

2025

Don Farmer's
Individual
Income Tax
Workshop

BY

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**Don
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Tax Education

2025 INDIVIDUAL INCOME TAX WORKSHOP

BY

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Preface**

This course is designed for the general practitioner and the CPA in industry who prepare and/or give advice concerning individual returns. The purpose of the material is to review key individual, federal income tax provisions of importance to CPAs.

We have not attempted to cover all provisions affecting individuals. Therefore, many provisions of the U.S. Internal Revenue Code (IRC) have been omitted.

The material discussed in this manual provides general information. Before taking any action, the appropriate regulations, cases, and rulings should be examined.

Note! Law changes in the form of statute changes, new regulations, IRS releases and court decisions are occurring at an unprecedented pace. Therefore, do not use these materials as reference material without researching new developments.

Disclaimer

This manual and the related lecture are designed to provide accurate and authoritative information about complex areas of tax law. The information contained in this manual may change as a result of new tax legislation, treasury department regulations, U.S. Internal Revenue Service (IRS) interpretations, or judicial interpretations of existing tax law. This manual is not intended to provide legal, accounting, or other professional services, and is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services.

This manual and related lecture should not be used as a substitute for professional advice. If legal advice or other expert assistance is required, the services of a competent tax advisor should be sought.

Note: The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

**THIS MATERIAL WAS FINALIZED ON OCT. 1, 2025. PLEASE CONSULT THE PDF HANDOUT FOR
SELECTED DEVELOPMENTS AFTER OCT. 1, 2024.**

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INDEXED ITEMS, ETC.

Table 1 — Married Filing Jointly & Surviving Spouses (§1(j)(2)(A)):

Tax Rate Taxable Income (MFJ/Surviving Spouse)

10%	\$0 – \$23,850
12%	\$23,851 – \$96,950
22%	\$96,951 – \$206,700
24%	\$206,701 – \$394,600
32%	\$394,601 – \$501,050
35%	\$501,051 – \$751,600
37%	Over \$751,600

Table 2 — Heads of Household (§1(j)(2)(B)):

Tax Rate Taxable Income (Head of Household)

10%	\$0 – \$17,000
12%	\$17,001 – \$64,850
22%	\$64,851 – \$103,350
24%	\$103,351 – \$197,300
32%	\$197,301 – \$250,500
35%	\$250,501 – \$626,350
37%	Over \$626,350

Table 3 — Unmarried Individuals (Single) (§1(j)(2)(C)):

Tax Rate Taxable Income (Single)

10%	\$0 – \$11,925
12%	\$11,926 – \$48,475
22%	\$48,476 – \$103,350
24%	\$103,351 – \$197,300
32%	\$197,301 – \$250,525
35%	\$250,526 – \$626,350
37%	Over \$626,350

Table 4 — Married Filing Separately (§1(j)(2)(D)): *All thresholds are half of the joint-filer amounts.*

Tax Rate Taxable Income (Married Filing Separately)

10%	\$0 – \$11,925 (half of \$23,850)
12%	\$11,926 – \$48,475
22%	\$48,476 – \$103,350
24%	\$103,351 – \$197,300
32%	\$197,301 – \$250,525
35%	\$250,526 – \$375,800 (to top of 35% bracket)
37%	Over \$375,800

Note: Married-separate filers reach the 37% bracket at much lower income than singles (e.g. 37% begins at \$375,801 for MFS vs \$626,351 for single).

Table 5 — Estates & Trusts (§1(j)(2)(E)):

Tax Rate Taxable Income (Estates and Trusts)

10%	\$0 – \$ 3,150
24%	\$3,151 – \$ 11,450
35%	\$11,451 – \$ 15,650

Tax Rate Taxable Income (Estates and Trusts)

37% Over \$15,650

Note: Trusts and estates have only four brackets (10%, 24%, 35%, and 37%). For 2025, 37% applies to fiduciary taxable income over **\$15,650**.

2025 Long-Term Capital Gains & Qualified Dividends Rates

Filing Status	0% Bracket (Income ≤)	15% Bracket (Income Between)	20% Bracket (Income >)
Single	\$48,350	\$48,351 – \$533,400	\$533,401+
Married Filing Jointly	\$96,700	\$96,701 – \$600,050	\$600,051+
Head of Household	\$64,750	\$64,751 – \$566,700	\$566,701+
Married Filing Separately	\$48,350	\$48,351 – \$300,000	\$300,001+

Net Investment Income Tax (NIIT) — IRC §1411

- Rate: 3.8%
- Base: Applies to the lesser of:
 1. Net Investment Income (NII), or
 2. The excess of Modified Adjusted Gross Income (MAGI) over the threshold amount.

Thresholds (Not Inflation-Adjusted)

- Married Filing Jointly & Surviving Spouse: \$250,000
- Married Filing Separately: \$125,000
- Single & Head of Household: \$200,000
- Qualifying Widow(er): Treated the same as Married Filing Jointly: \$250,000

Unlike ordinary tax brackets and capital gains/dividend thresholds, these NIIT thresholds never adjust for inflation — they've been the same since NIIT was enacted in 2013.

Additional Medicare Tax – IRC §3101(b)(2)

- **Rate: 0.9%**
- **Base:** Applies to **earned income** (wages or self-employment income) **above the threshold amount**.
- **Thresholds (Not Inflation-Adjusted):**
 - **Married Filing Jointly:** \$250,000
 - **Married Filing Separately:** \$125,000
 - **Single / Head of Household / Qualifying Widow(er):** \$200,000

Standard Deduction Amounts for 2025

- Married Filing Jointly/Surviving Spouse: \$31,500
- Head of Household: \$23,625
- Single or Married Filing Separately: \$15,750

Age 65+ Additional Standard Deduction

The additional standard deduction for seniors has been modestly increased for 2025:

- Single / Head of Household (age 65+): +\$2,000 (up from \$1,950 in 2024)
- Married Filing Jointly: \$1,600 per qualifying spouse (up from \$1,550)

New “Senior Bonus” Deduction (2025–2028)

A new, temporary provision provides further relief:

- **Additional Deduction:** Up to \$6,000 per senior (i.e., \$12,000 for couples where both spouses are 65+)
- Applies regardless of whether you itemize or not
- **Phase-out thresholds:**
 - Starts at \$75,000 MAGI for singles
 - Starts at \$150,000 MAGI for married filing jointly
 - Phases out fully by \$175,000 (single) / \$250,000 (joint)

Personal Exemption: Remains **\$0** – permanently repealed (except certain seniors' provisions).

AMT Exemption Amounts for 2025

- Married Filing Jointly / Qualifying Surviving Spouse: \$137,000
- Single or Head of Household: \$88,100
- Married Filing Separately: \$68,650

AMT Exemption Phase-Out Details for 2025:

Filing Status	Phase-out Begins at AMTI	Exemption Fully Phased Out at AMTI
Married Filing Jointly/QSS	\$1,252,700	\$1,800,700
Single/Head of Household	\$626,350	~\$978,750
Married Filing Separately	Same as Single (\$626,350)	~Same as Single (pro-rated)

AMT Tax Rates:

Filing Status	26% Bracket Range	28% Bracket Begins
MFJ, Single, HOH, QSS	AMTI ≤ \$220,700	> \$220,700
MFS	AMTI ≤ \$110,350	> \$110,350

Kiddie Tax:

First \$1,350 of a child's unearned income (e.g., interest, dividends, capital gains) is **tax-free** — it qualifies as the child's standard deduction.

The **next \$1,350** of unearned income is taxed at the **child's own tax rate**.

Any amount over \$2,700 is taxed at the **parent's tax rate** — the hallmark feature of the Kiddie Tax.

AMT Exemption for a Child Subject to Kiddie Tax

- When it comes to the AMT, a child subject to the Kiddie Tax is allowed a special exemption.
- That exemption is the lesser of:
 1. The regular AMT exemption for a single person (which is \$88,100 for 2025), or
 2. The child's earned income plus \$9,550.

Deductions & Credits: Key 2025 Values

Long-Term Care Insurance Premiums (Deductible Medical Expense Limits, IRC §213(d))

Per-individual maximum deductible premiums by attained age at the close of the tax year:

- Age 40 or under: \$480
- Age 41–50: \$900
- Age 51–60: \$1,800
- Age 61–70: \$4,810
- Age 71 and older: \$6,020

U.S. Savings Bonds Interest Exclusion for Education (IRC §135)

Interest earned on Series EE or I U.S. savings bonds used for qualified higher education expenses may be excluded from taxable income, subject to MAGI phase-out thresholds in 2025:

- **Phase-out begins:**
 - \$149,250 for Married Filing Jointly
 - \$99,500 for Single, Head of Household (and others excluding MFS)
- **Fully phased out at:**
 - \$179,250 for Married Filing Jointly
 - \$114,500 for Single, HOH, and other non-joint filers

Note: Married Filing Separately filers are not eligible for this exclusion

Student Loan Interest Deduction (§221): Maximum deductible interest = **\$2,500**. MAGI phase-out for deduction: **\$85,000 – \$100,000** (single) and **\$170,000 – \$200,000** (joint). (No deduction allowed above \$100k/\$200k MAGI.)

American Opportunity Tax Credit (AOTC): Maximum **\$2,500** per eligible student (40% refundable up to \$1,000). MAGI phase-out: **\$80,000 – \$90,000** (single) / **\$160,000 – \$180,000** (joint) – unchanged (not indexed).

Lifetime Learning Credit (LLC): Max **\$2,000** per return (20% of up to \$10k expenses). Same MAGI phase-out as AOTC: **\$80,000 – \$90,000** single / **\$160,000 – \$180,000** joint. (LLC remains nonrefundable.)

Educator “Above-the-Line” Deduction: **\$300** for out-of-pocket classroom supplies (per eligible educator).

Qualified Transportation Fringe (Monthly Limits, §132(f))

- \$325 per month for transit passes or vanpooling (commuter transportation)
- \$325 per month for qualified parking

Child Tax Credit (CTC):

Credit Type	2025 Amount	Refundable	Phase-Out Threshold (MAGI)
Child Tax Credit (CTC)	\$2,200 per child	Up to \$1,700	Begins at \$200K (single/HOH), \$400K (joint)
Other Dependent Credit (ODC)	\$500 per dependent	No (nonrefundable)	Begins at same thresholds as CTC

Adoption Credit:

Parameter	2025 Details
Max Credit	\$17,280 per child
Refundable Portion	Up to \$5,000 (new for 2025 via OBBBA)
Nonrefundable Portion	Remainder of credit; can carry forward five years
Phase-Out Begins (MAGI)	\$259,190
Phase-Out Ends (MAGI)	\$299,190

Individual Estimated Tax “Safe Harbor”: To avoid underpayment penalties, pay **100% of your 2024 tax** liability (or **110%** if 2024 AGI > \$150,000, or >\$75k MFS) **or at least 90% of your 2025 tax** by withholding/estimates.

Retirement & Savings Limits (2025)

Traditional IRA Contributions:

Age	Contribution Limit	Includes
Under 50	\$7,000	Standard annual limit
Age 50 and over	\$8,000	\$7,000 + \$1,000 catch-up

(Catch-up contributions for IRAs remain \$1,000 and will be indexed in future years; 2025’s catch-up is \$1,000.)

Deductible IRA Income Phase-Outs: If taxpayer (or spouse) is an active participant in an employer plan, the traditional IRA deduction is phased out based on MAGI:

Scenario	Fully Deductible if MAGI ≤	Partial Phase-Out	No Benefit If MAGI >
Traditional IRA (Single/HOH, covered)	\$79,000	\$79k – \$89k	\$89,000
Traditional IRA (MFJ, participant)	\$126,000	\$126k – \$146k	\$146,000
Traditional IRA (MFJ, non-participant)	\$236,000	\$236k – \$246k	\$246,000
Roth IRA (Single/HOH)	\$150,000	\$150k – \$165k	\$165,000
Roth IRA (MFJ)	\$236,000	\$236k – \$246k	\$246,000

**Annual Contribution Limit — Employer Plans:
401(k)/403(b)/457 Elective Deferrals**

Age Group	Employee Deferral	Catch-Up	Contribution Total (Max)
Under 50	\$23,500	—	\$23,500
Age 50–59 / 64+	\$23,500	\$7,500	\$31,000
Age 60–63	\$23,500	\$11,250	\$34,750

SIMPLE IRA Deferrals:

Age Group	Base Amount	Catch-Up Amount
Under 50	\$16,500	—
Age 50–59 / 64+	\$16,500	\$3,500
Age 60–63	\$16,500	\$5,250

Annual Addition Limit (Defined Contribution Plan §415(c)): \$70,000 total per participant (employee + employer contributions).

Annual Benefit Limit (Defined Benefit Plan §415(b)): \$280,000 of annual benefit can be funded (up from \$275k in 2024).

Compensation Cap for Plan Benefits (§401(a)(17)): \$350,000 – compensation above this cannot be counted for contributions/benefits (was \$345,000 in 2024).

“Highly Compensated Employee” Threshold (§414(q)): \$160,000 of prior-year compensation (up from \$155k) defines a highly compensated employee in 2025.

Health Accounts

Health Savings Accounts (2025):

Category	Self-Only	Family
HSA Contribution Limit	\$4,300	\$8,550
Age 55+ Catch-Up	+\$1,000	+\$1,000
Minimum HDHP Deductible	\$1,650	\$3,300
Max OOP (HDHP)	\$8,300	\$16,600

Archer Medical Savings Accounts (2025):

Coverage Type	Deductible Range	Out-of-Pocket Max
Self-Only	\$2,850 – \$4,300	\$5,700
Family	\$5,700 – \$8,550	\$10,500

Health FSAs (2025):

Feature	2025 Limit
Maximum Pre-Tax Contribution	\$3,300 per employee
Maximum Carryover to Next Year	\$660 , if plan allows

QSEHRA (Small Employer HRA) Limits (2025):

For employers offering QSEHRA to employees in 2025:

- **Self-only coverage:** maximum **\$6,350** per year (about \$529.16/month)
- **Family coverage:** maximum **\$12,800** per year (about \$1,066.66/month)

Estate & Gift Tax Amounts (2025)

Estate and Gift Tax Rate: 40% top rate (unchanged).

Basic Exclusion Amount (Estate/Gift Unified Exemption): \$13,990,000 per individual. A married couple can shield **\$27.98 million**. (This is the unified credit *equivalent exclusion*, made permanent by the 2025 Act. It had been scheduled to drop after 2025.)

Unified Credit (Tax Value): This \$13.99M exclusion corresponds to roughly **\$5.6 million** of tax offset per person (i.e. the estate/gift tax credit that eliminates tax on \$13.99M at 40%).

Annual Gift Tax Exclusion: \$19,000 per donee (increased from \$17k in 2023, \$18k in 2024). Thus, a married couple can gift \$38,000 per recipient in 2025 with no gift tax filing.

Annual Exclusion for Gifts to Non-U.S.-Citizen Spouse: \$190,000 in 2025.

GST Tax Exemption: \$13,990,000 (same as estate exclusion; GST tax rate also 40%).

Special-Use Real Estate Valuation (2032A): \$1,420,000 – maximum reduction in estate value for qualified farm/business real property electing 2032A use-valuation.

Estate Tax Installment Payment (Sec. 6166) 2% Amount: \$1,900,000 – the limit on the taxable estate value eligible for the special 2% interest rate on installment payments.

(Note: The estate/gift unified exclusion remains \$13.99M through 2025 and is indexed. Absent further law changes, it will revert to about ~\$7M in 2026.)

Social Security & Payroll Taxes

Social Security Wage Base (OASDI 12.4% tax):

Category	2025 Amount
Social Security Wage Base	\$176,100
OASDI Tax Rate	12.4% (6.2% + 6.2%)
Max OASDI Tax per Person	\$10,918.20
Medicare Tax	1.45% on all earnings (no cap)

Medicare 2.9% tax has *no* wage limit (all earnings are subject to Medicare). Combined FICA rate = **15.3%** on earnings up to \$176,100 (then 2.9% Medicare thereafter). *High earners* also owe the 0.9% additional Medicare tax on wages/SE income over \$250k (joint) / \$200k (single), as noted above.

Depreciation & §280F Auto Limits

Tax Year	With Bonus Depreciation	Without Bonus Depreciation
1st Year	\$20,200	\$12,200
2nd Year	\$19,600	\$19,600
3rd Year	\$11,800	\$11,800
Later Years	\$7,060	\$7,060

§280F Lease Inclusion Amounts (2025 leases): If a passenger automobile is leased in 2025, the taxpayer must include a small amount in income each year to partially offset the lease deduction (instead of depreciation limits). The IRS provides a table (Rev. Proc. 2025-16, Table 3) of inclusion amounts based on the vehicle's FMV. *(For example, a 2025 leased car with FMV ~\$60,000 has a first-year inclusion around \$10.)*

§179 Expensing (Tax Years *Beginning* in 2025):

Feature	2025 Limit / Details
§179 Max Deduction	\$2,500,000
Phase-Out Begins	\$4,000,000 in total asset purchases
Phase-Out Completion	Fully phased out at \$6,500,000 in purchase volume
Heavy SUV Cap (6–14k lb)	\$31,300

Bonus Depreciation:

100% bonus depreciation is available for property placed in service in 2025, effective **Jan. 20, 2025** with the signing of the 2025 Act.

Without this law change, the rate would have dropped to **40%** in 2025 under the TCJA schedule.

Standard Mileage Rates (2024–2025)

2024 vs 2025 Standard Mileage Rates

Category	2024 Rate	2025 Rate	Special Notes
Business Use	67¢ per mile (30¢ depreciation component)	70¢ per mile (33¢ depreciation component)	Standard mileage method allowed for ≤4 vehicles used simultaneously; if 5+ vehicles, must use actual expenses. Depreciation portion reduces basis and may be subject to recapture if switching methods or on sale.
Medical/Moving (active-duty military)	22¢ per mile	21¢ per mile	Moving expenses deductible only for active-duty military relocating under orders.
Charitable Service	14¢ per mile	14¢ per mile (unchanged, statutory)	Rate fixed by statute; not indexed for inflation.

Failure to File Partnership or S-Corp Return (Forms 1065/1120-S):

Tax Year (Return Filed)	Penalty per Partner/Shareholder, per Month (or part of a month)
2024 returns (due in 2025)	\$245
2025 returns (filed in 2026)	\$255

Example: A 10-partner partnership 2 months late incurs $\$255 \times 10 \times 2 = \$5,100$ penalty.

Failure to File Information Returns (e.g. Forms 1099)

Penalty per Form/Statement 2024 Returns (filed 2025) 2025 Returns (filed 2026)

Up to 30 days late	\$60	\$60
31 days late through Aug. 1	\$120	\$130
After Aug. 1 or not filed	\$310	\$330
Intentional disregard	\$630	\$660

Maximum Annual Penalties (per IRS §6721/§6722)

Penalty Tier	Small Businesses (< \$5M gross receipts)	Large Businesses (≥ \$5M gross receipts)
Up to 30 Days Late	\$1,366,000	\$4,098,500
31 Days Late to Aug. 1	— (<i>implicitly the same code</i>)	— (<i>implicitly the same code</i>)
After Aug. 1 or Not Filed	Same caps as above (<i>tier structure applies</i>)	Same caps as above (<i>tier structure applies</i>)

Failure to File Individual Tax Return (Form 1040): The usual penalty is **5% of the tax due** per month late (to max 25%). The **failure-to-pay** penalty is 0.5% per month. These can stack, so a return filed over 5 months late with unpaid tax can incur up to $25\% + 2.5\% = 27.5\%$ in penalties, plus interest.

199A Qualified Business Income Deduction (QBI) Thresholds (2025)

Filing Status	Threshold (Full Deduction)	Phase-In Range	SSTB Deduction Phase-Out
Married Filing Jointly	≤ \$394,600	\$394,600 – \$494,600 (range: \$100k)	Fully disallowed above \$494,600
Single / Other Filers	≤ \$197,300	\$197,300 – \$247,300 (range: \$50k)	Fully disallowed above \$247,300

Small Business Gross Receipts Test

Many tax provisions (interest deduction limits, UNICAP inventory rules, use of cash accounting, etc.) exempt “small” businesses under §448(c). For 2025, a business qualifies if average annual gross receipts for the prior 3 years ≤ **\$31,000,000**. (This threshold was \$29 million for 2024.) Businesses under this limit can use the cash method, avoid §163(j) interest caps, and are exempt from uniform capitalization rules, among other benefits.

SELECTED PROVISIONS SCHEDULED TO EXPIRE OR BE REDUCED

SELECTED FEDERAL INCOME TAX PROVISIONS SCHEDULED TO EXPIRE AFTER 2025 (According to Joint Committee on Taxation, [JCX-1-25](#), Jan. 9, 2025)

1. Modification of individual income tax rates (§1(j)). **Made permanent and modified by P.L. 119-21.**
2. Child tax credit: Increased credit amount, increased refundable amount, reduced earned income threshold, and modification of identification requirements (§24(h)). **Made permanent and modified by P.L. 119-21.**
3. Premium assistance credit enhancements (§§36B(b)(3)(A)(iii) and (c)(1)(E)). **EXPIRES.**
4. New markets tax credit (§45D(f)(1)). **Made permanent and modified by P.L. 119-21.**
5. Employer credit for paid family and medical leave (§45S(i)). **Made permanent and modified by P.L. 119-21.**
6. Work opportunity credit (§51(c)(4)). **EXPIRES.**
7. Increase in exemption amount and phaseout threshold of individual AMT (§55(d)(4)). **Made permanent and modified by P.L. 119-21.**
8. Rate on modified taxable income and treatment of credits in the calculation of base erosion minimum tax amount (§59A(b)(2)). **Modified by P.L. 119-21.**
9. Increase in standard deduction of individuals (§63(c)(7)). **Made permanent and modified by P.L. 119-21.**
10. Suspension of deduction for miscellaneous itemized deductions in excess of 2% of AGI (§67(g)). **Made permanent and modified by P.L. 119-21.**
11. Suspension of limitation on itemized deductions (Pease limitation) (§68(f)). **Made permanent and modified by P.L. 119-21.**
12. Exclusion from gross income of discharge of indebtedness on principal residence (§108(a)(1)(E)). **EXPIRES.**
13. Special rule for certain discharges of student loans (§108(f)(5)). **Made permanent and modified by P.L. 119-21.**
14. Exclusion for certain employer payments of student loans (§127(c)(1)(B)). **Made permanent and modified by P.L. 119-21.**
15. Suspension of exclusion for employer reimbursement of bicycle commuting (§132(f)(8)). **Made permanent by P.L. 119-21.**
16. Suspension of exclusion for moving expense reimbursement (§132(g)(2)) and deduction for moving expenses (§217(k)). **Made permanent and modified by P.L. 119-21.**
17. Suspension of deduction for personal exemptions (§151(d)(5)). **Made permanent and modified by P.L. 119-21.**
18. Limitation on deduction for qualified residence interest and suspension of deduction for home equity interest (sec. 163(h)(3)(F)). **Made permanent by P.L. 119-21.**

19. Limitation on deduction for State, local, etc., taxes (§164(b)(6)). **Made permanent and modified by P.L. 119-21.**
20. Modification of rules relating to computation of wagering losses (§164(b)(6)). **Made permanent and modified by P.L. 119-21.**
21. Personal casualty losses limited to losses from a Federally declared disaster (§165(h)(5)). **Made permanent and modified by P.L. 119-21.**
22. Seven-year recovery period for motorsports entertainment complexes (§§168(e)(3)(C)(ii) and (i)(15)(D)). **EXPIRES.**
23. Increase in percentage limitation on cash contributions to public charities (§170(b)(1)(G)). **Made permanent and modified by P.L. 119-21.**
24. Special expensing rules for certain film, television, and live theatrical productions (§181). **Modified by P.L. 119-21 but expires 12/31/2025.**
25. Qualified business income deduction (§199A(i)). **Made permanent and modified by P.L. 119-21.**
26. Deduction percentages for foreign-derived intangible income and global intangible low-taxed income (§250(a)(3)). **Modified by P.L. 119-21.**
27. Deductibility of employer *de minimis* meals and related eating facility, and meals for the convenience of the employer (§274(o)). **EXPIRES. Modified by P.L. 119-21**
28. ABLE accounts (§529A):
 - a. Contributions eligible for retirement saver's credit (§25B(d)(1)(D)). **Made permanent and modified by P.L. 119-21.**
 - b. Rollovers from qualified tuition programs permitted (§529(c)(3)(C)(i)(III)). **Made permanent by P.L. 119-21.**
 - c. Increase in contributions limit (§529A(b)(2)(B)). **Made permanent by P.L. 119-21.**
29. Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules (§954(c)(6)(C)). **Made permanent by P.L. 119-21.**
30. Empowerment zone tax incentives:
 - a. Designation of an empowerment zone and of additional empowerment zones (§1391(d)(1)(A)(i) and (h)(2)). **EXPIRES.**
 - b. Empowerment zone tax-exempt bonds (§§1394 and 1391(d)(1)(A)(i)). **EXPIRES.**
 - c. Empowerment zone employment credit (§§1396 and 1391(d)(1)(A)(i)). **EXPIRES.**
31. Increase in estate and gift tax exemption (§2010(c)(3)(C)). **Made permanent and modified by P.L. 119-21.**
32. Treatment of certain individuals performing services in the Sinai Peninsula of (Sec. 11026 of Public Law 115-97). **Made permanent and modified by P.L. 119-21.**

SELECTED FEDERAL INCOME TAX PROVISIONS SCHEDULED TO EXPIRE AFTER 2026
(According to Joint Committee on Taxation, [JCX-1-25](#), Jan. 9, 2025)

1. Elective deferrals and IRA contributions by certain individuals (§25B). **Made permanent and modified by P.L. 119-21.**
2. Credit for advanced manufacturing investment (§48D(e)). **Modified by P.L. 119-21 but expires for construction which begins after Dec. 31, 2026.**

3. Additional first-year depreciation with respect to qualified property (§§168(k)(2)(A)(iii) and 460(c)(6)(B)). **Made permanent and modified by P.L. 119-21.**
4. Election of additional depreciation for certain plants bearing fruits and nuts (§168(k)(5)(A)). **Made permanent and modified by P.L. 119-21.**
5. Election to invest capital gains in an opportunity zone (§1400Z-2(a)(2)(B)). **Made permanent and modified by P.L. 119-21.**

DISASTER RELIEF

WV-2025-04: [IRS announces tax relief for taxpayers impacted by severe storms, straight-line winds, flooding, landslides, and mudslides in West Virginia; various deadlines postponed to Feb 2, 2026](#)

The IRS announced tax relief for individuals and businesses in **Marion and Ohio counties, West Virginia**, impacted by **storms, flooding, landslides, and mudslides** that began **June 14, 2025**. Affected taxpayers now have until **Feb. 2, 2026** to file returns and make payments originally due during the disaster period. This includes **individual, business, and exempt organization returns, quarterly estimated tax payments, and payroll/excise filings**. Casualty losses can be claimed on either 2024 or 2025 returns, and penalty relief is available. The IRS will automatically apply relief, but those outside the area with relevant records must contact the IRS.

NM-2025-03: [IRS announces tax relief for taxpayers impacted by severe storms, flooding, and landslides in New Mexico; various deadlines postponed to Feb 2, 2026](#)

IRS Notice NM-2025-03 (issued **July 16, 2025**) grants tax relief to individuals and businesses in parts of **New Mexico**, specifically **Chaves, Lincoln, Otero, and Valencia counties**, which were affected by **severe storms, flooding, and landslides** beginning **June 23, 2025**. Affected taxpayers now have until **Feb. 2, 2026** to file various federal returns and make payments originally due during this period, including those for individuals, businesses, tax-exempt entities, and quarterly taxes. Filing extensions apply automatically; penalty relief and other assistance are available through IRS support for those outside the designated area.

TX-2025-04: [IRS announces tax relief for taxpayers impacted by severe storms, straight-line winds, and flooding in Texas; various deadlines postponed to Feb 2, 2026](#)

The IRS issued **Notice TX-2025-04** granting tax relief to taxpayers in designated Texas counties affected by **severe storms, straight-line winds, and flooding** beginning **July 2, 2025**. Affected individuals and businesses now have until **Feb. 2, 2026** to file federal returns and make payments originally due during this period, including quarterly estimated taxes, payroll and excise filings, and returns on extension. The relief is applied automatically for those in the covered area, with penalty relief available for late filings connected to the disaster.

MO-2025-01: [IRS provides tax relief for taxpayers impacted by severe storms, straight-line winds, tornadoes, and flooding in Missouri; various deadlines postponed to Nov. 3](#)

The IRS issued **Notice MO-2025-01** on **June 25, 2025**, offering tax relief to individuals and businesses in parts of **Missouri**, including the **City of St. Louis, Scott County, and St. Louis County**, among others, which were affected by **severe storms, straight-line winds, tornadoes, and flooding** beginning **May 16, 2025**. Affected taxpayers now have until **Nov. 3, 2025** to file various federal returns (individual, business, tax-exempt, estate/trust returns, etc.), make payments including estimated taxes, payroll/excise tax returns, and contributions to IRAs and HSAs originally due during the disaster period. Penalties on certain payroll and excise tax deposits within the affected window will be abated if paid by early June. The IRS automatically applies relief for those in designated areas, while taxpayers outside (but with relevant records in) these areas should contact the IRS to request relief.

MS-2025-01: [IRS announces tax relief for taxpayers impacted by severe storms, straight-line winds, tornadoes, and flooding in Mississippi; various deadlines postponed to Nov. 3](#)

The IRS issued **Notice MS-2025-01** on **June 11, 2025**, providing tax relief for individuals, businesses, and tax-exempt entities in select **Mississippi counties**, including Calhoun, Carroll, Covington, Davis, Grenada, Humphreys, Issaquena, Itawamba, Jefferson Davis, Lee, Leflore, Marion, Montgomery, Pike, Prentiss, Sharkey, Smith, Walthall, and Washington, which were affected by **severe storms, straight-line winds, tornadoes, and flooding** beginning **March 14, 2025**. Affected taxpayers now have until **Nov. 3, 2025** to file federal returns (including individual, business, corporate, fiduciary, payroll, excise, and tax-exempt forms) and make tax payments that were originally due during the disaster period. Additionally, the deadline extension applies to 2024 contributions to IRAs and HSAs, as well as estimated tax payments due April 15, June 16, and Sept. 15, 2025. Penalties on payroll and excise tax deposits due between March 14 and April 10, 2025, will be abated if the deposits were made by April 10. The relief is automatically applied for taxpayers in the covered areas; those outside with qualifying circumstances should contact IRS Special Services to request relief.

TX-2025-03: [IRS announces tax relief for taxpayers impacted by severe storms and flooding in Texas; various deadlines postponed to Nov. 3](#)

On **June 10, 2025**, the IRS issued **Notice TX-2025-03**, providing tax relief to individuals and businesses in parts of **Texas**, specifically **Cameron, Hidalgo, Starr, and Willacy counties**, which were affected by **severe storms and flooding** beginning **March 26, 2025**. Those eligible now have until **Nov. 3, 2025**, to file federal returns and make payments originally due during that period, including **individual income tax returns, 2024 IRA and Health Savings Account (HSA) contributions, estimated tax payments, quarterly payroll and excise filings, corporate and fiduciary returns, and tax-exempt organization filings**. Additionally, penalties on payroll and excise tax deposits due between March 26 and April 10, 2025, will be abated if received by April 10. The IRS will automatically apply this relief to those in covered areas; others who qualify but are outside should contact IRS Special Services to request it.

OK-2025-02: [IRS announces tax relief for taxpayers impacted by wildfires and straight-line winds in Oklahoma; various deadlines postponed to Nov.3](#)

On **June 9, 2025**, the IRS issued **Notice OK-2025-02**, granting tax relief to individuals, businesses, and tax-exempt entities in **Cleveland, Creek, Lincoln, Oklahoma, Pawnee, and Payne counties**, and any additional counties later added, affected by **wildfires and straight-line winds** beginning **March 14, 2025**. Affected taxpayers now have until **Nov. 3, 2025** to file federal returns (e.g., individual, business, partnership, corporate, fiduciary, and tax-exempt filings) and make payments originally due during the covered period, including **2024 IRA and HSA contributions, estimated tax payments, and quarterly payroll and excise tax filings**. Penalties on payroll and excise tax deposits due between March 14 and March 31 are waived if deposited by March 31. Relief is applied automatically for those in designated areas; eligible taxpayers outside these areas may request relief by contacting IRS Special Services.

MO-2025-02: [IRS announces tax relief for taxpayers impacted by severe storms, straight-line winds, tornadoes, and wildfires in Missouri; various deadlines postponed to Nov. 3](#)

On **June 9, 2025**, the IRS issued **Notice MO-2025-02**, granting tax relief to individuals, businesses, and tax-exempt entities in numerous Missouri counties, including **Bollinger, Butler, Callaway, Camden, Carter, Dunklin, Franklin, Howell, Iron, Jefferson, Madison, New Madrid, Oregon, Ozark, Perry, Phelps, Reynolds, Ripley, Scott, Shannon, St. Louis, Stoddard, Wayne, Webster, and Wright**, which were affected by **severe storms, straight-line winds, tornadoes, and wildfires** beginning **March 14, 2025**. Those in the designated areas now have until **Nov. 3, 2025** to file tax returns and make payments originally due during the relief period, which covers individual and business filings, 2024 IRA and HSA contributions, estimated tax payments due April 15, June 16, and Sept. 15, 2025, as well as quarterly payroll and excise tax deposits (with penalties abated for deposits due between March 14 and March 31, provided they're made by March 31). The relief is applied automatically for eligible taxpayers, while those outside the area but with ties to it may request assistance by contacting IRS Special Services.

VA-2025-03: [IRS announces tax relief for taxpayers impacted by severe winter storms and flooding in Virginia; various deadlines postponed to Nov. 3](#)

On **April 30, 2025**, the IRS issued **Notice VA-2025-03**, granting tax relief to individuals, businesses, and tax-exempt entities in numerous Virginia localities, such as Amelia, Appomattox, Bedford, Bland, Botetourt, the City of Bristol, and more, which were affected by **severe winter storms and flooding** that began on **Feb. 10, 2025**. Affected taxpayers now have until **Nov. 3, 2025** to file federal returns (including individual income, business, partnership, estate, fiduciary, tax-exempt, and payroll/excise filings), make 2024 IRA and HSA contributions, and submit estimated tax payments originally due during the relief period. Penalties on employment and excise tax deposits due between Feb. 10 and Feb. 25, 2025 will be abated if paid by Feb. 25. Relief is applied automatically for those in designated areas; others with ties to the area should contact IRS Special Services to request assistance.

NC-2025-01: [IRS further postpones various tax deadlines to Sept. 25 for North Carolina storm victims](#)

On **April 17, 2025**, the IRS issued **Notice NC-2025-01**, extending and consolidating tax relief for **North Carolina** taxpayers impacted by **Hurricane Helene**. Individuals, businesses, fiduciaries, and tax-exempt organizations located anywhere in North Carolina now have until **Sept. 25, 2025** to file federal returns (including 2023 returns filed with extensions, along with 2024 individual, corporate, and exempt-entity filings), contribute to IRAs and HSAs for 2024, submit quarterly estimated tax payments (including both 2024 and 2025 installments), and file payroll and excise tax returns originally due during the relief period from **Sept. 25, 2024 through Sept. 25, 2025**. The extension applies automatically to those with a North Carolina address of record; others with ties to the area, such as records located there, should call IRS Special Services.

TN-2025-02: [IRS announces tax relief for Tennessee storm victims; various deadlines postponed to Nov. 3](#)

On **April 14, 2025**, the IRS issued **Notice TN-2025-02**, granting tax relief to **all individuals and businesses throughout Tennessee** affected by **severe storms, straight-line winds, tornadoes, and flooding** beginning **April 2, 2025**. Eligible taxpayers now have until **Nov. 3, 2025** to file federal tax returns (including individual, business, fiduciary, tax-exempt, employment, and certain excise filings) and make payments originally due during the relief period, covering deadlines such as the April 15 individual return, 2024 IRA/HSA contributions, estimated payments (April 15, June 16, Sept 15), and calendar-year returns for corporations, fiduciaries, and tax-exempt organizations. Penalties on payroll and excise tax deposits due between April 2 and April 17 are waived so long as payment is made by April 17. The IRS automatically applies relief for those with an IRS address within Tennessee, while others with qualifying circumstances, such as those with records in the affected area, should contact IRS Special Services for assistance.

AR-2025-03: [IRS announces tax relief for Arkansas storm victims; various deadlines postponed to Nov. 3](#)

On **April 14, 2025**, the IRS issued **Notice AR-2025-03** — also published as **IR-2025-49** — granting comprehensive tax relief to all individuals, businesses, and tax-exempt entities across **all 75 counties of Arkansas** affected by **severe storms, tornadoes, and flooding** that began **April 2, 2025**. The IRS extended the due date for a wide range of federal filings and payments, such as individual income tax returns (normally due April 15), 2024 IRA and HSA contributions, estimated tax payments (due April 15, June 16, Sept. 15), payroll and excise tax returns (due April 30, July 31, Oct. 31), and calendar-year corporate, fiduciary, and tax-exempt organization returns (April 15 and May 15) to **Nov. 3, 2025**. Penalties on payroll and excise tax deposits owed between April 2 and April 17 will be waived if paid by April 17. Relief is automatically applied to taxpayers with an IRS address of record in Arkansas; those outside but with qualifying records in the state should contact IRS Special Services.

IR-2025-49: [IRS: All of Arkansas qualifies for disaster tax relief; various deadlines postponed to Nov. 3](#)

On **April 14, 2025**, the IRS issued **IR-2025-49**, confirming that **the entire state of Arkansas** — all **75 counties** — qualifies for federal tax relief following the **severe storms, tornadoes, and flooding** that began on **April 2, 2025**. Taxpayers, including individuals, businesses, fiduciaries, and tax-exempt organizations, now have until **Nov. 3, 2025** to file various tax returns (e.g., individual, corporate, fiduciary, payroll/excise, tax-exempt) and make payments originally due during the April 2 – Nov. 3 period. Additionally, 2024 IRA/HSA contributions and quarterly estimated tax payments (April 15, June 16, Sept. 15) are included in the extension. Penalties for payroll and excise tax deposits due between April 2 and April 17 will be abated if payments were made by April 17. Relief is applied automatically for Arkansas taxpayers based on IRS address records, though those outside the area or with special circumstances can contact IRS Special Services to request assistance.

IR-2025-47: [IRS: All of Tennessee qualifies for disaster tax relief; various deadlines postponed to Nov. 3](#)

On **April 14, 2025**, the IRS issued **IR-2025-47**, confirming that **the entire state of Tennessee** — all **95 counties** — qualifies for federal tax relief following severe storms, straight-line winds, tornadoes, and flooding that began on **April 2, 2025**. Taxpayers, including individuals, businesses, fiduciaries, and tax-exempt organizations, now have until **Nov. 3, 2025** to file various tax returns and make payments originally due between **April 2** and **Nov. 3**. This includes individual income tax filings, 2024 IRA and HSA contributions, estimated tax payments (April 15, June 16, Sept. 15), quarterly payroll and excise filings (April 30, July 31, Oct. 31), corporate, fiduciary, and tax-exempt organization returns. Penalties for payroll and excise tax deposits due between April 2 and April 17 will be waived if made by April 17. Relief is automatically applied based on IRS address records; those outside the area but with qualifying circumstances (such as records located in Tennessee) should contact IRS Special Services to request relief.

WV-2025-02: [IRS announces tax relief for West Virginia storm victims; various deadlines postponed to Nov. 3](#)

On **March 14, 2025**, the IRS issued **Notice WV-2025-02**, granting tax relief to individuals and businesses in parts of **West Virginia** affected by **severe storms, straight-line winds, flooding, landslides, and mudslides** beginning **Feb. 15, 2025**. Those in **Boone, Greenbrier, Lincoln, Logan, McDowell, Mercer, Mingo, Monroe, Raleigh, Summers, Wayne, and Wyoming** counties (and additional counties added later) now have until **Nov. 3, 2025** to file affected federal tax returns and make payments originally due during the relief period, including individual filings, IRA/HSA contributions for 2024, estimated payments, payroll/excise tax returns, partnership/S-corp returns, corporate/fiduciary returns, and tax-exempt organization filings. Penalties on payroll and excise tax deposits due between **Feb. 15 and March 3, 2025** are abated if deposits were made by **March 3**. Relief is

automatically applied for eligible taxpayers based on IRS address records; those outside these areas, or whose records are located there, should contact IRS Special Services to request relief.

IR-2025-34: [IRS: West Virginia storm victims qualify for tax relief; various deadlines postponed to Nov. 3](#)

On **March 14, 2025**, the IRS issued **IR-2025-34**, announcing tax relief for individuals, businesses, and tax-exempt entities in **parts of West Virginia** affected by **severe storms, straight-line winds, flooding, landslides, and mudslides** beginning **Feb. 15, 2025**. Taxpayers residing or operating in **Logan, McDowell, Mercer, Mingo, Wayne, and Wyoming** counties (with additional counties eligible as designated) now have until **Nov. 3, 2025** to file federal returns and make payments originally due during the relief window. The extension applies to individual income tax filings, 2024 IRA and HSA contributions, estimated tax installments (April 15, June 16, Sept. 15), payroll and excise tax returns (April 30, July 31, Oct. 31), partnership/S-corp returns, corporate/fiduciary filings, and tax-exempt organization returns. Furthermore, penalties for payroll and excise tax deposits due between Feb. 15 and March 3 are waived if paid by March 3. Relief is automatically applied via IRS address records, and affected individuals outside these areas with ties (e.g., records) should reach out to IRS Special Services.

KY-2025-02: [IRS announces tax relief for taxpayers impacted by severe storms, straight-line winds, flooding, and landslides in Kentucky; various deadlines postponed to Nov. 3](#)

On **Feb. 24, 2025**, the IRS issued **Notice KY-2025-02**, granting state-wide disaster tax relief in **Kentucky** for individuals, businesses, and tax-exempt entities affected by **severe storms, straight-line winds, flooding, and landslides** that began **Feb. 14, 2025**. Affected taxpayers now have until **Nov. 3, 2025** to file federal returns and make payments originally due between Feb. 14 and Nov. 3, including individual income tax, 2024 IRA and HSA contributions, estimated tax installments, payroll and excise filings, partnership/S corp, corporate/fiduciary, and tax-exempt organization returns. Penalties on payroll and excise tax deposits due between Feb. 14 and March 3 are waived if paid by March 3. Relief is applied automatically for those with Kentucky addresses on file; affected taxpayers outside the area should contact IRS Special Services to request assistance.

CA-2025-01: [IRS announces tax relief for taxpayers impacted by wildfires in California; various deadlines postponed to Oct. 15](#)

On **Jan. 10, 2025**, the IRS issued **Notice CA-2025-01** (also published as **IR-2025-10**), granting tax relief to individuals and businesses in parts of **Southern California**, notably **Los Angeles County**, impacted by **wildfires and straight-line winds** beginning **Jan. 7, 2025**. Affected taxpayers now have until **Oct. 15, 2025**, to file federal tax returns and make payments originally due during the postponement period, including individual income tax returns (normally due April 15), **2024 IRA and HSA contributions**, quarterly estimated tax payments, payroll and excise tax returns, partnership/S-corp filings, corporate/fiduciary filings, and tax-exempt organization returns. Penalties on payroll and excise tax deposits due between **Jan. 7 and Jan. 22, 2025**, are abated if paid by **Jan. 22**. The IRS will automatically apply relief for taxpayers with an IRS address of record in the designated disaster area; individuals outside but with relevant records in the area can request relief through the IRS disaster hotline.

