of the sale are reinvested in similar property in a qualifying like-kind exchange

IRC §1033: allows for tax-deferral of property that has been involuntarily converted due to its destruction, in whole or in part, theft, seizure, or condemnation. Insurance proceeds from such property may be converted to similar property that is related in service or in use whereby no gain is recognized

Irrevocable trust: a trust that generally may not be revoked or amended. California law provides for the ability to revoke an irrevocable trust under certain circumstances

Kiddie tax: a special tax on a person under age 18 who has earned income above an annually determined threshold. Income above the threshold is taxed at the parent's or guardian's rate. The tax deters shifting income to children in hopes of paying tax at the child's lower tax rate

Kilowatt hour (kWh): a means of measuring the amount of energy used. A kilowatt hour is a unit of energy equal to one kilowatt of power expended for one hour

Like-kind exchange: a transaction or series of transactions that allows for the reciprocal transfer of property without generating a current tax liability when the first asset is sold

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MACRS: the Modified Accelerated Cost Recovery System, a method of depreciation whereby taxpayers can recover basis in tangible property over an identified life through annual tax deductions, allowing for larger deductions in the early years of an asset's life and lower deductions in later years. MACRS replaced the accelerated cost recovery system (ACRS) for property placed in service post 1986

Material participation: participation on a regular, continuous, and substantial basis (IRC §469(h)(1))

Mega backdoor Roth: allows taxpayer to make after-tax contributions into a 401(k) that exceed the limit. The after-tax contributions are not tax deductible and grow tax-deferred

Money market fund: a type of mutual fund offered by an investment fund company that offers investors low risk and high liquidity; typically the investments are high quality, short-term debt instruments, cash, or cash equivalents. They are not considered suitable for long-term investment

Municipal bond: a debt obligation issued by a local, county, or state government entity. With the purchase of a bond, the taxpayer is loaning money to the issuer in exchange for interest payments paid over a fixed period. When the bond reaches its maturity date, the investment is returned to the taxpayer

Net investment income tax (NIIT): a 3.8% Medicare surtax on certain net investment income of individuals, estates, and trusts that have income above a statutory threshold amount. A child's income is included in the parent's computation of NIIT

Net operating loss (NOL): a period when a company's allowable tax deductions are more than the company's taxable income with negative taxable income as a result. The loss may be carried back against income in prior years or carried forward as a deduction against future income

Nonrecourse debt: a loan that is secured usually by property as collateral whereby if the borrower defaults, the issuer of the loan can only seize the collateral. The borrower is not personally liable for the loan

Passive activity: an activity in which the taxpayer does not "materially participate" or a rental activity, regardless of whether the taxpayer materially participates

Passive income: earnings from enterprises in which an individual does not materially participate, e.g., rental income, limited partnership income

Qualified business income (QBI): as pertains to IRC §199A, the net amount of qualified items of income, gain, deduction, and loss for a taxpayer's qualified trade or business

Qualified charitable distribution (QCD): distributions made directly by the IRA trustee to a charitable organization and made on or after the date the taxpayer reaches age 70½. Taxpayers may exclude up to $100,000 annually in QCDs from their AGI

Qualified Commercial Clean Vehicle Credit: a credit under IRC §45W available for qualified vehicles purchased after December 31, 2022, and before 2033. The credit is part of the IRC §38 General Business Credit. Vehicle use must be 100% for business purposes

Qualified exchange accommodation arrangement: in a reverse exchange, when an intermediary is used to hold title to the replacement property before the relinquished property is transferred to the intermediary in exchange for the replacement property. Another part then purchases the relinquished property from the intermediary. The intermediary is known as the accommodation party

Qualified intermediary (QI): in a §1031 exchange, an individual who is not the taxpayer or a disqualified person who facilitates the exchange of relinquished property for replacement property under the regulation rules. The taxpayer assigns its rights to the QI under the relinquished property sales contract and the replacement property sales contract

Qualified longevity annuity contract (QLAC): a deferred annuity that is funded from a qualified retirement plan or IRA and is exempt from required minimum distributions