IR-2025-10; [IRS: California wildfire victims qualify for tax relief; various deadlines postponed to Oct. 15](#)

On **Jan. 10, 2025**, the IRS issued **IR-2025-10**, confirming that taxpayers in **Los Angeles County**, and any additional counties later designated by FEMA, are eligible for tax relief due to **wildfires and straight-line winds** that began on **Jan. 7, 2025**. Filing and payment deadlines falling between **Jan. 7 and Oct. 15, 2025** are now extended through **Oct. 15, 2025**. This extension covers a wide range of obligations, including **individual income tax returns, 2024 IRA and HSA contributions, quarterly estimated tax payments, payroll and excise tax returns**, as well as **partnership/S-corp, corporate/fiduciary, and tax-exempt organization filings**. Penalty relief applies to payroll and excise tax deposits due between Jan. 7 and Jan. 22, if made by Jan. 22. The IRS applies this relief automatically for affected taxpayers, and those outside the designated area, but whose records or circumstances qualify, should contact the IRS to request relief

Claiming casualty losses. Taxpayers can claim casualty losses on their federal income tax return for either the year of loss (in this case, 2025) or the prior year (in this case, 2024). Taxpayers have up to six months after the due date of their income tax return (excluding extensions) for the year of the disaster to make this election. The loss is claimed on form 4684. Taxpayers must include the FEMA disaster declaration number (given above) on any return.

Practice Alert! Please see <https://www.irs.gov/newsroom/tax-relief-in-disaster-situations> for other areas provided disaster relief.

ONE BIG BEAUTIFUL BILL: TCJA EXTENSIONS

Extension and Enhancement of Reduced Rates

Removes the sunset clause: The original TCJA rates were set to expire after 2025. This section strikes the phrase “before Jan. 1, 2026,” effectively making the reduced rates permanent.

Updates the heading: The heading “2018 THROUGH 2025” is replaced with “BEGINNING AFTER 2017” to reflect the permanent nature of the changes.

Inflation adjustment clarification: The seven tax brackets (10% through 37%) introduced by TCJA are made permanent. All bracket thresholds will continue to be indexed for inflation. However, for tax years beginning after 2025, the base tax year for determining indexing for the 10% and 12% individual tax brackets and the 10% trust and estate tax bracket is 2016 instead of 2017.

Extension and Enhancement of Increased Standard Deduction

This provision makes permanent and enhances the increased standard deduction that was originally enacted under the 2017 Tax Cuts and Jobs Act (TCJA), which was set to expire after 2025.

Permanent Extension: The sunset clause that would have ended the increased standard deduction after 2025 is removed. The provision applies to taxable years beginning after Dec. 31, 2025.

Enhanced Deduction Amounts: **Beginning in 2025**, the standard deduction increases to \$15,750 for single filers (from \$15,000) and to \$31,500 for married joint filers (from \$30,000). Head of household filers see an increase from \$22,500 to \$23,625. These amounts are indexed for tax years beginning after 2025 for inflation after 2024.

Termination of Deduction for Personal Exemptions other Temporary Senior Deduction

Permanent Repeal of Personal Exemptions: The bill strikes the expiration date of the TCJA suspension, making the repeal of personal exemptions permanent for tax years beginning after 2025.

Temporary Senior Deduction Introduced: Personal exemptions remain repealed permanently (they do not return in 2026). **However, for 2025–2028, taxpayers aged 65 or older can claim a new \$6,000 standard deduction bonus** (on top of their regular standard deduction). This senior deduction phases out at 6% of MAGI above \$75,000 (singles) or \$150,000 (joint).

Note: seniors must file jointly to claim the deduction for both spouses, and the senior’s Social Security number must be on the return (failure to provide it is treated as a math error allowing IRS disallowance)

Extension and Enhancement of Increased Child Tax Credit

This section builds on the expanded Child Tax Credit (CTC) introduced in the 2017 Tax Cuts and Jobs Act (TCJA), making it more generous and permanent.

Permanent Extension: The Child Tax Credit expansion is made permanent (no expiration after 2025). In addition, both the \$500 “other dependent child” credit provisions and the \$400,000 and \$200,000 modified AGI phase-out thresholds are made permanent.

Increased Credit Amount: Raises the maximum credit from \$2,000 to \$2,200 per qualifying child under age 17 **for tax years beginning after 2024** and will be indexed for tax years beginning after 2025 for inflation after 2024.

Refundable Portion Adjustments: The refundable portion of the credit remains at \$1,700 for 2025 and will continue to be inflation-indexed going forward.

Social Security Number (SSN) Requirement: To claim the credit, the taxpayer must provide: Their own SSN (or one spouse’s SSN on a joint return), and The SSN of each qualifying child. The SSN must be issued by the due date of the return and must be valid for employment in the U.S.

Clerical Error Treatment: Failure to include the correct SSN is treated as a mathematical or clerical error, allowing the IRS to disallow the credit without a formal audit.

Effective Date: These changes apply to tax years beginning after Dec. 31, 2024

Extension and Enhancement of Increased Estate and Gift Tax Exemption Amounts

This provision permanently extends and significantly increases the exemption amounts for estate and gift taxes, which were temporarily raised under the 2017 Tax Cuts and Jobs Act (TCJA).

Increased Exemption Amount: The estate and gift tax basic exclusion amount (BEA) is **increased to \$15 million per person starting in 2026** (up from the roughly \$7 million that it would have been in 2026 absent this law). This change permanently preserves and boosts the higher exemption originally provided by TCJA. The \$15M amount will be indexed for inflation going forward, using 2025 as the new base year (instead of 2010).

Elimination of Sunset Clause: The provision removes the scheduled expiration of the increased exemption, making it permanent.

Effective Date: Applies to estates of decedents dying and gifts made after Dec. 31, 2025

Extension of Increased Alternative Minimum Tax Exemption Amounts and Modification of Phaseout Thresholds

The OBBB makes permanent and modifies the Alternative Minimum Tax (AMT) relief provisions originally enacted under the 2017 Tax Cuts and Jobs Act (TCJA), which were scheduled to expire after 2025.

Permanent Extension of Increased AMT Exemption: Removes the expiration date for the increased AMT exemption amounts, ensuring they remain in effect beyond 2025.

Modified Inflation Adjustments: Updates the inflation adjustment mechanism for AMT exemption amounts:

For the \$1,000,000 threshold (joint filers), inflation will now be calculated using calendar year 2025 as the base year.

For the \$109,400 (joint) and \$70,300 (single) exemption amounts, inflation will continue to be calculated using calendar year 2017 as the base year.

Phaseout Threshold Modifications: The AMTI threshold at which the AMT exemption begins to phase out for married taxpayers filing jointly and surviving spouses (\$1,252,700 for tax years beginning in 2025) is reduced to \$1,000,000 for tax years beginning in 2026 and adjusted annually in subsequent years for inflation after 2025. Phaseout thresholds for other taxpayers are not changed, and continue to be adjusted for inflation after 2017.

The Act also increases the phaseout rate for the AMT exemption from 25% to 50%, accelerating the reduction of the exemption for higher-income taxpayers.

Effective Date: These changes apply to taxable years beginning after Dec. 31, 2025

Extension and Modification of Limitation on Deduction for Qualified Residence Interest

This provision extends and modifies the rules governing the deduction for mortgage interest on qualified residence loans, originally limited under the 2017 Tax Cuts and Jobs Act (TCJA).

Permanent Extension: The \$750,000 cap on mortgage debt for interest deductions (from TCJA) is made permanent (no reversion to a \$1M cap)

Mortgage Insurance Premiums Treated as Interest: **For tax years beginning after 2025, mortgage insurance premiums (PMI)** are treated as deductible interest on a qualified residence loan. (The law removes the prior clause that disallowed PMI, effectively reinstating it as deductible after 2025.)

Scenario:

- **Taxpayer:** Married couple filing jointly
- **Home:** Purchased in 2026
- **Mortgage loan:** \$400,000
- **Annual mortgage interest paid (on acquisition debt):** \$14,000
- **Annual PMI premiums paid:** \$2,500
- **Adjusted Gross Income (AGI):** \$100,000

Treatment under the Updated Provision (Post-2025):

Under the provision, PMI premiums are permanently treated as qualified residence interest. This means:

- The \$2,500 of PMI is now deductible as mortgage interest (subject to income limitations, if any exist).
- The \$14,000 of mortgage interest remains fully deductible (subject to the \$750,000 acquisition debt cap).
-

Effective Date: These changes apply to taxable years beginning after Dec. 31, 2025

Extension and Modification of Limitation on Casualty Loss Deduction

The Act extends and modifies the limitation on the deduction for personal casualty losses, which had been significantly narrowed under the 2017 Tax Cuts and Jobs Act (TCJA).

Extension of TCJA Limitation: The TCJA had limited the casualty loss deduction to losses attributable to federally declared disasters. This limitation was originally set to expire after 2025. §70109 of the OBBB removes the expiration date, making the limitation permanent for tax years beginning after Dec. 31, 2025.

Additional Modifications: The Act also extends and expands the favorable tax treatment for personal casualty losses resulting from federally and state-declared disasters.

Extended Deduction Rules: The Act continues the application of the rules under §304(b) of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, which allowed taxpayers to deduct personal casualty losses without needing to itemize, without being subject to the 10% of AGI subtraction, and requiring a \$500 (rather than \$100) subtraction from each casualty loss. The OBBB extends these special provisions for “qualified disaster-related personal casualty losses” to include any area with a major disaster declared by the President under the Robert T. Stafford Disaster Relief and Emergency Assistance Act between Jan. 1, 2020, and Sept. 2, 2025, if the incident period begins on or after Dec. 28, 2019, and before Sept. 2, 2025.

Inclusion of State-Declared Disasters: The definition of a qualified disaster is expanded to include disasters declared by a state governor (or the Mayor of D.C.) and recognized by the Secretary of the Treasury as causing significant damage. This includes natural catastrophes such as hurricanes, tornadoes, earthquakes, wildfires, floods, and more.

Definition of “State”: For this purpose, “State” includes all U.S. states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands.

Effective Date: Applies to taxable years beginning after Dec. 31, 2025

Extension and Modification of Limitation on Deduction and Exclusion for Moving Expenses

OBBB makes the TCJA moving expense deduction suspension permanent after 2025, preserving the military exception **and adding an exception for intelligence community members.**

Extension of Limitation: The TCJA had suspended the deduction for moving expenses and the exclusion for employer-provided moving expense reimbursements for most taxpayers through 2025.

§70113 removes the expiration date, making the suspension permanent for tax years beginning after Dec. 31, 2025.

Military Exception Preserved: The exception for active duty members of the Armed Forces who move due to a military order remains intact.

Intelligence Community Members Qualify After 2025: The Act provides that the moving expense deduction or exclusion applies to employees and appointees of the U.S. intelligence community who relocate due to a change in assignment in tax years beginning after 2025.

Effective Date: These changes are effective for tax years beginning after Dec. 31, 2025

Permanent Renewal and Enhancement of Opportunity Zones

This provision permanently renews and significantly enhances the Opportunity Zone (OZ) program under §§1400Z-1 and 1400Z-2, expanding its reach, improving transparency, and introducing new incentives—particularly for rural development.

Permanent Decennial Designation Process: Establishes a recurring 10-year cycle for designating Opportunity Zones, beginning July 1, 2026 and every 10 years thereafter. Repeals the special designation rule for Puerto Rico effective Dec. 31, 2026.

Updated Eligibility Criteria: Redefines “low-income community” to include census tracts with:

- Median family income $\leq 70\%$ of state/metropolitan median, or
- Poverty rate $\geq 20\%$ and median income $\leq 125\%$ of state/metropolitan median

Eliminates the rule allowing contiguous tracts to qualify automatically.

Sunset Repeal and Basis Step-Up: Repeals the sunset on deferral elections, allowing indefinite deferral for reinvested capital gains.

For investments held:

- 5 years: 10% basis step-up (30% for rural OZ funds)
- 10 years: Basis equals fair market value at sale or after 30 years

Qualified Rural Opportunity Funds (QROFs): Introduces QROFs, which must hold $\geq 90\%$ of assets in rural OZ property. Rural areas are defined as areas outside cities/towns with $> 50,000$ people and adjacent urbanized areas.

Special Rules for Rural Improvements: Allows 50% of adjusted basis in existing rural structures to count toward substantial improvement tests.

Enhanced Reporting and Transparency: Requires annual IRS reporting by OZ funds and investors, including:

- Asset values, business types (NAICS), employment data, and investment locations
- Disclosure of investor-level data (e.g. acquisition/disposition dates and amounts)

Treasury must publish annual reports on OZ activity, including:

- Investment totals, job creation, housing units, and economic indicators
- Comparative data for census tracts over time (e.g. poverty, income, business starts)

Effective Dates: Most provisions apply to investments made after Dec. 31, 2026. Some reporting and structural changes take effect on July 4, 2025.

Scenario:

- **Investor:** Individual
- **Date of investment:** March 1, 2027
- **Capital gain realized:** \$500,000 from sale of stock

- **Capital gain reinvested into:** Qualified Rural Opportunity Fund (QROF) investing in a rural OZ housing project
- **Holding period:** Investor holds the investment for 10 years
- **OZ designation:** Extended permanently, next cycle begins July 1, 2026
- **Rural designation applies:** Yes (rural tract outside a metro area)

Application of new OZ Benefit:

Deferral of Capital Gain:

- The \$500,000 capital gain is **deferred indefinitely** (no sunset clause anymore).
- It will not be taxed until the earlier of:
 - The sale of the OZ investment, or
 - Dec. 31, 2032 (five years after the investment in the O Zone — the 2026 cliff is repealed)

Basis Step-Ups for Holding Period:

- **At 5 years:** 10% step-up in basis
 $\$500,000 \times 10\% = \mathbf{\$50,000 \text{ excluded}}$
- **At 10 years (QROF):** 100% of gain from OZ investment is excluded
 So, if the OZ investment grows from \$500,000 to \$900,000:
 - **\$400,000 gain is tax-free**
 - Only the **original deferred gain** (minus \$50,000 basis step-up) = \$450,000 would be taxed when recognized

Rural Boost:

- Because the investment is in a QROF:
 - **Step-up at 5 years is 30%**, not 10%
 $\$500,000 \times 30\% = \mathbf{\$150,000 \text{ excluded from deferred gain}}$
 - **Remaining deferred gain = \$350,000**, taxed when triggered

Expansion of Qualified Small Business Stock Gain Exclusion

This provision amends IRC §1202 to expand the capital gains exclusion for Qualified Small Business Stock (QSBS), reducing the holding period and increasing the exclusion percentage for stock acquired after the enactment date.

Phased Exclusion Based on Holding Period:

For stock acquired after Sept. 27, 2010 and on or before July 4, 2025, a 100% exclusion applies if the stock is held more than 5 years. No exclusion is allowed if not held more than five years. For QSBS **acquired after July 4, 2025**, the exclusion percentage is a graduated exclusion based on how long the stock is held.

- 3 years: 50% exclusion
- 4 years: 75% exclusion
- 5 years or more: 100% exclusion

Clarified Acquisition Date Rules: The “acquisition date” for purposes of §1202 is the first day the stock is held by the taxpayer, determined after applying §1223 (relating to holding periods in certain transfers).

Issuer’s Asset Limitation: Prior to the Act, the aggregate gross assets of the issuing corporation (cash and the adjusted basis of its assets) generally must not have exceeded \$50 million at any point before and immediately after the stock issuance (including amounts received in the issuance). The Act increases this gross asset limitation to \$75 million for stock issued after July 4, 2025.

Alternative Minimum Tax (AMT) Treatment: Gain from qualified small business stock acquired after Sept. 27, 2010, including stock acquired after July 4, 2025, is not subject to AMT.

Conforming Amendments: Updates various subsections of §1202 to reflect the new three-year minimum holding period and the phased exclusion structure.

Increased Per-Issuer Limitation: For QSBS acquired after July 4, 2025, the per-issuer gain exclusion cap is increased. Specifically, eligible gain from stock from any one issuer in any given tax year that a taxpayer may

exclude is limited to the greater of (i) the applicable dollar limit for the tax year, or (ii) 10 times the taxpayer's basis in the stock.

For this purpose, the applicable dollar limit for any tax year with respect to eligible gain from one or more dispositions of QSBS of a corporation by a taxpayer is:

- For stock acquired on or before July 4, 2025: \$10 million, reduced by the aggregate amount of eligible gain taken into account by the taxpayer under the gain exclusion rule for prior tax years and attributable to dispositions of stock issued by the corporation and acquired by the taxpayer before, on, or after July 4, 2025
- For stock acquired after July 4, 2025: \$15 million, reduced by the sum of:
 - The aggregate amount of eligible gain taken into account by the taxpayer under the gain exclusion rules for prior tax years and attributable to dispositions of stock issued by the corporation and acquired by the taxpayer before, on, or after July 4, 2025, plus
 - The aggregate amount of eligible gain taken into account by the taxpayer under the gain exclusion rules for prior tax years and attributable to dispositions of stock issued by the corporation and acquired by the taxpayer on or before July 4, 2025

For tax years beginning after 2026, the \$15 million per-issuer limit is adjusted for inflation.

Scenario:

- **Investor:** Jane
- **QSBS acquired:** Aug. 1, 2026 (after enactment date)
- **QSBS holding period:**
 - Sold 3 years later → Aug. 1, 2029
 - Sold 5 years later → Aug. 1, 2031
- **Gain on sale:** \$2,000,000
- **Jane meets all §1202 QSBS eligibility rules** (e.g., stock was issued by a C corporation with ≤ 75M in assets, held original issue, active business, etc.)
- **No prior QSBS sales** by Jane

New Exclusion Tiers:

For QSBS acquired **after the new law's enactment**, exclusion percentages are:

- **3 years:** 50% exclusion
- **4 years:** 75% exclusion
- **5+ years:** 100% exclusion

Outcome 1: Sale After 3 Years

- Holding period = 3 years
- Exclusion = 50%
- **Excludable gain = \$1,000,000**
- **Taxable gain = \$1,000,000**
 - Subject to 28% capital gain rate under §1202
 - Plus 3.8% Net Investment Income Tax (NIIT), if applicable
- **\$1,000,000 taxed**

Outcome 2: Sale After 5 Years

- Holding period = 5 years
- Exclusion = 100%
- **Excludable gain = \$2,000,000**
- **Taxable gain = \$0**

Jane pays **no federal tax** on the \$2,000,000 gain if held for at least five years.

Key Additions Under the New Law:

- **New phased-in exclusion levels** based on holding period
- **Per-issuer cap increase:** The \$10M lifetime or 10× basis cap is increased to 15M as adjusted for inflation.

- Effective Date: Applies to taxable years beginning after July 4, 2025

ONE BIG BEAUTIFUL BILL: INDIVIDUAL PROVISIONS

Termination of Miscellaneous Itemized Deductions Other than Educator Expenses

The Act makes permanent the suspension of miscellaneous itemized deductions, while preserving and expanding the deduction for educator expenses.

Permanent Termination of Miscellaneous Deductions: The temporary suspension of miscellaneous itemized deductions under TCJA (2018–2025) is made permanent by removing the expiration date from §67(g). This means deductions subject to the 2% adjusted gross income (AGI) floor, such as unreimbursed employee expenses, tax prep fees, and investment expenses, continue to be nondeductible after 2025.

Preservation and Expansion of Educator Expenses Deduction: The law explicitly allows teachers and certain other educators to deduct classroom and instructional expenses (including supplies for health/PE classes, and expenses of coaches or school administrators).

This educator expense deduction remains an above-the-line deduction and is not eliminated.

For 2025, the above-the-line deduction is limited to \$300.

The definition of “educator expenses” is expanded to include:

- Expenses incurred “as part of instructional activity” (not just “in the classroom”).
- Nonathletic supplies for health or physical education.
- Expenses of coaches and interscholastic sports administrators.

The Act provides that qualified educator expenses in excess of the above-the-line deduction limitation (e.g. \$300 for 2025) are deductible as an itemized deduction after 2025 if the educator itemizes deductions.

Effective Date: These changes apply to taxable years beginning **after Dec. 31, 2025**

Limitation on Tax Benefit of Itemized Deductions

After 2025, the Act reinstates and modifies a version of the Pease limitation, which reduces the value of itemized deductions for high-income taxpayers.

New Limitation Formula: A new overall limitation on itemized deductions is introduced (essentially a revived Pease limitation, but with a different formula). **For high-income taxpayers, allowable itemized deductions are reduced by 2/37 of the lesser of:** (1) the total itemized deductions, **or** (2) the amount by which the taxpayer’s **taxable income** (adding back itemized deductions) exceeds the income threshold for the 37% bracket. This effectively amounts to about a 5.4% reduction in itemized deductions for those in the top bracket. This new limitation applies **after** applying all other specific deduction limits, and notably it **does not apply to the Qualified Business Income deduction (§199A)**. (In other words, QBI deductions are unaffected by this itemized deduction haircut.)

Scenario:

- **Filing status:** Single
- **Taxable income before itemized deductions:** \$726,350
- **Itemized deductions claimed (before limitation):** \$60,000
- **Top 37% bracket threshold (for single filers in 2026):** \$626,350
- **QBI deduction (§199A):** \$0 (assume none, as it’s excluded from the limitation calculation)

New Pease-Like Limitation Rule:

The limitation reduces itemized deductions by **2/37** of the lesser of:

- The total itemized deductions, or
- The excess of taxable income over the 37% bracket threshold

Let's compute both:

- Total itemized deductions = **\$60,000**
- Excess income = \$726,350 - \$626,350 = \$100,000
- The excess of taxable income over the 37% bracket threshold

Take the **lesser** of the two: \$60,000 vs. \$100,000 = **\$60,000**

Now apply the haircut:

$$2/37 \times \$60,000 = \$3,243.24$$

Result:

- Original itemized deductions: \$60,000
- Limitation reduction: -\$3,243.24
- **Allowed itemized deductions:** \$56,756.76
- **Taxable income after deductions:** \$600,000 - \$56,756.76 = **\$543,243.24**

Summary:

This provision essentially reduces the value of itemized deductions by 5.4% ($2/37 = 5.41\%$) for high-income taxpayers. The result is that itemized deductions provide a benefit of 35% (instead of 37%). It's designed to limit the tax benefit without eliminating deductions outright, and it **does not apply to the §199A deduction**.

Effective Date: Applies to taxable years beginning after Dec. 31, 2025

Extension and Modification of Qualified Transportation Fringe Benefits

This section modifies and extends the tax treatment of employer-provided transportation benefits under Internal Revenue Code §132(f).

Under OBBB, employers' bicycle commuting reimbursements remain **taxable** as the law continues to exclude them from the "qualified transportation fringe" benefit exclusion. For qualified transportation fringe benefits other than bicycle commuting reimbursements, OBBB changes the base year for calculating inflation adjustments from 1998 to 1997.

Effective Date: These amendments apply to taxable years beginning **after Dec. 31, 2025**

Extension and Modification of Limitation on Wagering Losses

This section modifies the rules for deducting losses from wagering transactions, tightening the limitation and clarifying the scope of deductible expenses.

New Deduction Cap Introduced: The deduction for wagering losses is limited to 90% of the amount of such losses incurred during the taxable year.

Deduction Still Limited by Gains: As under prior law, the deduction is only allowed to the extent of gains from wagering transactions in the same taxable year.

Expanded Definition of Wagering Losses: The term "losses from wagering transactions" is clarified to include any deduction otherwise allowable under the tax code that is incurred in carrying on any wagering transaction. This codifies and expands the scope of what counts as a wagering-related deduction.

Scenario:

- **Filing status:** Single
- **Wagering winnings (from sports betting and slots):** \$50,000
- **Wagering losses (including travel and admission fees related to gambling):** \$60,000
- **Other deductions:** Assume none relevant here

Prior Law (pre-2026):

- Wagering losses were deductible **only to the extent of gains** under §165(d).
- So here, maximum deduction = \$50,000
- **Taxable gambling income = \$50,000 - \$50,000 = \$0**

New Law (post-2025):

- Still limits the deduction to the amount of winnings
- **AND** adds a **90% cap** on the *deduction itself*, even if losses exceed winnings.

So, two limits now apply:

1. Limit to amount of winnings = \$50,000
2. 90% cap on actual losses: $90\% \times \$60,000 = \mathbf{\$54,000}$

You can only deduct the **lesser** of these two: \$50,000 vs. \$54,000
⇒ **Deductible losses = \$50,000**

So in this case, **the new 90% rule doesn't change the result**, because the winnings cap already applies.

Now consider a second example:

- **Wagering winnings:** \$50,000
- **Wagering losses:** \$52,000
-

Under prior law: Deduct up to \$50,000 ⇒ Net taxable gambling income = \$0

Under new law:

- 90% of losses = $90\% \times \$52,000 = \mathbf{\$46,800}$
- Still limited to amount of winnings: \$50,000

So, under the new rule, **only \$46,800** is deductible
⇒ **Net taxable gambling income = \$3,200**

Effective Date: These changes apply to taxable years beginning **after Dec. 31, 2025**

Extension and Enhancement of Increased Limitation on Contributions to ABLE Accounts

This provision extends and enhances the increased contribution limits for ABLE (Achieving a Better Life Experience) accounts, which are tax-advantaged savings accounts for individuals with disabilities.

Extension of Increased Contribution Limit: The provision removes the expiration date (previously Jan. 1, 2026) for the increased contribution limit for employed individuals with disabilities, making it permanent. This allows eligible individuals to continue contributing above the standard annual gift tax exclusion amount.

Modified Inflation Adjustment: The inflation adjustment for the contribution limit is updated by substituting 1996 for 1997 as the base year in the calculation under §2503(b), which governs the annual gift tax exclusion.

Effective Date: These changes apply to contributions made **after Dec. 31, 2025**

Extension and Enhancement of Saver's Credit Allowed for ABLE Contributions

The Act expands and **permanently extends** the Saver's Credit to tax years beginning after 2025 for contributions to Achieving a Better Life Experience (ABLE) accounts — tax-advantaged savings accounts for individuals with disabilities.

Definition of Qualified Contributions: The term “qualified retirement savings contributions” includes: Contributions made by an eligible individual to their own ABLÉ account.

For tax years beginning before 2027, it also includes:

- Traditional retirement contributions (e.g., IRA contributions)
- Elective deferrals to 401(k), 403(b), and 457(b) plans
- Voluntary employee contributions to qualified retirement plans

Therefore, for tax years beginning after 2026, contributions eligible for the saver’s credit are limited to ABLÉ account contributions made during the tax year by the designated beneficiary.

Increased Credit Amount: The maximum credit amount is increased from \$2,000 to \$2,100, effective for **tax years beginning after Dec. 31, 2026**.

Repeal of SECURE 2.0 Coordination Rule: A provision from the SECURE 2.0 Act of 2022 that limited this coordination is repealed, restoring broader eligibility for ABLÉ-related Saver’s Credit benefits.

Extension of Rollovers from Qualified Tuition Programs to ABLÉ Accounts Permitted

This provision makes permanent the ability to roll over funds from a 529 qualified tuition program (commonly known as a 529 plan) into an ABLÉ account (Achieving a Better Life Experience account), which is designed to support individuals with disabilities.

Elimination of Expiration Date: The bill strikes the phrase “before Jan. 1, 2026” from §529(c)(3)(C)(i)(III) of the Internal Revenue Code. This effectively removes the sunset clause, making the rollover provision permanent.

This provision **permanently allows tax-free rollovers from 529 college savings plans to ABLÉ accounts** (within annual contribution limits). (Prior law permitted such rollovers only through the end of 2025, but the bill deletes that deadline.)

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Extension of Treatment of Certain Individuals Performing Services in the Sinai Peninsula and Enhancement to include Additional Areas

This section expands and makes permanent the tax benefits for U.S. Armed Forces personnel serving in designated hazardous duty areas.

Permanent Extension of Sinai Peninsula Treatment: The temporary tax exclusion for military personnel serving in the Sinai Peninsula is made permanent by removing the reference to a limited “applicable period” in prior law.

Expansion to Additional Countries: The definition of “qualified hazardous duty area” is expanded to include:

- Kenya
- Mali
- Burkina Faso
- Chad

These areas qualify only during periods when U.S. Armed Forces members are entitled to special pay for hostile fire or imminent danger under Title 37 of the U.S. Code.

Conforming Amendments: Subsections (c) and (d) of the original law (§11026 of Public Law 115–97) are repealed to align with the new permanent and expanded scope.

Effective Date: These changes take effect on **Jan. 1, 2026**

Extension and Modification of Exclusion from Gross Income of Student Loans Discharged on Account of Death or Disability

This provision makes permanent the exclusion from gross income for student loans discharged due to death or total and permanent disability.

Permanent Exclusion from Gross Income: Gross income will not include any amount discharged from a student loan if the discharge is due to:

- Death of the borrower, or
- Total and permanent disability of the borrower.

Eligible Loans: Applies to both:

- Student loans (as defined in §108(f)(2)) which includes loans made by the United States (or an instrumentality or agency of the United States); a state, territory, or possession of the United States (or political subdivision); certain tax-exempt public benefit corporations; or an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation or under a program designed to encourage students to serve in occupations or areas with unmet needs; and
- Private education loans (as defined in §140(a) of the Consumer Credit Protection Act).

Other Exclusions For Discharge Of Student Loans Under §108(f)(5) Not Extended: The exclusion from income of discharged qualified student loans in §108(f)(5) after 2020 and before 2026 was expanded to include the discharge of student loan or private education loan indebtedness. The temporary expanded exclusion covered discharged debt regardless of whether the discharge occurred due to a student's death or disability and was available to a broader category of loans. This provision was not extended beyond 2025.

Social Security Number Requirement: To qualify for the exclusion, the taxpayer must include their Social Security number on the tax return for the year in which the discharge occurs.

Clerical Error Treatment: If the Social Security number is omitted, the IRS may treat it as a mathematical or clerical error, allowing for correction without a formal audit.

Effective Date: Applies to discharges occurring **after Dec. 31, 2025**

Limitation on Individual Deductions for Certain State and Local Taxes, Etc.

This section modifies and extends the limitation on the deduction for state and local taxes (SALT) paid by individuals.

Extension of the SALT Cap: The previous \$10,000 cap (or \$5,000 for married individuals filing separately) is replaced with a new "applicable limitation amount" structure beginning in 2025.

New Deduction Limits by Year:

- **2025:** \$40,000 MFJ/Single (\$20,000 if married filing separately)
- **2026:** \$40,400 MFJ/Single - (\$20,200 if married filing separately)
- **2027–2029:** Indexed annually at 101% of the prior year's amount
- **2030 and beyond:** Reverts to \$10,000 (\$5,000 if married filing separately)

Income-Based Phaseout: For tax years before 2030, the deduction is reduced by 30% of the excess of the taxpayer's modified adjusted gross income (MAGI) over a threshold amount:

- 2025: \$500,000 (\$250,000)
- 2026: \$505,000 (\$252,500)
- 2027 and beyond: Indexed at 101% annually

The deduction cannot be reduced below \$10,000, even after phaseout.

The SALT limitation will be \$10,000 if taxpayer's MAGI is more than:

- For 2025: \$600,000 (\$300,000 if married filing separately)
- For 2026: \$606,333 (\$303,167 if married filing separately)

MAGI Definition: MAGI includes adjusted gross income plus any income excluded under §§911, 931, or 933 (e.g., foreign earned income exclusions).

Scenario (Tax Year 2026):

- **Filing status:** Married filing jointly
- **Modified Adjusted Gross Income (MAGI):** \$600,000
- **State and local taxes paid:** \$50,000

Key thresholds for 2026:

- **Applicable limitation amount:** \$40,400
- **Phaseout threshold (MAGI):** \$505,000
- **Phaseout rate:** 30% of MAGI above threshold
- **Minimum deduction floor:** \$10,000

Step 1: Compute phaseout amount

MAGI over threshold = \$600,000 - \$505,000 = **\$95,000**
 Phaseout amount = 30% × \$95,000 = **\$28,500**

Step 2: Apply phaseout to SALT deduction

Base deduction = **\$40,400**
 Phaseout reduction = **\$28,500**
 Remaining deduction = \$40,400 - \$28,500 = **\$11,900**

Now consider a higher-income scenario:

- **MAGI:** \$900,000
- **Excess over threshold:** \$900,000 - \$505,000 = **\$395,000**
- **Phaseout reduction:** 30% × \$395,000 = **\$118,500**

SALT deduction allowed = \$40,400 - \$118,500 = **negative** → **capped at \$10,000**. Since the law does not allow the deduction to drop below \$10,000, the taxpayer still gets \$10,000.

So this taxpayer would be **limited to a \$10,000 SALT deduction**, no matter how much SALT tax they actually paid.

Effective Date: Applies to **taxable years beginning after Dec. 31, 2024**

No Tax on Tips

This provision creates a new deduction for tax years **2025 through 2028** for individuals who receive qualified tips, effectively excluding a portion of those tips from taxable income.

New Deduction for Tips: New §224 allows a deduction of up to \$25,000 of qualified tip income (2025–2028), which can be claimed on top of the standard deduction. This effectively excludes those tips from taxable income (like the QBI deduction), even for non-itemizer. The deduction is available to both employees and non-employees (e.g., independent contractors) who receive tips in eligible occupations.

Annual Cap and Income Phaseout: The deduction is capped at **\$25,000 per year**. It is reduced by \$100 for every \$1,000 of modified adjusted gross income (MAGI) above:

- \$300,000 for joint filers.

- \$150,000 for others.
- The deduction for tips phases out completely when the taxpayer's MAGI reaches \$400,000 (\$550,000 for those filing a joint return)

Definition of Qualified Tips: Must be cash tips (includes tips paid in cash or charged) received in an occupation that customarily and regularly received tips on or before Dec. 31, 2024. Must be voluntary, not negotiated, and determined by the payor. Cannot be received in a specified service trade or business (as defined in §199A). The Act provides that an individual receiving tips in the trade or business of performing services as an employee, shall be treated as receiving tips in the course of a trade or business which is a specified service trade or business if the trade or business of the employer is a specified service trade or business.

Qualified tips received in the course of a nonemployee individual's trade or business are deductible only to the extent that gross receipts are greater than allocable deductions.

Note! The IRS is required to publish a list of occupations that customarily receive tips not later than 90 days after July 4, 2025.

Married Taxpayers Must File Joint Return: The Act provides that married taxpayers must file a joint return to claim the deduction.

Not Required to Itemize to Take Deduction: The deduction is available to non-itemizers. Therefore, a deduction for qualified tips can be claimed in addition to the standard deduction.

Reporting and Compliance: Tips must be reported on official IRS forms (e.g., Form 4137). A Social Security number must be included on the taxpayer's return to claim the deduction. Married taxpayers must file a joint return to claim the deduction.

Extension of Tip Credit to Beauty Services: The existing employer tip credit (§45B) is expanded to include tips received in:

- Barbering and hair care
- Nail care
- Esthetics
- Body and spa treatments

Withholding and Reporting Adjustments: Employers and third-party settlement organizations must separately report designated cash tips and the recipient's occupation. IRS withholding tables will be updated to reflect the new deduction.

Scenario (Tax Year 2026):

- **Filer:** Single
- **Occupation:** Waiter in a restaurant (customarily tipped occupation)
- **Total income:**
 - **Wages:** \$35,000
 - **Cash tips (properly reported):** \$20,000
- **Modified Adjusted Gross Income (MAGI):** \$155,000
- **Social Security number:** Provided
- **Tips meet requirements:** Cash, voluntary, and not from a specified service trade/business

Step 1: Determine Deductible Tips

- The law allows a **deduction of up to \$25,000 in qualified tips**
- Deduction **phases out by \$100** for every \$1,000 (or portion thereof) that MAGI exceeds **\$150,000**

MAGI over threshold:

\$155,000 - \$150,000 = \$5,000

Phaseout:

\$5,000 ÷ \$1,000 = 5 × \$100 = **\$500 phaseout**

Eligible deduction = \$20,000 – \$500 = \$19,500

Step 2: Deduct Tips

- Taxpayer gets a **deduction of \$19,500**
- The deduction is available in addition to the standard deduction where the taxpayer does not itemize.

Effective Date and Sunset: Applies to tax years beginning after Dec. 31, 2024. The deduction expires after 2028, unless extended by future legislation.

No Tax on Overtime

This provision introduces a new deduction for certain overtime wages, effectively exempting a portion of overtime pay from federal income tax for 2025 through 2028.

New Deduction for Overtime Pay: A new §225 of the Internal Revenue Code allows individuals to deduct “qualified overtime compensation”. The deduction is available to non-itemizers. Therefore, a deduction can be claimed in addition to the standard deduction.

Definition of Qualified Overtime Compensation: Refers to overtime pay required under §7 of the Fair Labor Standards Act of 1938 that is in excess of the regular hourly rate and is included on statements furnished to the individual pursuant to §6041(d)(4) or 6051(a)(19). Qualified overtime compensation does not include qualified tips under §224(d), even if earned during overtime hours.

Deduction Limits:

- \$25,000 for joint filers
- \$12,500 for others

Income-Based Phaseout: Deduction is reduced by \$100 for every \$1,000 of modified adjusted gross income (MAGI) above:

- \$300,000 for joint filers
- \$150,000 for others
- **Note!** The allowable qualified overtime pay deduction phases out completely when the taxpayer’s MAGI for the year reaches \$275,000 (\$550,000 for joint filers)

Eligibility Requirements: Taxpayers must include their Social Security number on the return. Married individuals must file jointly to claim the deduction.

Reporting Requirements: Employers must report qualified overtime compensation on Form W-2 (Box 19). Non-employees must receive similar reporting under Form 1099 rules.

Withholding Adjustments: IRS is directed to update withholding tables to reflect the new deduction.

Sunset Clause: The deduction expires after 2028, unless extended by future legislation

Scenario (Tax Year 2026):

- **Filing status:** Married filing jointly
- **Regular wages:** \$90,000
- **Overtime pay (§7 FLSA-compliant):** \$20,000
- **Total MAGI:** \$310,000
- **Social Security number:** Included on return
- **Joint return filed:** Yes

Step 1: Apply Overtime Deduction Limits

- Maximum deduction for overtime: **\$25,000** for joint filers
- Phaseout starts at \$300,000 MAGI and reduces **\$100 for every \$1,000 over the threshold**

MAGI over threshold:

$\$310,000 - \$300,000 = \$10,000$

Phaseout amount:

$\$10,000 \div \$1,000 = 10 \times \$100 = \$1,000$

Step 2: Calculate Final Deduction

- Base deduction: \$20,000 (overtime received, within limit)
- Phaseout: \$1,000
- **Allowed deduction = \$19,000**

Step 3: Apply to Tax Return

- The taxpayer gets a **\$19,000** deduction. The deduction is available in addition to the standard deduction even where the taxpayer does not itemize.
- This provides meaningful savings even for high earners

No Tax on Car Loan Interest

This provision creates a temporary deduction for interest paid on certain personal-use car loans, effectively excluding that interest from taxable income for eligible taxpayers.

Deduction Period: Applies to tax years beginning **after Dec. 31, 2024, and before Jan. 1, 2029**

Qualified Interest: The deduction applies to interest paid or accrued on loans used to purchase a new personal-use vehicle. The loan must be secured by a first lien on the vehicle.

Vehicle Requirements:

- Must be a new vehicle (original use begins with the taxpayer).
- Must be manufactured primarily for use on public roads and have at least 2 wheels.
- Includes cars, vans, minivans, SUVs, pickup trucks, motorcycles.
- Final assembly must be in the United States.
- Gross vehicle weight rating (GVWR) must be less than 14,000 pounds.

Exclusions: No deduction for interest on loans to finance:

- Fleet sales
- Commercial vehicles
- Leased vehicles
- Salvage title vehicles
- Vehicles intended for scrap or parts

VIN Reporting Requirement: Taxpayer must report the Vehicle Identification Number (VIN) on their tax return to claim the deduction.

Deduction Limits: Maximum deduction: \$10,000 per year.

Income phaseout: Begins at \$200,000 MAGI for joint filers and \$100,000 MAGI for others, and deduction is reduced by \$200 for every \$1,000 (or portion thereof) over the threshold.

The deduction is completely phased out for joint filers when MAGI is \$250,000 or greater for joint filers or \$150,000 or more for others.

Refinancing Allowed: Interest on the refinancing of a qualified loan may qualify for the interest deduction to the extent of the balance on the original loan on the date of the refinancing.

Non-Itemizer Eligibility: The deduction is available even if the taxpayer does not itemize.

Reporting Requirements for Lenders: Any person that, in the course of its trade or business, receives from any individual interest aggregating \$600 or more for any calendar year on a specified passenger vehicle loan, must make a return with respect to each individual from whom the interest was received. The lender must report borrower details, loan terms, and vehicle information.

Penalties and Compliance: Penalties apply for failure to file required information returns or furnish statements to borrowers.

Trump Accounts and Contribution Pilot Program

This provision establishes a new tax-advantaged savings vehicle called the Trump Account, along with a pilot contribution program aimed at children born between 2025 and 2028.

1. Trump Accounts (§530A)

Definition and Structure: A Trump Account is an individual retirement account (IRA) under §408(a) subject to special requirements. The account may only be created for individuals under age 18. These accounts are eligible to receive contributions from parents, relatives, employers, and other taxable entities as well as non-profit and government entities.

Accounts can be: Created by the Secretary of the Treasury or established by others on behalf of eligible children.

Eligibility: Individuals under age 18 who are U.S. citizens with a valid Social Security number.

Contribution Limitations: Contributions are generally limited to \$5,000 per year (indexed for inflation after 2027) and are not deductible. No contributions are allowed before July 4, 2026.

Investment Restrictions: Funds must be invested in low-cost mutual or exchange-traded funds tracking broad U.S. equity indexes (e.g., S&P 500). No leverage or sector-specific indexes allowed.

Distributions: Generally prohibited before the beneficiary turns 18. Special rules apply for rollovers to ABLE accounts at age 17 or upon death.

Reporting: Trustees must report contributions, distributions, and account values. Contributions over \$25 from third parties must be disclosed.

2. Pilot Program (§6434)

\$1,000 Federal Contribution: Parents of eligible children can elect to receive a \$1,000 refundable credit deposited into the child's Trump Account.

Applies to children: Born between Jan. 1, 2025, and Dec. 31, 2028, Who are U.S. citizens, and for whom no prior election has been made.

Election Requirements: Must include the child's Social Security number. Election is made in a manner prescribed by the Secretary.

Protection from Offsets: The \$1,000 payment is not subject to offset for past-due taxes or debts.

3. Employer Contributions (§128)

Employers may contribute up to \$2,500 per year to Trump Accounts of employees or their dependents. Contributions are excluded from gross income and are indexed for inflation after 2027.

4. General Contributions (§139J)

Contributions from qualified entities (e.g., 501(c)(3) organizations or tribal governments) to Trump Accounts are excluded from gross income.

5. Penalties for Improper Claims (§6659)

The Act provides penalties for individuals who elect the \$1,000 Pilot Program credit for an individual who is not an eligible child of the taxpayer. The penalties are \$500 for negligent claims and \$1,000 for fraudulent claims.

Enhancement of Adoption Credit

Beginning in 2025, this provision strengthens the federal adoption tax credit by making part of it refundable and updating how it is adjusted for inflation.

Partial Refundability: Up to \$5,000 of the adoption credit is now refundable, meaning eligible taxpayers can receive that portion even if they owe no federal income tax.

Inflation Adjustments: The credit amount and income phaseout thresholds will be adjusted for inflation using a revised base year:

For most amounts, calendar year 2001 is used as the base.

For the refundable portion, calendar year 2024 is used.

Technical Clarification: The refundable portion of the credit may not be carried forward. The refundable portion is treated as a credit under subpart C of the tax code, not subpart A, which affects how it interacts with other credits and carryforward rules.

Effective Date: These changes apply to taxable years beginning **after Dec. 31, 2024**

Recognizing Indian Tribal Governments for Purposes of Determining whether a Child has Special Needs for Purposes of the Adoption Credit

Effective after 2024, this provision amends the Internal Revenue Code to allow Indian tribal governments to determine whether a child has special needs for purposes of qualifying for the federal adoption tax credit.

Expanded Authority: §23(d)(3) is amended to treat determinations made by an Indian tribal government as equivalent to those made by a State when assessing whether a child has special needs for adoption credit purposes.

This change means that for adoptions finalized under the authority of tribal courts or agencies, a tribal government's declaration that a child has special needs will allow the adoptive parents to claim the adoption credit's special-needs benefits (such as the full credit regardless of expenses), just as a state's determination would.

Effective Date: These changes apply to taxable years beginning **after Dec. 31, 2024**

Enhancement of the Dependent Care Assistance Program

After 2025, this provision increases the maximum amount that can be excluded from an employee's income under an employer-provided Dependent Care Assistance Program (DCAP).

Increased Exclusion Limit: The annual exclusion for dependent care benefits is increased from \$5,000 to \$7,500 for most taxpayers.

For married individuals filing separately, the limit increases from \$2,500 to \$3,750.

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Enhancement of Child and Dependent Care Tax Credit

After 2025, this section significantly expands the Child and Dependent Care Tax Credit (CDCTC) by increasing the credit rate and adjusting the income thresholds for phaseout.

Increased Applicable Percentage: The maximum credit rate is increased from 35% to 50% of qualifying expenses.

Two-Tiered Phaseout Structure: The credit rate is reduced:

From 50% to 35%: Reduced by 1 percentage point for every \$2,000 (or fraction thereof) of AGI over \$15,000. The credit rate drops to 35% by AGI \$43,000, and for AGI over \$75,000 (or \$150,000 joint) it phases down again (1% per \$2,000/\$4,000) but not below 20%.

From 35% to 20%: Further reduced by 1 percentage point for every \$2,000 (or \$4,000 for joint filers) of AGI over \$75,000 (or \$150,000 for joint filers). The credit percentage is 35% from \$43,001 to \$75,001 (150,001 if married filing jointly). After 2025, the maximum credit percentage is reduced to 20% for taxpayers with AGI greater than \$103,000 (greater than \$206,000 if married filing jointly).

Minimum Credit Rate: The credit cannot be reduced below 20%, ensuring a baseline benefit for higher-income families.

Maximum Qualifying Expenses: The credit continues to be calculated by multiplying the amount of qualifying expenses: a maximum of \$3,000 if the taxpayer has one qualifying individual, and up to \$6,000 if the taxpayer has two or more qualifying individuals, by the appropriate credit rate.

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Tax Credit for Contributions of Individuals to Scholarship Granting Organizations

After 2026, a new nonrefundable tax credit is created to encourage charitable donations to **Scholarship Granting Organizations (SGOs)** that fund K-12 education scholarships. Key points:

- **Credit Amount:** 100% of the donation, up to a maximum credit of **\$1,700 per year**. (If the donor also receives a state tax credit for the contribution, the federal credit is reduced accordingly.)
- **Eligible Donations:** Must be cash contributions to a qualifying SGO in the donor's state, which provides scholarships for elementary or secondary school students (K-12). The donation must be made by a U.S. citizen or resident individual.
- **Student Eligibility:** Scholarships must go to students from families with income \leq 300% of area median income, and the students must be school age (able to attend public school).
- **Qualified Expenses:** Scholarships can cover expenses defined in IRC §530(b)(3)(A) (tuition, books, supplies, etc., for K-12).
- **SGO Requirements:** The SGO must be a 501(c)(3) public charity (not a private foundation) that spends at least 90% of its revenue on scholarships, serves a broad base of students (\geq 10 students at different schools), prioritizes existing scholarship students and siblings, does not allow donors to earmark for specific individuals, and verifies beneficiaries' income eligibility annually. SGOs must maintain separate accounts for qualified contributions. *Anti-abuse:* SGOs cannot award scholarships to a donor's child or relative (using private foundation disqualified person rules).
- **No Double Benefit:** Donations claimed for this credit cannot also be claimed as a charitable deduction.
- **Credit Carryforward:** Unused credit can carry forward up to five years.
- **State Opt-In:** This program applies only in states that opt in by providing a list of eligible SGOs to the IRS each year.
- **Scholarship Tax-Free:** Scholarships a student receives from an SGO under this program are non-taxable to the family (excluded from gross income by new §139K).
- **Recommendation:** Emphasize to clients that this credit effectively gives a federal tax benefit for supporting school choice programs, but it's capped at \$1,700 and depends on your state's participation. Also note that if they take the credit, they cannot deduct the donation — it's one or the other.

Effective Date: Applies to tax years ending **after Dec. 31, 2026**

Exclusion for Employer Payments of Student Loans

This exclusion was to expire after 2025. The Act makes the provision permanent and indexes the \$5,250 exclusion limitation after 2026.

Tax-Free Benefit: Employer payments made toward an employee's qualified student loans, whether paid directly to the lender or reimbursed to the employee, are excluded from the employee's gross income.

Exclusion Limit: The exclusion applies to payments made under an educational assistance program, up to a maximum of \$5,250 per year. This amount is consistent with the existing limit for educational assistance benefits under IRC §127.

Eligible Loans: Applies to principal and interest payments on qualified education loans, as defined under IRC §221(d)(1), which includes loans taken out solely to pay qualified higher education expenses.

Inflation Adjustment: The \$5,250 exclusion is adjusted for inflation for tax years beginning after 2026.

Effective Date: Applies to payments made **after Dec. 31, 2025**.

Additional Expenses Treated as Qualified Higher Education Expenses for Purposes of 529 Accounts

This provision expands the definition of “qualified higher education expenses” under §529 to include a broader range of educational costs, particularly for elementary and secondary education.

Expanded Qualified Expenses: The following are now treated as qualified expenses for 529 account distributions:

- Tuition for public, private, or religious elementary and secondary schools.
- Curriculum and curricular materials.
- Books and other instructional materials.
- Online educational materials.
- Tuition for tutoring or educational classes (if the tutor is not related to the student and meets specific qualifications).
- Fees for standardized tests (e.g., AP exams, college entrance exams).
- Fees for dual enrollment in higher education institutions.
- Educational therapies for students with disabilities (e.g., occupational, behavioral, physical, and speech-language therapies) when provided by licensed or accredited professionals.

Effective Date: Applies to distributions made **after July 4, 2025**

Increased Distribution Limit: The annual limit on tax-free 529 plan distributions for K–12 tuition is increased from **\$10,000 to \$20,000**.

Effective Date: The effective date for the increased limitation for K-12 tuition is for taxable years beginning **after Dec. 31, 2025**

Certain Postsecondary Credentialing Expenses Treated as Qualified Higher Education Expenses for Purposes of 529 Accounts

This provision expands the definition of “qualified higher education expenses” under §529 to include specific postsecondary credentialing costs.

Expanded Qualified Expenses: The following are now eligible for tax-free 529 plan distributions:

- Tuition, fees, books, supplies, and equipment required for enrollment in a recognized postsecondary credential program
- Fees for testing required to obtain or maintain a recognized postsecondary credential
- Fees for continuing education required to maintain such credentials

Recognized Postsecondary Credential Programs: Eligible programs must meet one of the following criteria:

- Listed on a State list under the Workforce Innovation and Opportunity Act
- Included in the Veterans Benefits Administration’s WEAMS directory
- Prepares individuals for an exam required for a credential
- Identified by the Secretary of the Treasury (in consultation with the Secretary of Labor) as reputable

Recognized Postsecondary Credentials Include:

- Credentials accredited by the Institute for Credentialing Excellence, NCCA, or ANSI
- Credentials listed in the Department of Defense’s COOL directory
- Any postsecondary employment credential identified for purposes of this clause by the Secretary of Treasury, after consultation with the Secretary of Labor, as being industry recognized
- Certificates of completion from registered apprenticeships
- State or federally issued occupational/professional licenses
- Credentials defined under the Workforce Innovation and Opportunity Act

Effective Date: Applies to distributions made **after July 4, 2025**

Permanent and Expanded Reinstatement of Partial Deduction for Charitable Contributions of Individuals Who Do Not Elect to Itemize

After 2025, §170(p) is amended to permanently restore and expand the deduction for charitable contributions made by individuals who take the standard deduction.

Deduction Amount:

- Up to \$1,000 for single filers
- Up to \$2,000 for married individuals filing jointly

Available to taxpayers who do not elect to itemize deductions.

Contributions must be made in cash.

The non-itemizers' charitable deduction is a below-the-line deduction, deducted from adjusted gross income in arriving at taxable income.

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

0.5% Floor on Deduction of Contributions Made by Individuals

After 2025, this provision imposes a minimum threshold for charitable contribution deductions by individuals who itemize, effectively limiting the deduction to contributions that exceed a small percentage of income.

Deduction Floor: For taxpayers who itemize deductions, charitable contributions are deductible only to the extent they exceed 0.5% of the taxpayer's contribution base (typically adjusted gross income) for the taxable year.

Ordering Rule: Contributions are applied in the following order to determine whether they exceed the 0.5% floor:

1. Capital gain property to private foundations (20% limit normally)
2. 30% limit capital gain property to public charities
3. Other charitable contributions subject to 30% limitation
4. Contributions of qualified conservation easements
5. Contributions subject to the 50% limitation
6. Cash contributions to public charities (60% limit). **Note!** The 60% of AGI limit for cash contributions was slated to expire after 2025. However, the Act makes this 60% limit permanent.

Carryforward Rule: Contributions disallowed due to the 0.5% floor may be carried forward, but only from years in which the taxpayer's contributions exceeded the floor. The carryforward is subject to specific coordination rules with other charitable deduction limitations.

Scenario (Tax Year 2026):

- **Filing status:** Single
- **Adjusted Gross Income (AGI):** \$200,000
- **Charitable contributions:**
 - \$500 cash to a church (public charity, 60% limit)
 - \$4,000 of appreciated stock to a donor-advised fund (30% limit)
 - \$2,000 contribution to a private foundation (20% limit)
- **Total contributions:** \$6,500
- **Itemizing deductions:** Yes

Step 1: Calculate the 0.5% Floor

0.5% of AGI = $0.005 \times \$200,000 = \$1,000$

So, only **contributions above \$1,000** are deductible.

Step 2: Apply the Ordering Rules

The floor applies in this order (simplified here):

1. **Stock to donor-advised fund** (30% limit) = \$4,000
2. Contribution to private foundation (20% limit) = \$2,000
3. **Cash to public charity** = \$500

Total = \$6,500

Amount exceeding \$1,000 floor = **\$5,500**

So **\$5,500 is deductible this year**, subject to other limits (e.g., 30%, 60% AGI caps, not triggered here).

Step 3: Carryforward

- The **\$1,000 disallowed** (under the floor) is **not deductible this year**
- But it **can be carried forward** — but only **if** total contributions for the year **exceed** the floor
- In this case, they did, so the \$1,000 is eligible for carryforward to the next year

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Treatment of Capital Gains from the Sale of Certain Farmland Property

For sales in tax years beginning after July 4, 2025, this provision allows taxpayers to defer capital gains tax on the sale of farmland to qualified farmers by paying the tax in installments.

Taxpayers may elect to pay the portion of their net income tax attributable to the gain from the sale of qualified farmland property to a qualified farmer in four equal annual installments.

Qualified Farmland Property: Real property located in the U.S. that:

- Has been used by the taxpayer (or leased to a qualified farmer) for farming purposes for substantially all of the 10-year period before the sale
- Is subject to a legally enforceable restriction prohibiting non-farming use for 10 years after the sale

Qualified Farmer: An individual actively engaged in farming, as defined under the Food Security Act of 1985.

Acceleration of Payment: If an installment is not paid on time, or in the event of death (for individuals) or cessation of business, sale of assets, or liquidation (for C corporations, trust or estate), all remaining installments become immediately due.

Scenario:

- **Seller:** Individual
- **Property sold:** U.S. farmland
- **Holding period:** Leased to a qualified farmer for the past 10 years
- **Sale price:** \$1,000,000 paid at closing
- **Adjusted basis:** \$200,000
- **Capital gain:** \$800,000
- **Buyer:** Qualified farmer (actively engaged in farming)
- **Deed restriction:** The property includes a 10-year enforceable restriction against non-farm use
- **Election made:** To defer tax under the new installment rule

Without the Election:

- Full \$800,000 capital gain taxed in the year of sale
- If taxed at 20%, capital gains tax = **\$160,000** due in one year

With the New Installment Election:

Taxpayer elects to pay tax on the \$800,000 gain in **4 equal annual installments**:

- Each installment = $\$800,000 \div 4 = \mathbf{\$200,000}$
- Annual capital gains tax (20%) = **\$40,000 per year**
- Spread over **four years** beginning in the year of sale

Effective Date: Applies to sales or exchanges in taxable years beginning **after July 4, 2025**

Termination of Previously-Owned Clean Vehicle Credit

The §25E credit of up to \$4,000 for buying a used electric/clean vehicle is **repealed**. It will **no longer be available for vehicles acquired after Sept. 30, 2025**. Advise clients considering used EV purchases that taxpayers will not get the credit if the vehicle is acquired after Sept. 30, 2025.

Termination Date: The credit is terminated for vehicles acquired after **Sept. 30, 2025**

Termination of Clean Vehicle Credit

The **\$7,500 §30D Clean Vehicle credit for new electric vehicles** is **terminated for vehicles acquired after Sept. 30, 2025**. (So the third quarter of 2025 is the cutoff.) Make sure any clients planning EV purchases know the timeline — vehicles acquired after that date won't get the federal credit.

Practitioners should be on the lookout for further guidance on how the IRS defines “acquired.”

Termination Date: The credit is terminated for vehicles acquired **after Sept. 30, 2025**

Termination of Alternative Fuel Vehicle Refueling Property Credit

The tax credit for installing electric vehicle charging stations or other alternative fuel refueling property (30C) is **terminated for any property placed in service after June 30, 2026**. In practice, 2026 is the last year (first half) to get this credit.

Termination Date: The credit is terminated for property placed in service **after June 30, 2026**

Termination of Energy Efficient Home Improvement Credit

The §25C **Energy Efficient Home Improvement Credit (for upgrades like windows, insulation, HVAC)** is **repealed for improvements placed in service after Dec. 31, 2025**. The credit remains available through the end of 2025; after that, taxpayers cannot claim it.

Termination Date: The credit is terminated for property **placed in service after Dec. 31, 2025**

Termination of Residential Clean Energy Credit

The §25D **Residential Clean Energy Credit** (for solar panels, solar water heaters, geothermal, etc.) is **terminated for expenditures made after Dec. 31, 2025**. This accelerates the end of the credit, so 2025 is effectively the last year to install home renewable energy property for a credit.

Termination Date: The credit is terminated for **expenditures made after Dec. 31, 2025**

Termination of New Energy Efficient Home Credit

The §45L **Energy Efficient New Home Credit** for builders/developers of efficient residences is **terminated for homes acquired by buyers after June 30, 2026**. So it effectively ends mid-2026 instead of 2032.

Termination Date: The credit is terminated for homes acquired **after June 30, 2026**

Allow Refund of Excise Tax for Payments to Certain Individuals Who Dyed Fuel

This provision establishes a mechanism for certain individuals to receive payments for previously taxed dyed fuel.

Refund Eligibility: Individuals who remove indelibly dyed diesel fuel or kerosene from a terminal may receive a payment equal to the federal excise tax previously paid on that fuel, provided:

- The fuel was taxed under IRC §4081 and the tax was not previously credited or refunded
- The fuel qualifies for exemption under IRC §4082(a) (i.e., it is dyed and used for nontaxable purposes such as farming or heating)

Payment Details: The refund is paid without interest and is limited to the amount of tax previously paid on the eligible fuel.

Compliance and Penalties: A cross-reference is made to IRC §6675, which imposes civil penalties for excessive claims under this section.

Effective Date: Applies to eligible dyed diesel fuel or kerosene removed on or after 180 days **after July 4, 2025**

Social Security Number Requirement for American Opportunity and Lifetime Learning Credits

This provision imposes a new identification requirement for claiming education tax credits under §25A after 2025.

SSN Requirement for Taxpayer and Student: No credit is allowed unless the taxpayer includes their own Social Security Number (SSN) on the return.

If the credit is claimed for qualified tuition and related expenses of someone other than the taxpayer or their spouse (e.g., a dependent), the name and SSN of that individual must also be included on the return.

Institutional Reporting Requirement: For the American Opportunity Tax Credit (AOTC), the taxpayer must also report the Employer Identification Number (EIN) of the educational institution to which tuition was paid.

Definition of SSN: The term “Social Security Number” has the same meaning as defined in §24(h)(7), which generally requires that the SSN be issued by the Social Security Administration and valid for employment.

Clerical Error Treatment: Failure to include the required SSN or EIN will be treated as a mathematical or clerical error, allowing the IRS to disallow the credit without a formal audit.

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Permitting Premium Tax Credit Only for Certain Individuals

After 2026, this provision limits eligibility for the Premium Tax Credit (PTC) under §36B of the Internal Revenue Code to a narrower group of lawfully present individuals.

Eligibility Restriction: Only individuals who are either U.S. citizens or “eligible aliens” are permitted to claim the PTC. *The term “eligible alien” is defined to include:*

- Lawful permanent residents (green card holders)
- Cuban and Haitian entrants as defined in the Refugee Education Assistance Act of 1980
- Individuals lawfully residing in the U.S. under a Compact of Free Association (e.g., citizens of Micronesia, the Marshall Islands, and Palau)

Exchanges must verify an individual's eligibility, including immigration status, before any month can be treated as a "coverage month" for PTC purposes. This includes:

- Household income and family size
- Immigration status
- Health coverage status or eligibility for coverage
- Place of residence
- Other information required by the Treasury Secretary

Advance Payments: The provision also amends the ACA to prohibit advance PTC payments for individuals who are not eligible aliens.

Effective Dates: Most provisions apply to taxable years beginning **after Dec. 31, 2026**. Verification-related amendments apply to plan years beginning **on or after Jan. 1, 2027**.

Disallowing Premium Tax Credit during Periods of Medicaid Ineligibility due to Alien Status

After 2025, this provision restricts access to the Premium Tax Credit (PTC) under the Affordable Care Act (ACA) for individuals who are ineligible for Medicaid due to their immigration status.

The provision amends §36B(c)(1) of the Internal Revenue Code by striking subparagraph (B), which previously allowed certain lawfully present non-citizens to qualify for the PTC even if they were ineligible for Medicaid.

As a result, individuals who are ineligible for Medicaid due to alien status will also be disqualified from receiving the PTC during those periods.

Policy Intent: This change aligns PTC eligibility more closely with Medicaid eligibility, effectively narrowing the pool of non-citizens who can receive subsidized health insurance through the ACA marketplace.

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

ONE BIG BEAUTIFUL BILL: SELECT PROVISIONS AFFECTING SCHEDULE C AND F

Extension and Enhancement of Deduction for Qualified Business Income

After 2025, this provision permanently extends and enhances the Qualified Business Income (QBI) deduction under IRC §199A. Under §199A certain individuals, trusts, and estates may deduct (with limitations) 20% of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20% of aggregate qualified real estate investment trust (“REIT”) dividends and qualified publicly traded partnership income. The provision was scheduled to expire for tax years beginning after 2025.

Expanded Phase-In Thresholds:

The taxable income thresholds for fully applying the wage and capital limitations and for completely phasing out the QBI for specified service trade or businesses (SSTBs) are increased:

- Single filers: \$50,000 to \$75,000
- Joint returns: \$100,000 to \$150,000

Therefore, for 2026 the wage and capital limitations and the SSTB disallowance provisions should phase in as taxable income increases from:

- Single filers: \$197,300 to \$272,300 (prior to the Act: \$197,300 to \$247,300)
- Joint returns: \$394,600 to \$544,600 (prior to the Act: \$394,600 to \$494,600)

Minimum Deduction for Active Businesses: Introduces a new minimum deduction of \$400 for taxpayers with at least \$1,000 in active qualified business income. Applies only to businesses in which the taxpayer materially participates (as defined under §469(h)).

Inflation Adjustments: Both the \$400 minimum deduction and the \$1,000 income threshold will be adjusted for inflation starting in 2027, using 2025 as the base year.

Effective Date: The amendments apply to taxable years beginning **after Dec. 31, 2025**

Full Expensing for Certain Business Property

The OBBB revives and makes permanent the 100% bonus depreciation (full expensing) for qualified business property under IRC §168(k), **for qualifying property acquired after Jan. 19, 2025.**

Permanent 100% Expensing: The provision amends IRC §168(k) to allow a 100% first-year deduction for the cost of qualified property. This applies to most tangible depreciable property with a recovery period of 20 years or less, including machinery, equipment, and certain improvements.

Specified Plants: The 100% expensing also applies to certain plants bearing fruits and nuts, with special rules for those planted or grafted after Jan. 19, 2025.

Transitional Election: Taxpayers may elect a reduced bonus depreciation percentage (e.g., 40% or 60% [for long production period property or noncommercial aircraft]) for property placed in service in the first taxable year ending after Jan. 19, 2025.

Effective Date: Applies to property acquired after Jan. 19, 2025. Property subject to a binding written contract entered into before Jan. 20, 2025, is not eligible for the 100% rate and is subject to a 40% rate if placed in service in 2025 (60% in the case of long production period property and noncommercial aircraft), a 20% rate if placed in service in 2026 (40% in the case of long production period property and noncommercial aircraft), and a 0% or 20% rate if placed in service in 2027.

Full Expensing of Domestic Research and Experimental Expenditures

For amounts paid or incurred after 2024, this provision restores and enhances the immediate deductibility of *domestic* research and experimental (R&E) expenditures, reversing the amortization requirement introduced by the 2017 Tax Cuts and Jobs Act (TCJA).

Immediate Deduction for Domestic R&E: Taxpayers may fully deduct domestic research or experimental expenditures in the year they are paid or incurred. Applies only to expenditures connected with a trade or business and **excludes foreign research costs**.

Optional Amortization Election: Taxpayers may elect to amortize domestic R&E expenditures over a period of not less than 60 months, beginning in the month benefits are first realized. Once elected, the method and period must be consistently applied unless changed with IRS approval.

Coordination With Research Credit: For expenditures paid or incurred in tax years beginning after 2024, the research credit is limited to domestic research and experimental costs only. A taxpayer claiming the research credit must reduce the deduction for research and experimental expenditures by the amount of the research credit.

Small Business Taxpayers My Expense For Tax Years Beginning After 2021: Small business taxpayers (other than a tax shelter) with average annual gross receipts of \$31 million or less may retroactively elect to apply this change to tax years beginning after Dec. 31, 2021. The election must be made by July 4, 2026 (within one year of the date of enactment) and requires amended returns for tax years impacted by the election.

Acceleration provisions. Taxpayers that capitalized domestic research or experimental expenditures after Dec. 31, 2021, and before Jan. 1, 2025, may elect to accelerate the remaining unamortized deductions for such expenditures over a one-year period or ratably over a two-year period beginning with the first tax year beginning after 2024.

Exclusions: The provision does not apply to:

- Land acquisition or improvement costs
- Property subject to depreciation or depletion
- Mineral exploration expenditures
- Foreign research expenditures

Software Development: Software development costs are explicitly treated as domestic R&E expenditures and are eligible for full expensing.

Coordination with Other Provisions: Updates are made to integrate the new rules with the research credit (§41), AMT adjustments (§56), and other related sections (e.g., §280C, §59(e), §1202).

Effective Date: Generally, applies to amounts paid or incurred in taxable years beginning **after Dec. 31, 2024**

Exceptions from Limitations on Deduction for Business Meals

TCJA provided that business deductions paid or incurred for certain meals were not deductible **after 2025**. This includes amounts paid or incurred for: 1) meals excludable from an employee's income under §119(a) provided to employees and their spouses and dependents for the employer's convenience and on the employer's business premises; or 2) food, beverage, and facility expenses for meals qualifying as a *de minimis* fringe benefit under §132(e).

OBBB retains the disallowance of deductions for the above meal expenses for amounts paid or incurred after 2025.

Act Clarifies Following Costs Remain Fully Deductible:

Costs of Food and Beverages Sold (§274(e)(8)): Employers may deduct the entire amounts incurred for the purchase and preparation of food and beverages sold to customers for adequate and full consideration.

Food and Beverages Provided to Crew Members of Commercial Vessels or Drilling Rigs (§274(o)) - Meals remain fully deductible if provided to the crews of commercial vessels that employers are required to provide under federal law and the crews of offshore drilling rigs that meet certain requirements (Code Sec. 274(o)).

Act Modifies Rules under §274 to Allow Broader Deductibility of Following business Meal Expenses:

Food and Beverages Provided to Crews of Fishing Vessels §274(n)(2)(C) - Employers may deduct 100% (50% prior to the Act) of the cost of food and beverages provided to the crews of fishing vessels, as defined by Sec. 2101 of Title 46 of the U.S.C., and fish processing facilities. Fishing processing facilities only qualify if they are located in the United States north of 50 degrees north latitude and are not situated in a metropolitan area, as defined by §143(k)

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Increased §179 Dollar Limitations for Expensing of Certain Depreciable Business Assets

This provision enhances the expensing limits under IRC §179, allowing businesses to immediately deduct a greater amount of the cost of qualifying depreciable property, rather than recovering it through depreciation over time.

Increased Expensing Limits: The **maximum amount** a taxpayer may expense under §179 is increased from \$1,250,000 as indexed to \$2,500,000 for 2025.

The phase-out threshold is increased from \$3,130,000 as indexed to \$4,000,000.

Inflation Adjustments: The new dollar amounts will be adjusted for inflation beginning in 2026, using calendar year 2024 as the base year.

Effective Date: Applies to property placed in service in taxable years beginning **after Dec. 31, 2024**

Repeal of Revision to De Minimis Rules for Third-Party Network Transactions

This provision repeals the lower reporting threshold for third-party network transactions introduced by the American Rescue Plan Act of 2021 and restores the prior de minimis exception under IRC §6050W.

Restoration of Prior Thresholds: A third-party settlement organization is only required to report transactions if:

- The aggregate amount exceeds \$20,000, and
- The number of transactions exceeds 200

Effective Date: Applies to returns for calendar years beginning **after 2021**

Backup Withholding Coordination: Amends IRC §3406 to ensure that backup withholding applies only if both the \$20,000 and 200 transaction thresholds are met.

Exception: If a payee had reportable transactions under the backup withholding rules in the prior year, the backup withholding rules apply regardless of current-year thresholds.

Effective Date for Backup Withholding Rule: Applies to calendar years beginning after **Dec. 31, 2024**

Increase in Threshold for Requiring Information Reporting with Respect to Certain Payees

After 2025, this provision raises the reporting threshold for payments made to non-employees, easing compliance burdens for businesses and aligning the threshold with inflationary trends.

Increased Reporting Threshold: Amends IRC §6041(a) to increase the threshold for information reporting from \$600 to \$2,000.

Inflation Adjustment: Introduces a new subsection §6041(h) to provide for annual inflation adjustments to the \$2,000 threshold beginning in calendar year 2027. The adjustment is based on the cost-of-living index, rounded to the nearest multiple of \$10,000.

Effective Date: Applies to taxable years beginning **after Dec. 31, 2025**

Modification and Extension of Limitation on Excess Business Losses of Noncorporate Taxpayers

This provision makes permanent and modifies the limitation on excess business losses for noncorporate taxpayers under §461(l) of the Internal Revenue Code.

Permanent Rule: The temporary limitation on excess business losses, previously set to expire after 2028, is made permanent.

Adjustment of Thresholds: **For tax years beginning after 2025**, the base year for calculating the inflation-adjusted threshold amounts (i.e., \$250,000 or \$500,000 for those filing a joint return) is updated from 2017 to 2024, and the reference date for the inflation adjustment is changed from Dec. 31, 2018 to Dec. 31, 2025. For 2025, the threshold amounts are \$313,000 (626,000 for those filing joint returns). The threshold amounts should be significantly lower for 2026.

Scenario (Tax Year 2026):

- **Filer:** Single individual (non-corporate taxpayer)
- **Business income:** \$200,000
- **Business deductions:** \$1,000,000
- **Net business loss:** \$800,000
- **Other income (e.g., wages, dividends):** \$50,000

Resulting total income before limitation = \$50,000 - \$800,000 = \$750,000

Step 1: Understand the Excess Business Loss (EBL) Threshold

- For 2026, assume the **inflation-adjusted EBL threshold** is **\$260,000** (actual amount will be indexed from \$250,000 base using 2025 as reference year)
- This means: **Only \$260,000** of business loss can offset nonbusiness income

Step 2: Apply the Limitation

- **Claimable business loss in 2026:** \$260,000
- **Excess business loss disallowed:** \$800,000 - \$260,000 = **\$540,000**

The **\$540,000** excess becomes a **Net Operating Loss (NOL) carryforward** under §172 in 2027.

Final Taxable Income (2026):

- **Other income:** \$50,000
- **Business loss allowed:** -\$260,000
- **Taxable income = -\$210,000 → NOL**

The taxpayer effectively gets to use only \$260,000 of their \$800,000 business loss in the current year. The rest carries forward.

Effective Dates: The permanent extension applies to taxable years beginning **after Dec. 31, 2026**. The adjusted calculation thresholds apply to taxable years beginning **after Dec. 31, 2025**.

ONE BIG BEAUTIFUL BILL: SUMMARY OF SIGNIFICANT PROVISIONS BROKEN DOWN BY YEAR OF ENACTMENT

Items Affecting Individuals in 2025

Several of the provisions now require the inclusion of one or more Social Security Numbers (SSN) on the tax return. Failure to include the required SSNs is treated as a mathematical or clerical error under §6213(g)(2), which allows the IRS to deny the deduction and assess the additional tax. The denial is not considered a Notice of Deficiency. A Notice of Deficiency, sometimes called a “90-day letter” and issued under §6212, triggers a series of taxpayer rights, obligations, and potential consequences under the IRC.

Tips deduction (70201): A deduction of up to \$25,000 for qualified tips received in certain occupations is allowed. The deduction is temporary for 2025 through 2028 and is available whether or not the taxpayer itemizes (new IRC §224).

- **Qualified tips:** §224(d) defines “qualified tips” as cash tips received from customers in occupations which “customarily and regularly” received tips on or before Dec. 31, 2024. The tips must be paid voluntarily and not negotiated. Cash tips include those charged, and for employees, tips received under tip-sharing arrangements.
- **Phaseout:** The deduction is phased out by \$100 for every \$1,000 of MAGI above \$150,000 (\$300,000 MFJ). No deduction is allowed if MAGI equals or exceeds \$400,000 (\$550,000 MFJ).
- **Other limitations:** The deduction is not available to self-employed individuals in an SSTB nor to employees whose employer is an SSTB as defined in §199A(d)(2). For self-employed individuals operating a business in which they receive tips, the deduction cannot exceed the net income (not considering the tips deduction) from the business. In addition, the deduction is excluded from QBI (no double benefit). Taxpayers must include their SSN on the return and if married, file jointly to claim the deduction.
- **Reporting:** Qualified tips are to be reported on Form W-2, Form 1099, or other specified statement furnished to the taxpayer, or reported by the individual on Form 4137.

Overtime deduction (70202): A deduction of up to \$12,500 (\$25,000 MFJ) for qualified overtime compensation is allowed. The deduction is temporary for 2025 through 2028 and is available whether or not the taxpayer itemizes (new IRC §225).

- **Qualified overtime:** §225(c) defines “qualified overtime” as that paid to individuals as required by §7 of the Fair Labor Standards Act of 1938 in excess of the regular rate of pay. Tips are excluded.
- **Phaseout:** The deduction is phased out by \$100 for every \$1,000 of MAGI above \$150,000 (\$300,000 MFJ). No deduction is allowed if MAGI equals or exceeds \$275,000 (\$550,000 MFJ).
- **Other limitations:** Taxpayers must include their SSN on the return and if married, file jointly to claim the deduction.
- **Reporting:** Qualified overtime is to be reported on Form W-2, Form 1099, or other specified statement.

Car loan interest deduction (70203): A deduction of up to \$10,000 for qualified interest on applicable passenger vehicles is allowed. The deduction is temporary for 2025 through 2028 and is available whether or not the taxpayer itemizes (new IRC §163(h)(4)).

Qualified interest: §163(h)(4)(B) defines “qualified passenger vehicle loan interest” as interest paid on loans incurred after Dec. 31, 2024 for the purchase of an applicable passenger vehicle for personal use. The loan must be secured by a first lien on the vehicle and does not include loans to finance the purchase of a vehicle with a salvage title nor loans to finance the purchase of a vehicle intended to be used for scrap or parts. Leases do not qualify. If the loan is subsequently refinanced, the interest will also qualify but only if the loan is secured by a first lien and only on the amount of the loan that was outstanding at the time of the refinance.

Applicable passenger vehicle: §163(h)(4)(D) requires that the vehicle be new (used vehicles do not qualify), manufactured primarily for use on public streets, roads, and highways, have at least two wheels, be a car, minivan, van, SUV, pickup truck or motorcycle, and have a gross vehicle weight rating of less than 14,000 pounds. The vehicle must have final assembly in the U.S. The location of final assembly is listed on the vehicle information label attached to each vehicle. The IRS [has stated](#) that taxpayers may also rely on the vehicle identification

number (VIN), which includes the vehicle's plant of manufacture. The [VIN Decoder](#) website for National Highway Traffic Safety Administration provides a link to the decoder and the instructions on how to identify the plant of manufacture.

- **Phaseout:** The deduction is phased out by \$200 for every \$1,000 of MAGI above \$100,000 (\$200,000 for married filing jointly). No deduction is allowed if MAGI equals or exceeds \$150,000 (\$250,000 for married filing jointly).
- **Other limitations:** Taxpayers are required to include the VIN of the vehicle on the return to claim the deduction.
- **Reporting:** Lenders must report the interest (via information returns) to taxpayers.

Deduction for seniors (70103): A deduction of \$6,000 for each qualifying taxpayer age 65 or older is allowed. The deduction is per individual, making it \$12,000 on a joint return if both spouses qualify. The deduction is a special personal exemption (under new IRC §151(d)(5)(C)), making it available whether or not the taxpayer itemizes. The deduction is temporary for 2025 through 2028.

- **Qualifying taxpayer:** Age 65 must be attained on or before the last day of the taxable year.
- **Phaseout:** The deduction phases out by 6% of the amount by which MAGI exceeds \$75,000 (\$150,000 for married filing jointly). No deduction is allowed if MAGI equals or exceeds \$175,000 (\$250,000 for married filing jointly if one spouse is 65 or older, \$350,000 MFJ if both spouses are 65 or older).
- **Other limitations:** Taxpayers must include the SSN of the qualifying individual(s) on the return and if married, file jointly to claim the deduction.
- **Disaster-related personal casualty losses (70438):** The legislation extends, as of July 4, 2025, the application of §304(b) of Taxpayer Certainty and Disaster Relief Act of 2020 (division EE of Public Law 116-20). Those rules permit taxpayers who are victims of qualified natural disasters to deduct net personal casualty losses without needing to itemize by increasing the standard deduction by the amount the net disaster loss.
- **Qualified disaster-related personal casualty loss:** This term refers to losses described in IRC §165(c)(3) which arise in a qualified disaster area on or after the first day of the incident period of the qualified disaster. The loss is not reduced by 10% of AGI but is reduced by \$500 after being reduced by any salvage value or other reimbursement. These losses must be from a disaster declared between Jan. 1, 202, and Sept. 2, 2025, where the incident period begins after Dec. 27, 2019, and before Sept. 2, 2025.
- **Net disaster loss:** This is the excess of qualified disaster-related personal casualty losses over personal casualty gains.

Standard deduction (70102): The 2025 standard deduction is \$15,750 for single filers, \$31,500 for married filing jointly, and \$23,625 for head of household (see indexed items). This is an increase of the previously announced amounts of \$15,000, \$30,000, and \$22,500, respectively.

State and Local Tax (SALT) deduction limitation (70120): The SALT deduction limitation is \$40,000 (\$20,000 MFS) (amended §164(b)(6), new §164(b)(7)). This limit is reduced by 30% of the amount by which MAGI exceeds \$500,000 (\$250,000 MFS) but not below \$10,000 (\$5,000 MFS). The \$10,000 (\$5,000) limit applies when MAGI exceeds \$600,000 (\$300,000 MFS).

Child tax credit (CTC) (70104): The 2025 maximum CTC is \$2,200 per child under age 17, with the refundable amount remaining at \$1,700. SSNs for the child and the taxpayer (at least one spouse if married filing jointly) are required to claim the credit.

Adoption credit (70402, 70403): Up to \$5,000 of the adoption credit is refundable (new IRC §23(a)(4)). The refundable portion is excluded from any carryforward. In addition, Indian tribal governments are allowed to determine if a child has special needs for purposes of the credit.

Previously owned clean vehicle credit (70501) and clean vehicle credit (70502) terminated: Both the used clean vehicle credit (§25E) and the new clean vehicle credit (§30D) are eliminated for vehicles acquired after Sept. 30, 2025 (§25E(g) and §(30D(h)).

§529 account distributions can cover more expenses (70413, 70414): The definition of elementary and secondary tuition is expanded to include additional expenses. In addition, certain post-secondary credentialing

expenses may be paid from §529 accounts. These provisions are effective for §529 account distributions made after July 4, 2025.

Elementary and secondary tuition: §529(c)(7) is amended to include, in addition to tuition, curriculum and curricular materials; books or other instructional materials; online educational materials, tuition for tutoring or educational classes outside of the home, if the tutor or instructor is not related to the student and is either a licensed teacher, has taught at an eligible educational institution, or is a subject matter expert in the relevant subject; fees for certain standardized tests, advanced placement exams, and college entrance exams; fees for dual enrollment at a higher education institution; and educational therapies for students with disabilities provided by a licensed or accredited practitioner or provider, including occupational, behavioral, physical, and speech-language therapies.

Certain postsecondary credentialing expenses: New §529(e)(3)(C) references these expenses, which are defined in the new §529(f) and include tuition, fees, books, supplies, and equipment required for enrollment or attendance in a recognized postsecondary credentialing program; fees for testing if the testing is required to obtain or maintain a recognized postsecondary credential; and fees for continuing education if required to maintain a recognized postsecondary credential. The terms “recognized postsecondary credentialing program” and “recognized postsecondary credential” are defined in §529(f)(2) and (3), respectively.

Qualified small business stock (QSBS) gain exclusion (70431): For QSBS (§1202) acquired after July 4, 2025, a tiered gain exclusion applies under amended §1202(a)(1). The exclusion is 50% for stock held for three years, 75% for stock held for four years, and 100% for stock held for five years (new §1202(a)(5)). The gain continues to be excluded from AMT.

Items affecting individuals after 2025. Some of these items were scheduled to expire at the end of 2025 (see Selected Federal Income Tax Provisions Scheduled to Expire After 2025 earlier) but have been made permanent.

Tax rates and brackets (70101): The seven tax rates (10%, 12%, 22%, 24%, 32%, 35%, and 37%) are permanent. The income thresholds for the brackets will continue to be adjusted annually for inflation, with a modification of the base year used for the 10% and 12% brackets.

Wagering losses (70114): The definition of what is included in wagering losses under amended §165(d) is permanent and is expanded to include any deduction otherwise allowable related to a wagering transaction. The deduction for wagering losses is limited to 90% of the losses for the year, further limited to wagering gains.

Dependent care assistance program exclusion (70404): The maximum exclusion is increased from \$5,000 (\$2,500 for married filing separately) to \$7,500 (\$3,750 for married filing separately).

Student loan discharges (70119): The exclusion from income under §108(f)(5) for student loans discharged due to death or disability is permanent and now requires inclusion of the SSN on the return.

Educational assistance program exclusion (70412): The maximum exclusion for educational assistance programs, currently \$5,250 under §127(a)(2), will be adjusted for inflation after 2026. The exclusion for employer payments for student loans (considered educational assistance under §127(c)(1)(B)) is permanent.

Moving expenses (70113): The suspension of the deduction for moving expenses (§217(k)) and exclusion of reimbursements (§132(g)(2)) for all except members of the military is permanent. Both §217(k) and §132(g)(2) are amended to permit certain members of the intelligence community to qualify for the deduction and exclusion.

Excess business losses (70601): The limitation on excess business losses in §461(l)(1), scheduled to expire after 2028, is permanent for taxable years beginning after Dec. 31, 2026. Beginning in 2026, the inflation adjustment in §461(l)(3)(C) has been modified to change the base year for the cost-of-living adjustment from 2017 to 2024, which will likely result in smaller increases in the future.

Standard deduction (70102): The higher standard deduction is permanent. The 2025 amounts listed above will be adjusted for inflation.

SALT deduction limitation (70120): The SALT deduction limitation and phaseout threshold are increased by 1% each year for tax years 2026 through 2029, with the same reduction calculation as in 2025. For 2026, the deduction

limit is \$40,400 (\$20,200 for married filing separately) and the phaseout threshold is \$505,000 (\$252,500 for married filing separately). The SALT limitation reverts to \$10,000 (\$5,000 for married filing separately) in 2030.

Qualified residence interest (70108): The provision limiting the deduction for residence interest only to that paid on acquisition indebtedness of up to \$750,000 (§163(h)(3)(F)) is permanent and mortgage insurance premiums are treated as interest. Under §163(h)(3)(E)(ii), the deduction for mortgage insurance premiums is subject to a phaseout of 10% for each \$1,000 (\$500 MFS) or fraction thereof by which AGI exceeds \$100,000 (\$50,000 MFS). No deduction is allowed for mortgage insurance premiums for mortgage insurance contracts issued before Jan. 1, 2007 (§163(h)(3)(E)(iii)).

Charitable contributions deduction for itemizers (70425): The 60% of AGI limitation on cash contributions is permanent (amended §170(b)(1)(G)(i)). A 0.5% floor applies to contributions (new §170(b)(1)(I)) and requires contributions be applied in a specific order to determine if they exceed the floor.

- **Ordering rule:** The aggregate of contributions for purposes of the 0.5% floor are applied in the following order:
 - Contributions described in §170(b)(1)(D) (capital gain property contributed to private foundations, limited to the lesser of 20% of AGI or the amount of excess 30% contributions)
 - Contributions described in §170(b)(1)(C) (capital gain property contributed to public charities, limited to 30% of AGI)
 - Contributions described in §170(b)(1)(B) (generally other contributions, limited to the lesser of 30% of AGI or the excess of the 50% AGI limit over 50% contributions)
 - Contributions described in §170(b)(1)(E) (qualified conservation contributions, limited to 50% of AGI)
 - Contributions described in §170(b)(1)(A) (other contributions, limited to 50% of AGI)
 - Contributions described in §170(b)(1)(G) (cash contributions to public charities, limited to 60% of AGI)

Carryforward of contributions disallowed due to the 0.5% floor. Such contributions may be carried forward only if the taxpayer's contributions for the year result in a carryover of contributions due to the AGI limitations (new §170(d)(1)(C)).

Charitable contributions deduction for non-itemizers (70424). A permanent cash contributions deduction of \$1,000 (\$2,000 MFJ) for non-itemizers is allowed (amended §170(p)). A qualified cash contribution is one that would otherwise be allowed as an itemized deduction (contributed to churches, nonprofit educational institutions, nonprofit medical institutions, public charities, or any other organization described in §170(b)(a)(A)). The contribution cannot be made to a supporting organization (§509(a)(3)), or to a new or existing donor advised fund (as defined in §4966(d)(2)).

Educator expenses (70110). These are no longer considered miscellaneous itemized deductions (included on the list of "deductions other than" in §67(b) and are once again deductible. No changes were made to the above-the-line deduction in §62; however, for purposes of the itemized deduction, the definition of "educator" (new §67(g)) is expanded to include interscholastic sports administrators and coaches and broadens the expenses to include non-athletic supplies for courses of instruction in health or physical education and those used by the educator as a part of instructional activity (not just in the classroom).

Personal casualty losses (70109). The inability to deduct personal casualty losses other than those in a federally declared disaster area is permanent (amended §165(h)(5)) and is expanded to include state declared disasters as defined in new §165(h)(5)(C). As modified by the Filing Relief for Natural Disasters Act ([P.L. 119-29](#)) the IRS, after consultation with the administrator of FEMA, may apply the rules for federally declared disasters to a qualified state declared disaster upon written request of the state's governor (in the case of the District of Columbia, the mayor.)