Qualified personal residence trust (QPRT): a grantor trust that holds a transferred personal residence, with the grantor retaining a qualified term interest. If the grantor dies before the end of the qualified term interest, the value of the residence is included in the grantor's estate. If the grantor survives to the end of the qualified term interest, the residence passes to the beneficiaries of the trust

Qualified retirement plan: a type of retirement plan established by an employer for a company's employees. The employers get a tax break for contributions made for their employees, and employees get to defer a portion of their income and reduce current taxable income

Qualified research expenses (QREs): specifically relate to those expenses that are eligible for the credit for increasing research activities under IRC §41, commonly referred to as the Research Credit

Real estate investment trust (REIT): a company that invests in income-producing real estate through property or mortgages and may trade on a major exchange like stock or through nonlisted, private REITs. They are modeled after mutual funds

Real estate professional: a professional status that is achieved by meeting two tests: More than half of the personal services performed by the taxpayer during the year must be in real property trades or businesses, and at least 750 hours of the personal services performed during the year must be in real property trades or businesses

Recourse liability: a loan for which the borrower is personally liable. With recourse debt, the lender can take the collateral and pursue the borrower's other assets to satisfy any remaining debt

Research Credit: provides incentives for companies to invest in research and development by providing credits for qualified research expenditures

Reverse like-kind exchange: aka ***Starker*** exchange; occurs when the taxpayer in a §1031 exchange acquires the replacement property before transferring the relinquished property

Revocable trust: aka living trust; may be revoked, cancelled, or amended by the settlor. On revocation of the trust, the trustee must transfer the assets of the trust back to the settlor and the rights of the beneficiaries are extinguished

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RMD: required minimum distribution, which is the minimum amount a taxpayer must withdraw from their retirement account every year by April 1 following the year they reach age 70½. This includes withdrawals from an IRA, SEP IRA, SIMPLE IRA, or retirement plan account. Roth IRAs do not require withdrawals until after the owner dies. Penalties apply if RMD is not taken. The SECURE Act increases the age at which taxpayer must take RMDs to age 72

Rollover: a transfer of funds from a retirement account into a traditional or Roth IRA by a direct transfer or by a check written by the custodian of the retirement account to the account holder who must deposit the funds into another IRA account. The purpose of the rollover is to maintain the tax-deferred status of the funds

Roth IRA: a special retirement account where taxes are paid on money going into the account, but all future withdrawals are tax-free

Routine maintenance: considered routine if: (a) the maintenance is performed to keep a unit of property in its ordinarily efficient operating condition; and (b) when it is place in service, the taxpayer has a reasonable expectation that routine maintenance will be performed more than once during the property's class life (in the case of a building, more than once every 10 years). There is a safe harbor for routine maintenance whereby it need not be capitalized

Safe harbor: a provision in the Tax Code which sets out terms and conditions that if complied with will ensure a specific tax result that is typically a simpler method of determining a tax consequence

SEP IRA: Simplified Employee Pension Plan, which allows self-employed individuals and small employers to contribute to retirement plans on behalf of themselves and their employees without the complexities of a qualified plan. All contributions are funded by the employer. Withdrawals are taxed as ordinary income. The SECURE 2.0 Act provides that SEP IRAs can now be designated as Roth SEP IRAs beginning in 2023. Any employer contributions to a Roth SEP IRA are treated as taxable compensation to the employee, whereas contributions to a traditional SEP IRA are excluded from the employee taxable compensation

Series I savings bond: a security issued by the U.S. Treasury that earns interest based on both a fixed rate and a rate that is set twice a year based on inflation

Series EE savings bond: along with the Series I bond, these constitute the two savings bonds issued by the U.S. Treasury. Series EE bonds are interest bearing bonds that are guaranteed to at least double in value over their term. Considered a low risk investment

SIMPLE IRA: Savings Incentive Match Plan for Employees, a savings incentive match plan that allows employees and small employers to contribute to a traditional IRA. An eligible employer must have employed 100 or fewer employees who earned a minimum of $5,000 during the previous year. Under the SECURE 2.0 Act, SIMPLE IRAs are authorized to accept Roth contributions beginning in 2023