Limitation on itemized deductions (70111). The pre-TCJA Pease limitation is repealed. However, for taxpayers in the 37% tax bracket, itemized deductions are reduced by 2/37 of the lesser of the itemized deductions or the amount by which the taxpayer's taxable income (before this limitation and increased by the amount of itemized deductions) exceeds the dollar amount at which the 37% bracket begins for the taxpayer's filing status. This limitation applies after any other limitations on itemized deductions, such as the SALT cap (amended §68).

Child tax credit (CTC) (70104). The higher amount of the CTC and the \$500 credit for other dependents are permanent. The amount of the CTC and its refundable portion will be adjusted annually for inflation (amended §24(i)). The credit for other dependents will not be indexed for inflation.

Child and dependent care credit (70405). Via amended §21(a)(2), the maximum credit has been increased to 50% for taxpayers with an AGI of \$15,000 or less. The credit is reduced by 1% for each \$2,000 or fraction thereof by which the taxpayer's AGI exceeds \$15,000, but not below 35%, so the 35% credit rate applies at AGI above \$43,000. The credit is further reduced by 1% for each \$2,000 (\$4,000 MFJ) or fraction thereof by which the taxpayer's AGI exceeds \$75,000 (\$150,000 MFJ), but not below 20%, so the 20% credit rate applies at AGI above \$103,000 (\$206,000 MFJ).

Adoption credit (70402): The \$5,000 refundable portion of the credit will be adjusted for inflation.

Premium tax credit (PTC):

- **Aliens (71301, 71302):** The legislation denies, beginning in 2027, the PTC to aliens who are lawfully present but not "eligible aliens" by amending §36B(e)(2) and adding §36B(e)(2)(B), which provides the definition. "Eligible aliens" includes those lawfully admitted for permanent residence, those who have been granted the status of Cuban and Haitian entrant, or those who lawfully reside in the U.S. in accordance with a Compact of Free Association. In addition, beginning in 2026, no PTC is allowed during periods of Medicaid ineligibility due to alien status (§36B(c)(1)(B) is stricken).
- **No PTC if enrolled during special enrollment period (71304):** There is a continuous special enrollment period (SEP) available to individuals with projected household income of no greater than 150% of the federal poverty level. For those who enroll in plans through health exchanges during special enrollment periods for this reason, no PTC is allowed (new §36B(c)(3)(A)(iii)).
- **Recapture of excess advance payments (71305):** The limit on the amount of excess advance PTCs that must be repaid is removed (§36B(f)(2)(B) is stricken). Taxpayers with advance PTCs in excess of the amount calculated on Form 8962 will be required to repay the excess.

Energy credits (70505, 70506): The energy efficient home improvement credit (§25C) (for insulation and energy efficient windows, doors, heat pumps, central air conditioners, water heaters, furnaces, or boilers), scheduled to expire Dec. 31, 2032, is terminated as of Dec. 31, 2025 (amended §25C(h)). The residential clean energy credit (§25D) (for solar property, fuel cell property, small wind energy property,, geothermal heat pump property, and battery storage technology) , scheduled to expire Dec. 31, 2034, is terminated as of Dec. 31, 2025 (amended §25D(h)).

Education credits (70606): SSNs are required to claim the American Opportunity Credit or the Lifetime Learning Credit.

Saver's Credit (70116): The maximum annual contribution eligible for this credit increases from \$2,000 to \$2,100 beginning in 2027 (amended §25B(a)). In addition, the credit is modified after 2026 to *exclude* from the definition of "qualified retirement savings contributions" those contributions defined in §219(e); elective deferrals defined in §402(g)(3) (elective employer contributions) and §457(b) (certain deferred compensation plans); and voluntary employee contributions to qualified plans under §4974(c) (contributions to certain annuity plans and contracts) (amended §25B(d)).

Note: §103 of the SECURE 2.0 Act added §6433, Saver's Match, which replaces the Saver's Credit after Dec. 31, 2026. The Saver's Match is a federal program which provides government matching contributions to eligible individuals who make qualified retirement savings contributions. The matching contribution is made to the taxpayer's designated retirement account. Below is a summary of the program (see [Notice 2024-65](#) for more information).

- **Eligibility:** The individual must be at least 18 years of age by the end of the taxable year, cannot be claimed as a dependent on another taxpayer's return and cannot be a full-time student. Nonresident aliens are not eligible unless they elect to be treated as U.S. residents for tax purposes (§6433(c)).
- **Qualified retirement savings contributions:** Contributions to traditional and Roth IRAs, elective deferrals to 401(k), 403(b), 457(b), SIMPLE IRAs, SEP plans, 501(c)(18) plans, and voluntary after-tax employee contributions to qualified retirement plans are considered qualified retirement savings contributions, reduced by certain distributions (§6433(d)).

- **Amount of match:** The match is 50% of the first \$2,000 of qualified retirement savings (maximum match of \$1,000) and is subject to phaseout. The 50% is reduced by a percentage representing the amount by which MAGI exceeds the applicable dollar amount divided by the phaseout range. For MFJ, the phaseout begins at MAGI of \$41,000, with a phaseout range of \$30,000, so it is completely phased out at MAGI of \$71,000. For Single and MFS, the phaseout range is \$20,500 to \$35,500 and for HoH, the phaseout range is \$30,750 to \$53,250 (§6433(b)). These amounts will be adjusted for inflation beginning after 2027 (§6433(h)). If the amount of the match is less than \$100, the taxpayer can elect to receive it as a refundable tax credit (§6433(a)(2)).
- **Accounts to receive match:** The match must be deposited into a non-Roth account. Taxpayers cannot designate Roth IRAs, Roth 401(k)s, or Roth portions of a 403(b) or 457(b) accounts to receive the match (§6433(e)).
- **Special rules:** Saver's Match contributions do not count against annual contribution limits for retirement plans, are not subject to certain plan nondiscrimination rules, and are protected from offset for most federal debts and tax liabilities. Distributions before age 59 ½ are subject to the 10% early withdrawal penalties unless recontributed .

Alternative minimum tax (AMT) (70107): Generally, the changes made by the TCJA are permanent (amended §55(d)(4)); however, the exemption phaseout threshold is set at 2018 levels. The threshold for MFJ and surviving spouses is reduced from \$1,252,700 in 2025 to \$1,000,000 in 2026, and for other taxpayers is reduced from \$626,350 in 2025 to \$500,000 in 2026. These amounts will be adjusted for inflation after 2026. In addition, the rate at which AMT exemptions phase out from 25% to 50% (new §55(D)(4)(A)(ii)(IV)).

529 account distributions (70413): The limit for distributions for eligible elementary and secondary expenses in §529(c)(7) is increased from \$10,000 to \$20,000 (amended §529(e)(3)).

Estate and gift tax basic exclusion (70106): The higher estate and gift tax exclusion is permanent. For the estates of individuals dying and gifts made in 2026, the basic exclusion is increased to \$15 million (amended §2010(c)(3)(A), with §2010(c)(3)(C) stricken). The amount of the exclusion will be adjusted for inflation beginning in 2027 (amended §2010(c)(3)(B)).

ABLE accounts:

- **Contributions limitation (70115):** The additional contribution allowed to be made by the account beneficiary, if employed, made permanent (amended §529A(b)(2)(B)(ii)) with a slight modification of the inflation adjustment.
- **Saver's credit for contributions (70116):** The eligibility for the Saver's credit (see above) for contributions made by the account beneficiary is permanent (amended §25B(d)(1)).
- **Rollovers from qualified tuition programs (70117):** The ability to roll over funds from qualified tuition programs to ABLE accounts is permanent (amended §529(c)(3)(i)(III)).

Trump savings accounts (70204): Beginning in 2026, a traditional IRA account may be established for eligible children under 18. Contributions to the account, which are not deductible and are excluded from income of the beneficiary, cannot be made until after July 4, 2026, and are limited to \$5,000 per year, adjusted for inflation after 2027. Distributions are not generally allowed before the beneficiary turns 18 (new §530A). For eligible children born between Jan. 1, 2025, and Dec. 31, 2028, parents may elect to receive a \$1,000 refundable tax credit which will be deposited into the child's account. The child must be a U.S. citizen and the child's SSN must be included on the return (new §6434). In addition, there are penalties for improper claims for the tax credit. If due to negligence or disregard of the rules or regulations, the penalty is \$500. If due to fraud, the penalty is \$1,000 (new §6434).

Qualified hazardous duty areas (70118): The tax exclusion for military personnel serving the Sinai Peninsula is permanent and is expanded to include Kenya, Mali, Burkina Faso, and Chad (amended §11026 of P.L. 115-97).

Suspended items scheduled to expire at the end of 2025 made permanent: Certain items suspended by the TCJA through 2025 would have returned in 2026 absent Congressional action. Made permanent in the legislation was no deduction for personal exemptions, other than the senior deduction above (70103), miscellaneous itemized deductions subject to 2% of AGI (70110), and reimbursements for bicycle commuting (70112) which is no longer a qualified fringe benefit, making such reimbursements includible in income.

ONE BIG BEAUTIFUL BILL: IRS RELEASED GUIDANCE

No changes to 2025 Forms W-2, 1099 or withholding tables ([IR-2025-82](#), Aug. 7, 2025): The new tips, overtime, and car loan interest deductions contain certain reporting requirements. In addition, the new law requires the IRS to update the withholding tables to reflect the tips and overtime deduction. In this Notice, the IRS announced that there will be no changes to Form W-2, Forms 1099, and Form 941 or other payroll forms and the federal income tax withholding tables will not be updated for tax year 2025. Employers and payroll providers are to continue using current procedures for reporting and withholding. The IRS is working on guidance and updated forms for tax year 2026 and intends to engage with employers, payroll providers and tax professionals on these. The Notice also stated that more information will be coming on how individuals will claim the tax benefits associated with these items on their 2025 returns as well as guidance for employers and other reporting entities. The IRS is maintaining a [web page](#) on the provisions of the new law.

Beginning of construction for wind and solar credits ([Notice 2025-42](#), Aug. 15, 2025): The new law terminates the clean energy production and investment tax credits under §§45Y and 45E for facilities placed in service after Dec. 31, 2027, but provides for a safe harbor if construction starts by Jul. 4, 2026, and the facility is completed in four years. [Executive Order 14315](#) (Jul. 7, 2025) required Treasury to, within 45 days, issue guidance on what the “beginning of construction” means to ensure the deadlines “are not circumvented.” Below are the major provisions in Notice 2025-42.

- **Beginning of construction defined:** Under the Notice, “beginning of construction” is defined as “when physical work of a significant nature begins” (the Physical Work Test). It gives examples of what is considered “work of a significant nature,” including both off-site and on-site physical work, and emphasizes that cost is not a consideration.
- **Continuity requirement:** The Notice requires that the work be continuous, although certain disruptions are permitted. Allowable disruptions include delays due to severe weather conditions and natural disasters, labor stoppages, financing, supply shortages, and others. The list included in the Notice is not an exclusive list.
- **Placed in service:** The Notice makes it clear that the facility must be placed in service by the end of a calendar year that is no more than four calendar years after the calendar year during which construction began.
- **Effective date:** The Notice is effective for facilities that do not begin construction **before Sept. 2, 2025**.

Proposed regs on tips deduction ([IR-2025-92](#), [REG-110032-25](#), Sept. 19, 2025): The IRS announced the publication of proposed regulations that define “qualified tips” eligible for the new §224 tips deduction and identify occupations that customarily and regularly receive tips. Comments on the proposed regulations are due by Oct. 22, 2025, and a public hearing has been scheduled for Oct. 23, 2025.

Background: Section 224 permits an eligible individual to deduct qualified tips, limited to \$25,000, for tax years 2025 through 2028. The deduction is subject to a phaseout of \$100 for every \$1,000 by which the taxpayer’s modified AGI exceeds \$150,000 (\$300,000 MFJ). Married taxpayers must file jointly to claim the deduction and the taxpayer’s social security number (SSN) must be included. For this purpose, an SSN is valid only if issued to a U.S. citizen or a person authorized to work in the U.S. before the due date of the return.

Qualified tips: Section 224(d)(1) defines “qualified tips” as cash tips received in an occupation that customarily and regularly received tips on or before Dec. 31, 2024, and defines “cash tips” in §224(d)(3) as tips received from customers that are paid in cash or charged and tips received by an employee under any tip-sharing arrangement.

The proposed regulations (§1.224-1(c)(2)) clarify that “cash tips” are those paid by cash; check; credit, debit and/or gift card; tangible or intangible tokens that are regularly exchanged for a fixed amount of cash (such as casino chips); and any other form of electronic settlement or mobile payment application that is denominated in cash. Not included in “cash tips” are items paid in other mediums (event tickets, meals, services, etc.) or assets not exchangeable for a fixed amount of cash (most digital assets).

Section 224(d)(2) states that an amount is *not* a qualified tip unless (1) the amount is paid voluntarily without any consequence if not paid, is not the subject of negotiation, and is determined by the payor; (2) the trade or business in which the individual receives the amount is not a specified service trade or business (SSTB) as defined in §199A(d)(2); and (3) other requirements established in regulations or other guidance is satisfied.

Regarding voluntary payment, the proposed regulations clarify that mandatory amounts added to a customer's bill, such as service charges and automatic gratuities, are not qualified tips even if the amounts are subsequently distributed to employees. If the customer can disregard or modify the amount added to the bill, the amount is not mandatory. Examples of mandatory versus non-mandatory amounts are provided in proposed Reg. §1.224-1(c)(3)(ii) through (x).

The proposed regulations clarify that an employee receiving tips in the course of working for an SSTB is *not* entitled to the tips deduction even if (1) the employee is working in an occupation that customarily and regularly received tips on or before Dec. 31, 2024 or (2) the owner of the SSTB is not able to claim the §199A deduction. Examples are provided in proposed Reg. §1.224-1(c)(4)(ii) through (iv).

Further, the proposed regulations clarify that qualified tips *do not* include (1) those received while performing a service that is a felony or a misdemeanor under applicable law (§1.224-1(c)(6)); (2) amounts received for prostitution services (§1.224-1(c)(7)); or pornographic activity (§1.224-1(c)(8)); and (3) amounts received by those having an ownership in or is employed by the payor of the tip (§1.224-1(c)(9)).

Section 224(c) limits the tips deduction to the net income of the trade or business. The proposed regulations clarify that the deduction for qualified tips is not a trade or business deduction (§1.224-1(d)). Examples are provided in proposed Reg. §1.224-1(d)(3) and (4).

Occupations that customarily and regularly receive tips: The proposed regulations list the occupations that customarily and regularly received tips on or before Dec. 31, 2024 (§1.224-1(f)(1), Table 1). The occupations are divided into eight industry categories: beverage and food service, entertainment and events, hospitality and guest services, home services, personal services, personal appearance and wellness; recreation and instruction, and transportation and delivery. The 68 tipped occupations included are the same as those released earlier.

Tips deduction limitations: The proposed regulations (§1.224-1(b)(1)) clarify that the \$25,000 maximum deduction amount applies regardless of filing status, i.e., the deduction is per tax return, not per taxpayer. In addition, the phaseout (§1.224-1(b)(2)) is applied to the amount of qualified tips (i.e., the lesser of the tips received or \$25,000), not the maximum deduction amount. Examples of these two provisions are provided in proposed Reg. §1.224-1(b)(4) and (5).

OTHER RECENT PRACTICE DEVELOPMENTS

Two U. S. Supreme Court Decisions Dealing With Challenges to IRS Regulations

1. Court Strikes Down Chevron Doctrine, Eliminating Courts' Deference to Federal Agency Regulations (*Loper Bright Enterprises et al., v. Raimondo, Secretary of Commerce, et al.*, Docket No. 22-451, June 28, 2024).

a. **Background.** Since the 1984 Supreme Court decision in *Chevron U.S.A Inc. v. Natural Resources Defense Council, Inc.*, courts have generally been required to defer to certain Federal agency interpretations of statutes (including IRS regulations) that are silent or ambiguous, even if the court's reading of the law is different, provided the agency's interpretation was reasonable. The *Loper Bright* case concerns a pair of challenges to a regulation issued by the National Marine Fisheries Service (NMFS), the agency charged with administering the Magnuson Stevens Fishery Conservation and Management Act (MSA). The MSA incorporates the Administrative Procedure Act (APA), a 1946 federal law that governs the process by which federal agencies (including the IRS) develop and issue regulations. The APA also provides instructions for courts to review the actions of Federal agencies. The NMFS regulation required certain vessels to carry on board observers charged with collecting data "necessary for the conservation and management of the fishery." In 2020, the regulation was changed to require those vessels to bear the costs of carrying the observers if a government-paid observer is not available. NMFS estimated the cost of an observer would be up to \$710 per day. The district court granted summary judgment to the Government citing *Chevron* and the D. C. Circuit Court of Appeals affirmed the decision. The courts found that while there was ambiguity in the statute regarding the responsibility to pay for the observers, the NMFS regulation was reasonable.

b. **The decision.** In a 6-3 decision, the Supreme Court overruled *Chevron*. The court said,

Chevron is overruled. Courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority, as the APA requires. Careful attention to the judgment of the Executive Branch may help inform that inquiry. And when a particular statute delegates authority to an agency consistent with constitutional limits, courts must respect the delegation, while ensuring that the agency acts within it. But courts need not and under the APA may not defer to an agency interpretation of the law simply because a statute is ambiguous.

Because the D. C. and First Circuits relied on Chevron in deciding whether to uphold the Rule, their judgments are vacated, and the cases are remanded for further proceedings consistent with this opinion.

c. **Courts May Still Give "Due Respect" to IRS Interpretations.** While overruling automatic deference, the *Loper Bright* decision preserved the ability of courts to give "due respect" to agency interpretations under the standard established in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). In that decision, the Court held that agency rulings, interpretations, and opinions, "while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance."

Under *Skidmore*, the weight assigned to agency interpretations of statutory provisions depends on the agency's thoroughness, the validity of its reasoning, its consistency with earlier and later pronouncements, and its persuasiveness.

However, the *Loper Bright* majority also recognized that Congress can expressly delegate interpretive authority to agencies (such regulations are generally called legislative regulations). In those cases, the court ruled that a less stringent standard of judicial review applies, with the court stating **that a reviewing court's role under the APA is to independently identify the statutory delegation, determine its boundaries, and ensure the agency has engaged in reasoned decision-making within those boundaries.**

d. **Loper Bright Does Not Overrule Prior Decisions.** The Court makes it clear that this opinion does not apply to previous cases in which decisions relied on *Chevron*, stating "The holdings of those cases that specific agency actions are lawful ... are still subject to statutory *stare decisis* despite our change in interpretive methodology."

Practice Alert! IRS regulations will now be subject to final interpretation by the courts. This may also affect the timing and content of new regulations as the IRS may no longer assume the courts will defer to its regulations. Expect more challenges to regulations issued by Treasury and the IRS and other Federal agencies.

2. Supreme Court Changes the Start of the Six-Year Statute of Limitations for Suits Against the U.S. (*Corner Post, Inc. v. Board of Governors of the Federal Reserve System*, Docket No. 22-1008, July 1, 2024).

- a. Background.** According to 28 U. S. C. §2401(a), suits against the United States (for example, a suit challenging a regulation) must be filed “within six years after the right of action first accrues.” In 2011, the Federal Reserve Board published Regulation II, which set the transaction fees charged to businesses for their acceptance of debit cards. The Board was sued, with the plaintiffs arguing that the costs in Regulation II did not appear in the statute. The D. C. Circuit ruled in 2014 that the rule rested on reasonable construction of the statute. *Corner Post*, a truck stop and convenience store, opened for business in 2018. In 2021, it joined a suit brought against the Board under the Administrative Procedure Act (APA) challenging Rule II. The case was dismissed in District Court and the Eighth Circuit affirmed the dismissal. The Eighth Circuit ruled that the six-year statute of limitations for filing a suit against the U.S. begins to run upon publication of the regulation (2011 in this case) and expires six years later (2017 in this case). Therefore, *Corner Post* filed its lawsuit four years too late (i.e., in 2021).
- b. The decision.** In a vote of 6-3, the Supreme Court determined that the “right of action first accrues” (i.e., the statute for challenging a Federal regulation) begins to run, under the APA when “the plaintiff is injured by final agency action.” The majority opinion mentions that Congress could have included language to make it clear that the statute of limitations begins to run when the regulation is issued. In her dissent, Justice Jackson, joined by Justices Sotomayor and Kagan, argues “there is effectively no longer any limitations period for lawsuits that challenge agency regulations on their face.” The dissent urges Congress to amend the APA to clarify the start of the statute of limitations for challenges to government regulations.

Observation! Expect litigation challenging older IRS regulations to commence.

Practice Alert! Although, taxpayers are no longer required to challenge a government regulation, including an IRS regulation, within six years from the date the regulation is issued, if the challenge involves income taxes, any claim for refund must be filed before the statute of limitations on refunds expires.

Standards of Tax Practice

[Treasury Department Circular No. 230 \(31 U.S.C. §330\)](#). Circular 230 is a document containing the statute and regulations detailing a tax professional's duties and obligations while practicing before the IRS. It contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, registered tax return preparers, and other persons representing taxpayers before the IRS.

In enacting §330, Congress contemplated that only individuals professionally and ethically fit to represent the interests of taxpayers, claimants, and others would be eligible to practice before the IRS. Those eligible would be of good character, have a good reputation, have the necessary qualifications to provide valuable service to the client, and have the competence to advise and assist the client in presenting their cases. Attorneys, Certified Public Accountants (CPA), or Enrolled Agents (EA) not currently under suspension or disbarment from practice before the IRS are eligible without any additional qualifications to represent clients in proceedings before the IRS. Other practitioners are generally eligible to represent clients before the IRS only for returns they prepared. Representing clients includes all communication with the IRS regarding client matters without the client present.

Circular 230 and the regulations thereunder were last updated in June 2014. Several judicial decisions have affected the applicability of the Circular 230 provisions and in November 2020, the Department of the Treasury announced its intention to update them and solicited comments. The AICPA provided its comments in 2021, recommending revisions that encompass the judicial decisions as well as additional recommendations for new

sections covering privacy, data protection, and record retention. Although the submitted comments are currently being reviewed, no date for the release of a revised Circular 230 has been announced.

Latest News on Proposed Regs Updating Circular 230 ([REG-116610-20](#))

Summary. The proposed update to Treasury Department Circular 230 (Circular 230), issued last December, [elicited more than 700 comments](#) from tax practitioners and others affected by the proposed changes. A March 6 public hearing held by the IRS and Treasury included 13 speakers representing the opinions of various stakeholders, including the AICPA, the National Taxpayers Union Foundation, the New York State Society of Enrolled Agents, and several appraiser groups, regarding the proposed regulations. Several issues were identified by the speakers as being troublesome.

Background. Circular 230 governs practice before the IRS and was last updated in 2014. The much-anticipated proposed regulations were published in the *Federal Register* on Dec. 26, 2024, with comments requested by Feb. 24, 2025. The major proposed changes, which were covered in the December newsletter, include tax return preparation, contingent fees, and knowledge of an error or omission. Also provided are rules related to appraisers.

Public comments. Some of the issues raised in the comments were:

- **The Texas Society of CPAs** is concerned that practitioners may be forced to advise their clients to waive their rights under the Fifth Amendment against self-incrimination under the “Knowledge of Error or Omission” section and asks for further clarification on the proposed rule to generally make contingent fees disreputable conduct.
- **The American Institute of CPAs (AICPA)** proposed several changes, including revisions about the practitioner’s duty to advise clients on the disclosure of errors to the IRS, revision or removal of the proposed sections regarding best practices, and the recommendation to focus on the qualifications of the appraisers rather than specific valuation standards.
- **The American Society of Appraisers, the Appraisal Institute, and others** criticized the proposed changes affecting appraisers and business valuation professionals. **The National Taxpayers Union Foundation** requested that the appraisal rules for private appraisers also apply to appraisals by the IRS.
- **The American Society of Tax Problem Solvers** urged the agency to continue to pursue legislative action to grant the IRS the authority to regulate return preparers, arguing that such oversight protects taxpayers. The group also recommended exceptions to the rule against contingent fees.
- **The National Association of State Boards of Accountancy** requested that the IRS rethink the best practice provision requiring a practitioner to evaluate any mental impairments of a client that could affect representation.
- **Reed Smith LLP**, a law firm, commented on the prohibition of contingency fees and its disreputable conduct designation, arguing that Treasury lacks the authority to apply the rule to lawyers. Removal of the applicable section regarding contingent fees was requested and if not removal, a revision to state that the ban on contingent fees does not apply to lawyers was requested.

Key issues identified in the March 6 hearing. Many of the issues identified in the public hearing were previously raised in the public comments. The key issues identified by the hearing participants are as follows:

- **Contingent fees.** Multiple speakers opposed the proposed prohibition on contingent fees, arguing it would limit access to competent tax representation, particularly for taxpayers with limited resources. They suggested that contingent fees should be allowed in most situations, except for original tax returns.
- **Appraisal standards, disqualification of appraisers.** Concerns were raised about the exclusive reference to Uniform Standards of Professional Appraisal Practice (USPAP) in the proposed regulations. Speakers argued that other appraisal standards should also be recognized to avoid confusion and ensure fairness. Concerns were also expressed about the broad authority granted to the IRS to disqualify appraisers. It was suggested that appraiser boards should handle disciplinary actions.
- **Limited practice rights.** The proposed expansion of practice rights for non-credentialed tax preparers was criticized for potentially compromising taxpayer service quality and undermining the enrolled agent credential.
- **Best practices.** New best practices related to data security, mental impairment, and practice continuity were discussed, with some speakers suggesting these should not be mandatory requirements under Circular 230.

- **Continuing education.** There were recommendations to expand allowable continuing education topics to include technology and practice management, and opposition to proposed user fees for CE providers.

Overall, the speakers urged the IRS and Treasury to reconsider certain aspects of the proposed regulations to ensure they do not negatively impact tax professionals and taxpayers.

Comment. It is unknown when the proposed regulations will be finalized. Keep in mind the Jan. 20 [executive order](#) which imposed a regulatory freeze on any new rules or those not yet published in the *Federal Register* until the rule is reviewed by a department or agency head designated by the President, unless the OMB Director exempts the rule.

[AICPA Statements on Standards for Tax Services \(SSTS\)](#). CPAs who are members of the AICPA are bound by the Code of Professional Conduct (“the Code”), the authority under which the SSTS were issued. CPAs who are not members of the AICPA may also be bound by the Code via membership in state CPA societies or by state law. In May 2023, the AICPA adopted the revised SSTS, effective Jan. 1, 2024. The previous seven SSTSs were reorganized into a practice-based framework, and three new standards were incorporated. This resulted in four SSTSs. The new standards are:

- **Data protection.** §1.3 of SSTS No. 1, *General Standards for Members Providing Tax Services*, contains the data protection standard. It requires the practitioner to make a reasonable effort to safeguard taxpayer data and to consider applicable privacy laws when collecting and storing taxpayer data. The standard references both the Gramm-Leach-Bliley Act (GLBA) and the Federal Trade Commission’s Safeguards Rule and compliments the confidentiality standards of the AICPA Code.
- **Reliance on tools.** Despite the increasing reliance on technology in providing tax services, there was no standard specifically addressing this. §1.4 of SSTS No. 1 addresses this oversight by providing guidance. Tools should be used to improve efficiency and to enhance the professional’s understanding of an issue; however, tools cannot supplant professional judgement. Reasonable steps must be taken to satisfy the professional that the results presented by the tool are reliable.
- **Tax representation.** SSTS No. 4 covers the entirely new standard of the representation of clients before any taxing authority. The task force was careful not to duplicate other existing standards, such as those provided in Circular 230, which only covers federal taxes. SSTS No. 4 does not override those standards; rather, it supplements them and serves as a basic standard where a lower or no standard exists. SSTS No. 4 draws on the competency standard included in §1.300.010 of the AICPA Code and reminds tax professionals of the conflict-of-interest standards in §1.000.020 and the integrity and objectivity rules in §§1.100.001 and 2.100.001.

In addition to the new standards, the AICPA released two interpretations related to SSTS No. 1 and No. 2, *Standards for Members Providing Tax Compliance Services, Including Tax Return Positions*. There is also an FAQ document. These items are available on the AICPA website.

Written Information Security Plan (WISP). Tax professionals are required to have a security plan and must acknowledge the requirement when applying for or renewing their Preparer Tax Identification Number (PTIN) by checking the box on line 11 of Form W-12. The authority for this requirement stems from the GLBA, passed by Congress in 1999. The U.S. Federal Trade Commission (FTC) is charged with implementing the GLBA and issued its Standards for Safeguarding Customer Information, known as the Safeguards Rule. Tax and accounting professionals are included in the FTC’s definition of “financial institutions” (§214.2(h)) and are, therefore, subject to this rule. The Safeguards Rule became effective in 2003 but was amended in 2021 to provide more concrete guidance. The Safeguards Rule includes nine specific elements of a written information security plan (WISP). Although the FTC and others have issued guides on creating and maintaining the plan, some have had difficulty developing it, prompting the IRS to issue [Publication 5708, Creating a Written Information Security Plan for your Tax & Accounting Practice](#), which incorporates the nine elements of the Safeguards Rule. Updated in Aug. 2024, Publication 5708 is a template designed to help tax professionals, especially those with smaller practices, meet the security plan requirement.

Caution! Tax professionals now need to report a security event (that is, personal identifying information has been stolen or lost) affecting 500 or more people to the FTC as soon as possible, but no later than 30 days from the date of discovery, using the FTC’s online Safeguards Rule Security Event Reporting Form. This is in addition to

the requirement to report the security event to others, including the IRS and state tax authorities, as outlined in Publication 5708.

Self-reporting of Circular 230 misconduct. In an Alert from the IRS Office of Personal Responsibility (OPR) (Issue 2025-12, Aug. 6, 2025, direct link not available on IRS [website](#) as of this writing), practitioners who self-report Circular 230 violations may benefit from doing so. Violations of Circular 230 can result in sanctions and suspensions, leading to the loss of the ability to practice before the IRS. Self-reporting of the violations may result in less harsh sanctions and favorable settlements.

Circular 230 does not require self-reporting of misconduct; however, as noted in the Alert, other requirements may effectively do so. OPR warns that it is often notified of violations from other sources, such as when state boards of accountancy discipline a CPA, or when a practitioner has been subjected to a criminal or civil judgment. The Alert identifies benefits from self-reporting, including the potential to serve a Circular 230 suspension simultaneously or concurrently with one imposed by state board of accountancy or state bar. The Alert states that practitioners who self-report, accept responsibility of their conduct, and express a genuine intention to reform their behavior are “prime potential candidates for a deferred discipline agreement or other settlement.”

IRS to Start Verifying PTINs. According to a recent *Tax Notes* article, the IRS is planning to start verifying preparer identification numbers (PTIN). Thousands of preparers are not renewing the numbers, and some are using fake numbers. In addition, Form 14157, *Return Preparer Complaint*, [has been digitized](#), which the IRS hopes will make it easier for tax professionals to report bad actors. Previously, the form had to be mailed to the IRS.

Updated Offer in Compromise Form 656-B (Rev. 4-2024). The IRS updated its [Form 656 Booklet, Offer in Compromise](#), in April 2024. To make an offer in compromise (OIC), you must use this latest booklet, which includes the instructions and forms necessary to make the offer.

- **What is an OIC?** An offer in compromise allows taxpayers to settle their tax debt for less than the full amount owed. The IRS will consider the taxpayer’s ability to pay, income, expenses and equity in assets, based on the taxpayer’s unique facts and circumstances, to determine approval. Offers can be for a lump sum amount or for periodic payments. The IRS states that it generally accepts an OIC when the amount “represents the most we can expect to collect in a reasonable period of time.”
- **Who is eligible for an OIC?** The IRS has a tool (available at irs.gov/OICtool) for individual taxpayers to use to determine their eligibility. To be eligible, the taxpayer must have filed all required returns and made all required estimated payments, have received a bill for at least one tax period included in the offer, and are not in an open bankruptcy proceeding. If the taxpayer is an employer, they must have made tax deposits for the current and past two quarters. If the taxpayer applies but is not eligible, the application fee (\$205, unless the taxpayer meets the low-income certification guidelines) and any offer payment included with the application to their balance due is not returned.
- **More information.** [IRS Tax Tip 2024-37](#) (April 24, 2024) contains additional information on an OIC, including a warning to be aware of promoters who mislead taxpayers and charge often excessive fees. There is also an [FAQ](#) on OIC.

Practice pointer! An OIC may not be appropriate for a taxpayer, even if they are eligible. For some, the offer terms (included in §7 of Form 656 in the booklet) may be onerous, such as the filing of a federal tax lien against the taxpayer’s property.

Updated list of automatic changes in accounting methods (Rev. Proc. 2025-23). The IRS has updated the list of automatic changes in accounting methods for which the procedures in Rev. Proc. 2015-13, as modified, apply. The new Rev. Proc. also supersedes, in part, Rev. Proc. 2024-23. Listed are 18 significant changes, including 10 that remove obsolescent language and five that are clarifications. Automatic accounting method changes are generally made by attaching Form 3115, “[Application for Change in Accounting Method](#),” to the income tax return and filing a duplicate.

Delay in electronic payment processing. The IRS [announced](#) that there has been a delay in processing some electronic payments. This may result in notices being sent to affected taxpayers, which the IRS urges taxpayers to ignore if the tax owed was paid in full and on time.

Digital asset reporting relief ([Notice 2025-33](#)). The IRS is providing an additional year of relief from backup withholding and related penalties for brokers who fail to report the sale and exchange of certain digital assets on Form 1099-DA, “Digital Asset Proceeds From Broker Transactions.” An earlier notice (Notice 2024-56) extended relief for transactions effected in calendar year 2025. The latest notice extends the relief to transactions effected in calendar year 2026.

Interim final regulations and proposed regulations for user fee on estate closing letter ([T.D.10031](#), [REG-107459-24](#)). The user fee imposed on a request for the issuance of an estate closing letter is to be reduced from \$67 to \$56. The interim final regulations and the proposed regulations contain identical text. Comments are requested on the proposed regulations by July 21.

Some scam victims can deduct theft loss ([CCA 202511015](#), released March 14, 2025). A CCA memorandum provides guidance on five taxpayers who are the victims of various scams and determines that some of them are deductible under § 165.

Background. Section 165 permits the deduction of losses to the extent not reimbursed by insurance or otherwise. The deduction for individual losses under § 165(c) are limited to (1) losses incurred in a trade or business; (2) non-trade or business losses incurred in a transaction entered into for profit; and (3) other losses of property arising from fire, storm, shipwreck, or other casualty, or from theft. Unless there are casualty gains, the TCJA limited the last category of losses to those in a Federally declared disaster area. This provision was made permanent and beginning in 2026, losses incurred in state declared disasters also qualify (§ 165(h)(5)).

Deductible theft losses. The CCA concluded that in each scenario, the taxpayer sustained a theft loss due to an illegal taking of property that is considered criminal theft under applicable state law. If deductible, § 165(e) permits deduction of the theft loss in the taxable year of discovery, unless there is a reasonable prospect of recovery. In none of the scenarios was the taxpayer eligible to use the Ponzi loss safe harbor provided in [Rev. Proc. 2009-20](#) as modified by [Rev. Proc. 2011-58](#) because the requirements were not met.

The CCA provides this background to the discussion of the five taxpayers:

Scammer A perpetrated scams against Taxpayers 1 through 5 through fraud and deceit that constituted criminal fraud, larceny or embezzlement under the law of the state where the victims reside. In addition, Scammer A’s true identity was unknown, the transfers of funds were irreversible, the losses were not covered by insurance, the victims had no legal recourse against any third party, and law enforcement stated that there was little to no prospect of any recovery. Accordingly, as of December 31, 2024, Taxpayers 1 through 5 had no reasonable prospect of recovery and sustained an actual theft loss under § 165. [...] Taxpayers 1 through 5 invested funds in IRA and non-IRA brokerage type accounts that generally invest in securities, and other financial products, the purchase of which is considered prima facie evidence of a profit motive.

In all cases, then, the year of loss is 2024. The IRA accounts are presumed to be traditional IRA accounts in which the taxpayer has no basis.

Taxpayer 1 — Compromised Account Scam, Taxpayer 2 — Pig Butchering Scam, and Taxpayer 3 — Phishing Scam. Scammer A contacted Taxpayer 1, claiming to be a fraud specialist at the taxpayer’s financial institution. Scammer A stated that Taxpayer 1’s computer and bank accounts had been compromised and induced Taxpayer 1 to authorize distributions from IRA and non-IRA accounts and to transfer the distributions to new investment accounts created by Scammer A. Once the transfers were completed, Scammer A emptied the accounts.

Scammer A sent an unsolicited email to Taxpayer 2 advertising an investment opportunity in cryptocurrency and promising large profits. Taxpayer 2, via a website provided by Scammer A, invested a small sum, saw it increase in value, and withdrew the money. This happened several times, with Taxpayer 2 investing increasing amounts of money taken from IRA and non-IRA accounts. A last attempt to liquidate the account was met with an error message on the website and no response from customer support.

Taxpayer 3 also received an unsolicited email from Scammer A, this one claiming that Taxpayer 3’s accounts had been comprised. The email looked official and contained a phone number to call. Taxpayer 3 called the number and was directed to click on the link in the email and log into their tax-deferred and non-IRA accounts. By clicking on the link, Taxpayer 3 gave Scammer A access to Taxpayer 3’s computer and Scammer A was able to obtain Taxpayer 3’s login information and used this information to distribute the funds to an overseas account.

In all three cases, the CCA concluded that the theft losses incurred are deductible theft losses under § 165(c)(2) and that the amount of the loss is the taxpayer's basis under § 165(b). The taxpayers will be liable for tax on the IRA account distributions and recognize gain or loss from the disposition of the assets in the non-IRA accounts. The CCA indicates that basis for determining the theft loss will be increased by any gain recognized on the IRA distributions and increased or decreased by any gain or loss recognized on the disposition of assets in non-IRA accounts. A theft loss from a transaction entered into for profit is reported on [Form 4684](#), Section B — Business and Income-Producing Property.

Taxpayer 4 — Romance Scam and Taxpayer 5 — Kidnapping Scam. Taxpayer 4 received an unsolicited text message from Scammer A and the two developed a virtual romantic relationship. Scammer A convinced Taxpayer 4 to take distributions from IRA and non-IRA accounts to help pay the medical bills of a relative of Scammer A. The distributed money was transferred to an overseas account, after which Scammer A stopped responding to messages.

Scammer A contacted Taxpayer 5 by text and phone, claiming to have kidnapped Taxpayer 5's grandson for ransom. Scammer A used artificial intelligence to clone the grandson's voice, with him begging for help, which Taxpayer 5 heard over the phone. Taxpayer 5 authorized distributions from IRA and non-IRA accounts and transferred the funds to an overseas account provided by Scammer A. Shortly after, Taxpayer A was able to contact the grandson and determined that no kidnapping had taken place.

The CCA concluded that there was no profit motive in these two cases, as the losses were not incurred in a transaction entered into for profit. Therefore, the losses are personal casualty losses under § 165(c)(3). As there were no casualty gains and the losses were not attributable to a Federally declared disaster, the theft losses are not deductible. The taxpayers will be liable for any tax on the IRA account distributions and will recognize gain or loss from the disposition of the assets in the non-IRA accounts.

IRS Revenue Agent Indicted for Filing False Tax Returns (*United States v. Ndeye Amy Thioub*, Docket No. 1:24-cr-10098, United States District Court, District of Massachusetts, April 16, 2024)

Background. Ndeye Amy Thioub was hired in 2006 as a Revenue Agent (RA) in the IRS Large Business and International Division, working in the Boston office. As an RA, Thioub received training related to her duties, including annual training on employee tax compliance. In addition to a master's degree in accounting and a master's degree in business administration in financial management, she obtained her Massachusetts CPA license in 2010. In addition to her IRS position, Thioub worked as a Visiting Instructor at Salem State University, teaching college-level classes that included instruction on the verification of records; valuation and analysis of accounts; the importance of financial accounting and financial statements; professional standards; and **ethics**, professional responsibilities and legal liabilities issues facing auditors

An IRS Criminal Investigation Division Investigative Analyst (IA) began to review information related to taxpayers with large Schedule C losses over several consecutive years, concerned that they may have exceeded the presumption contained in IRC §183(d) that an activity is engaged in for profit if it is profitable for three years in five consecutive tax years. During the review, the IA noticed that one taxpayer had such losses for tax years 2010 through 2017. The taxpayer also had an IRS W-2 and was identified as Thioub. The review expanded to include tax years through 2019.

- **The indictment.** Barred by the statute of limitations for tax years 2010 through 2016, Thioub was arrested in March 2024 for allegedly filing false personal returns for tax years 2017, 2018, and 2019. She was subsequently indicted on April 16, 2024, for three counts each of filing false tax returns and filing false tax returns as an employee of the United States. She is alleged to have understated her income by \$90,192 over the three years resulting in additional tax owed of \$20,511.
- If convicted, Thioub is facing prison time, fines, and being fired. The charge of filing a false tax return carries a sentence of up to three years in prison, followed by one year of supervised release and a fine of \$100,000. The charge of filing a false return by a U.S. employee provides for discharge from employment, a sentence of up to five years in prison followed by one year of supervised release, and a \$10,000 fine.

Observation. The potential penalties for this conduct far outweigh the taxes saved by Thioub by claiming these losses.

IRS Increases Security Measures for Obtaining Client Transcripts by Phone to Protect Against Identity Theft (IR-2024-136, May 9, 2024)

The IRS has taken new security steps to change how tax professionals can order transcripts by phone through the Transcript Delivery System (TDS). IR-2024-136 says that beginning April 8, 2024, tax professionals need to call the Practitioner Priority Service (PPS) line at 866-860-4259 to request transcripts to be deposited into their Secure Object Repository (SOR) mailbox. IRS employees on other phone lines may not be authorized to provide transcripts through the SOR delivery method. The information release says tax professionals will need to pass enhanced authentication which requires them to verify their Short ID. A Short ID is an 8 to 10 alphanumeric code assigned when an IRS e-Services account is established. If the identity of the caller cannot be verified, transcripts will not be delivered using the SOR delivery method but will instead be mailed to the taxpayer's address of record. For additional information, please see [Practitioner Priority Service® | Internal Revenue Service](#).

Practice Alert! There are other ways to obtain transcripts other than by phone. Please see [Practitioner Priority Service® | Internal Revenue Service](#) for other ways to receive a taxpayer's transcript.

IRS Warns of Scams Targeting Tax Professionals

EFIN Scam. The IRS is warning tax professionals about a scam email that tries to steal electronic filing identification numbers (EFINs) to gain access to client data and a tax preparer's identities. The IRS says the scheme creates the potential for scammers to file fraudulent tax returns for refunds. The scammers impersonate software companies and say in the email that they need EFIN documents for a required verification to transmit tax returns.

The IRS says it has received dozens of reports of the scam targeting tax professionals and says professionals should be alert for a scam email that includes a U.S.-based area code for faxing EFIN documents and provides instructions on obtaining EFIN documentation from the IRS e-Services site. Scam variations seen by the IRS use different fax numbers for software vendors. Other warning signs of a scam include inconsistencies in the email wording and a German footer in the email. The IRS says tax professionals who receive these emails should not respond to the email and should not proceed with any of the steps displayed in the email. **IRS says the body of the fraudulent email states:**

Dear [recipient_email_address],

Help us protect you.

Because many Electronic Filing Identification Numbers (EFINs) are stolen each year and used to file fraudulent tax returns, the IRS has asked software vendors, such as Software A, to verify who the EFIN owner is by getting a copy of the IRS issued EFIN document(s). Our records show that we do not have a document for one or more of the EFINs that you transmit with.

What this means for you: Until your EFIN is verified, you will be unable to transmit returns. Please provide a copy of your EFIN Account Summary from IRS e-Services, with a status of 'Completed', to Software B for verification.