SIMPLE 401(k): differs from a SIMPLE IRA in that the employer is not permitted to match contributions of more than 3% of the employee's compensation. No other amount of employer contribution is allowed, and there is no flexibility of contributions. Also, withdrawals in the first two years are subject to a 10% penalty (rather than 25% for a SIMPLE IRA), and the employer is required to file IRS Form 5500 each year

Small taxpayers with buildings safe harbor election: for taxpayers with average annual gross receipts of $10 million or less during the three preceding taxable years. Regulations include a maximum $10,000 yearly safe harbor election for buildings owned or leased with an unadjusted basis not greater than $1 million under which the taxpayer is not required to capitalize, and may deduct, qualifying expenditures

Specified research or experimental (SRE) expenditures: specifically refers to IRC §174 expenses. SRE expenditures are those that must be amortized over five or 15 years for taxable years beginning after December 31, 2021; those expenditures incurred in connection with a taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense. Generally includes all such costs incident to the development or improvement of a product or a component or subcomponent of the product, as well as costs of obtaining a patent

Specified service trade or business (SSTB): for purposes of IRC §199A, any trade or business described in section 1202(e)(3)(A) (not including engineering or architecture), or any business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities. Qualified trades or businesses for the §199A deduction do not include service businesses unless taxable income is below the top of the phaseout range

Survivor's trust: typically comprised of the surviving spouse's separate property and share of community property; basically a continuation of the original living trust

Swap and drop: a tax-deferred property exchange whereby sellers receive their replacement property in a complete tax-deferred exchange and then contribute the replacement property or tenancy-in-common interest in that property to a partnership with other persons

Syndicate: any partnership or other entity (other than a corporation that is not an S corporation) if more than 35% of the losses of the entity during the taxable year are allocable to limited partners or limited entrepreneurs

Tenancy-in-common (TIC): shared ownership of property by two or more persons in which each individual owns a share that may be unequal in size to shares owned by other tenants-in-common (or cotenants), unlike joint tenancy. All owners have the right to occupy and use all of the property. The shares may be transferred to other owners during life or through a will

TIC §1031: allows taxpayers to either join forces with other investors to buy a replacement property and/or to buy into an existing investment arrangement

Transferable development rights (TDRs): allows landowners to sell development rights from their land to a developer to use to increase the density of development at another designated location. The seller of development rights retains ownership and can continue to use it

Treasury bond: a fixed-rate government-issued security that pays semiannual interest payments until the bond matures (20 or 30 years) and the face value of the bond is paid to the owner

Triple net lease: a net-net-net lease agreement in which on top of normal fees, e.g., rent and utilities, the lessee pays all net real estate taxes, net building insurance, and net common-area maintenance on the property

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Trust: contractual agreement between the settlor and the trustee. The settlor transfers assets to a trustee, and instructs the trustee to hold the property for the benefit of the beneficiary

UBIA: unadjusted basis immediately after acquisition. Applies to qualifying depreciable property of a business for purposes of the §199A deduction

Unified exclusion amount: the value of assets that can be transferred upon death before an estate tax liability is incurred. For 2024, the unified exclusion amount is $13.61 million

Work Opportunity Tax Credit: a federal tax credit available to employers that hire an individual who is in a WOTC targeted group. The group consists of persons who have consistently faced barriers to employment

Zero Energy Ready Home: a program under the U.S. Department of Energy to recognize homes that achieve exceptional levels of energy savings

§280C election: an irrevocable election made by taxpayers to reduce the amount of the Research Credit claimed by the corporate tax rate of 21% in exchange for not reducing their deductible/amortizable research expenses

401(k) plan: a defined contribution plan whereby retirement savings contributions are deducted from an employee's paycheck before taxation (and sometimes matched by the employer), deferring taxes until funds are withdrawn after retirement or as permitted by law

403(b) plan: a retirement plan for certain employees of public schools, certain tax-exempt organizations, and certain ministers. Also known as a tax-sheltered annuity (TSA) plan

457(b) plan: a nonqualified, defined contribution retirement plan for state and local public employees and certain nonprofits

§529 plan: aka a qualified tuition program or QTP; a tax-advantaged vehicle for education savings held in an account for a designated beneficiary