To send us your EFIN Summary document:

- 1. Fax to Software B at 631-995-5984*

PLEASE NOTE THAT YOUR PREPARER TAX IDENTIFICATION NUMBER (PTIN) APPLICATION CANNOT BE USED AS DOCUMENTATION FOR YOUR EFIN.

If you do not have the above documentation you can get a copy of your IRS Application Summary from IRS e-Services by following the below steps or call the IRS e-Services helpline at 866-255-0654.

- 2. Sign in to your IRS e-Services account*
- 3. Choose your organization from the list provided and click Submit*
- 4. Click the Application link to access your existing application*
- 5. Click the e-File Application link*

6. Select the existing application link that applies to your organization
7. Click the Application Summary link for the area of the application you wish to enter
8. Click the Print Summary link at the bottom of the summary presented on the screen

If you have any questions please contact the Compliance Department at xxx-xx-xxxx for assistance.

Thank you for your business. We look forward to serving you this coming season. Software B (edited) for verification.”

IRS Commissioner Danny Werfel said in a statement, "This scam serves as a powerful reminder that tax professionals should ensure strong security at their practices, including reminding employees to be careful with any emails coming in that could be posing as an official communication."

The IRS says that tax professionals who receive the scam email should report it to the [Treasury Inspector General for Tax Administration](#) (TIGTA). The professional should also send the email as an attachment to phishing@irs.gov. The IRS says that tax professionals who suspect data theft has occurred should report it to their local [IRS stakeholder liaison](#).

New Client Scam. As part of its “Dirty Dozen” tax scams, the IRS warns tax professionals about a “New Client Scam”. In this scam the tax preparer receives an email that seems to be from a new potential client. The preparer responds to the email and the scammer sends a malicious attachment or URL usually pretending to be the potential client’s tax information that, if opened, enables the scammer to gain access to sensitive client information on the preparer’s computer systems. The IRS says to never click suspicious links, double check the requests with the original sender, and to be vigilant year-round, not just during filing season.

BOI Reporting Not Required for Domestic Entities and Owners

Summary. All entities created in the United States and their U.S. beneficial owners are no longer required to file Beneficial Ownership Information (BOI) reports. Existing foreign companies have at least 30 days from March 21 to file.

Background. The Financial Crimes Enforcement Network (FinCEN) is a bureau of the U.S. Department of the Treasury (Treasury) and is responsible for implementing the Corporate Transparency Act (CTA), which includes BOI reporting. After numerous court challenges, some still ongoing, FinCEN [announced](#) on Feb. 18 a filing deadline of March 21, 2025, for most reporting companies established prior to Jan. 1, 2024, to file initial, updated, and/or corrected BOI reports. Its Feb. 18 notice indicated that it would be revising the BOI reporting requirements and that a further delay in the requirement may be forthcoming.

In a Feb. 27 [release](#), FinCEN announced that it would not take any enforcement actions, including fines or penalties, against any reporting companies that failed to comply with the BOI reporting requirements by the current deadlines. The release stated that an interim final rule to extend the BOI reporting deadlines would be issued by March 21.

On March 2, Treasury [released](#) a statement that it will not enforce any penalties or fines associated with the BOI reporting requirements under the existing deadlines and that no penalties or fines will be enforced against U.S. citizens, domestic reporting companies, or their beneficial owners after rule changes take effect. Further, Treasury will be issuing a rule “that will narrow the scope” of the BOI reporting rule “to foreign reporting companies only.”

The Treasury release elicited some pushback from the bipartisan FACT Coalition and other groups concerned that the exclusion of domestic reporting companies made it possible for [dirty money](#) to flow into the U.S. and may be unconstitutional. In a March 6 briefing, the groups stated that as many as 99.8 percent of all covered entities would be exempt, effectively gutting the anti-money laundering law.

BOI reporting requirements eliminated for U.S. companies and U.S. persons. In a March 21 [release](#), FinCEN announced the issuance of an [interim final rule](#) (IFR) that eliminated the requirement for U.S. companies and U.S. persons to report beneficial ownership information. Entities formed under the law of a foreign country and have registered to do business in the United States will have to report their foreign beneficial owners only. Those foreign entities who registered to do business in the United States before the publication of the IFR must file BOI reports within 30 calendar days of publication. Those who register to do business after the publication of the IFR have 30 calendar days after receiving notification that their registration is effective to file their initial reports.

Comment. It was previously estimated that 71,000 foreign entities would have to file BOI reports in 2024, and about 11,000 new foreign entities would have to file each year after 2024. This pales in comparison to the estimated 36 million domestic entities required to file in 2024 and an additional 5 million each year after that. During the March 6 briefing, one concern voiced was that the distinction between shell companies formed in the U.S. and those formed in foreign companies fails to consider the underlying risk. Transparency International's Scott Greytak stated in the briefing that "The problem here is anonymous shell companies, regardless of where they are formed." It is reasonable to expect litigation on this.

New ID.me PTIN registration sign-in process. On June 26, the Director of the IRS Return Preparer Office sent an email announcing that tax preparers with a Social Security number would soon be required to sign into the [Tax Professional PTIN System](#) with ID.me. A subsequent email on July 15 announced that the sign-in process has been updated, allowing access to those with an ID.me account. The email notes that the existing sign-in method (Username and Password) for tax return preparers with a SSN will no longer be supported in the near future. Those with an ID.me account from a state government or another federal agency can sign in without re-verifying their identity. Those without an ID.me account will have to create one. To do so, users will need a government-issued photo ID, an email address, and a camera-enabled computer or mobile device. Additional information about ID.me can be found on the [IRS website](#). The ID.me credential enables access to various IRS online services, including the [Tax Pro Account](#), [e-Services](#), and others.

IRS, Security Summit Protect Your Clients, Protect Yourself campaign ([IR-2025-73](#)). The IRS and Security Summit partners announced a five-week campaign to help tax professionals protect themselves against tax-related identity theft threats. Week one of the series covered new and evolving scams targeting tax pros, including the "new client" scheme, phishing attempts to obtain the tax pro's EFIN, PTIN, and CAF numbers, and various phone, text, and correspondence scheme. In week two ([IR-2025-75](#)), phishing scams are highlighted and information on the six essential steps needed to address the attacks. The third week focuses on the details of the Written Information Security Plan, which all tax pros are required to have. The fourth week will cover the tools to help protect the tax pro and clients. The final week will address identify theft — how to recognize the signs of it and how to report it.

Chatbot available for e-Services. The IRS recently announced that its chatbot technology has been expanded to e-Services. The new feature provides answers to frequently asked questions and is available via the Chat icon on the [e-Services page](#). Note that the chatbot will not answer account-specific questions.

Privacy Concerns. Via another [executive order](#), the Department of Government Efficiency (DOGE) was established in the Executive Office of the President. The order renamed the United States Digital Service to the United States DOGE Service (USDS) and a temporary organization, the U.S. DODGE Service Temporary Organization, was established within the USDS. Further, the order stated that the USDS was to be led by an Administrator. Each agency was directed to establish a DOGE Team of at least four employees, and the team could include Special Government Employees. The order also required agency heads to ensure USDS access to "all unclassified agency records, software systems, and IT systems."

DOGE's access to various IT systems has been the subject of many news articles but its [attempt to access IRS's systems](#) has privacy advocates concerned. As noted above, the Administrator of USDS is unknown but the Feb. 17 court filings show it is not Elon Musk; rather, Musk is a Special Government Employee and is, therefore, eligible to be a member of an agency's DOGE team.

Nineteen state attorneys general obtained a temporary restraining order (TRO) ([State of New York, et al., v. Trump, et al.](#), No. 1:25-cv-01144), preventing Treasury from giving any political appointees or special government employees (which would include DOGE) access to the payment systems of the Bureau of the Fiscal Service (BFS). The TRO was [modified](#) to allow the Secretary and Deputy Secretary of the Treasury to have access.

Several other lawsuits have been filed by taxpayer advocacy groups, nonprofits, unions, and others seeking to deny DOGE access. Part of the arguments being made point to IRC §6103. This Code section declares that tax returns and tax return information is confidential and cannot be disclosed except in certain circumstances and only with the permission of the Treasury Secretary. One of the lawsuits notes that the protection of tax return information in §6103 came in response to Watergate and the Nixon administration's attempts to audit its opponents. In conjunction with §6103, §7431 provides for civil damages for the unauthorized inspection or disclosure of returns and return information, §7213A provides for criminal penalties for the unauthorized inspection

of returns or return information (the section under which former IRS contractor Charles Littlejohn, who shared tax return information with the New York Times and Pro Publica, pled guilty and was sentenced to 5 years in prison), and §7217 prohibit executive branch interference with audits or investigations of a taxpayer's tax liability.

Meanwhile, former Treasury officials are speaking out. Ten former officials, including former IRS Commissioner Danny Werfel, filed [a brief](#) in support of the 19 state attorneys general, arguing that DOGE access to BFS systems poses serious risks to the integrity of the payment system. In a *Tax Notes* article, former IRS Commissioner John Koskinen said, "As a general matter, political appointees never, as in never, have access to individual taxpayer files."

Finally, both the Treasury Inspector General and the GAO [have opened investigations](#) into DOGE's "unprecedented access to the federal government's payment systems."

Final Regulations on Catch-Up Contributions ([IR-2025-91](#), [T.D. 10033](#), Sept. 15, 2025)

Summary. The SECURE 2.0 Act permits increased catch-up contributions for those ages 60 to 63 and also requires catch-up contributions for certain high earners to be Roth contributions.

Background. Section 109 of the SECURE 2.0 Act modified §414(v)(2) to provide a higher catch-up limit for those turning ages 60 through 63 in the calendar year, effective for tax years beginning after Dec. 31, 2024. The higher catch-up limit for employer plans other than SIMPLE plans is 150% of the catch-up limit in effect for 2024 (\$7,500 x 150% = \$11,250 for 2025), while for SIMPLE plans, the higher catch-up limit is 150% of the catch-up limit in effect for 2025 (\$3,500 x 150% = \$5,250 for 2025).

Separately, section 117 of the SECURE 2.0 Act modified §414(v) for SIMPLE plans to allow those with no more than 100 employees who received at least \$5,000 in pay in the previous year an increased catch-up limit for employees ages 50 to 59 and 64 or older equal to 110% of the catch-up limit. This increased limit applies to taxable years beginning after Dec. 31, 2023, using the 2024 catch-up limit (\$3,500 x 110% = \$3,850 for 2024 and 2025). The increased deferral limit applies automatically for employers with up to 25 employees who received at least \$5,000 in pay in the previous year. For employers with 26 to 100 employees who received at least \$5,000 in pay in the previous year, the increased deferral limit applies if the employer provides a fully vested 4% (instead of 3%) matching contribution or a 3% (instead of 2%) non-elective contribution.

Finally, section 603(a) of the SECURE 2.0 Act added §414(v)(7) to the IRC and contains the requirement that catch-up contributions by certain employees must be designated Roth contributions. This requirement does not apply to SEP or SIMPLE plans. In [Notice 2023-62](#), the first two taxable years beginning after Dec. 31, 2023, are an administrative transition period for the Roth catch-up requirement. Roth contributions, therefore, are not required for 2024 or 2025 for those with wages in excess of \$145,000. The Notice also stated that the Roth catch-up requirement would not apply to those who did not have FICA wages in the preceding year from the employer sponsoring the plan.

The IRS released proposed regulations on these issues in January ([IR-2025-07](#), Jan. 10, 2025, [REG-101268-24](#), Jan. 13, 2025), as noted in the April newsletter. Regarding sections 109 and 117 of the SECURE 2.0 Act, the proposed regulations made it clear that the higher catch-up limit for those turning 60, 61, 62, or 63 during the calendar year are optional for employers to include in their plans. In the proposed regulations related to section 603(a) of the SECURE 2.0 Act, the proposed regs permit employers to offer catch-up contributions but do not require that the plan contain a Roth component. In that case, employees subject to the Roth catch-up rule would not be allowed to make any catch-up contributions. The proposed regulations also included a deemed irrevocable Roth catch-up election and two methods of correcting violations of the Roth catch-up requirement.

Final regulations. The final regulations generally follow the proposed regulations, with changes that were made in response to comments. The preamble addresses many of the comments and explains the reasoning for adopting or rejecting them. The final regulations generally apply to contributions in tax years beginning after Dec. 31, 2026.

Among the changes made are the following:

- a. **Increased catch-up for small employers.** The final regulations clarify that the 10% increase (under section 117 of the SECURE 2.0 Act) only applies to those employees not eligible for the higher catch-up contributions for those ages 60 to 63.

b. **Deemed Roth catch-up election.** To facilitate compliance with the Roth catch-up requirement, the final regulations maintain the rule that permit a plan to provide that a participant who is subject to the rule is deemed to have irrevocably designated any catch-up contributions as Roth contributions; however, they clarify that the deemed election must cease to apply to an employee within a reasonable time following the date on which the employee is no longer subject to the Roth catch-up requirement or an amended W-2 is filed indicating the employee is not subject to the requirement. Catch-up contributions that were designated as Roth contributions do not need to be recharacterized as pre-tax contributions. The final regulations also incorporate a commenter's request to be permitted to deem elective deferrals as designated Roth contributions once total elective deferrals have reached the §401(a)(30) limit. A plan amendment is required to apply a deemed Roth catch-up election to a participant. A request to permit plans to require that all participants' catch-up contributions be made as designated Roth contributions was rejected.

c. **Correction of violations of Roth catch-up requirement.** Generally, excess pre-tax contributions are required to be distributed to the employee. Instead of making a distribution, the proposed regulations included two methods to correct these but required that an employer apply the same method for all affected employees.

The final regulations retain the "Form W-2 Correction Method" in which the contribution (not adjusted for allocable gain or loss) would be includible in the participant's gross income for the year of deferral as if the contribution had been correctly designated as a Roth contribution. Use of this method would only be allowed if the participant's W-2 for the year has not been filed or furnished to the participant. The final regulations retain the Form W-2 correction method; however, the amount would be adjusted for allocable gain or loss.

The second correction option is the "In-Plan Rollover Correction Method." Under this method, a plan would directly roll over the excess amount (adjusted for allocable gain or loss) from the participant's pre-tax account to the participant's Roth account and report the amount on Form 1099R. The final regulations clarify that only a plan – and not a plan participant – is permitted to make the in-plan rollover. In addition, they clarify that the adjustment for allocable gain or loss be calculated in accordance with the flexible standard under §1.402(g)-1(e)(5).

Lastly, the final regulations do not require that a plan apply the same correction method to all applicable participants.

VIRTUAL CURRENCY

IRS Treatment of Virtual Currency

IRS Definition of Virtual Currency. The IRS defines a virtual currency as a digital representation of value, other than a representation of the U.S. dollar or a foreign currency (“real currency”), that functions as a unit of account, a store of value, and a medium of exchange. Some of these have equivalent values in relation to a “real” currency and can be exchanged for such. **Bitcoin is one example of a convertible virtual currency.** Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. The IRS generally uses the term “virtual currency” to describe the various types of convertible virtual currency that are used as a medium of exchange, such as digital currency and cryptocurrency. Regardless of the label applied, the IRS says if a particular asset has the characteristics of virtual currency, it will be treated as virtual currency for Federal income tax purposes.

Cryptocurrency. Cryptocurrency is a type of virtual currency that uses cryptography (think of this as using mathematical or algorithmic codes) to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. A blockchain is basically a digital ledger of transactions that is duplicated and distributed across the entire network of computer systems on the blockchain. This makes it very difficult to inappropriately change the records. A transaction involving cryptocurrency that is recorded on a distributed ledger is referred to as an “on-chain” transaction; a transaction that is not recorded on the distributed ledger is referred to as an “off-chain” transaction.

Virtual Currency Generally Treated as Property for Income Tax Purposes. The federal tax rules generally treat virtual currencies as property and thus the rules related to property transactions will generally apply to virtual currencies. So, normally the disposition of a virtual currency will result in capital gain or loss. If the result is a capital loss, it is subject to the normal rules limiting capital losses. As with other capital assets, whether the capital gain or loss is long-term or short-term depends on the taxpayer’s holding period of the virtual currency. The gain or loss is the difference between the taxpayer’s basis in the virtual currency and the amount realized (amount received) in the exchange. Also as with most assets, the taxpayer’s basis is usually the amount spent in real currency to acquire the virtual currency, including fees, commissions, and other acquisition costs in U.S. dollars.

Receipt of Virtual Currency for Services Triggers Ordinary Income. If a taxpayer receives virtual currency in exchange for performing services, such as “mining,” the taxpayer will recognize ordinary income based on the value of the virtual currency received. (Mining is the way the network confirms new transactions. It involves the use of sophisticated computers that solve complex computational math problems.) This is true even if the services are not performed as an employee. In fact, **if the taxpayer is an independent contractor, the virtual currency received will also be subject to the self-employment tax.** The fair market value of virtual currency paid as wages, measured in U.S. dollars at the date of receipt, is subject to Federal income tax withholding, FICA tax, and FUTA tax and must be reported on Form W-2. In all cases, the income amount is the fair market value (in U.S. dollars) of the virtual currency at the time received. In an on-chain transaction the virtual currency is received on the date and at the time the transaction is recorded on the distributed ledger. In the case of service providers, the amount included in income becomes the basis in the virtual currency.

Virtual Currency in Return for Services or Property. The IRS says using virtual currency held as a capital asset to pay for a service will usually result in a capital gain or loss equal to the difference in the taxpayer’s basis in the currency and the value of the services on the date of the payment. This is also the result if the taxpayer exchanges virtual currency for property. The basis of the property received is its fair market value at the time of the exchange. While acquiring virtual currency for cash does not result in gain or loss, if the taxpayer transfers capital assets in exchange for virtual currency, this will result in a capital gain or loss from the disposition of the property. If property other than capital assets is exchanged for virtual currency, the taxpayer will recognize ordinary gain or loss.

Transferring From One Wallet or Account to Another. When a taxpayer transfers virtual currency from a wallet, address, or account belonging to another wallet, address, or account **that also belongs to them, this is a non-taxable event.**

Identifying Which Virtual Currency Is Transferred. As with other types of property, taxpayers may choose which units of virtual currency are deemed to be transferred. Therefore, they can specifically identify which unit or units of virtual currency are involved in the transaction. **If the taxpayer does not specifically identify the units, the units of virtual currency are deemed to have been sold on a first in, first out (FIFO) basis.**

To specifically identify a unit of virtual currency, the taxpayer can document the specific unit's unique digital identifier such as a private key, public key, and address, or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet, or address. This information must show 1) the date and time each unit was acquired, 2) the basis and the fair market value of each unit at the time it was acquired, 3) the date and time each unit was sold, exchanged, or otherwise disposed of, and 4) the fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property or services received for each unit.

Charitable Contributions of Virtual Currency. As with other non-cash property, taxpayers may donate virtual currencies to charitable organizations. When virtual currencies are donated to a charitable organization (§170) the taxpayer will not recognize income, gain, or loss from the donation. If the virtual currency is held for more than one year prior to the donation, the charitable deduction is generally equal to the fair market value of the virtual currency at the time of the donation. However, if the virtual currency has been held for one year or less at the time of the donation, the deduction is the lesser of the taxpayer's basis in the virtual currency or the virtual currency's fair market value at the time of the contribution.

Practice Alert! As with other charitable contributions, a proper receipt must be obtained and Form 8283 may be required to receive a deduction for the charitable contribution.

Current Information Reporting Rules for Virtual Currency. Taxpayers often wonder whether payments made with virtual currency are subject to information reporting. The IRS clarified in Notice 2014-21 that the information reporting rules for payments with virtual currency are the same as for payments with other types of property. So, the trade or business that makes a fixed and determinable payment using virtual currency with a value of \$600 or more to a U.S., non-exempt recipient in a taxable year is required to report the payment to the IRS and to the recipient. Examples of this type of payment include rent, salaries, wages, premiums, annuities, and compensation.

The IRS also points out in Notice 2014-21 that payments in virtual currency by a business of \$600 or more in a taxable year to an independent contractor for the performance of services is required to be reported to the IRS and to the payee on Form 1099-MISC (now form 1099-NEC). The fair market value of the virtual currency in U.S. dollars as of the date of payment should be reported on the form.

Backup Withholding May Apply to Payments in Virtual Currency. Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required.

1099-K Reporting May Apply to Payments in Virtual Currency. Businesses that settle payments made in virtual currency for merchants that accept virtual payments from customers also have reporting requirements. The IRS notes that generally a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization (TPSO) and that these organizations are required to report payments made to a merchant on a Form 1099-K, Payment Card and third-party Network Transactions, if, for a calendar year prior to 2022, 1) the number of transactions settled for the merchant exceeded 200, and 2) the gross amount of payments made to the merchant exceeded \$20,000. However, the American Rescue Plan Act (ARP) lowered the exception from filing Form 1099-K by Payment Settlement Entities to **\$600, with no minimum number of transactions effective for calendar years beginning after Dec. 31, 2021.**

Practice Alert! IRS Notice 2023-10 provides that 2022 will be a transition period and penalties will not apply where a third-party settlement organization applies the prior law \$20,000/200 transaction exemption for 2022.

Virtual Currency Forks. A fork in a cryptocurrency occurs when it is decided that there needs to be a change in the protocol of the currency.

- **Hard Fork.** A hard fork occurs when a virtual currency undergoes a protocol change resulting in a permanent diversion from the legacy distributed ledger. Another way to think about this is that the change is not backwards compatible. This may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. The IRS says, if a taxpayer's cryptocurrency went through a hard fork but the taxpayer did not receive any new

cryptocurrency, whether through an airdrop (a distribution of cryptocurrency to multiple taxpayers' distributed ledger addresses) or some other kind of transfer, the taxpayer does not have taxable income.

If a hard fork is followed by an airdrop and the taxpayer receives a new cryptocurrency, the taxpayer may have taxable income in the taxable year the taxpayer receives that cryptocurrency.

The IRS says when a new cryptocurrency is received, the recipient will have ordinary income equal to the fair market value of the new cryptocurrency when the transaction is recorded on the distributed ledger, provided the recipient has dominion and control over the cryptocurrency so that the recipient can transfer, sell, exchange or otherwise dispose of the cryptocurrency.

- **Soft Fork.** A soft fork occurs when a distributed ledger undergoes a protocol change that does not result in a diversion of the ledger and thus **does not result in the creation of a new cryptocurrency.** Because soft forks do not result in the owner of the cryptocurrency receiving a new cryptocurrency, the owner will be in the same position the owner was in prior to the soft fork, and **the soft fork will not trigger income.**

IRS Guidance on Valuing Cryptocurrency. The IRS says the value of any cryptocurrency in an exchange is the amount that is recorded by the cryptocurrency exchange for that transaction in U.S. dollars. If the transaction is facilitated by a centralized or decentralized cryptocurrency exchange but is not recorded on a distributed ledger or is otherwise an off-chain transaction, then the fair market value is the amount the cryptocurrency was trading for on the exchange at the date and time the transaction would have been recorded on the ledger if it had been an on-chain transaction.

The IRS says cryptocurrency received in a peer-to-peer transaction or some other transaction not facilitated by a cryptocurrency exchange, the fair market value of the cryptocurrency is determined as of the date and time the transaction is recorded on the distributed ledger, or would have been recorded on the ledger if it had been an on-chain transaction. The IRS says it will accept as evidence of fair market value the value as determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of a cryptocurrency and calculates the value of the cryptocurrency at an exact date and time. If a taxpayer does not use an explorer value, the IRS says the taxpayer must establish that the value used is an accurate representation of the cryptocurrency's fair market value.

When cryptocurrency is received in exchange for property or services, and that cryptocurrency is not traded on any virtual currency exchange and does not have a published value, then the IRS says the fair market value of the cryptocurrency received is equal to the fair market value of the property or services exchanged for the cryptocurrency when the transaction occurs.

Receiving a Gift of Virtual Currency. If a virtual currency is received as a bona fide gift, the recipient will not recognize income until the recipient sells, exchanges, or otherwise disposes of the virtual currency. However, as with other gifts of property, the basis of the virtual currency to the recipient of the gift for determining gain is the basis of the donor plus any gift tax the donor paid on the gift. The basis of the virtual currency for determining loss is the lesser of 1) the donor's basis or 2) the fair market value of the virtual currency at the time of the gift. The holding period of the recipient of the gift includes the holding period of the donor of the virtual currency.

FBAR Reporting Not Required for Virtual Currency. FINCEN Notice 2020-2 says "the *Report of Foreign Bank and Financial Accounts (FBAR)* regulations do not define a foreign account holding virtual currency as a type of reportable account. (See 31 CFR 1010.350(c)). For that reason, at this time, a foreign account holding virtual currency is not reportable on the FBAR (unless it is a reportable account under 31 C.F.R. 1010.350 because it holds reportable assets besides virtual currency)."

Infrastructure Act Reporting Rules for Digital Assets

New Form 8300 And 1099 Reporting Rules for Digital Assets Under Infrastructure Act

Summary. The Infrastructure Investment and Jobs Act of 2021 (Infrastructure Act) created additional reporting requirements under §6045 for digital asset transactions. The Infrastructure Act defines digital assets (except as otherwise provided by the Treasury Secretary) as any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary. The 1040 instructions say, "*Digital assets are any digital representations of value that are recorded on a cryptographically secured distributed ledger or any similar technology. For example, digital assets include non-fungible tokens*

(NFTs) and virtual currencies, such as cryptocurrencies and stablecoins. If a particular asset has the characteristics of a digital asset, it will be treated as a digital asset for federal income tax purposes.”

Form 8300 Reporting. The Infrastructure Act treats digital assets as cash for purposes of the §6050I Form 8300 reporting requirements for cash transactions. So businesses receiving more than \$10,000 of cash (which includes digital assets after 2022) are required to file Form 8300.

Practice Alert! On Jan. 16, 2024, the IRS issued Announcement 2024-4. The announcement says that “[U]ntil the Treasury Department and the IRS publish regulations under §6050I to implement §80603(b)(3) of the Infrastructure Act, persons engaged in a trade or business who, in the course of that trade or business, receive digital assets or digital assets and other cash in one transaction (or two or more related transactions) will not be required to include those digital assets when determining whether cash received has a value in excess of the \$10,000 reporting threshold for purposes of determining if reporting is required under §6050I with respect to those transactions. Persons engaged in a trade or business who, in the course of that trade or business, receive cash (other than digital assets) in excess of \$10,000 in one transaction (or two or more related transactions) must continue to file an information return under §6050I with respect to that cash received.”

Form 1099-DA Reporting (Draft form published on April 24, 2024) & IRS Final Regs Defining “Brokers” and Explaining Reporting Rules for Sales or Exchanges of Digital Assets (TD 10000 [Regs1.6045-1], July 9, 2024).

Summary. On July 9, 2024, the Department of the Treasury and the IRS issued final regs that require brokers to report sales and exchanges of digital assets by customers. The final regs cover a range of digital asset issues, including defining brokers and requiring proceeds to be reported to the IRS on new Form 1099-DA. The regs are available here: [2024-14004.pdf](#).

Under the final regs, reporting under §6045 would be required for digital asset transactions made in exchange for cash, different digital assets, stored-value cards, broker services, or property subject to reporting under existing regulations. Transaction information must generally be held on to for seven years and made available upon IRS request.

Several highlights should be noted:

- The rules for noncustodial brokers will be provided in a different set of final regulations.
- There is an aggregate reporting method available for certain sales of stablecoins and certain nonfungible tokens (NFT) applicable only after those sales exceed de minimis thresholds. This method is optional.
 - For certain processors of digital asset payments, reporting is required on a transactional basis only if the customer's sales are above a de minimis threshold.
 - Taxpayers are not required to report transaction identifications on their Form 1099-DA. (This was required under the proposed regs.)

Definition Of “Broker” For 1099-DA Reporting Expanded. A broker is defined in the guidance as any person who, **in the ordinary course of a trade or business**, acts as an agent, principal, or digital asset middleman for others to effect sales or exchanges of digital assets for cash, broker services, or property of a type that is subject to reporting by the brokers (including different digital assets, securities, **and real estate**) under §6045 of the Internal Revenue Code (Code) or effects on behalf of customers payments of digital assets associated with payment card and third party network transactions subject to reporting under §6050W of the Code. The definition is meant to be wide-ranging and include anyone who “effects” the sale of digital assets, including online brokers, trading platforms, operators of noncustodial trading platforms, digital asset payment processors, owners and operators of digital asset kiosks, wallet hosting service providers, securities custodians, escrow agents, stock transfer agents, and real estate brokers who use cryptocurrency as a part of real estate transactions. This is generally consistent with the definition provided in Reg 1.6045-1(a)(10).

Practice Pointer! The term person generally includes an individual, a legal entity, and an unincorporated group or organization through which any business, financial operation or venture is carried on.

There are several persons who are specifically exempted from the definition of a “broker”:

- A stock transfer agent for a corporation, which agent daily records transfers of stock in such corporation, if the nature of the activities of the agent is such that the agent ordinarily would not know the gross proceeds from sales.
- A person (such as a stock exchange) who merely provides facilities in which others effect sales
- An escrow agent or nominee if such agency is not in the ordinary course of a trade or business
- An escrow agent, otherwise a broker, which agent effects no sales other than such transactions as are incidental to the purpose of the escrow (such as sales to collect on collateral)
- A floor broker on a commodities exchange, which broker maintains no records with respect to the terms of sales
- A corporation that issues and retires long-term debt on an irregular basis
- A clearing organization
- A merchant who is not otherwise required to make a return of information under §6045 of the Code and who regularly sells goods or other property (other than digital assets) or services in return for digital assets
- A person solely engaged in the business of validating distributed ledger transactions, through proof-of-work, proof-of-stake, or any other similar consensus mechanism, without providing other functions or services
- A person solely engaged in the business of selling hardware or licensing software, the sole function of which is to permit a person to control private keys which are used for accessing digital assets on a distributed ledger, without providing other functions or services

Gross Proceeds for Sales or Exchanges of Digital Assets Reported on Form 1099-DA For Sales Or Exchanges After 2024. For sales or exchanges of digital assets after 2024, the final regs **require brokers, including digital asset trading platforms, digital asset payment processors and certain digital asset hosted wallet providers, to report gross proceeds on a newly developed Form 1099-DA** and to provide payee statements to customers.

Practitioner Alert! The draft Form 1099-DA shares many similarities to the Form 1099-B. For example, the preparer is required to indicate if it is a covered or noncovered transaction (Box 9), report gross proceeds (box 1f), report cost basis (1g), and indicate if the transaction is short-term or long-term (box 6).

Reporting on Form 1099-DA will begin in 2026 (reporting information for the 2025 tax year).

Not Every Instance of Digital Assets Resulting in Income Is Covered in the Final Regs. For example, the guidance does not address information reporting related to hard forks, which generally results in income to the recipient. The IRS says this is better addressed in other provisions within the Internal Revenue Code.

Also, the regulations point to IRS Notice 2014-21 requirements when virtual currency is used to pay wages (requiring the filing of Forms W-2, Wage and Tax Statement), to make miscellaneous payments (requiring the filing of Forms 1099-MISC, Miscellaneous Income), and to settle third party network transactions (requiring the filing of Forms 1099-K, Payment Card and Third Party Network Transactions). The final regulations only cover situations where virtual currency payments requiring reporting are received by payees.

In Certain Cases, Gain or Loss and Basis Information Required to Be Reported After 2025. Brokers, in certain circumstances, would be required to include gain or loss and basis information for sales that take place after 2025, on these information returns and statements, so that customers have the information they need to prepare their tax returns. **However, brokers of digital assets will only be required to report the basis for digital assets the customer acquired from, and held with, the same broker after 2025.**

For Transactions Closing After 2025 Title Companies, Closing Attorneys, Mortgage Lenders and Real Estate Brokers, Who Are Treated as Brokers for Dispositions of Digital Assets Must Report Value of Digital Assets Used to Acquire Real Estate. The final regs require real estate reporting persons, such as title companies, closing attorneys, mortgage lenders and real estate brokers, who are treated as brokers for dispositions of digital assets, to report the disposition of digital assets paid as consideration by real estate purchasers to acquire real estate in real estate transactions that close after 2025. These real estate reporting persons **would be required to file both a 1099-S with the seller and a 1099-DA with the purchaser reporting the fair market value of digital assets paid to sellers of real estate in real estate transactions that close after 2025.**

Definition of Digital Asset. The definition of digital assets in the final regs follows the definition in the Infrastructure Act. Specifically, a digital asset **as a digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Treasury.** The regs provide that digital assets include digital representations of value that are capable of being recorded using technology that is similar to technology that uses cryptography to secure transactions. The regulations also clarify that transactions involving specific **non-fungible tokens and stablecoins** are digital assets subject to the reporting rules.

Certain Digital Assets Are Not Subject to Reporting Under the Final Regulations. This includes assets that exist only in a closed system (such as video game tokens that can be purchased with U.S. dollars or other fiat currency but can be used only in-game and that cannot be sold or exchanged outside the game or sold for fiat currency). It is also intended that the regulations would not apply to uses of distributed ledger technology or similar technology for ordinary commercial purposes that do not create new transferable assets, such as tracking inventory or processing orders for purchase and sale transactions, which are unlikely to give rise to sales as defined for purposes of the regulations.

Transitional Relief for Brokers Who Make a Good Faith Effort (IRS Notice 2024-56, July 1, 2024). As a result of the final regulations, brokers are required to report sales of digital assets, including sales of digital assets that are disposed of in consideration for specified NFTs, on Form 1099-DA. Penalties apply under Sec 6721 for failure to file information returns and under 6722 for failure to furnish payee statements. In order to provide brokers additional time to develop appropriate procedures to comply with the reporting requirements described in the final regulations, which apply to sales of digital assets effected after 2024, **the IRS says it will not impose penalties under §§6721 and 6722 on brokers that fail to file information returns and furnish payee statements under the final regulations with respect to sales of digital assets effected during calendar year 2025,** provided such brokers make good faith efforts to file accurate and timely Forms 1099-DA and furnish accurate and timely payee statements.

Additionally, **backup withholding** under §3406 **will not be required for** 1) any digital asset sale effected by brokers during calendar year 2025; 2) any sale of a digital asset effected by a broker during 2026 for a preexisting customer (payee) if the broker submits that payee's name and tax identification number (TIN) combination to the IRS TIN Matching Program and receives a response that the name and TIN combination furnished by the payee matches the name and TIN combination for that payee in IRS records; 3) any sale of a digital asset effected by a broker in return for specified nonfungible tokens (specified NFTs), until further notice; 4) any digital asset for real property sale effected by a real estate reporting person, until further notice; and 5) certain sales of digital assets effected by processors of digital asset payments (PDAPs), until further notice..

Certain Digital Asset Transactions Are Not Subject to Information Return Reporting or Penalties (IRS Notice 2024-57, July 1, 2024). The IRS has identified certain digital asset transactions that are temporarily not subject to information return reporting, including wrapping and unwrapping transactions, liquidity provider transactions, staking transactions, the lending of digital assets, short sales of digital assets and notional principal contracts. The IRS believes these transactions require additional study to facilitate proper information reporting, **so this is a temporary exception to reporting.**

Transitional Guidance on the Allocation of Basis in Digital Assets (Rev. Proc. 2024-28, July 1, 2024). Consistent with §1012(c)(2), the 2024 final regulations require basis determination for digital assets to be allocated on a single-wallet or an account basis.

The IRS received several comments concerning the digital asset regulations stating that FAQ 39 to 41 of the virtual currency FAQ could be interpreted as “permitting, or at least not prohibiting, specific identification of units or application of the FIFO rule based on a so-called universal or multi-wallet approach because the FAQ do not explicitly limit the specific identification or FIFO rule to units held within a single account, wallet, or address.” Therefore, Rev. Proc. 2024-28 provides transitional guidance for situations where taxpayers were utilizing a method permissible under the FAQ (like utilizing FIFO or specifically identified units on a universal or “multi-wallet” approach) and need to transition to allocating basis on a single-wallet or account basis as required by the final regulations. The final regulations apply to all acquisitions and dispositions of digital assets on or after Jan. 1, 2025.

Rev. Proc. 2024-28 generally allows taxpayers to rely on any reasonable allocation of units of unused basis to a wallet or account that holds the same number of remaining digital asset units based on the taxpayer’s records of such unused basis and remaining units. Such “reasonable allocations” must be made as of Jan. 1, 2025. These

rules described in §5.01 of the revenue procedure are available only to a taxpayer who holds remaining digital asset units and has units of unused basis as of Jan. 1, 2025. Rev. Proc. 2024-28 states that a taxpayer may identify the method of allocation and may comply with the requirements set forth in §4.02 of the revenue procedure at a later date to the extent permitted by §5.02(4) or 5.02(5)(b) (see “**Timing Requirements**” below).

a) Reasonable Allocation: An allocation is deemed to be reasonable if it meets the requirements of Sec 5.02 of Rev. Proc. 2024-28:

The taxpayer must identify the remaining digital asset units and maintain records sufficient to show the units of unused basis by the applicable date (see “Timing Requirements” below);

- The taxpayer must complete the allocations of all units of unused basis to the same number of remaining digital asset units within all wallets or accounts held by the taxpayer by the applicable date on a specific unit basis or a global basis;
- The taxpayer must separately account for any acquisitions or transfers to the taxpayer of digital asset units on or after Jan. 1, 2025, held within the same wallet or account as remaining digital asset units and units of unused basis;
- The taxpayer complies with the timing requirements set forth below;
- The determination of whether a taxpayer’s allocations to wallets or accounts is reasonable with respect to one type of digital asset held by the taxpayer prior to Jan. 1, 2025, does not impact whether the taxpayer’s allocations to other wallets or accounts is reasonable with respect to another type of digital asset held by the taxpayer prior to Jan. 1, 2025; and
- Any allocation of previously identified and used basis to digital assets held by the taxpayer as of Jan. 1, 2025, does not constitute a reasonable allocation.

b) Timing Requirements:

Specific Allocation Method: A taxpayer making a specific unit allocation must satisfy the requirements before the earlier of:

- The date and time of the first sale, disposition, or transfer by the taxpayer of the same type of digital asset completed on or after Jan. 1, 2025, or
- Either:
 - The due date (including by extension) of the taxpayer’s Federal income tax return or Form 1065 for the taxable year that includes Jan. 1, 2025 (the 2025 return); or
 - If the taxpayer is not otherwise required to file a 2025 return, the last date for filing the 2025 return (without extensions) of the type of return that would be applicable to the taxpayer if the taxpayer were required to file a 2025 return.

Global Allocation Method: A taxpayer using the Global Allocation Method:

- Must describe the global allocation method in the taxpayer’s books and records before Jan. 1, 2025;
- Must satisfy the requirements set forth in §§5.02(1) of the revenue procedure (item 1) under “Reasonable Allocation” above) and complete the allocations of all units of unused basis to the pools of remaining digital asset units within each of the taxpayer’s wallets or accounts before the **later of** the dates set forth in §5.02(4)(a) and (b) of the revenue procedure, as applicable (these are items (a) and (b) under the “Specific Allocation Method” above); and
- Must comply with the rules outlined in §5.02(5)(c) of Rev. Proc. 2024-28 with respect to sales, dispositions or transfers of any remaining digital assets units on or after Jan. 1, 2025.

Examples. §6 of Rev. Proc. 2024-28 provides 5 examples illustrating the application of these basis allocation rules.

OTHER DIGITAL ASSET DEVELOPMENTS

Digital Asset Question on Tax Returns. The **draft Form 1040 for 2024** contains a modified digital asset question. The question on the draft Form 1040 asks, “*At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)*” The question on the 2022 Form 1040 asked “*At any time*

during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)”

Interestingly, the 2023 or 2024 digital asset question does not mention gifts. In 2022 the AICPA suggested that the question concerning digital currency should deal with transactions that could create income on an income tax return. It seems the IRS has taken the AICPA’s comments into consideration.

This same digital asset question is included on page 4 of draft Form 1065; page 3 of draft Form 1120-S, Page 5 of draft Form 1120, and page 3 of draft Form 1041.

The IRS website also reminds taxpayers that they must report income, gain, or loss from all taxable transactions involving virtual currency on the Federal income tax return for the taxable year of the transaction, regardless of the amount or whether they receive a payee statement or information return.

Practitioner Alert! The receipt of a Form 1099-DA requires the taxpayer to check the yes box on the top of Form 1040 per the draft instructions accompanying the form.

IRS Clarifies Definition Of Digital Assets June 15, 2023. On June 15, 2023, the IRS updated its website to clarify the definition of digital assets. It clarified that *“Digital assets include (but are not limited to):*

- *Convertible virtual currency and cryptocurrency*
- *Stablecoins*
- *Non-fungible tokens (NFT)”*

This addition of stablecoins and NFTs is significant since it was previously unclear as to whether these items were included. These items are treated as property under IRS Notice 2014-21 which provides the rules for digital assets including virtual currency and cryptocurrency.

The IRS also reiterated that digital assets *“are not real currency (also known as “fiat”) because they are not the coin and paper money of the United States or a foreign country and are not digitally issued by a government’s central bank. A digital asset that has an equivalent value in real currency, or acts as a substitute for real currency, has been referred to as convertible virtual currency. A cryptocurrency is an example of a convertible virtual currency that can be used as payment for goods and services, digitally traded between users, and exchanged for or into real currencies or digital assets.”*

IRS Modifies Previous Guidance That Virtual Currency Can Have Legal Tender Status (Notice 2023-34, April 24, 2023). In Notice 2023-34, the IRS modified Notice 2014-21 by revising a sentence in the Background section of that Notice to remove the statement that virtual currency does not have legal tender status in any jurisdiction. The IRS now does recognize that certain foreign jurisdictions have enacted laws that give virtual currencies (like Bitcoin) legal tender status. The Notice also clarifies that the FAQ section in Notice 2014-21 is unaffected by this revision.

Chief Counsel Advice Says Qualified Appraisal Requirements Apply To Charitable Contributions Of Virtual Currency (CCA202302012). CCA202302012 states that the requirement to obtain a qualified appraisal under §170(f)(11)(C) applies to charitable donations of virtual currency where the taxpayer claims a deduction over \$5,000. It also clarifies that the reasonable cause exception provided for failure to obtain a qualified appraisal (§170(f)(11)(A)(ii)(II)) does NOT apply where the taxpayer determines the value of the cryptocurrency based on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded. Specifically, the CCA says *“if Taxpayer A determines the value of the donated cryptocurrency based on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded rather than by obtaining a qualified appraisal, the reasonable cause exception provided in §170(f)(11)(A)(ii)(II) will not excuse noncompliance with the qualified appraisal requirement, and Taxpayer A will not be allowed the charitable contribution deduction under §170(a).”*

CCA Says Protocol Upgrades To Virtual Currency Are Not Considered A Realized Gain Or Gross Income (CCA 202316008). CCA202316008 says that if a taxpayer is holding virtual currency that undergoes a protocol upgrade (such as changes to how a transaction is validated) the taxpayer does not have a realization event under §1001. A realization event requires the exchange to result *“in the receipt of property that is materially different from the property transferred....in the sense of being “material” for purposes of §1001, they must embody legally distinct entitlements.”* Since a protocol change does not result in legally distinct entitlements, there is no realization

event. Similarly, there is no additional gross income recognized under §61, as long as there is “no accession to wealth from the upgrade.”

Rev. Rul. Explains When Staking Rewards Are Income (Rev. Rul. 2023-14, July 31, 2023). Rev. Rul. 2023-14 provides that if a taxpayer stakes cryptocurrency native to a proof-of-stake blockchain and receives additional units of cryptocurrency as rewards when validation occurs, the fair market value of the rewards received is included in the taxpayer's gross income in the taxable year in which the taxpayer gains dominion and control over the rewards. The fair market value is determined as of the date and time the taxpayer gains dominion and control over the rewards.

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

Facts. The ruling contains the following facts:

- A, a cash basis taxpayer, receives two units of cryptocurrency M for staking units and validating transactions on the M blockchain.
- On Date 3, A gains the ability to sell, exchange, or otherwise dispose of the two M units. Thus, on Date 3, A has dominion and control over the two M units.

Conclusion. A must include the FMV of the two M units in the tax year that includes Date 3. The Rev. Rul. says “The two units of M represent A's reward for staking units and validating transactions on the M blockchain. On Date 3, A has an accession to wealth as A gains dominion and control through A's ability, as of this date, to sell, exchange, or otherwise dispose of the two units of M received as validation rewards. Accordingly, the fair market value of the 2 units of M, as of the date and time A gains dominion and control over the 2 units of M, is included in A's gross income for the taxable year that includes Date 3.”

What Is Staking? Staking is a process where persons who hold cryptocurrency may participate in the validation and confirmation of transactions on a blockchain, if they hold the requisite number of units of a particular cryptocurrency. By locking up a certain amount of cryptocurrency as collateral, stakers contribute to the security and decentralization of the network while earning rewards in return.

Validators may be selected by the protocol for the blockchain associated with the specific cryptocurrency based on a variety of factors including the number of coins or tokens staked. These validators confirm transactions and add blocks to the blockchain in accordance with the protocol. If a validator is chosen by the protocol and validation is successful, the validator will receive a reward.

Deducting Virtual Currency Losses (CCA 202302011).

Background. Notice 2014-21 provides that convertible virtual currency is treated as property and that general tax principles applicable to property transactions apply to convertible virtual currency. The ability of a taxpayer to deduct a loss related to virtual currency depends on how the virtual currency is disposed of.

Sales or Exchanges. Sales, exchanges, and other dispositions of virtual currency may result in recognition of gain or loss. The character of a gain or loss resulting from a disposition of a cryptocurrency generally depends on whether the property is a capital asset in the hands of the taxpayer. A taxpayer not in the trade or business of dealing in cryptocurrency will generally realize capital gain or loss on the sale or exchange of a cryptocurrency. A taxpayer realizes ordinary gain or loss on the sale or exchange of property that is not held as a capital asset.

Worthlessness. §165(g) allows a loss “if any security which is a capital asset becomes worthless during the taxable year.” However, for this purpose, a security is defined as “(A) a share of stock in a corporation; (B) a right to subscribe for, or to receive, a share of stock in a corporation; or (C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.” **Since virtual currency does not fit this definition of security, the IRS says no deduction is available for cryptocurrency simply because it is worthless.**

CCA202302011

Facts: Taxpayer A is an individual who purchased units of Cryptocurrency B in 2022 at \$1.00 per unit for personal investment purposes on a cryptocurrency exchange. After Taxpayer A acquired Cryptocurrency B, the per unit value of Cryptocurrency B decreased significantly, such that **each unit of Cryptocurrency B was valued at less**

than one cent at the end of 2022. On Dec. 31, 2022, Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, and Taxpayer A maintained dominion and control over the units of Cryptocurrency B as evidenced by Taxpayer A's ability to sell, exchange, or transfer the units. Taxpayer A claimed a deduction on Taxpayer A's 2022 tax return under §165 and took the position that the units of Cryptocurrency B were either worthless or abandoned. [Emphasis added]

Conclusions: The IRS concluded that Taxpayer A was not allowed a deduction under §165 on Taxpayer's 2022 return for Cryptocurrency B. The CCA said, "§165 provides a deduction for losses that are evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Taxpayer A has not abandoned or otherwise disposed of the cryptocurrency, and the cryptocurrency is not worthless because it still has value. Therefore, Taxpayer A has not sustained a loss under §165 and the corresponding regulations. Further, even if Taxpayer A sustained a loss under §165, the loss would be disallowed because §67(g) suspends miscellaneous itemized deductions for taxable years 2018 through 2025." [Emphasis added]

Planning Pointer! If the value of a digital asset has declined and the taxpayer wants to trigger a tax loss, the taxpayer should consider selling the asset in an arms-length transaction to an unrelated party. This should produce a capital loss. If a client sells virtual currency and the total receipts are under \$1, we should consider rounding the sales price up to \$1 so the IRS will not assume the client is taking a nondeductible loss for worthlessness.

Virtual Currency Or Cryptocurrency Exchange Is In Bankruptcy. The AICPA points out at its website that where a bankruptcy proceeding is still underway, a party expecting a return or recovery must generally wait until the bankruptcy proceeding is complete. Generally, a realization event must occur, (e.g., a sale of exchange) to create a gain or loss.

Theft Losses Of Virtual Currency. A theft loss on virtual currency may be deductible. §165(c) provides that individuals may take a loss that is sustained during the year that is not compensated by insurance or otherwise in three instances:

- The loss is incurred in a trade or business;
- The loss is incurred in "any transaction entered into for profit, though not connected with a trade or business;" or
- It is a property loss "not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft."

Under §165(h)(5), personal casualty losses (losses described in Sec 165(c)(3) above) are disallowed for tax years 2018 to 2025 unless the loss is from a Federally declared disaster. However, this disallowance does not apply to (c)(1) or (c)(2) above. In other words, if the virtual currency loss is incurred in a trade or business or in "any transaction entered into for profit not connected with a trade or business," it is still deductible. Taxpayers who have experienced a theft of virtual currency should see if their loss qualifies as a deductible theft loss under §165, Reg 1.165-1, Reg 1.165-8, and relevant rulings to be sure a theft occurred. In addition, taxpayers should review Rev. Rul. 2009-9 and Rev. Proc. 2009-20 for the possibility of deducting the theft loss under the rules provided in these authorities. The following **are brief summaries** of Rev. Rul. 2009-9 and Rev. Proc. 2009-20. However, please see these two documents for details.

Rev. Rul. 2009-9. Rev. Rul. 2009-9 explains the tax consequences of fraudulent investment arrangements. Just days after Bernard Madoff's guilty plea, the IRS issued this comprehensive guidance for the many investors caught in his Ponzi-style fraud. However, it appears the guidance could apply to losses from criminal fraud or embezzlement other than Ponzi schemes. Overall, the guidance takes a generous, pro-taxpayer position, allowing these losses to be claimed as ordinary losses. Rev. Rul. 2009-9 reached the following conclusions:

- **Nature of Loss.** A loss from criminal fraud or embezzlement in a transaction entered into for profit is a **theft loss under §165** and not a capital loss.
- **Theft Loss Not a Miscellaneous Itemized Deduction.** A theft loss in a transaction entered into for profit is deductible under §165(c)(2), not §165(c)(3). **Tax Tip.** Since this type of theft loss is not classified as a "miscellaneous itemized deduction," the deduction is not suspended until 2026.
- **Year Loss Is Deductible.** Under §165(e), a theft loss in a transaction entered into for profit is **deductible in the year the loss is discovered**, if the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery. If in the year of discovery, there exists

a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether the reimbursement will be received, for example, by a settlement, adjudication, or abandonment of the claim.

Note! Rev. Proc. 2009-20, covered below, provides a safe harbor for determining the loss year in a Ponzi-type scheme.

Amount Deductible As Theft Loss. The amount of a theft loss in a transaction entered into for profit is **generally: i) the amount invested** in the arrangement, **less any amounts withdrawn; ii) plus** amounts reported by the investor in **income** (prior to discovery of the theft) and **reinvested** in the scheme, **minus iii) reimbursements or recoveries, and claims** as to which there is a **reasonable prospect of recovery**. Where an amount is reported to the investor as income prior to the scheme's discovery and the investor includes that amount in gross income and reinvests it in the scheme, the **amount of the theft loss is increased by the purportedly reinvested amount**.

Rev. Proc. 2009-20. Rev. Proc. 2009-20 provides safe harbors for deducting losses from thefts meeting the requirements of a "fraudulent investment scheme" as defined in the Rev. Proc.. Most Ponzi schemes will most likely qualify as "fraudulent investment schemes." The safe harbors are designed to provide more certainty about the year of the theft loss and the amount of the theft loss compared to Rev. Rul. 2009-9. However, the safe harbors **only apply to "qualified investors" that incur "qualified losses" in a "qualified investment" and the loss results from a "specified fraudulent arrangement."**

- **Loss Year Safe Harbor.** Under the **loss year safe harbor**, the **year of the theft loss is deemed to be the tax year of the investor in which the lead figure or figures in the scheme are i) charged** by indictment, etc., with fraud, embezzlement, or a similar crime, that is a theft under state law **or ii) are** the subject of a state or federal criminal complaint alleging the commission of a crime.
- **Safe-Harbor Loss Deduction.** The safe-harbor loss deduction is **i) 95% of the investment (75% if pursuing third party recovery), less ii) any actual recovery plus any SIPC recovery.**
- **"Qualified Investor."** To use the safe harbors, the taxpayer must be a **"qualified investor."** A qualified investor is generally an investor that: 1) Is a U.S. citizen, U.S. resident, domestic partnership, domestic corporation, and U.S. trusts and estates, 2) Did not have actual knowledge of the fraudulent nature of the Ponzi scheme before it became known to the general public, 3) With respect to which the Ponzi scheme is not a tax shelter as defined in §6662(d)(2)(C)(ii), and 4) Transferred cash or property to the Ponzi scheme.
- **"Qualified Losses" Eligible for The Safe Harbor.** Qualified losses eligible for the safe harbors of Rev. Proc. 2009-20 are losses resulting from a Ponzi scheme in which: **1) The lead figure (or one of them, if more than one) was charged by indictment or information (not withdrawn or dismissed) with the commission of fraud, embezzlement or a similar crime** that, if proven, would meet the definition of theft for purposes of §165 and Reg 1.165-8(d), under the law of the jurisdiction in which the theft occurred; **or 2) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime** described in the preceding sentence, and either **i) the complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or ii) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.**
- **"Qualified Investment" For Purposes Of The Safe Harbor.** The qualified investment generally is defined the same way as the "amount deductible as a theft loss" under Rev. Rul. 2009-9, discussed at item d. under the Rev. Rul. 2009-9 heading above.
- **"Specified Fraudulent Arrangement."** Rev. Proc. 2009-20 says *"A specified fraudulent arrangement is an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property. For example, the fraudulent investment arrangement described in Rev. Rul. 2009-9 is a specified fraudulent arrangement." This is the description of a typical Ponzi scheme.*

Planning Alert! As can be seen from the specific requirements to use Rev. Proc. 2009-20, some taxpayers may not qualify to use the Rev. Proc.. In that case, they should use Rev. Rul. 2009-9 to determine the deductible theft

loss. In addition, taxpayers who are confident they can substantiate the year they discovered the loss and the amount of the loss, and where there is no reasonable prospect of third-party recovery, may receive a larger current tax deduction by taking the theft loss in the year of discovery using Rev. Rul. 2009-9 rather than Rev. Proc. 2009-20. **However, taxpayers should calculate the present value of the tax benefits received with and without the safe harbor before making a final decision.**

Where Is the Deduction Taken? The deduction for a theft loss from a transaction entered into for profit (e.g. an investment in virtual currency) is an itemized deduction deductible on Schedule A, Line 16, and Form 4684 §B, if the taxpayer does not qualify to use Rev. Proc. 2009-20 or chooses not to use Rev. Proc. 2009-20. However, if the theft loss is deducted using the safe harbor in Rev. Proc. 2009-20, the loss deduction is an itemized deduction deductible on Schedule A, Line 16 and on Form 4684 Section C.

Digital Asset Reporting Regulations Repealed (P.L. 119-5)

Summary. On Apr. 10, the president signed into law a joint resolution of Congress that repealed the regulations that required certain disclosures by cryptocurrency brokers who operate in decentralized finance (DeFi) transactions.

Background. The IRS published TD 10021, “Gross Proceeds Reporting by Brokers That Regularly Provide Services Effectuating Digital Asset Sales,” on Dec. 30, 2024. The regulations modified Reg. §1.6045-1 to expand the definition of broker to include some DeFi brokers. This required them to report gross proceeds from cryptocurrency sales on Form 1099-DA and was to apply to digital asset sales after Jan. 1, 2027.

A DeFi broker is referred to as a “digital asset middleman” in the regulations. The middleman effectuates sales on behalf of others. They are neither the broker nor the customer in a digital asset transaction.

Under the Congressional Review Act (CRA) (5 USC Ch 8), new rules (i.e., regulations) are subject to Congressional review prior to taking effect. Congress has the authority to pass “a joint resolution of disapproval” of a rule within 60 days of its issuance. Once signed by the president, the joint resolution not only repeals the rule but also prohibits the agency from subsequently reissuing the same, or a similar, rule unless authorized by law. H.J. 25 passed the House and Senate with bipartisan support. The Joint Committee on Taxation estimated in a Feb. 24 report (JCX-11-25) that repeal of the rule would cost \$3.9 billion through 2034, while a Congressional Budget Office Mar. 7 report estimated repeal would cost \$4.5 billion over the 2025-2035 period.

This was the first use of the CRA for tax regulations.

Future effects. Professionals in the digital asset area see several areas of concern. Brokers will need to track their own earnings, since there will be no tax documents reporting that information to them. More products may be made DeFi, which would increase the deficit. Relief from the reporting rules for centralized brokers was not included in H.J. 25 because the resolution was not introduced within the 60-day time frame for those regulations, which were issued in July 2024 (TD 10000), but some believe that such a repeal may be forthcoming.

Comment. It is possible that the IRS may withdraw the regulations under an Apr. 9 White House memo directing the repeal of “unlawful, unnecessary, and onerous regulations.”

RETURNS: SELECTED HIGHLIGHTS AND DEVELOPMENTS

Tax Cuts And Jobs Act: One Big Beautiful Bill

Due Diligence Requirements Apply to Returns Claiming Head of Household Filing Status As Well As EITC, CTC, And AOTC (§6695(g), Effective for tax returns and claims for refunds filed for tax years beginning after 2017)

Summary. For 2017, any tax return preparer for any return or claim for refund who fails to comply with due diligence requirements in determining the eligibility for, or the amount of, an earned income tax credit (EITC) a child tax credit (CTC), or an American Opportunity tax credit (AOTC), must pay a **penalty of \$510** (as adjusted for inflation) for **each failure. Form 8867 is to be completed and filed with each return claiming any of these credits.**

TCJA expands the penalty to apply to each failure of a tax return preparer for any return or claim for refund who fails to comply with due diligence requirements for determining the eligibility of an individual to file as a head of household. This provision **applies beginning with 2018 individual income tax returns filed in 2019.**

Form 8867 “Paid Preparer’s Due Diligence Checklist.” Please see Form 8867 “Paid Preparer’s Due Diligence Checklist” and the related instructions for details.

Selected Items of Interest

First-Time Penalty Abatement (IRM 20.1.1.3.6)

Beginning in 2001, the IRS began an internal policy of granting penalty relief under an administrative waiver known as the First-Time Abatement (FTA). The FTA generally provides relief to taxpayers who are assessed failure to file or failure to pay penalties, provided the taxpayer has been compliant for the preceding three years. Thus, if the taxpayer has satisfied all filing and payment requirements for the previous three years, the FTA should be available.

Practice Alert! The IRS has not traditionally indicated the availability of the FTA on its penalty notices or on the IRS website. Therefore, taxpayers generally must affirmatively request the FTA before the IRS will consider its availability.

IRS Announces To Examiners That FTA Waiver Applies To Excise Taxes. On June 12, 2015, the Small Business/Self-Employed Division of the IRS announced that the First Time Abate (FTA) administrative penalty waiver may be utilized by Excise Tax Examiners.

Summary Of FTA Administrative Penalty Relief Policy. Based on a taxpayer’s compliance history, FTA relief is potentially available for the **a) Failure to file** penalties under **§6651(a)(1), §6698, and §6699; b) Failure to pay penalties** under **§6651(a)(2) and §6651(a)(3); and c) Failure to deposit penalties** under **§6656**. Relief is **not available for information reporting penalties**, including delinquent foreign information returns. **Use of the FTA can be requested by calling the IRS Practitioner Priority Service (PPS) line at (866) 860-4259.**

To qualify for the First Time Abate (FTA) waiver, the taxpayer must meet the following criteria:

- Taxpayer has not previously been required to file a return or **taxpayer has no penalties for preceding three years, except the Estimated Tax Penalty.**
- **Taxpayer has filed, or has filed a valid extension for, all currently required returns.**
- **Taxpayer has paid, or arranged to pay, all tax currently due. Practice Alert!** A taxpayer is considered current if the taxpayer has an open installment agreement and is current with the installment payments.

In addition, the following are other attributes of the FTA outlined in §20.1.1.3.6.1 of the Internal Revenue Manual:

The **FTA relief only applies to a single tax period for a taxpayer.** For example, if a request for penalty relief is being considered for two or more periods of a taxpayer, and the earliest period meets the FTA criteria, FTA would apply only to the earliest period, and not for all periods.

A “reasonable cause” penalty waiver will be considered only after deciding if the FTA criteria apply. If FTA does not apply, then IRS will consider a taxpayer’s explanation to determine if the penalty may be waived under the reasonable cause criteria.

Penalty relief under the first-time abatement provision does not apply to returns with an event-based filing requirement, such as **Form 706**, U.S. Estate Tax Return; **Form 709**, United States Gift (and Generation-Skipping Transfer) Tax Return.

FTA also does not apply to: 1) Form 1120, U.S. Corporation Income Tax Return, **or 2) Form 1120S**, U.S. Income Tax Return for an S Corporation **if, in the prior three years, at least one Form 1120S was filed late but not penalized.** This list is not all-inclusive.

Practice Alert! Taxpayers billed for penalty charges who feel they qualify for FTA or who have reasonable cause, should call the IRS at the number given on the penalty notice. Taxpayers may also use Form 843, Claim for Refund and Request for Abatement.

Certificate of Mailing Insufficient to Prove Timely Mailing of Tax Returns (SCA 1998-051)

This service center advice concludes that a U.S Postal Service Certificate of Mailing, unlike a registered or certified mail receipt, is not conclusive proof of mailing and is inadmissible to contradict an untimely postmark appearing on the envelope in which a tax return is mailed. The absence of a showing that a return was sent by registered or certified mail creates a “conclusive statutory presumption” that the postmark date on the envelope is controlling, under F.E. Moffat, Est., Dec. 28,033. **Thus, a taxpayer that relies on a certificate of mailing risks that the postmark on the envelope may bear a date later than the filing deadline. However, a certificate of mailing is evidence of timely mailing if the postmark is missing or illegible. If the return is not delivered to the IRS, the certificate of mailing may be inadmissible in some judicial circuits to prove timely mailing. The IRS has concluded that if a return is lost or undelivered, only evidence of registration or certification pursuant to Code Sec. 7502(c) will allow the taxpayer to take advantage of the timely mailing as timely filing provision.**

IRS Provides Procedures for Organizations That Lost Exempt Status for Failing to File Returns for Three Consecutive Years (Rev. Proc. 2014-11, Jan. 2, 2014)

Summary. This revenue procedure provides procedures for reinstating the tax-exempt status of organizations that have had their tax-exempt status automatically revoked under §6033(j)(1) for failure to file required Annual Returns or notices for three consecutive years. Please consult Rev. Proc. 2014-11 for details.

Due Date for FinCEN Form 114 Automatically Extended

On Dec. 16, 2016, the Financial Crimes Enforcement Network (FinCEN) issued the following release:

*“The new annual due date for filing Reports of Foreign Bank and Financial Accounts (FBAR) for foreign financial accounts is April 15. This date change was mandated by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Public Law 114-41 (the Act). Specifically, §2006(b)(11) of the Act changes the FBAR due date to April 15 to coincide with the Federal income tax filing season. The Act also mandates a maximum six-month extension of the filing deadline. To implement the statute with minimal burden to the public and FinCEN, **FinCEN will grant filers failing to meet the FBAR annual due date of April 15 an automatic extension to Oct. 15 each year. Accordingly, specific requests for this extension are not required.**”*

RECENT DEVELOPMENTS

IRS Allows All Taxpayers to Receive IP PIN Online

Summary. An Identity Protection PIN (IP PIN) is a six-digit number that takes the place of an individual's social security number on the individual's income tax return. Previously IP PINs were only available to victims of identity theft and individuals in select states who were not victims of identity theft. The IRS says Starting in 2021, individuals may voluntarily opt into the IP PIN program as a proactive way to protect themselves from tax-related identity theft. Individuals who wish to receive an IP PIN must pass a rigorous identity verification process. In addition, spouses and dependents are eligible for an IP PIN if they can pass the identity proofing process.

Individuals wishing to obtain an IP PIN should use the online Get an IP PIN tool. If an individual does not already have an account on IRS.gov, the individual must register to validate the individual's identity. Also, an IP PIN is valid for one calendar year. Therefore, an individual must obtain a new IP PIN each year. Please visit the IRS website at <https://www.irs.gov/identity-theft-fraud-scams/get-an-identity-protection-pin> for additional information.

IRS Explains How Taxpayers Can Obtain Tax Transcripts (IRS Tax Tip 2022-46, March 24, 2022)

Online Account. The IRS says an online account is the fastest and easiest way to see account information such as estimated tax payments, prior year adjusted gross income, economic impact payment amounts and to obtain tax transcripts.

Five Types of Transcripts. There are five types of transcripts. The IRS says taxpayers should review each transcript type to determine which one best meets their needs. For more information, see <https://www.irs.gov/individuals/transcript-types-and-ways-to-order-them> for the types of transcripts.

Ways Taxpayers Can Get Transcripts. The IRS says the following are ways taxpayers can get transcripts.

From Their Online Account. Individuals can view their tax records in their Online Account. From there, they can visit Get Transcript Online to view, print, or download transcripts. Taxpayers can sign in or create an online account here: <https://www.irs.gov/payments/your-online-account>

By Using “Get Transcript By Mail.” Taxpayers can use “Get Transcript by Mail” to get a tax return or tax account transcript **delivered within 5-10 calendar days**. “Get Transcript By Mail” is available here: <https://sa.www4.irs.gov/irfof-tra/login>

By Filing Form 4506-T. Taxpayers can also get a transcript by submitting Form 4506-T to request any transcript type. Most Form 4506-T transcript requests are **processed within 10 business days and then mailed**. Form 4506-T is available on the Forms, Instructions and Publications page on IRS.gov.

By Phone. Taxpayers can call the IRS's **automated phone transcript service at 800-908-9946** to get a tax return or tax account transcript delivered by mail within **5-10 calendar days**.

Note! There is no charge for transcripts.

Practice Pointer. Given the many changes in the tax system in the COVID era, along with the issues related to identity theft, it is wise for taxpayers to have an IRS account and check it.

Access to information returns added to the IRS individual online account tool ([IR-2025-28](#)). Form W-2 and Form 1095-A for tax years 2023 and 2024 have been added to taxpayer's Individual Online Account. More forms are expected to be added soon.

Returns: Planning Ideas

Sometimes File Even if Not Required

Even though a return is not required, an individual should file a return if entitled to the **earned income credit**, or if **paid estimated tax** or had **tax withheld**. The return is the only way to receive the refund.

Prepare Extension Properly

Regulation 1.6081-4 says for an extension to be valid without the payment of the tax, the balance due must be shown on the extension request. **So, always make a “good faith” effort to calculate the proper tax based on all available information even though the client cannot pay with the extension.**

Establishing Reasonable Cause

The Supreme Court has ruled in *U.S. v. Boyle* that reliance by a taxpayer on his attorney, etc. to file a tax return, is not reasonable cause. However, the IRS has historically told its personnel (IR Manual Transmittal 4500-432,

Feb. 25, 1987) that a taxpayer does have “reasonable cause” where incorrectly advised that a return is not due. (Also see **Estate of Buring**, TCM, 1985-610 and the IRS penalty handbook).

Extension

Consider the use of an **extension** to obtain additional time to make various elections due with the tax return and to make qualified retirement plan contributions.

Practice Alert! An extension will not extend the time for an IRA contribution beyond April 15.

Filing Returns Via UPS, FedEx, Etc.

The rules for using private delivery services can be misleading. The Taxpayer Bill of Rights gives the IRS authority to issue two sets of rules for determining if documents are sent to the IRS on time or if payments are sent on time.

First, under §§7502(a) and (b), documents and/or payments will be deemed delivered or paid to the IRS on the date of the postmark by the U.S. Postal Service **rather than the date of actual receipt**. The Bill of Rights added §7502(f) which provides at (f)(1) and (f)(2) that the IRS may designate private delivery services (PDS) to be treated the same as the postal service so that an item sent UPS, for example, will be deemed received by the IRS on the date of “postmark” rather than the date of actual receipt.

Second, §7502(c) provides that documents and payments mailed certified or registered mail will be deemed received by the IRS on the date of such registration or certification.

Note! §7502(c) presumes that the item is delivered to the IRS even if it is never received.

Worker Classification Controversies Guidance ([REV. RUL. 2025-3](#), [REV. PROC. 2025-10](#), Jan. 8, 2025)

Summary. Whether an employer is permitted to treat a worker as an independent contractor under the relief provided by §530 of the Revenue Act of 1978 depends on whether the requirements are met. If §530 does not apply, the employer may be eligible to pay the employment taxes at reduced rates under IRC §3509. Guidance on whether an individual is an employee is also provided.

Background. §530 of the Revenue Act of 1978, as amended, applies to worker classification controversies between taxpayers and the IRS. It allows a taxpayer to treat a worker as an independent contractor, known as §530 relief, if certain requirements are met. The requirements are:

- **Reporting consistency requirement.** The taxpayer must have filed all required federal tax returns, including information returns, consistent with the taxpayer treating the worker as an independent contractor; and
- **Substantive consistency requirement.** The taxpayer did not treat anyone holding a substantially similar position as an employee; and
- **Reasonable basis requirement.** The taxpayer had a reasonable basis for not treating the worker as an employee by relying on either judicial precedent, a prior audit, industry practice, or some other reasonable basis.

Note that §530 is not a part of the Internal Revenue Code. More information on §530 relief can be found on the [IRS website](#).

If §530 relief does not apply, IRC §5309 allows the taxpayer to pay withholding equal to 1.5% of wages and employee Social Security tax equal to 20%. These amounts are doubled (to 3% and 40%, respectively) if the employer disregards the reporting requirements (i.e., issuance of information returns) unless due to reasonable cause.

Application of §530, IRC §3509, and §7436 Notice (Rev. Rul. 2025-3). The revenue ruling provides five scenarios to an answer whether the relief under §530 or the reduced rates under IRC §3509 apply, and whether a Notice of Employment Tax Determination Under IRC §7436 (§7436 Notice) will be issued. If a taxpayer is not entitled to §530 relief, the IRS will issue a §7436 Notice, which allows them to petition the Tax Court for review.

In all five scenarios, the taxpayer does not pay employment taxes on some or all of the amounts paid to its workers. In Situation 1, the taxpayer pays workers weekly a fixed amount and a bonus. The total amounts are reported on Form 1099-NEC. An IRS audit determines the workers are employees, but the taxpayer claims it meets the requirements for §530 relief. The IRS holds that §530 is applicable but whether §530 relief applies depends on whether the requirements are met; if not, §3509 may apply and a §7436 Notice will be issued.

In Situation 2, the taxpayer pays the workers weekly a salary and a bonus. The salary is treated as wages and properly reported on federal employment returns. The bonuses, however, are not treated as wages and are instead reported on Form 1099-NEC. An IRS audit determines that the bonuses are wages, but the taxpayer claims it meets the requirements for §530 relief. The IRS holds that neither §530 nor §3509 applies in this case because the workers are not being reclassified since the taxpayer treated them as employees. A §7436 Notice will be issued.

Situation 3 is the same as Situation 2 except the bonus amounts were not reported on any information return. Situation 4 is also the same as Situation 2 except not only are the bonus amounts not reported on any information return but also the taxpayer does not claim it satisfies the requirements for §530 relief. As in Situation 2, the IRS holds that neither §530 nor §3509 apply. A §7436 Notice will be issued in Situation 3 but not in Situation 4 since the taxpayer did not claim it was entitled to §530 relief.

In Situation 5, the taxpayer uses a third party to handle payroll, including the weekly payment of salaries, the withholding and payment of federal employment taxes, and the preparation of payroll reporting on Form 941 and Forms W-2. The taxpayer pays a year-end bonus directly to its workers but does not treat the bonus as wages, does not withhold or pay any federal employment taxes, and does not report the bonuses on any information return. An IRS audit determines that the bonuses are wages, but the taxpayer claims it meets the requirements for §530 relief. The IRS holds that neither §530 nor §3509 apply in this case because the workers are not being reclassified since the taxpayer treated them as employees. A §7436 Notice will be issued.

Updated Guidance on §530 implementation (Rev. Proc. 2025-10). Issued at the same time as Rev. Rul. 2025-3, Rev. Proc. 2025-10 provides updated guidance on whether an individual was treated as an employee within the meaning of §530(a)(1). It modifies and supersedes Rev. Proc. 85-18 (1985-1 CB 518), as follows:

- Clarifies the definition of “employee” by providing five situations in which a worker will be considered an employee.
- Clarifies the §530 requirement for the filing of required returns.
- Clarifies the reasonable basis safe harbor rules.
- Amplifies the guidelines in §3.03 of Rev. Proc. 85-18 by interpreting the word “treat” for purposes of determining whether a taxpayer did not treat an individual as an employee for purposes of §530(a).
- Adds new provisions that reflect statutory changes made to §530 that added §530(d) which provides an exception to §530, (e) which covers some special rules, and (f), which covers test room supervisors and proctors who assist in the administration of college entrance and placement exams.
- Removed the provisions in Rev. Proc. 85-18 that are no longer applicable that explained how refunds, credits, abatements, and the handling of claims applied to taxpayers under audit or otherwise involved in processes with the IRS.

Included as Attachment 1 to Rev. Proc. 2025-10 is the complete §530, as amended.

IRS News

Fast Track Settlement, Post-Appeals Mediation Pilot Programs for Alternative Dispute Resolution ([IR-2025-14](#), [A-2025-06](#), Jan. 15, 2025). Three pilot programs were announced to test changes to the IRS’s existing Alternative Dispute Resolution (ADR) programs. The programs are designed to help taxpayers resolve tax disputes quicker and more efficiently. The proposed enhancements to the ADR programs take into account recommendations from the Government Accountability Office, the Taxpayer Advocate Service, and stakeholders who provided suggestions in response to IRS’s earlier request for comments.

The focus of the announcement is the Fast Track Settlement (FTS) program and the Post-Appeals Mediation (PAM) program. The FTS program is currently available to taxpayers under examination in the Large Business and International (LB&I) division, the Small Business/Self-Employed (SB/SE) division, and the Tax Exempt/Government Entities (TE/GE) division. The FTS program allows Appeals to mediate disputes between a taxpayer and the IRS. The PAM program introduces a mediator to help with a settlement between Appeals and the taxpayer while the case is under consideration by Appeals. Both the taxpayer and Appeals must agree to non-binding mediation.

The changes to the FTS and PAM programs incorporate and rely on all existing guidance except for the pilot provisions. The pilots include offering FTS on an issue-by-issue basis. Previously, if one issue was ineligible for FTS, the entire case was ineligible. In addition, denials of requests to participate in FTS and PAM must be approved by a first-line executive and when requests for FTS or PAM are denied, taxpayers will receive an explanation for the denial.

The announcement also includes a limited-scope SB/SE pilot – Last Chance FTS – in which Appeals will reach out to taxpayers or their representatives to make them aware of the availability of FTS. This pilot is designed to test the awareness of taxpayers of FTS. The final pilot removes the restriction that prohibits eligibility for PAM when the taxpayer participates in FTS.

The pilots are in effect for two years, beginning Jan. 15, 2025. Comments are requested.

Final Appeals regulations issued ([T.D. 10030, Jan. 15, 2025](#)). Final regulations providing guidance on the resolution of Federal tax controversies by the IRS Independent Office of Appeals (Appeals) have been issued. As noted in the summary, “The final regulations provide that while the Appeals resolution process is generally available to all taxpayers to resolve Federal tax controversies, there are certain exceptions to consideration by Appeals.” It was the 24 exceptions that were provided in the proposed regs (REG-125693-19, released in 2022) that elicited comments. A lengthy “Summary of Comments and Explanation of Revisions” in the final regs addresses the comments received and mostly implements the regulations as proposed. The regulations are effective for all requests for consideration by Appeals received on or after Feb. 14, 2025.

Proposed regs on increased catch-up contributions for those 60-63, Roth catch-up rule ([IR-2025-07, Jan. 10, 2025](#), [REG-101268-24, Jan. 13, 2025](#)). §109 of the SECURE 2.0 Act modified §414(v)(2) to provide a higher catch-up limit for those turning ages 60 through 63 in the calendar year, effective for tax years beginning after Dec. 31, 2024. The higher catch-up limit for employer plans other than SIMPLE plans is 150% of the catch-up limit in effect for 2024, while for SIMPLE plans, the higher catch-up limit is 150% of the catch-up limit in effect for 2025.

Separately, §117 of the SECURE 2.0 Act modified §414(v) for SIMPLE plans to allow those with no more than 25 employees an increased catch-up limit equal to 110% of the catch-up limit. This increased limit applies to taxable years beginning after Dec. 31, 2023, using the 2024 catch-up limit.

Finally, §603(a) of the SECURE 2.0 Act added §414(v)(7) to the IRC and contains the requirement that catch-up contributions by certain employees must be designated Roth contributions. This requirement does not apply to SEP or SIMPLE plans. In Notice 2023-62, the first two taxable years beginning after Dec. 31, 2023, are an administrative transition period for the Roth catch-up requirement, i.e., Roth contributions for those wages in excess of \$145,000 would not be required for 2024 or 2025. The Notice also stated that the Roth catch-up requirement would not apply to those who did not have FICA wages in the preceding year from the employer sponsoring the plan.

The proposed regs provide the necessary guidance related to §§109 and 117 of the SECURE 2.0 Act. Specifically, the proposed regs make it clear that the higher catch-up limit for those turning 60, 61, 62, or 63 during the calendar year are optional for employers to include in their plans. In the guidance related to §603(a) of the SECURE 2.0 Act, the proposed regs permit employers to offer catch-up contributions but do not require that the plan contain a Roth component. In that case, employees subject to the Roth catch-up rule would not be allowed to make any catch-up contributions.

IRS Actions. As mentioned in our January newsletter, there was an avalanche of guidance from the IRS just ahead of the inauguration. Such activity is not unusual with administration changes. However, [an executive order](#) issued on Jan. 20 imposed a regulatory freeze on any new rules or those not yet published in the *Federal Register* until the rule is reviewed by a department or agency head designated by the President, unless the OMB Director

exempts the rule. The order also asks that the effective date of any rules be postponed for 60 days or more, during which time agencies are to consider opening a comment period. As the result, much of what has come from the IRS has been tax season reminders and tips, requests for comments on forms, and the monthly applicable federal interest rates (the March interest rates were released in [Rev. Rul. 2025-6](#)). A couple of items of interest are below.

The 2025 depreciation limits for passenger automobiles, including trucks and vans, placed in service during the calendar year have been released ([Rev. Proc. 2025-16](#)). Two tables are provided: one for the annual depreciation for 2025 and beyond and the other for the amount to be included in income for lessees of passenger autos with lease terms beginning in 2025. The annually inflation-adjusted amounts are lower than those for 2024, and are as follows:

- First year (no bonus): \$12,200 (\$200 lower)
- First year including bonus: \$20,200
- Second year: \$19,600 (\$200 lower)
- Third year: \$11,800 (\$100 lower)
- Subsequent years: \$7,060 (\$100 lower)

In an Information Release ([IR-2025-18](#)), the IRS stated that the easiest way to check a refund's status is by using either the "[Where's My Refund?](#)" tool on its website or by using the [IRS2Go](#) app. Most refunds are issued within 21 days but can take longer. Refunds for Earned Income Tax Credit (EITC) and the Additional Child Tax Credit (ACTC) cannot be issued before mid-February and the IRS anticipates these refunds to be available by March 3.

The release also mentions additional functionality has been added to the [Online account for individuals](#). It announced that 284 notices that have been redesigned and these will be added to the individual's account so that taxpayers receiving a notice will be able to see it. In addition to the redesigned forms, the IRS also announced that it now has 67 forms that can be accessed on cell phones and tablets. The most recent forms include "save and draft" capabilities.

Latest News on Proposed Regs for Catch-Up Contributions, Automatic Enrollment

Summary. In mid-January, the IRS released proposed regulations regarding the catch-up contributions by plan participants who are 50 or older ([REG-101268-24](#)) and the automatic enrollment of retirement plan participants ([REG-100669-24](#)) and the requirements reflected in the SECURE 2.0 Act of 2022. Both proposed regulations elicited a number of comments and public hearings were held on Apr. 7 and Apr. 8, respectively.

Background. The SECURE 2.0 Act (the Act), signed into law Dec. 29, 2022 as Division T of the Consolidated Appropriations Act, 2023 ([P.L. 117-328](#)), was designed to enhance retirement security. §603 of the Act requires that the catch-up contributions of certain high income plan participants be designated as Roth contributions. Originally effective for taxable years beginning after Dec. 31, 2023, a two-year administrative transition period regarding the Roth requirement was announced in [Notice 2023-62](#), making this provision effective for taxable years beginning after Dec. 31, 2025. Catch-up contributions of employees whose prior year wages from the employer sponsoring the plan exceed \$145,000 are required to be Roth contributions. (This provision does not apply to SIMPLE or SEP plans.)

REG-101268-24 addresses the changes to the regulations under §414(v), which include the Roth requirement. Also included is the so-called super catch-up limit for those ages 60 through 63. For 2025, the super catch-up limit for plans other than SIMPLE plans is \$11,250. For SIMPLE plans, the super catch-up limit is \$5,250.

§101 of the Act added §414A to the Code. It provides that certain retirement plans must automatically enroll employees and includes minimum contribution percentages. Excluded from the requirement are SIMPLE plans, governmental and church plans, as well as new businesses (in existence for less than three years) and small businesses (normally employing 10 or fewer employees). Automatic enrollment for §401(k) and §403(b) plans is required beginning in 2025. Employees can elect to opt out.

REG-100669-24 provides regulations under §414A, as well as amending the regulations under §414(w). The amendments address the notice requirements under new §§414(bb) and 402A(e)(5)(C) added to the Code by §§127 and 341, respectively, of the Act.

Public Comments on REG-101268-24. Some of the issues raised in the comments are the following:

- **The American Benefits Council** suggests employers be offered additional flexibility and requested clarification on areas of uncertainty, particularly the Roth catch-up requirement and the catch-up limit for participants aged 60 to 63.
- **The U.S. Chamber of Commerce** requested clarification on the application of the regs to non-calendar year plans.
- **The American Council of Life Insurers** asked that plans be given the flexibility to institute a Roth-exclusive catch-up provision as an alternative to a pretax and required Roth catch-up approach.
- **SPARK Institute** recommended simplifying the in-plan Roth conversion correction method.
- **Several commenters** raised concerns about multiple employer plans.

Public Comments on REG-100669-24. Some of the issues raised include the following:

- **The AICPA** commented that there should be clarification that the investment requirements for trustee-directed plans do apply to plans that do not adopt participant direction of investment and that the final regs should state that only employees of the plan sponsor are included in the count for determining status as a small business.
- **Health & Pension WORKS**, a multiemployer group, suggested that the regs be interpreted as applying to a multiple employer plan (a plan maintained by more than one employer) and not a multiemployer plan.
- **Ferenczy Benefits Law Center**, a law firm, requested clarity on the small business exception and plan mergers.
- **Several commenters** raised concerns about the automatic escalation increases and notice requirements for unenrolled participants.

Public Hearings. The April 7 hearing on catch-up contributions (REG-101268-24) included four public speakers. No new issues were raised. The April 8 hearing on automatic enrollment requirements (REG-100669-24) included three public speakers, two representing multiemployer groups and one former IRS employee. No new issues were raised.

IRS Obsoletes 83 Pieces of Guidance ([Notice 2025-36](#)). In accordance with two executive orders, the IRS announced the obsolescence of 83 pieces of guidance, including Notices, Revenue Procedures, Revenue Rulings, and Announcements. Most of the items dealt with Code sections or regulations that had been amended or repealed. The Notice indicates that additional items will be revoked or obsoleted in the near future.

College Athletes Can Now Be Paid Directly by Schools. A [deal](#) between the NCAA, several of its conferences, and lawyers representing all Division I athletes was approved in June, bringing an end to three antitrust lawsuits. Colleges and universities are able to make direct payments to student athletes, through revenue sharing, beginning July 1, 2025. This is in addition to the Name, Image, and Likeness (NIL) programs that have been in place for the last few years. In anticipation, the NCAA [passed rules](#) earlier in 2025 that allowed the payments and set a cap of \$20.5 million for player compensation.

A recent article from *Practical Tax Strategies* notes that when NIL came into existence, various income tax factors, including self-employment income tax, estimated income taxes, and state and local tax payments came into play. (The IRS has [a page](#) on its website regarding NIL income, which currently references such payments as self-employment income.) With direct pay, the number of athletes receiving taxable income will increase. The article indicates that consideration of an employment contract should be a priority. Practitioners are uniquely positioned to assist these athletes (and their parents) who may be unaware of their tax obligations and the opportunities to mitigate their tax liabilities through such strategies as retirement plans and to provide guidance on the tax implications of the provisions of the employment contract.

However, the article's authors believe the IRS will step in and force colleges to treat them as employees. The article indicates that one of the strongest arguments the IRS can make for this will be the amount of athlete's time that is controlled by the school. If this happens — and, as the article notes, the IRS has been aggressive in similar situations — the tax considerations will change.

AI IN TAX PRACTICE

Artificial Intelligence in Tax Practice: Introduction and Overview

Artificial intelligence (AI) is no longer a theoretical concept in the tax and accounting profession. It is already transforming workflows, streamlining compliance processes, augmenting research capabilities, and reshaping client interactions. According to a recent industry report, 77% of professionals expect AI to have a "high or transformational" impact on their work within five years, and over 80% view it as a "force for good" in the profession. Early adopters are using technologies such as machine learning (ML), natural language processing (NLP), and large language models (LLMs) to improve efficiency, reduce manual workloads, and create competitive advantage.

Yet for many CPAs, the sheer pace and breadth of technological change can be daunting. This guide is designed to demystify AI for CPAs by offering a practical, real-world approach to understanding, evaluating, and implementing AI tools in tax practice.

We will start by explaining the fundamentals of AI, including core concepts and technologies relevant to tax professionals. Then, we will explore how AI is being used today across the tax landscape: from automating data entry and organizing client documents, to assisting with technical research and even predicting tax outcomes.

Next, we will examine use cases in detail across compliance, planning, client service, and practice management. After that, we will turn to implementation strategies, including how to pilot tools, train staff, and evaluate ROI. We will conclude with a discussion of risks, ethics, and regulatory concerns and provide a roadmap for continuing your AI journey.

Understanding AI: Key Concepts for CPAs

AI encompasses a range of technologies that simulate aspects of human intelligence. These include:

Machine Learning (ML): Algorithms that learn from data to make predictions or identify patterns. For example, categorizing transactions as deductible or nondeductible based on past entries.

Scenario:

A mid-size accounting firm handles hundreds of business clients' books. Each month, the firm processes thousands of expense transactions across various industries. To improve efficiency and accuracy, the firm implements a **machine learning model** trained on historical transaction data labeled as **deductible** or **nondeductible**.

How ML Works in This Context:

- 1. Data Collection and Labeling:**
 - The firm's tax staff label past transactions based on IRS guidance and professional judgment.
 - Example labels:
 - *Deductible*: "Office supplies," "Travel to client site"
 - *Nondeductible*: "Fines," "Political contributions"
- 2. Model Training:**
 - The ML algorithm (e.g., a random forest or neural network) learns from labeled features such as:
 - Merchant name
 - Description
 - Expense category
 - Date and amount
 - Client industry
- 3. Prediction:**
 - When new transactions are imported (e.g., from QuickBooks), the model automatically flags:
 - Deductible (e.g., "Zoom subscription" for a consultant)
 - Nondeductible (e.g., "Parking ticket")
- 4. Human Review and Feedback Loop:**

- Staff review flagged transactions. Their corrections are fed back into the model to improve future predictions.

Benefits in Practice:

- **Time Savings:** Reduces manual review of routine transactions.
- **Consistency:** Applies standardized rules across clients.
- **Audit Defense:** Keeps an audit trail of classification logic.
- **Scalability:** Supports large volumes of data during tax season.

Natural Language Processing (NLP): Enables computers to understand and generate human language. Useful for reading regulations or generating memos.

Using NLP for Regulation Review and Memo Generation in Tax Practice

Scenario:

A tax professional must stay up to date on frequently changing IRS regulations, court rulings, and Treasury guidance. Manually reading hundreds of pages from the Internal Revenue Bulletin (IRB), Tax Court opinions, or IRS Notices is time-consuming.

To streamline this, the firm integrates an NLP-powered platform into their workflow.

How NLP Is Applied

1. Regulation Summarization

- The NLP engine ingests and analyzes IRS publications, court cases, or state tax bulletins.
- It identifies and summarizes:
 - Relevant code sections
 - New compliance rules
 - Penalty updates
 - Effective dates and filing thresholds

Example Output: “IRS Notice 2025-18 clarifies that taxpayers using virtual currencies in barter transactions must report such income under §61. Reporting is required for transactions over \$600 starting Jan 1, 2026.”

2. Search & Extraction

- NLP tools allow staff to query documents conversationally:
 - “What is the threshold for 1099-K reporting in 2025?”
 - “List all deductions disallowed under §280E.”
- The tool extracts answers directly from authoritative sources.

3. Memo Drafting

- NLP models trained on prior memos automatically generate first drafts of client deliverables.
- Based on input such as “client sold §1202 stock” or “partnership electing out of centralized audit regime,” the model produces tailored memos.

Example Output: “Based on your sale of Qualified Small Business Stock (QSBS) held for over five years, you may be eligible to exclude up to 100% of the gain under §1202(a). Please retain documentation supporting your original investment and holding period.”

4. Language Translation or Simplification

- For firms working with multilingual clients or junior staff, NLP can translate IRS documents or simplify legal jargon.

Benefits in Tax Practice

- **Speed:** Rapidly processes thousands of pages of tax law.
- **Accuracy:** Minimizes human error in interpreting legal text.
- **Consistency:** Ensures firm-wide application of interpretations.
- **Productivity:** Gives staff more time for analysis and client service.

Generative AI: A subfield of NLP that can create new content (e.g., summaries, emails, answers to questions) based on training data.

Example: Using Generative AI in Tax Practice for Client Communication and Research Summaries

Scenario:

A tax advisory firm handles a wide variety of client inquiries, from R&D credit qualification to §1202 stock treatment, SALT cap workarounds, and late filing relief. Responding thoroughly, accurately, and quickly is critical, but time-intensive.

The firm integrates **Generative AI**, such as GPT-based models, into its workflow to automate **content generation** for both internal and client-facing purposes.

How Generative AI Is Applied

1. Generating Client Email Responses

When a client emails a question such as: “Can I deduct expenses from a hobby business?”

The generative AI tool (e.g., embedded in Outlook or a CRM) drafts a professional, customized response:

Example Output:

“Thanks for your question. Generally, expenses from activities not engaged in for profit are not deductible under IRC §183, known as the ‘hobby loss rule.’ However, if you can demonstrate a profit motive, deductions may be allowed. I’d be happy to review your situation in more detail.”

2. Summarizing IRS Notices and Tax Memos

The firm uploads IRS guidance (e.g., Notice 2025-23) or Tax Court opinions. The AI reads and produces a short, readable summary with key takeaways:

Example Output:

“Notice 2025-23 delays the implementation of the \$600 1099-K threshold until 2026. For 2025, the threshold remains at \$5,000. The IRS is developing a new reporting portal for gig economy workers.”

3. Drafting Planning Memos or Whitepapers

For high-net-worth clients or business owners, the AI helps draft tax planning documents based on client facts and applicable law.

Prompt Input:

“Generate a memo for a client selling §1202 QSBS for \$4M in 2024. Holding period is 6.5 years. C corporation startup. Wants to know about gain exclusion and filing requirements.”

Generated Memo Excerpt:

“You may qualify to exclude 100% of the gain under IRC §1202, given your 6.5-year holding period and the stock’s status as Qualified Small Business Stock. To claim the exclusion, ensure Form 8949 is properly completed, and retain records of the original stock issuance.”

4. Knowledge Base or Chatbot for Staff

Firms can deploy internal chatbots powered by generative AI that answer questions like:

- “What are the §199A limitations for SSTBs?”
- “How do I elect out of the partnership audit regime?”

Benefits in Practice

- **Scalability:** AI can handle hundreds of queries simultaneously.
- **Consistency:** Ensures advice and language are aligned across staff.
- **Speed:** Drafts memos and emails in seconds, not hours.
- **Client Experience:** Quick and clear responses improve trust and satisfaction.

Large Language Models (LLMs): Advanced NLP models trained on massive text datasets. ChatGPT (based on GPT-4) is a prime example, capable of answering questions, summarizing documents, and drafting technical content.

Example: Using Large Language Models (LLMs) in Tax Practice

Scenario:

A tax advisory firm is preparing for year-end planning and receives a flood of complex client questions on issues like:

- Late election filing
- §163(j) interest limitation
- International information reporting penalties
- State PTE election compliance

Instead of assigning each question manually to a senior associate or partner, the firm integrates an **LLM-powered assistant** (like ChatGPT via API or Microsoft Copilot) into its workflow.

How LLMs Are Applied in Practice

1. Client Question Answering

When a staff member receives a question like:

“Can we still file a late S Corp election for 2023?”

They use an LLM to generate a technically accurate and readable response:

LLM Output:

“Yes, the IRS allows late S corporation elections under Revenue Procedure 2013-30, provided the entity meets certain criteria and reasonable cause exists for the delay. Form 2553 should be submitted with an explanation attached.”

Staff review and customize before sending.

2. Document Summarization

LLMs summarize:

- IRS Notices, court cases, or tax articles
- Tax provisions relevant to a client situation
- Client documents (e.g., partnership agreements or prior returns)

Example:

Upload a 12-page IRS Notice → Get a 4-paragraph plain-English summary with key takeaways and action items.

3. Drafting Technical Memos and Reports

Instead of starting from scratch, junior staff use the LLM to generate initial drafts of:

- Technical tax memos
- Research writeups
- Whitepapers for clients

Prompt Example:

“Draft a memo explaining §280E implications for a cannabis distributor, including cases and penalties.”

LLM Output:

“IRC §280E prohibits deductions for expenses incurred in trafficking Schedule I or II controlled substances. As cannabis remains Schedule I under federal law, businesses cannot deduct most ordinary and necessary expenses. Courts have upheld this in *CHAMP* and *Olive* decisions. Only cost of goods sold is allowed.”

4. Internal Knowledge Retrieval

Team members ask LLMs questions like:

- “What are the material participation tests under §469?”
- “How do you calculate depreciation for listed property?”

LLMs return relevant answers instantly with references, allowing staff to focus on planning and execution—not research alone.

Benefits in Tax Practice

- **Accelerated Learning Curve:** Junior staff learn faster with on-demand expert guidance.
- **Time Savings:** Cut drafting and research time by 50–80%.
- **Consistency:** Aligns tone and technical depth across the firm.
- **Higher Quality Work Product:** Senior staff can focus on review, not grunt work.

Retrieval-Augmented Generation (RAG): Combines LLMs with document retrieval to improve factual accuracy.

Example: Using Retrieval-Augmented Generation (RAG) in Tax Practice

What is RAG?

Retrieval-Augmented Generation (RAG) is a technique that **combines Large Language Models (LLMs)** (like ChatGPT) with a **document retrieval system**. Instead of relying purely on the model’s memory, it first retrieves relevant documents or data from a trusted source (e.g., IRS regulations, firm memos, client files), then **generates an answer grounded in that content**.

Practical Scenario: Memo Drafting with RAG

Scenario:

A senior manager is writing a memo for a client on the **§163(j) interest expense limitation** and how it applies to a real estate business with an aggregation election.

Instead of searching multiple databases and manually reviewing IRS guidance, prior memos, and client tax returns, the firm uses a RAG-based system.

How the RAG Workflow Operates

Step 1: Retrieval

The system searches internal resources such as:

- Prior memos on §163(j) elections
- IRS documents (e.g., Form 8990 instructions)
- Client documents like past-year 1065 returns and elections filed
- Internal knowledge base articles

Step 2: Generation

The LLM reads the retrieved documents and generates a custom response:

RAG Output:

“Per the attached 2022 memo and IRS instructions to Form 8990, your real estate activities are eligible to elect out of the §163(j) limitation under the ‘real property trade or business’ exception. Based on the aggregation election filed with the 2020 return, interest expense should be fully deductible. Be sure to continue using ADS depreciation for affected assets per §168(g).”

The output cites documents or provides excerpts with links, ensuring accuracy and traceability.

Other Applications in Tax Practice

1. Real-Time Tax Research

Ask a question like: “What are the QBI limitations for a high-income SSTB?”

RAG retrieves the latest IRS guidance, internal whitepapers, and recent court cases, and the LLM answers with grounded content.

2. Reviewing Client Files for Advisory

- LLM generates a planning letter using current-year client data, incorporating specific facts (e.g., net income, elections, deductions).
- All statements are **tied back to retrieved source documents**, such as prior returns or entity agreements.

Benefits of RAG in Tax Practice

- **Factual Accuracy:** Reduces hallucinations by grounding responses in trusted sources
- **Compliance Confidence:** Ensures answers are based on current laws and firm policy
- **Productivity Boost:** Automates research and document review
- **Custom Outputs:** Answers and memos are tailored to specific client facts

Hallucination: When an AI generates plausible but incorrect information. Critical to identify and mitigate in professional settings.

Example: Hallucination in Tax Practice

Scenario: AI Drafts a Tax Memo with Incorrect Authority

Prompt:

“Write a memo explaining the deductibility of legal fees related to business dissolution under IRC.”

AI Output (Hallucinated):

“According to IRC §165(c)(3), legal fees incurred during the dissolution of a business are fully deductible as ordinary business expenses.”

What's Wrong:

- IRC §165(c)(3) **has nothing to do with legal fees** — it refers to casualty and theft losses for individuals.
- Legal fees **may be capitalized or treated as nondeductible personal expenses**, depending on context.
- The AI **invented** a statute-citation combination that **doesn't exist** in tax law.

Risks of Hallucination in Tax Practice

Misleading Clients: Inaccurate memos could lead to erroneous positions or misinformed decisions.

Compliance Violations: Relying on false authorities may result in IRS penalties or preparer negligence claims.

Loss of Credibility: If an AI-generated memo is challenged in audit or litigation, credibility of the preparer is at stake.

How to Identify and Mitigate Hallucinations

1. Always Fact-Check Citations

- Verify any code sections, regs, or case names in authoritative sources like:
 - IRC text
 - Treasury Regs
 - IRS Notices and Rulings
 - CCH or Bloomberg Tax

2. Use Retrieval-Augmented Generation (RAG)

- Implement RAG systems that **cite source documents** (e.g., IRS guidance, internal memos) instead of relying solely on model output.

3. Layer AI With Human Review

- Use AI for **drafting and summarization**, not final advice.
- Ensure a qualified tax professional reviews all outputs.

4. Train the AI on Firm-Specific Knowledge

- Use vetted documents and memos to fine-tune outputs and reduce risk of hallucination.

Best Practice: "Trust, but verify."

Use AI as a **co-pilot**, not an autonomous agent. It's a tool to accelerate thinking, not a replacement for technical expertise.

Current AI tools are narrow (task-specific), not general AI capable of abstract thinking. In tax, they function like ultra-fast, tireless junior staffers: able to process and summarize large volumes of information, but still requiring oversight.

Current State of AI in Tax Practice

CPAs across firm sizes are using AI in meaningful ways. Key findings from industry research include:

- **Efficiency Gains:** Firms report saving 4+ hours per week per professional, with expectations of 12+ hours weekly savings in five years.
- **Use Cases:** Common applications include drafting responses to IRS notices, summarizing documents, automating data entry, and conducting technical research.
- **Democratization:** Small firms are leveraging AI with off-the-shelf tools, showing that innovation isn't limited to the Big Four.
- **Cautious Optimism:** While many firms are experimenting, adoption is still early-stage, with security and quality control being common concerns.

Examples of AI Use in Practice From Journal of Accountancy

- **Automated Mail Processing:** One nonprofit automated the intake and triage of physical mail using Microsoft Power Automate, AI image recognition, and secure LLMs.

Case Study 1 — Automating the Mailroom:

Problem: A nonprofit’s accounting department was drowning in paper mail — hundreds of pieces weekly, from vendor invoices to IRS notices. Important documents were at risk of being misplaced.

AI Solution: The controller, Karl Spanbauer, built a workflow using Microsoft Power Automate and AI services to digitize and route mail. Staff feed all incoming mail through a scanner; an image recognition AI extracts the text, then a secure LLM (large language model) generates a summary of each piece of mail. The system automatically creates a ticket in their workflow software (Jira) with the summary and attaches the scanned document.

Result: The team now processes the mail in efficient 20-minute sprints, and nothing gets lost or overlooked. What used to be a tedious, error-prone chore is largely automated — humans step in only to take action on the summarized items. This DIY solution cost virtually nothing extra (leveraging existing software licenses) and was implemented by a CPA with tech know-how in a matter of weeks. It’s a great example of combining off-the-shelf tools to solve a pain point. Imagine applying similar tactics to sort client email inquiries or to triage information requests from taxing authorities.

- **Drafting Memos:** A regional firm created a custom AI bot to draft goodwill impairment memos, reducing drafting time from four hours to 30 minutes.

Case Study 2 — Drafting Technical Memos With Generative AI:

Problem: A regional advisory firm often prepares complex accounting memos (e.g., analyzing goodwill impairment for clients). These memos are time-consuming, requiring technical precision but also clear communication for non-experts.

AI Solution: Glenn Hopper, who heads AI development at the firm, created a custom generative AI bot for memo drafting. He took the firm’s trove of past memos and broke them into thematic chunks, then used a retrieval-augmented generation (RAG) approach to feed this knowledge to an OpenAI model. The bot was fine-tuned with hundreds of examples to adopt the firm’s style and reduce “hallucinations.” Now, when a new memo is needed, the AI can produce a solid first draft, pulling in relevant prior language and ensuring coherence.

Result: What used to take a senior staff 4+ hours of writing has been cut to about 30 minutes of editing a draft. The firm keeps a human in the loop — final memos are reviewed and tweaked by experienced CPAs — but the efficiency gain is tremendous. Hopper notes that this custom solution required specialized expertise and about 60 hours of initial work to set up, something not every firm will want to do in-house. But it demonstrates the power of AI when tailored to a firm’s knowledge base. The memo bot also wowed many staff who were new to ChatGPT and sparked further ideas of automating other analysis tasks. (Notably, Hopper has since built bots to analyze 10-Ks and other financial filings, hinting at the potential in tax for reviewing complex client documents.)

- **Marketing Chatbots:** A 15-person firm developed an AI chatbot to answer succession planning questions on their website, capturing new leads.

Case Study 3 — Client-Facing Chatbot as a Marketing Tool:

Problem: A small CPA firm (15 employees) wanted to differentiate itself and generate leads by sharing knowledge on a niche topic (family business succession planning). Writing blogs or guides was useful but not highly interactive.

AI Solution: The firm’s marketing partner, Barrett Young, used OpenAI’s ChatGPT platform to create a custom chatbot called “Generations Advisor”. This AI, accessible on the firm’s website, answers questions about ownership transitions for family businesses — essentially giving free preliminary advice in a conversational format. Young achieved this by supplying written instructions and context documents (the firm’s own marketing materials

and expertise on succession) to a custom instance of ChatGPT. The bot was tuned to adopt a helpful, non-technical tone consistent with the firm's style.

Result: Prospective clients can query this tool to learn about succession planning basics, which provides value and builds trust before they even speak to the firm. In exchange for this “free advice,” users sign up with an email, growing the firm's mailing list (the bot has added ~50 new contacts in three months). Even if the audience is small, it's highly targeted — and just one or two new clients from it easily justifies the effort in terms of revenue. Implementation was quick and cheap: aside from a \$20/month ChatGPT Plus subscription, it mainly took Young's time to set it up (which he did after experimenting with personal uses of custom GPTs). This creative use of AI shows how even a boutique firm can harness generative AI not only internally but as a client engagement tool, showcasing their forward-thinking approach. It's marketing that provides a service, enabled by AI.

- **Coding Assistant:** CPAs are using ChatGPT and Claude to generate Excel formulas or VBA code on demand.

Case Study 4 — AI-Assisted Coding and Data Analysis:

Problem: A consultant CPA often needed to manipulate and analyze client data in Excel, sometimes requiring complex macros or code. In the past, he would outsource some of the heavier coding tasks or spend a lot of time writing VBA scripts.

AI Solution: Starting in 2023, he turned to AI platforms like ChatGPT and Anthropic's Claude to generate code snippets on demand. For example, he described in plain English a problem — “In Excel, find a given text string and delete all rows above it” — and the AI produced a working VBA macro in seconds. He did this for various needs, essentially using AI as a programming assistant.

Result: According to the CPA, since adopting AI he “hasn't had to outsource coding”, saving significant time and money. Projects that might have stalled waiting for a programmer can be executed immediately. This use case underscores that AI's value isn't limited to purely “accounting” tasks; it can extend to any technical aspect of your workflow. While writing code by AI may be niche, even non-coders can benefit from AI-assisted tools (for instance, Microsoft's Excel formula suggestions or Power BI's natural language queries). The broader point: AI can reduce reliance on specialized external support by empowering CPAs to do more themselves with the help of intelligent assistants.

- **Tax Research AI (Blue J):** A specialized tax tool that answers questions with citations and can predict legal outcomes based on case law analysis.

Case Study 5 — Tax Research and “Ask Blue J”:

Problem: Researching nuanced tax questions (like varying state treatments or complex multi-factor tests) is labor-intensive. Practitioners might spend hours combing through code, regulations, and case law.

AI Solution: New tools like Blue J's tax research AI aim to streamline this. Blue J's “Ask” feature is essentially a chatbot trained specifically on tax law and cases. One CPA firm reported that they subscribed to Ask Blue J and found it helpful for getting quick answers with citations on federal and state tax queries. The AI can even generate draft memos or client emails explaining a tax issue.

Result: The tool often comes back with solid responses “95% factual,” according to one user, but occasionally struggles especially with numeric computations like inflation-adjusted figures. The firm's staff appreciate the speed — likening it to having a tax manager on call to answer any question without judgment. However, they also emphasize the need to double-check the answers.

AI in Tax Compliance and Preparation

AI excels at automating routine, rules-based tasks:

- **Data Capture:** OCR + ML can extract fields from scanned W-2s, 1099s, or brokerage statements.
- **Document Classification:** AI can identify document types and sort them accordingly.
- **Transaction Categorization:** QuickBooks and similar tools already use ML to categorize expenses.
- **Error Detection:** AI can compare current-year returns to prior-year data or peer norms to flag anomalies.
- **IRS Notice Responses:** AI can draft initial responses or client letters.
- **Planning Suggestions:** Tools are starting to flag opportunities (e.g., bunching deductions, QCDs) during return prep.

AI in Tax Research and Planning

AI tools offer faster and broader research capabilities:

- **LLM-based Q&A:** Tools like ChatGPT or Blue J can answer technical questions in plain language and cite code sections.
- **Scenario Modeling:** AI can help forecast tax outcomes under different entity structures or tax strategies.
- **Outcome Prediction:** Blue J predicts legal outcomes with confidence scores, useful in audit risk analysis.
- **Idea Generation:** AI can prompt planning opportunities based on taxpayer profiles (e.g., defined benefit plans, entity conversions).
- **Plain English Summaries:** AI can translate complex tax analysis into client-friendly explanations.

AI in Client Service and Communication

- **Chatbots:** Answer FAQs 24/7, assist with client intake, and improve responsiveness.
- **Personalized Outreach:** Segment clients by situation (e.g., parents, high earners) and generate tailored messages.
- **Assistant Drafting:** AI can generate draft emails or memos for review.
- **Data Analysis:** AI can scan client histories for service opportunities.

AI in Practice Management and Operations

- **Admin Automation:** AI can triage emails, schedule meetings, and extract action items from meetings.
- **Time Tracking:** AI can infer time entries based on calendar and file activity.
- **Document Management:** AI can tag templates and suggest usage.
- **Training Bots:** Staff can query internal AI bots about procedures and best practices.
- **Analytics:** Partners can ask questions about realization, turnaround time, or profitability and get instant insights.

Implementation: How to Get Started

- **Start Small:** Pilot low-risk tools (e.g., AI drafting assistant) before scaling.
- **Evaluate Vendors:** Focus on security, accuracy, compatibility, and user experience.
- **Train Staff:** Educate on prompting, review best practices, and emphasize oversight.
- **Set Policies:** Establish acceptable use policies, especially regarding data confidentiality.
- **Review Outputs:** Build in review layers for all AI-assisted work.

Ethics and Risk Management

- **Confidentiality:** Do not enter PII into public AI tools. Use enterprise tools or redact data.
- **Due Diligence:** Verify citations and facts. AI output is a starting point, not final advice.
- **Professional Standards:** Circular 230 and SSTS apply to AI-assisted work. The CPA is still responsible.
- **Documentation:** Keep records showing your review and validation of AI work.

Looking Ahead

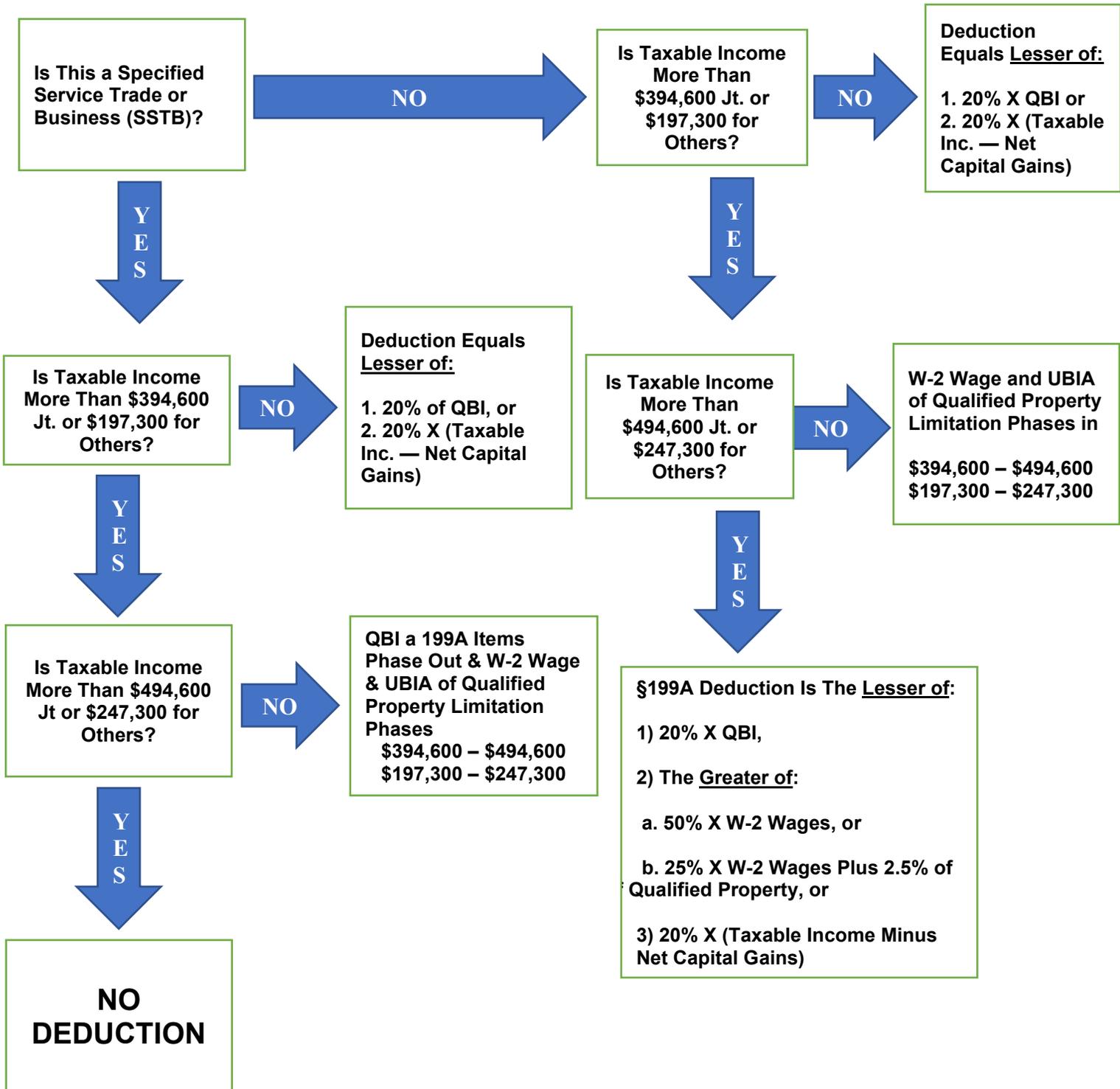
- **Upskilling:** CPAs will need comfort with data analysis, AI tools, and critical review.
- **Role Shift:** CPAs will spend less time on rote tasks and more on strategic advisory.
- **Integration:** AI will increasingly be embedded in everyday software.
- **Client Expectations:** Clients will expect faster, smarter, more tailored service.

Conclusion

AI is not replacing CPAs, but enhancing them. By removing drudgery, AI allows professionals to focus on higher-value work. Firms that adapt now will gain an edge in client service, efficiency, and innovation. Used wisely and ethically, AI is a powerful ally in the evolving tax landscape.

20% §199A DEDUCTION

§199A Qualified Business Income Deduction for 2024



Note! This flow chart only deals with the QBI component of the §199A deduction and not with the §199A deduction for qualified REIT dividends and publicly traded partnership (PTP) income. If a taxpayer has REIT dividends and PTP income qualifying for the §199A deduction, 20% of such amounts would be added to the QBI deduction and the total would be limited to 20% of taxable income minus net capital gains. Please see the Reg 1.199A-1 for the calculation of the §199A deduction where the taxpayer has QBI, REIT dividends, and PTP income.

Selected §199A Planning Strategies

Property or Services Provided to 50% or More Commonly Owned SSTB

Owners of Rental Property Who Do Not Own Interests in SSTB Do Not Have SSTB Income

Facts:

- **A, B, C, D, and E** each own 20% of Partnership **X**, which owns a commercial office building.
- **A, B, C, D, and E** are not related to one another as described in §267(b).
- **X** rents 100% of its office building to Law Partnership **Y** (an SSTB) and the rental income from **Y** is the only income of **X**.
- **A, B, C, and D** each own 25% of Law Partnership **Y**.
- **E** is not an attorney and does not own an interest in Law Partnership **Y**.

Conclusions:

- Reg 1.199A-5(c)(2)(i) says *“If a trade or business provides property or services to an SSTB within the meaning of this section and there is 50% or more common ownership of the trades or businesses, 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] **Practice Alert!** It appears from the Preamble to the final regs, *“related parties,”* refers to those who make up the 50% or more common ownership test.
- **A, B, C, and D’s** allocable share of income from Rental Partnership **X** is SSTB income since together they own 100% of Law Partnership **Y** and 80% of Rental Partnership **X** and, therefore, meet the 50% or more common ownership test.
- It appears that **E’s** allocable share of the income from Rental Partnership **X** is not SSTB income because **E** is not one of the group of individuals owning 50% or more of both Law Partnership **Y** and Rental Partnership **X**.

Practice Alert! Reg 1.199A-1(b)(14) says *“rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a §162 trade or business is nevertheless treated as a trade or business for purposes of §199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A-4(b)(1)(i).”* Reg 1.199A-4(b)(1)(i) provides that trades or business are *“controlled”* where *“The same person or group of persons, directly or by attribution under §§267(b) or 707(b), owns 50% or more of each trade or business * * * .”* This test does not require *“common ownership”* in both the entities. It only requires that the *“same person or group of persons”* directly or through attribution owns 50% or more of each trade or business. In fact, the Preamble to the final regs says that those included in the 50% ownership test are not required to own an interest in each trade or business.

Although the more stringent *“control”* test under SSTB Reg 1.199A-5(c)(2) is not met in this example for **E** (because **E** does not own an interest in both Rental Partnership **X** and Law Partnership **Y**), it appears the self-rental safe harbor under Reg 1.199A-1(b)(14) applies to **E** as well as to **A, B, C, and D**, since **A, B, C, D, and E** together own 100% of Rental Partnership **X** and Law Partnership **Y**. Therefore, the rental income received from Law Partnership **Y** by Rental Partnership **X** and allocated to **A, B, C, D** and **E** should be trade or business income under the Reg 1.199A-1(b)(14) self-rental safe harbor. However, as noted above, the **A, B, C, and D’s (but not E’s)** allocable share of income from Rental Partnership **X** is SSTB income.

SSTB Owners of Rental Property That Is Only Partially Rented to Commonly Owned SSTB Only Partially Have SSTB Income

Facts:

- **A, B, C, D, and E** each own 20% of Partnership **X**, which owns a commercial office building.
- **A, B, C, D, and E** are not related to one another as described in §267(b).

- **X** rents **80%** of its office building to Law Partnership **Y** (an SSTB), and the **remaining 20%** of the office building is rented to **F** (an unrelated third party). **80% of the total rents** are generated from the rental to Law Partnership **Y**, and the **remaining 20%** is generated from the rental to **F**.
- **A, B, C, and D** each own 25% of Law Partnership **Y**.
- **E** is not an attorney and does not own an interest in Law Partnership **Y**.

Conclusions:

- As concluded in the previous example, none of **E**'s share of the rental income from Partnership **X** would be re-classified as SSTB income.
- Reg 1.199A-5(c)(2)(i) states that the portion of the self rental that is re-classified as SSTB income is **“that portion of the trade or business of providing property or services to the 50% or more commonly-owned SSTB.”** [Emphasis added]. Since **only 80%** of Partnership **X**'s rental income is generated from the self rental to Law Partnership **Y**, **only 80%** of Partnership **X**'s rental income would be re-classified as SSTB income.
- Therefore, **A, B, C, and D**'s allocable share of **only 80%** of the income from Rental Partnership **X** is treated as SSTB income.
- Also, Reg 1.199A-5(c)(2)(i) states: **“If a trade or business provides property or services to an SSTB within the meaning of this section and there is 50% or more common ownership of the trades or businesses, 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.”** Consequently, the fact that **80%** of Partnership **X**'s rental income that is treated as SSTB income as to **A, B, C, and D** is presumed to be a **“separate”** trade of business, the 10%/5% SSTB anti-abuse de minimis rule should not cause the remaining 20% of Partnership **X**'s rental income to be re-classified as SSTB income with respect to **A, B, C, and D**.

Rental Income Received By Partnership Owned Equally by Four Dentists and Rented to Dentists' Separate Dental Practices Arguably Not SSTB Income

Facts:

- Four dentists, **A, B, C, and D**, who are not related parties under §267(b), each owns 25% of Rental Partnership **X** which owns an office building.
- Each dentist owns 100% of an S corporation which conducts the dentist's practice.
- One-fourth of the office building owned by **X** is rented to **A, B, C, and D**'s respective S corporation.

Conclusions:

- As mentioned in the immediately preceding item, the regulations say that rental income from renting property to an SSTB is SSTB income if there is 50% or more common ownership of the rental property trade or business and the SSTB.
- Reg 1.199A-5(c)(2)(ii) says **“50% or more common ownership includes direct or indirect ownership by related parties within the meaning of §§267(b) or 707(b).”**
- In this example, there is not 50% or more common ownership of each of the S corporations and Rental Partnership **X**.
- Each dentist owns 100% of his or her dental practice. However, each dentist owns only 25% of Rental Partnership **X**.
- Therefore, if none of the dentists are related under §267(b), it appears that **A, B, C, and D**'s allocable share of **rental income from Partnership X would not be SSTB income**.

Practice Alert! From a reading of Reg 1.199A-5(c)(2), your authors believe this is a proper interpretation of the anti-abuse provision of the regulation. However, your authors have asked the IRS to provide examples explaining Reg 1.199A-5(c)(2). This SSTB anti-abuse provision is a totally new concept under the tax law and needs additional clarification.

Rental Income From Renting Real Estate to a C Corporation Performing SSTB-Type Services Is Arguably Not SSTB Income

Facts:

- Four CPAs own 25% each of Rental Partnership **X** which owns a commercial office building.
- The four CPAs also each own 25% of C Corporation **Y** in which they conduct a CPA practice.
- The office building is rented entirely to C Corporation **Y**.

Conclusions:

- Although C Corporation **Y** is conducting an SSTB activity (i.e., Accounting) and there is 100% common ownership of C Corporation **Y** and Rental Partnership **X**, the rental income of Partnership **X** allocated to the CPA partners is arguably not SSTB income.
- On Feb. 22, 2019, your authors discussed this issue with a representative of the Associate Chief Counsel's Office. She said it is their position that a C corporation is not included in the definition of "trade or business" under §199A. Therefore, a C corporation cannot be an SSTB. Thus, rental income received from a 50% or more commonly owned C corporation conducting an SSTB activity is not SSTB income. **Caution!** This is an unofficial opinion and is not binding on the IRS. Hopefully, the IRS will clarify this issue in future guidance.

Wages Paid to S Corporation Shareholder/Employee

S Corp Shareholder/Employee's W-2 Wages Treated Same as Other Employees' W-2 Wages

Facts

- S corporation **X** has net income of \$50,000 for 2020.
- **Y** owns 100% of **X** and is paid wages of \$30,000 by the S corporation during 2020.
- Does the S corporation have QBI of \$50,000 or \$80,000 (i.e., \$50,000 plus \$30,000)?

Conclusion:

The QBI of X is \$50,000. The W-2 wages of an S corporation shareholder/employee are treated under §199A the same as the W-2 wages paid to any other employee.

Practice Alert! The \$30,000 of wages paid to the shareholder may also qualify as W-2 Wages for purposes of the W-2 Wage and Qualified Property Limitation if the wages are properly reported on a Form W-2 filed within 60 days of the due date.

S Corp Shareholder/Employee's Medical Insurance Premiums Timely Included in W-2 Are Generally W-2 Wages for Purposes of The W-2 Wage Limitation

Wages subject to withholding are qualified W-2 wages assuming the Form W-2 is filed within 60 days of its due date. Medical insurance premiums included in an S corporation shareholder/employee's W-2 are generally not subject to FICA or Medicare tax, but, are subject to wage withholding. So, they are qualifying wages, assuming the W-2 is filed within 60 days of its due date. However, please see Rev. Proc. 2019-11 for the three methods for determining wages. If the "Unmodified Box Method" is chosen for determining the W-2 Wage Limitation and Box 5 is less than Box 1, then the W-2 wages of the S corporation owner would not be picked up (even though they are qualifying wages) because Box 5 only includes Medicare wages.

Business Must Be §162 Trade or Business to Produce QBI

There Are No Owner "Material Participation" Requirements Under §199A.

Facts:

- Individuals **A, B, C, and D** each own 25% of a Partnership **W** that owns a commercial rental property.
- **A** works in the rental partnership managing the rental property and takes care of the record keeping. **B, C, and D** do not work in the partnership at all.

- Based on the work done by **A**, the rental of the commercial property qualifies as a §162 trade or business and Partnership **W** has substantial income (QBI) for 2020.
- Since only **A** participates in Partnership **W**'s trade or business, does that mean that **B, C, and D**'s allocable share of **W**'s rental income does not qualify for the §199A deduction?

Conclusions:

- Each partner's allocable share of Partnership **W**'s income is QBI, even for the partners who do not work in the business.
- **There are no material participation requirements for business owners under §199A.** Therefore, if the owner, employees, and/or independent contractors work with regard to the rental property, that work counts toward demonstrating the rental activity is a §162 trade or business. So, if the rental activity rises to the level of a §162 trade or business activity as discussed in the following paragraph, the pass-through income should be QBI for all the partners.

Practice Alert! The IRS confirms the conclusion in this example at FAQ 62 which says “§199A does not have a material participation requirement. Eligible taxpayers with income from a qualified trade or business may be entitled to the QBID regardless of their level of involvement in the trade or business.”

Do Not Have to Use Rev. Proc. 2019-38 to Show Rental of Real Property Is §162 Trade or Business.

For the income from rental property, or any other business, to be QBI, Reg 1.199A-1(b)(14) requires the business to be a §162 trade or business. There are three ways to show the rental of real property is a §162 trade or business: **1)** Qualifying under the §162 trade or business safe harbor outlined in Rev. Proc. 2019-38, **2)** Qualifying under the Self-Rental safe harbor under Reg 1.199A-1(b)(14), **or 3)** Based upon facts and circumstances.

- Rev. Proc. 2019-38 Deemed §162 Trade or Business Safe Harbor for Rental Real Estate Enterprise.** Generally, an individual or pass-through entity meets the §162 safe harbor under Rev. Proc. 2019-38 and may treat a rental real estate enterprise as a §162 trade or business if **1)** the owner of the rental real estate “enterprise” or someone else (e.g., employees, independent contractors, etc.) provides at least 250 hours of the types of services recognized under Rev. Proc. 2019-38 with respect to the rental real estate enterprise for the year; **2)** separate books and records are maintained for each rental real estate enterprise; **3)** for taxable years beginning after 2019, the taxpayer or pass-through entity keeps contemporaneous records, including time reports, logs, or similar documents, documenting the hours for all services performed, a description of the services performed, dates the services were performed, and who performed the services; **4)** the lease is not a “triple net lease” as defined in Rev. Proc. 2019-38, **and 5)** a statement is attached to the tax return stating that the requirements of the safe harbor have been satisfied (including the contemporaneous records requirement for tax years beginning after 2019).

Practice Alert! A concern with using the safe harbor is whether the individual or pass-through entity owning the rental real estate enterprise will be willing to include a statement with the return that the individual or pass-through entity has contemporaneous records of the hours of rental services provided, the types of services provided, and who performed those services. “Contemporaneous” records are not required for 2018 or 2019. However, “contemporaneous” records are required for 2020 and subsequent years to use the safe harbor under Rev. Proc. 2019-38.

- Self-Rental §162 Trade Or Business Safe Harbor.** Reg 1.199A-1(b)(14) provides that the rental or licensing of tangible or intangible property to a §162 trade or business is treated as a §162 trade or business if the rental or licensing activity and the §162 trade or business are commonly controlled under Reg 1.199A-4(b)(1)(i) and the lessee is not a C corporation. Reg 1.199A-4(b)(1)(i) provides that businesses are “Commonly Controlled” if the businesses are owned 50% or more by the same person or group of persons. In determining if there is 50% or more common ownership, the attribution rules under §267(b) or §707(b) apply.
- Facts And Circumstances.** If an individual or pass-through entity does not qualify for or chooses not to use the 250-hour safe harbor under Rev. Proc. 2019-38 and the self-rental safe harbor does not apply, whether the rentals constitute a §162 trade or business is a facts and circumstances determination.

Practice Pointer! If the owner of a rental “enterprise” or someone else (e.g., employees, independent contractors, etc.) provides at least 250 hours of the types of services recognized in the safe harbor under Rev. Proc. 2019-38 with respect to the rental real estate property or properties owned by an individual or

pass-through entity, it is arguable that the rental real estate property or properties are §162 trade or business activities without the safe-harbor. If we can demonstrate the rental real estate activity is a §162 trade or business activity based upon facts and circumstances, the rental income would be QBI.

The Supreme Court said in *Groetzinger*, 59 AFTR 2nd 87-532, to be a §162 trade or business, the activity must be **conducted for profit and conducted with regularity and continuity**. In addition, to understand when the courts, in general, have recognized a rental activity as a §162 trade or business, your authors suggest reading the “trade or business” segment of a 2013 article in the *Journal of Taxation* by Todd Keator. Although Mr. Keator’s article focuses on the 3.8% net investment income tax under §1411, his discussion of whether renting real estate constitutes a §162 trade or business is relevant under §199A and his article analyzes the bulk of the case law on the issue. You can find the article by googling “Journal of Taxation, Todd Keator.” Mr. Keator concludes in the article *“the holding of real estate for rental usually (and perhaps ‘almost always’) constitutes a trade or business activity, even if the activity involves only a single rental and the taxpayer’s efforts with respect to the rental are modest in scale * * * Provided the taxpayer leases the property with continuity and regularity, and with the intent to earn a profit.”*

A review of the cases cited in this article (especially those discussed on pages 63, 64 and 65 of the article) confirms Mr. Keator’s conclusions. However, on page 65 of the article, Mr. Keator says, *“a triple-net lease is the most likely candidate to fail the trade or business determination, although this may not be certain in every instance.”* Therefore, where rental properties do not qualify for any of the safe harbors, it would be preferable to avoid triple-net leases if possible.

IRS QBI FAQ 65 Speaks To Triple Net Leases. IRS FAQ 61 says the following:

“Q65. Triple net leases do not qualify for the safe harbor of Revenue Procedure 2019-38. Does this mean that income, gains, deductions, and losses from a triple net lease can never be included in QBI?”

A65. No. As explained in Q&A 56, rental real estate is treated as a trade or business for purposes of the QBID if it rises to the level of a §162 trade or business, is a self-rental as described in Treas. Reg. §1.199A-1(b)(14) or is a rental real estate enterprise relying on the safe harbor described in Revenue Procedure 2019-38. Revenue Procedure 2019-38 only excludes triple net leases from being included in a rental real estate enterprise (and are therefore not eligible for the safe harbor).

A single triple net lease does not generally rise to the level of a §162 trade or business. See Notice 2006-77. However, if rental real estate involving a triple net lease is otherwise treated as a trade or business under §199A, then the income, gains, losses, and deductions would be included in QBI.”
[Emphasis added]

Practice Alert! FAQ 65 indicates that income from even a single triple net lease could be QBI where the lease is a self-rental under Reg 1.199A-1(b)(14). Also, several triple net leases may constitute a §162 trade or business qualifying for the QBI deduction where the individual or pass-through entity owns multiple properties subject to triple net leases which require someone to manage the properties, etc., on a regular, continuing basis as required by the Supreme Court in *Groetzinger*. However, to be safe for triple net leases that are not self-rentals, taxpayers should consider renegotiating existing triple-net leases if possible so the owner must pay the taxes and insurance and is responsible for the lawncare and landscaping, janitorial service, garbage pickup, repairs, and maintenance. If this is done, there are two potential benefits: **1)** the owner will not be prohibited from using the 250-hours safe harbor under Rev. Proc. 2019-38, **and 2)** if the safe harbor is not used, the landlord has a more than fighting chance the rental activity is a §162 trade or business activity, even where the lease involves a single rental property.

Rental Real Estate Qualifying as a Trade or Business May Be Aggregated With Other Trades or Business.

In QBI FAQ 61, the IRS says that rental real estate qualifying as a trade or business under any of the alternatives at item 2, above, may be aggregated with other trades or businesses including other trade or business rental properties if the requirements of Reg 199A-4 are met.

The FAQ says:

“Q61. Can rental real estate that is a trade or business for purposes of §199A be aggregated using the rules in Treas. Reg. §1.199A-4?”

A61. *Rental real estate that is a trade or business can be aggregated with other trades or businesses, including other rental real estate trades or businesses, if the rules of §1.199A-4 of the Regulations are met. This includes rental real estate that rises to the level of a §162 trade or business, rental real estate enterprises that meet the safe harbor requirements of Revenue Procedure 2019-38 and self-rentals as described in §1.199A-1(b)(14)."*

Rental Real Estate Qualifying as a Trade or Business Is Still Generally Reported on Form 1040 Schedule E, Not Schedule C, and Is Generally Not Subject to S/E Tax. IRS QBI FAQ 60 confirms that rental real estate qualifying as a §162 trade or business is generally reported on 1040 Schedule E (not Schedule C) and is generally not subject to S/E tax. Here is the FAQ:

"Q60. If rental real estate is treated as a trade or business for purposes of the QBID (discussed in Q&A 56), do I report the rental real estate on Schedule C of my Form 1040, and is it subject to self-employment tax?"

A60. In general, the answer to both questions is no. How rental real estate is reported on Form 1040 has not changed due to the QBID. Rental real estate is usually reported on Schedule E, Part I, and is not subject to self-employment tax.

Even if rental real estate rises to the level of a §162 trade or business, it is generally reported on Schedule E, Part I, because rental real estate is generally excluded from self-employment taxable income under §1402(a)(1).

However, some rental real estate is subject to self-employment tax (e.g., boarding house, hotel or motel, and bed and breakfast, where substantial services are rendered for the convenience of the occupants). Rental real estate subject to self-employment tax is reported on Schedule C." [Emphasis added]

Preamble to Final Regs Suggests Filing 1099s for Rental Property Trades or Businesses

It has been unclear whether owners of rental real estate had to file 1099s as required under §6041 of the Code. However, in the Preamble to the final §199A regs, the IRS says in part **"Similarly, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of §199A where the taxpayer does not comply with the information return filing requirements under §6041."** [Emphasis added] Therefore, it is prudent to file 1099s for reportable payments of \$600 or more by those conducting rental real estate trades or businesses. However, clients with rental properties should consider paying for reportable services with a credit or debit card. If they pay with a credit or debit card, there is no 1099 reporting requirement because the credit card or debit card company is required to report the payments.

Encourage Clients To Maintain Contemporaneous Records Of Hours Worked If Using Safe Harbor. Hours spent by owners, employees, agents, and independent contractors will count for purposes of the 250-hour safe harbor. Starting in 2020, "contemporaneous records" of hours spent on the rental property must be maintained by the taxpayer. Owners planning to rely on the Rev. Proc. 2019-38 safe harbor should inform any agents or independent contractors who are being used by the owner that their hours need to be documented in a contemporaneous manner.

Aggregation Confusion for Rental Real Estate Properties

There Are at Least Three Different Aggregation Considerations for Rental Real Estate

- a. **Aggregating Rental Real Estate Properties as One Rental Real Estate Enterprise Under Notice Rev. Proc. 2019-38 §162 Trade or Business Safe Harbor.** As discussed above, if a rental real estate "enterprise" satisfies the requirements of Rev. Proc. 2019-38, the rental real estate "enterprise" is deemed to be a §162 trade or business. In satisfying the requirements of Rev. Proc. 2019-38, including the 250-hour requirement, an individual or a pass-through entity may aggregate all commercial rental real estate properties owned into one "enterprise" and may treat all residential rental real estate properties owned as one "enterprise." However, residential rental and commercial rental properties may not be aggregated together in one "enterprise." If the individual or pass-through entity does not aggregate, each rental real estate property is a separate "enterprise" and the 250-hour test and the other requirements of Rev. Proc. 2019-38 must be met for each property. **No formal election is required to aggregate qualifying rental real estate properties into one "enterprise" under Rev. Proc. 2019-38.** Please see Rev. Proc. 2019-38 for details.

b. Treating Multiple Rental Real Estate Properties as One §162 Trade or Business. If an individual or pass-through entity owns directly several business activities (including several rental real estate properties) and **1)** there is one set of books and records for all the businesses, **2)** the businesses share employees, **3)** the businesses conduct similar activities or depend upon one another, the businesses arguably constitute one trade or business under §446 and the related regulations. **Practice Alert!** This treatment of several business operations as one trade or business, could apply to a group of rental real estate properties owned by an individual or a pass-through entity (arguably even where there is a combination of residential rental properties and commercial rental properties). If various rental real estate properties constitute one trade or business under §446 and the related regulations, **1)** the QBI, W-2 wages, and UBIA of Qualified Property for all the activities are aggregated in calculating the §199A deduction, **and 2)** the activities of the owners, employees, and independent contractors with respect to the properties are aggregated in determining if the properties constitute a §162 trade or business. **No formal election is required to treat these multiple business operations as one trade or business.** Please see footnote 63 of the Blue Book (JCS-1-18, 12/20/18) for guidelines in determining if two or more business activities are one trade or business or separate trades or businesses. Also, please see Reg 1.199A-5(c)(1)(iii)(A) - Example 1 and Reg 1.199A-5(c)(1)(iii)(B) - Example 2. **The Blue Book!** On Dec. 20, 2018, the Joint Committee on Taxation issued the General Explanation of Public Law 115-97 (i.e., the Tax Cuts and Jobs Act of 2017) - the so called "Blue Book." The Blue Book contains 443 pages explaining Tax Cuts and Jobs Act provisions.

c. Aggregating Separate Rental Real Estate §162 Trade Or Business Interests Under Reg 1.199A-4. When one or more rental real estate properties constitute separate §162 trades or businesses, an individual's interests in those separate rental real estate trades or businesses can only be aggregated in calculating the §199A deduction (e.g., aggregating W-2 Wages and UBIA of Qualified Property) if the requirements of Reg 1.199A-4 are met. An individual or pass-through entity may make an "aggregation" election for interests in two or more §162 *trades* or businesses (including rental real estate trades or businesses) only if the individual or pass-through entity can demonstrate that: **1)** The same person or group of persons own 50% or more of each trade or business for the majority of the taxable year, including the last day of the taxable year, **2)** The businesses have the same taxable year, **3)** The businesses are not SSTBs, and **4)** The trades or businesses satisfy at least **two of the following three factors:** **a)** the trades or businesses provide property, products, or services that are the same or customarily offered together; **b)** the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; **c)** the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Practice Alert! The Final Regs provide that for purposes of meeting two of the three requirements at item 4) above, a commercial rental property trade or business and a residential rental property trade or business are not the same type of property. Please see Final Reg 1.199A-4(d), Example 17.

To aggregate an individual's or pass-through entity's interests in different trades or businesses under Reg 1.199A-4, **a formal election must be made with Form 8995-A** to the individual's or the pass-through entity's return.

Practice Pointer! Please remember, the aggregation of two or more §162 trades or businesses is not necessary for individuals filing jointly where taxable income is below the first income, since the W-2 Wage and Qualified Property Limitations do not apply.

Rental Real Estate Properties With Losses

May Be Better if Rental Real Estate Activity Not a §162 Trade or Business If Produces a Loss. If a rental real estate activity is a §162 trade or business activity, incurs a loss, and the loss is currently deductible, the loss is negative QBI that reduces the QBI of the taxpayer's other §162 trades or businesses with positive QBI. Therefore, if the rental real estate activity will produce tax losses, it may be advantageous if the rental activity does not qualify as a §162 trade or business. However, if the rental loss is a passive activity loss under §469 and is not currently allowed as a deduction, it will not reduce QBI until the year the loss is deductible.

Unadjusted Basis Immediately After Acquisition (UBIA)

Possible Advantage of Treating Significant Costs of Repairing A Roof as a Capitalized Expenditure Rather Than a Repair and Maintenance Expense. If a taxpayer needs additional UBIA and incurs a significant expenditure repairing a roof and decides that it is a close call whether the cost should be “expensed” or “capitalized” under the capitalization regulations, capitalizing the expenditure may be advantageous. If the taxpayer writes off the expenditure as an immediate repair “expense,” the cost will not go into UBIA. However, if the taxpayer capitalizes the cost of the roof improvement, the cost will go into UBIA. Moreover, for property and capitalized improvements placed in service in tax years beginning after 2017, capital improvements to existing roofs of commercial buildings qualify for the §179 deduction. Therefore, the taxpayer could capitalize the roof improvement (which would be included in UBIA), and then deduct the cost under §179 (which does not reduce UBIA).

The Employee vs. Independent Contractor Anti-Abuse Rules Apply Only for Purposes of §199A!

Solely for purposes of §199A, there is generally a presumption that a worker who has previously been treated as a W-2 employee by a business and is later treated as an independent contractor (or partner or S corp shareholder) by that business, will be considered an “employee” for three years after the change. However, this presumption does not apply for determining whether the business should have treated the worker as a “common law” employee for: **1)** payroll tax purposes, **2)** purposes of the requirements under the Affordable Care Act (ACA) for “Applicable Large Employers” to provide qualified health care coverage to its “employees,” or **3)** purposes of determining whether the unreimbursed business expenses of the worker will be allowed as an above-line deductions (for independent contractors) or non-deductible unreimbursed employee expenses incurred by a common law employee. Consequently, even if a worker is presumed to be an “employee” during the three-year presumption period for purposes of §199A, the worker and the business should continue to maintain the necessary arrangement (and documentation) that supports the worker being classified as an “independent contractor” under the common law tests.

Do Individuals At or Below the First Taxable Income Thresholds Ever Have a Reason To Make an Aggregation Election Under Reg 1.199A-4?

Generally, no! However, for tax years after 2018, if the tax return is later amended (through audit or otherwise) causing the taxpayer’s taxable income to exceed the income thresholds on the amended return, the taxpayer will not be able to amend the return to make the aggregation election if the election would otherwise be beneficial.

Retirement Homes

Retirement homes providing medical services to its residents (e.g., nurse assistance, medical helpers, etc.) could end up being classified an SSTB in the field of health, even though they are providing significant non-SSTB services (e.g., meals, cleaning, entertainment, etc.) to the residents. It might be possible for a retirement home to preserve the §199A deduction for the income generated by the non-SSTB services by placing those services in a separate trade or business (have separate books, employees, billings, and separate entities for the SSTB and non-SSTB services). Please see the example discussed previously in this Chapter for an example contained in the final regulations where a veterinarian was able to operate his veterinarian services (an SSTB activity) in a separate trade or business from his business that developed and sold organic dog food (a Non-SSTB activity).

Qualified Business Income

- 1. Don’t Overlook §751 Gain In The Computation Of QBI.** We should be advising clients who sell a partnership interest to be sure to review and prepare (if necessary) Form 8308 and determine whether the seller will be reporting any portion of the gain as ordinary income under §751(a). This ordinary gain under §751(a) is included in QBI. Generally, gain on the sale of a partnership will be “ordinary” under §751(a) to the extent of the selling partner’s pro-rata share of the gain in the underlying partnership’s so-called “hot assets” (i.e., appreciated inventory including “dealer” real estate; zero-basis accounts receivables; and, potential depreciation recapture amounts under §§1245 and 1250). Moreover, final Reg 1.199A-3(b)(1)(i) confirms that any “ordinary gain” that is triggered under §751(b) to a partner on the redemption of all or a portion of the partner’s partnership interest will likewise be included in QBI.
- 2. Make Sure To Consider Negative §481 Adjustment’s Effect On QBI.** §481(a) adjustments attributable to a qualified trade or business (whether positive or negative) and arising in a taxable year ending

after Dec. 31, 2017, are treated as attributable to that trade or business and enter into the calculation of QBI.

Practice Alert! For tax years beginning after 2017, TCJA generally allows taxpayers with average gross receipts of \$31 million for tax year 2025 or less to use the cash method of accounting, even if the business utilizes inventories. Accrual-method taxpayers that change accounting methods to switch to the cash method will generally have a negative §481(a) adjustment in the year of the change. When evaluating whether to take advantage of this \$25/\$26 million safe harbor, taxpayers should factor into their evaluation that the negative §481(a) adjustment reduces QBI.

- 3. Day Traders Below the Taxable Income Thresholds Might Qualify for the §199A Deduction if They Timely Make the Mark-To-Market Election Under §475(f).** Generally, “traders” in stocks and securities are classified as “SSTBs” and their net income from their trades does not qualify for the §199A deduction. However, if the trader’s taxable income is at or below the **\$340,100/\$170,050 thresholds (for 2022)**, their net gains could qualify for the 20% deduction so long as the net gains are not capital gains (capital gains whether long-term or short-term are never included in QBI). However, if the “trader” makes a timely “mark-to-market” election under §475(f), his or her net gains will be treated as “ordinary” gains. So, in that event, if the “electing” trader is below the taxable income thresholds mentioned above, his or her net “ordinary” gains should be included in QBI. **Caution!** A **§475(f) election to use the mark-to-market method must generally be filed no later than the due date (without regard to extensions) of the original Federal income tax return for the taxable year immediately preceding the election year** and must be attached either to that return or to a request for extension to file the return. **For example**, if a “trader” wanted to elect the mark-to-market method for **calendar year 2022**, the election was due by the **due date of the 2021 return** (excluding extensions). **Once timely made, the election is applicable for the year specified in the election and for each subsequent year.**

Updates To IRC § 199A (QBI Deduction) Under the One Big Beautiful Bill Act of 2025

Permanent Extension of the 20% QBI Deduction

The One Big Beautiful Bill Act (OBBBA), signed July 4, 2025, **made the Qualified Business Income deduction permanent** by repealing its previous 2025 sunset. Pass-through business owners (partners, S-corp shareholders, sole proprietors) will continue to benefit from the **20% QBI deduction** indefinitely, as the Act **maintained the deduction rate at 20%** (earlier proposals to raise it to 23% were not adopted). This extension preserves the tax break that effectively lowers top pass-through tax rates (37%) down to about 29.6% (80% of 37%), helping keep **parity with the 21% corporate tax rate**. In short, **§199A’s core feature — a 20% deduction on qualified business profits — is now a permanent part of the tax code.**

Higher-Income Thresholds and Phase-Out Range

While OBBBA left the basic **eligibility thresholds and limitations framework unchanged**, it **expanded the income range over which the deduction phases out** for high earners. Under prior law, once taxable income exceeded a certain “threshold” (approximately \$394,600 joint / \$197,300 single in 2025, inflation-adjusted), the QBI deduction became subject to limits – phasing in a wage-and-capital limitation and eventually barring the deduction for owners of **Specified Service Trades or Businesses (SSTBs)** like law, accounting, healthcare, etc. Originally, these limits phased in over a \$100,000 range for joint filers (above the threshold) or \$50,000 for others. The OBBBA **increased those phase-in ranges by \$50,000 for joint returns and \$25,000 for other filers**, meaning the deduction’s restrictions now kick in more gradually. In practical terms, for joint filers the wage/SSTB limitations fully apply at **threshold + \$150,000** of income (up from +\$100,000), and for single filers at **threshold + \$75,000** (up from +\$50,000).

For example, if the 2025 joint-filer threshold was ~\$394,600, a joint taxpayer could have income up to ~\$544,600 in 2026 and still receive at least a partial QBI deduction, whereas under prior law the deduction would have phased out completely by ~\$494,600. **By extending the phase-out band upward, more high-income business owners can qualify for at least a partial 199A deduction** than before. Notably, the Act **retained the existing SSTB exclusion rules** — owners of specified service businesses **still lose the deduction once above the income phase-out range**, but now that cutoff occurs at a modestly higher income level due to the expanded phase-out window.

New Minimum Deduction for Small QBI

To encourage small business activity, the OBBBA added a **new minimum deduction of \$400** for taxpayers with at least **\$1,000 of QBI** from one or more active trades or businesses (in which the taxpayer materially participates). This means even very small businesses are guaranteed a deduction (e.g. \$400 on \$1,000 of QBI, instead of only \$200 which would be 20%). The \$400 minimum will be **indexed for inflation** in future years (adjusted in \$5 increments after 2026). While relatively modest in size, this new provision ensures that entrepreneurs and gig workers with small amounts of qualified income still receive at least some tax benefit from §199A. (If a taxpayer's 20% QBI calculation already exceeds \$400, the normal larger deduction applies — the \$400 is simply a floor.)

Effective Date and Transition Rules

The changes to §199A **do not take effect until after 2025**. Since the pre-OBBBA law already allowed the QBI deduction through the end of 2025, Congress made the new provisions **effective for tax years beginning on or after Jan. 1, 2026**. There is no retroactive application to 2025 (unlike some other OBBBA provisions), meaning **tax year 2025 still falls under the old 199A rules and limits**. Starting in **2026**, taxpayers will see the permanent deduction and updated phase-out ranges and minimum deduction in action. Notably, no special transition relief was needed for QBI because the deduction was available through 2025 anyway — the Act simply assures it **continues seamlessly into 2026 and beyond, with the new modifications kicking in at that point**. Tax advisors and filers should be aware that the **20% deduction remains in place for 2025 under prior law**, and then the OBBBA enhancements (broader phase-out bands and \$400 minimum) apply going forward. Overall, the One Big Beautiful Bill Act's §199A provisions provide **long-term certainty and minor improvements** to the QBI deduction regime, effective post-2025, allowing pass-through business owners to plan around this deduction for the foreseeable future.

PASSIVE ACTIVITIES

Selected Highlights

Basic Operating Rules

General Statutory Rules

Although the detailed passive loss rules are contained in the regulations, §469 itself gives the blueprint for the passive activity loss rules. The following is a survey of the statutory rules under §469.

General Rule. Passive activity deductions can be applied only against passive activity income (and cannot be applied against "material participation" or "portfolio" income).

Credits. Similarly, credits from passive activities generally are **limited to the tax** allocable to the passive activities.

Suspended Losses and Credits. Suspended losses and credits are carried forward for use against passive income in later years.

Dispositions. Suspended losses (but **not** credits such as low-income housing and rehab credits) are generally allowed when a taxpayer disposes of his interest in a passive activity in a fully taxable transaction. **Note!** Suspended credits are allowed only when sufficient tax on passive income is generated.

Taxpayers Subject to Rules. The passive loss rules generally apply to individuals, estates, trusts, and personal service corporations where employee/owners providing services own 10% or more of the value of the stock. **Note!** A special rule limits the use of passive activity losses against portfolio income in the case of closely-held C corporations.

Rental Activities. "Rental activities" are generally deemed passive. However, there is a special rule allowing up to \$25,000 of rental real estate losses against nonpassive income. Also, there is a special rule for persons that spend more than 750 hours and more than 50% of their time during the year in real estate businesses (i.e., qualified real estate professionals).

Oil And Gas. Losses from working interests in oil and gas property are not limited unless the taxpayer's liability with respect to the interest is limited. These rules are discussed in more detail later.

Limited Partnerships. Subject to exceptions discussed later in this chapter, limited partnership interests are generally deemed to be passive.

Passive Activities That Are Not a Trade or Business. To the extent provided by regulations, a passive activity may include an activity conducted for profit (within the meaning of §212), including an activity that is not a trade or business. This rule is intended to cause the passive loss limitation rules to apply to activities that give rise to tax losses that can be used to shelter positive income, but that may not rise to the level of a trade or business (page 217 of Blue Book).

Working Interest in Oil and Gas Property

General. §469(c)(3)(A) provides that the term "passive activity" does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the taxpayer's liability with respect to such interest.

Income From Oil and Gas Property. §469(c)(3)(B) provides that income from oil and gas property that previously generated non-passive losses, will not be treated as passive income.

- See Regs. §1.469-2(c)(6)(i) for special transition rules regarding this position. Also see Regs. §1.469-2(c)(6)(iii) for definition of "oil and gas property."

Interaction Of Passive Losses With Other Provisions

General Rule. Regulation §1.469-1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income or passive activity deductions does not affect the treatment of any item of income or gain under any provision of the Code other than on §469. Thus, for example, an item of capital gain from a passive activity that is treated under the regulations as an item of passive activity gross income is taken into account in determining both the passive activity loss and credit for the taxable year and the allowable capital loss for the taxable year.

Example. In 2023, Joe's only income and loss from passive activities are a \$10,000 capital gain from passive activity X and a \$12,000 ordinary loss from passive activity Y. He also has a \$10,000 capital loss that is not derived from a passive activity. Under Regs. §1.469-2T(b), Joe has a net \$2,000 passive activity loss for the taxable year. The only effect of §469 and the regulations thereunder is to disallow a deduction for his net \$2,000 passive activity loss for the taxable year. Thus, Joe's capital loss for the year is allowed because the \$10,000 capital gain from passive activity X is taken into account under §1211(b) in computing the allowable capital loss for the year.

Capital Loss Restrictions Apply in Addition to Passive Loss Rules. Even though there is sufficient passive activity ordinary income to allow the use of a passive activity capital loss, the \$3,000, etc. limits of §1211 still apply.

Example: In 2023, Sally has \$10,000 of ordinary income from passive activity X, no gains from the sale or exchange of capital assets or assets used in a trade or business, \$12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction. Under §469 and the regulations thereunder, Sally is allowed \$10,000 of the \$12,000 passive activity deduction and has a \$2,000 net passive activity loss for the taxable year. Since the \$10,000 passive activity deduction allowed under §469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under §1211. Therefore, she is allowed \$3,000 of the \$10,000 capital loss under §1211 and has a \$7,000 capital loss carryover (within the meaning of §1212(b)) to the succeeding taxable year.

Passive Restrictions Apply for Self-Employment Purposes. Regs. §1.469-1T(d)(3) provides that, except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under §469 is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by Subtitle A of the Code. Thus, for example, if a deduction is disallowed under §469 for purposes of computing taxable income subject to income tax, the deduction is not taken into account in computing the taxpayer's net earnings from self-employment for purposes of the tax on self-employment income imposed under Chapter 2 of the Code.

Coordination With §§465, 704(d), and 1366(d). Since, for purposes of §469, a deduction is not treated as arising in a taxable year in which it is disallowed under §§465, 704(d), or 1366(d), rules are needed to determine which deductions are disallowed for the taxable year under such sections. Regs. §1.469-2T(d)(6) provides such rules. Under Regs. §1.469-2T(d)(6), if §§465, 704(d), or 1366(d) disallows all or any part of the taxpayer's loss attributable to an activity (within the meaning of §465), or to an interest in a partnership or S corporation, as the case may be, a portion of each deduction taken into account in computing such loss is disallowed.

One Taxpayer if Filing a Joint Return. Regs. §1.469-1T(j) provides that taxpayers filing a joint return are treated as one taxpayer for that year for purposes of the passive activity rules.

Exceptions to One Taxpayer Rule for Joint Filers:

- Spouses filing a joint return **must account separately** for their portion of disallowed passive activity losses and credits.
- The treatment of spouses as one taxpayer under this rule shall not affect the application of Code §§704(d), 1366(d), or §465 to taxpayers filing a joint return for the year.
- The fact that one spouse holds a working interest in an oil or gas well through an entity that does not limit the spouse's liability is not taken into account in determining whether the working interest exception applies to any portion of the working interest that is held by the other spouse even if a joint return is filed. For this purpose, married individuals are treated as separate taxpayers.
- When an **individual ceases to file a joint return**, there are special rules for the suspended passive activity losses and credits carried to the following separate return year. These **suspended losses and credits** shall be determined by taking into account the items of deduction and credit **attributable to the individual's interests** in the passive activities for the immediately preceding year.

Year for Determining if Deductions Are Passive

General Rule. Regs. §1.469-2T(d)(1) provides that a deduction is a "passive activity deduction" for a taxable year if the deduction **1) arises in connection with the conduct** of an activity that is a **passive activity** for the taxable year, or **2) is carried over** from the preceding taxable year under §469(b). For purposes of this rule, a deduction is treated as **arising in the taxable year in which the deduction would be allowable if taxable income for all taxable years were determined without regard to §§469 and 1211**. Thus, for example, if a partner's distributive share of a partnership deduction is disallowed under §704(d) in 1994 but is not disallowed under §704(d) for lack of basis (or any other provision other than §§469 or 1211) in 1995, the deduction is treated as arising in 1995.

This rule has two significant effects. First, a deduction is not taken into account in computing the passive activity loss and credit until the first taxable year in which the deduction is not disallowed by any applicable limitation other than those contained in §§469 and 1211. **Second, the determination of whether a deduction from an activity is a passive activity deduction does not depend on the character of the activity in taxable years in which the deduction is disallowed under limitations other than §469.** Thus, in the example in the preceding paragraph, the determination of whether the partner's deduction is a passive activity deduction in 1995 depends solely on whether the activity in which it arises is a passive activity of the partner in 1995. See Regs. §1.469-2T(d)(1)(ii) for an example.

Passive Activity Credits

Credits Subject To §469. A credit may be limited under §469 if it is from a passive activity and is described in §38(b)(1) through (5) (relating to general business credits), §27(b) (relating to §936 corporations), §28 (relating to clinical testing of certain drugs), or §29 (relating to fuel from nonconventional sources).

Regs. §1.469-3T(b) provides that a credit is treated as from a passive activity if **1) it arises in connection with a passive activity** (i.e., an activity that is passive for the taxable year in which the credit would be allowed if §469 and the limitations of §§26(a), 28(d)(12), 29(b)(5) and 38(c) did not apply) or **2) in the case of a credit attributable to qualified progress expenditures, if it is reasonable to believe that the progress expenditure property will be used in a passive activity when it is placed in service.**

Determination of Regular Tax Liability Allocable to Passive Activities. Under §469(d)(2), the passive activity credit is the amount by which the sum of the taxpayer's credits that are subject to §469 for the taxable year exceeds the taxpayer's regular tax liability allocable to all passive activities for such year. §469(j)(3) provides that the term "regular tax liability" has the meaning given that term by §26(b). Regs. §1.469-3T(d)(1) provides that the taxpayer's regular tax liability allocable to all passive activities for the taxable year is the excess (if any) of:

1. the taxpayer's regular tax liability for such taxable year; **over**
2. the amount of such regular tax liability determined by reducing the taxpayer's taxable income for such year by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions for such year.

See Regs. §1.469-3T(f) for several examples of the passive activity credit rules.

Defining and Identifying an "Activity" (Reg. 1.469-4)

Importance Of Activity Definition In applying the passive loss rules, one of the most important determinations that must be made is the **scope of a particular activity**. This determination is important for several reasons.

Same Activity — Material Participation. If two businesses are part of the same activity, the taxpayer need only establish material participation with respect to the **activity as a whole**.

Separate Activities — Material Participation. If various businesses are separate activities, the taxpayer must establish material participation separately for each.

Scope Critical for Dispositions. In the case of a disposition, knowing the scope of the activity is critical to determining whether the taxpayer has disposed of his entire interest in the activity.

10% Requirement. Determining the scope of an activity also is important with respect to the 10% ownership requirement for "actively participating" in a rental real estate activity, and in certain situations where the taxpayer disposes of an activity other than through a taxable transaction.

Scope of an Activity (Regs. 1.469-4(a))

General. The Final "Activity" Regulations were issued in 1994, and generally provide that "A taxpayer's activities include those conducted through **C corporations that are subject to §469**, S corporations and partnerships". C corporations subject to §469 include closely-held corporations and Personal Service Corporations.

Practice Alert! Activities conducted through C corporations may be grouped with other activities only for purposes of determining material or significant participation (§1.469-4(d)(5)(ii)).

Grouping Activities Conducted Through C Corporations. Final Regulation 1.469-4(d)(5) provides that an activity a taxpayer conducts through a C corporation subject to §469 may be grouped with another activity of the taxpayer but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity.

Practice Pointer! This provision may allow us to group businesses owned by individuals or passthrough entities with businesses owned by C corporations for purposes of proving material participation. Of course, we would apparently have to demonstrate that all the businesses are part of an "**appropriate economic unit**" (as discussed below). Apparently, one of the reasons for this inclusion of C corporations is to provide authority for the IRS' audit policy disclosed in the Passive Activity Audit Guide. The Audit Guide says that rentals to a C corporation in which a taxpayer materially participates will not be passive activity income under Regs. 1.469-2(f)(6). The Audit Guide also says that this new rule is generally effective for tax years ending after May 10, 1992 (the effective date of the proposed 1.469-4 regulations and the general effective date of the final activity regulations).

Order for Grouping Activities Owned by Passthrough Entities and C Corporations. Final Regulation 1.469-4(5)(i) says a C corporation subject to §469, an S corporation, or a partnership (a §469 entity) must group its activities under the rules of the 1.469-4 regulations. Once the §469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other §469 entities.

Practice Alert! A shareholder or partner may not treat activities grouped together by a §469 entity as separate activities. Also, activities conducted through C corporations may be grouped with other activities only for purposes of determining material or significant participation (§1.469-4(d)(5)(ii)).

Grouping Rental Activity With Other Activities (Reg 1.469-4(d)(1)). The regulations allow a rental activity to be grouped with another trade or business activity if **1)** the rental and nonrental activity constitute **an appropriate economic unit** (as discussed below) under the regulations **and 2)** either the rental or the nonrental activity is **insubstantial**.

In addition to allowing the grouping of rental and nonrental activities under the "insubstantial rule" discussed above, the **final regulations** provide that the portion of certain **rental activities that involves the rental of items of property to a trade or business activity** may be grouped with that trade or business activity if they constitute an appropriate economic unit, regardless of whether one activity is insubstantial. However, this rule only applies if **each owner of the trade or business activity has the same proportionate ownership interest in the rental activity**.

Example 1. H and W are married and file a joint return. **H** is the sole shareholder of an S corporation that conducts a grocery store trade or business activity. **W** is the sole shareholder of an S corporation that owns and rents out a building. Part of the building is rented to **H's** grocery store trade or business activity (the grocery store rental). The grocery store rental and the grocery store trade or business **are not insubstantial in relation to each other**.

Because they file a joint return, **H** and **W** are treated as **one taxpayer** for purposes of §469. See §1.469-1T(j). Therefore, the sole owner of the trade or business activity (taxpayer **H-W**) is also the sole owner of the rental activity. Consequently, each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. Accordingly, the grocery store rental and the grocery store trade or business activity may be grouped together into a single trade or business activity, if the grouping results in an "appropriate economic unit."

Example 2. Attorney **D** is a sole practitioner in town **X**. **D** also wholly owns residential real estate in town **X** that **D** rents to third parties. **D's** law practice is a trade or business activity. The residential real estate is a rental activity and is insubstantial in relation to **D's** law practice. Under the facts and circumstances, **the law practice and the residential real estate do not constitute an "appropriate economic unit."** Therefore, **D** may not treat the law practice and the residential real estate as a single activity.

General Rules for Determining an Activity Under Final Regulation 1.469-4(c)

"Appropriate Economic Unit." One or more trade or business activities or one or more rental activities are treated as a single activity if the activities constitute an **"appropriate economic unit"** for the measurement of gain or loss for purposes of §469.

Facts and Circumstances Test. Generally, whether businesses or rental operations constitute an "appropriate economic unit" and, therefore, may be treated as a single activity depends upon all the relevant **"facts and circumstances."** A taxpayer may use any reasonable method of applying the relevant **"facts and circumstances"** in grouping activities. The factors listed below, **not all of which are necessary** for a taxpayer to treat more than one activity as a single activity, are **given the greatest weight** in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469:

- Similarities and differences in types of business;
- The extent of "common control;"
- The extent of "common ownership;"
- Geographical location; **and**
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between themselves, involve product or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Note! There may be more than one reasonable method for grouping activities after considering all the relevant facts and circumstances.

Note! An election to group rental activities with other activities under §Regulation 1.469-4(c) is a completely different concept than a qualified real estate professional electing to aggregate their rental activities under §469(c)(7), discussed later.

Examples (Reg 1.469-4(c)(3)):

Example (1). Taxpayer **C** has a **significant ownership interest** in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, **after taking into account all the relevant facts and circumstances**, there **may be** more than one reasonable method for grouping **C's** activities. For instance, **depending on the relevant facts and circumstances**, the following groupings may or may not be permissible: **a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or "four separate activities."** Once **C** chooses one of these groupings, **however, the regulations require C to continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.**

Example (2). Taxpayer **B**, an individual, is a partner in a wholesale business that sells non-food items to grocery stores (partnership **L**). **B** also is a partner in a partnership that owns and operates a trucking business (partnership **Q**). The two partnerships are under common control. The predominant portion of **Q's** business is transporting goods for **L**, and **Q** is the only trucking business in which **B** is involved. **B** may treat **L's** wholesale trade activity and **Q's** trucking activity as a single activity.

Consistency Requirement (Reg 1.469-4(e))

Once a taxpayer has grouped activities in accordance with the regulations, the taxpayer may not regroup those activities in subsequent taxable years **unless the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original group "clearly inappropriate."** If it is determined that the original grouping was clearly inappropriate or if a material change occurs that makes the original grouping clearly inappropriate, a taxpayer must regroup activities and must comply with the disclosure requirements as determined by the Commissioner.

Practice Alert! Please see **Rev. Proc. 2010-13** (discussed in the “**Selected Items of Interest**” segment of this chapter) for IRS requirements to report groupings and re-groupings for tax years, beginning on or after Jan. 25, 2010.

Rules for Grouping Certain Limited Partnership Activities

There are special rules for limited partners and limited entrepreneurs that own activities involved in:

- Holding, producing, or distributing motion picture films or video tapes;
- Farming (as defined in §464(e));
- Leasing any §1245 property (as defined in §1245(a)(3));
- Exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income; **or** exploring for, or exploiting, geothermal deposits (as defined in §613(e)(2)).

Except as provided below, a taxpayer who is a limited partner or a limited entrepreneur in one of the listed activities or in an activity designated in a revenue procedure published pursuant to this regulation may not group that activity with any other activity. A taxpayer who is a limited partner or limited entrepreneur in an activity described above may group that activity with another activity in the same type of business if the grouping is appropriate under the appropriate economic unit, facts, and circumstances test of these regulations.

Example. Taxpayer A, an individual, owns and operates a farm. A is also a member of M, a limited liability company that conducts a cattle-feeding business. A does not actively participate in the management of M (within the meaning of §464(e)(2)(B)). In addition, A is a limited partner in N, a limited partnership engaged in oil and gas production. Because A does not actively participate in the management of M, **A is a limited entrepreneur** in M's activity. M's cattle-feeding business is described in §465(c)(1)(B) (relating to farming) and may not be grouped with any other activity that does not involve farming. **Moreover, A's farm may not be grouped with the cattle-feeding activity unless the grouping constitutes an appropriate economic unit for the measurement of gain or loss for purposes of §469.**

Because A is a limited partner in N and N's activity is described in §465(c)(1)(D) (relating to exploring for, or exploiting, oil and gas resources), A may not group N's oil and gas activity with any other activity that does not involve exploring for, or exploiting, oil and gas resources. Thus, N's activity may not be grouped with A's farm or with M's cattle-feeding business.

Grouping Other Activities Identified By IRS

A taxpayer that owns an interest in an activity identified in guidance issued by the Commissioner as an activity covered by this rule (Reg. 1.469-4(d)(4)) may not group that activity with any other activity, except as provided in the guidance issued by the Commissioner.

IRS' Regrouping Authority

The Commissioner **may regroup** a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping (or failure to regroup) is to circumvent the underlying purposes of §469.

The following example illustrates the application of this rule.

Example. Taxpayers **D, E, F, G,** and **H** are doctors who operate separate medical practices. **D** invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to engage in the trade or business of acquiring and operating X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. The partnership is managed by a general partner selected by the taxpayers; the taxpayers do not materially participate in its operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership's services are set at a level equal to the amounts that would be charged if the partnership were dealing with the taxpayers at arm's length and are expected to assure the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.

For each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute an appropriate economic unit, but the services provided by the partnership do not separately constitute an appropriate economic unit. Moreover, a principal purpose of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of §469. Accordingly, the Commissioner may require the taxpayers to treat their medical practices and their interests in the partnership as a single activity, regardless of whether the separate medical practices are conducted through C corporations subject to §469, S corporations, partnerships, or sole proprietorships. The Commissioner may assert penalties under §6662 against the taxpayers in appropriate circumstances.

Note! The Preamble to the regulations says that it is expected that the Commissioner's regrouping authority will be exercised infrequently.

Some Dispositions of a Part of an Activity May Be Treated as a Disposition of an Entire Activity

A taxpayer may, for the taxable year in which there is a disposition of "substantially all" of an activity, treat that part of the activity as a separate activity, **but only if the taxpayer can establish with reasonable certainty:**

1. The amount of deductions and credits allocable to that part of the activity for the taxable year under Regs. §1.469-1(f)(4) (relating to carryover of disallowed deductions and credits); **and**
2. The amount of gross income and of any other deductions and credits allocable to that part of the activity for the taxable year.

Practice Alert! This "substantially all" requirement makes it important to consider keeping activities separate if they are passive to make it easier to "free-up" any suspended losses upon disposition.

Rental Activities

General Rule

§469(c)(2) generally provides that a "rental activity" is passive regardless of the extent to which the taxpayer participates in the activity. **See item J in this chapter** for a special exception from this rule for rental real estate activities of "qualified real estate professionals."

What Is a Rental Activity?

Payments Made Principally For Use of Property. §469(j)(8) provides that the term "rental activity" means any activity where payments are made **principally** for the use of **tangible property**. Regs. §1.469-1T(e)(3)(i) provides that an activity generally is a rental activity for a taxable year if the gross income attributable to the conduct of the activity for the year represents amounts paid or to be paid **principally** for the use of tangible property.

In Private Letter Ruling 9247003, the Service ruled that payments made by the residents of a retirement center were not rentals. The IRS said in this case the payments made to the retirement center were principally for the services provided rather than for the use of tangible property.

In deciding that the retirement centers were not rental property because the payments received were principally for services, the IRS listed the following key factors for their decision:

- The monthly payments made by residents were more than twice the cost of a luxury apartment;
- The difference between the monthly payments and the value of the tangible property used by the residents represents the value of the services received; **and**
- The services provided were numerous and included: **three meals per day; tray service to the resident's apartment; weekly maid service; weekly laundering of bed and bath linens; on-site and off-site recreational activities; and transportation to town, doctors and shopping.**

Regulation 1.469-1T(e)(3)(ii) Provides Six Exceptions to the General Definition of Rentals

1. **Seven Day or Less Rule.** An activity involving the use of tangible property is not a rental activity if, **on the average**, the period for which each customer uses the property is **seven days or less**. This exception will exclude from treatment as a "rental activity" most activities involving short-term use of tangible

personal property such as automobiles, videocassettes, tuxedos, and tools, and short-term use of hotel and motel rooms.

- 2. More Than Seven Less Than Thirty-One Day/Significant Personal Service Rule.** An activity involving the use of tangible property is not a rental activity if: **1) on the average, the period for which each customer uses the property is greater than seven days but not greater than 30 days, and 2) significant personal services are provided.** Thus, for example, a taxpayer operating a hotel will not be treated as engaged in a rental activity, even if guests stay for an average period that exceeds seven days, if **significant personal services** are provided.

Significant Personal Services. Regs. §1.469-1T(e)(3)(iv) provides that only services performed by individuals are treated as personal services. Thus, services such as telephone and cable television service are not taken into account.

Also, certain specified services, referred to as "**excluded services**" are **not taken into account**. Excluded services are: **1) all services necessary to permit the lawful use of the property, 2) services in connection with the construction of improvements or in connection with the performance of repairs that extend the useful life of the property; and 3) in the case of improved real property, the kinds of services commonly provided in connection with long-term rentals of high-grade commercial and residential property (e.g., janitorial services).**

Example. The taxpayer is engaged in an activity of owning and operating a **residential apartment hotel**. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exits, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a **daily maid and linen service at no additional charge**.

All of the services other than maid and linen service are excluded services because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is **less than 10%** of the amount charged to tenants for occupancy of the apartments. Under these facts, **neither significant personal services nor extraordinary person services are provided** in connection with making apartments available for use by customers. **Accordingly, the activity is a rental activity.**

- 3. The More Than 30 Day/Extraordinary Personal Service Rule.** An activity involving the use of tangible property is not a rental activity if "**extraordinary personal services**" are provided by or on behalf of the owner in connection with making property available for use by customers. This exception applies even if, on the average, the period for which each customer uses the property exceeds 30 days.

"**Extraordinary personal**" services are provided only if the services are performed by individuals, and the customers' use of the property is incidental to their receipt of the services provided.

For example, the use by patients of a **hospital's** boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. In some cases, it may be difficult to determine whether the use of property is incidental to the services provided.

- 4. Rentals Incidental To Non-Rental Activities.** Rentals that are "**incidental**" to "**non rental activities**" (whether "**investment**" or "**trade or business activities**") **are not considered rental activities.**
 - **Rentals "Incidental" To Property Held For "Investment."** Rentals will be considered "incidental" to property held for "investment" if: **1) The principal purpose** for holding the property during the year is to **realize gain from appreciation of the property** (without regard to whether the gain will be realized from a sale or exchange in its current state of development), **and 2) The gross rental income** for the taxable years is **less than 2% of the lesser of the unadjusted basis or the fair market value of the property.**
 - **Rentals "Incidental" To Property Used In A "Trade Or Business" (Reg. 1.469-1T(e)(3)(vi)(c)).** Rentals will be incidental to a trade or business activity owned by the taxpayer during the taxable year if: **1) the property was predominantly used** in the trade or business activity during the **tax year** or during at least **two of the five** tax years that immediately precede

the tax year, and 2) the gross rental income for the tax year from the property is less than 2% of the lesser of the unadjusted basis or the fair market value of the property.

Note! See **R.W. Blewett** TC Summary Opinion 2001-174, 11/08/01. In this case, the court allowed 100% of a rental loss to be deducted under regulation 1.469-1T(e)(3)(vi)(c). Two brothers rented equipment to their C corporation. The brothers bought the equipment and rented it to the corporation because the corporation was in such poor financial condition that it could not borrow the necessary funds. Also, the brothers reported a large loss from the rentals because the corporation did not have the cash to make significant rental payments. The Court held that since the gross rental income for the year was less than 2% of the lesser of the value or the adjusted basis of the property, the requirements of regulation 1.469-1T(e)(3)(vi)(c) were met. Therefore, the rental losses were not passive and were allowed, in full, on the brothers' returns.

- • **Lodging Rented for Convenience of Employer.** The provision of lodging to an employee or the employee's spouse or dependents shall be incidental to the employer's activities if the lodging is furnished for the employer's convenience within the meaning of §119. Therefore, such property is not "rental property."

- 5. Property Customarily Made Available During Defined Business Hours for Non-Exclusive Use by Customers.** An activity of making property available for use by customers is not a rental activity if the taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers. Thus, operating a facility (such as a golf course) that is used by customers who would normally be characterized as invitees or licensees rather than lessees or tenants is not a rental activity.
- 6. Property Provided by an Owner for Use in a Partnership, S Corporation, or Joint Venture.** This exception relates to property provided for use in a non-rental activity of a partnership, S corporation, or joint venture in which the taxpayer owns an interest. The provision of such property is not a rental activity if the taxpayer does not rent the property to the partnership, S corporation, or joint venture, but provides the property in the taxpayer's capacity as an owner of such an interest. **Note!** If the owner rents the property to the activity then the exception does not apply.
- 7. Average Period of Customer Use.** Regs. §1.469-1T(e)(3)(iii) provides that the activity's average period of customer use for property held in connection with the activity is the **sum of** the average use factors for each class of property held in connection with the activity.
 - **Average Use Factor.** The "average use factor" for a class of property held in connection with an activity is the "average period of customer" use for such class of property multiplied by the fraction obtained by dividing: 1) the activity's gross rental income attributable to such class of property; **by** 2) the activity's gross rental income.
 - **Average Period of Customer Use.** The average period of customer use for a class of property held in connection with an activity is determined by dividing: 1) the aggregate number of days in all periods of customer use for property in such class (taking into account only periods that end during such taxable year or that include the last day of such taxable year); **by** 2) the number of such periods of customer use.
 - **Period of Customer Use.** Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customers uses the property for the entire period or whether such right to use the property is pursuant to a single agreement or to renewals thereof) is treated as a separate period of customer use. The duration of a period of customer use that includes the last day of a taxable year may be determined on the basis of reasonable estimates.
 - **Class of Property.** Taxpayers may organize property into classes for purposes of this calculation using any method under which items of property for which the daily rent differs significantly are not included in the same class.

Examples. See Regs. §1.469-1T(e)(3)(viii) for 10 detailed examples of these rules. The following are summaries of the conclusions in the examples:

1. The rental of office equipment for more than 30 days is a "rental activity" even if service costs exceed 50% of the rental income (Example 1).

2. The rental of office equipment for more than 7 days but not more than 30 days is not a rental activity if service costs exceed 50% of rental income (Example 2).
3. Taxpayer who provides tractor-trailers and drivers to customer where rental is for more than 30 days does not have rental income. The services provided are extraordinary (Example 3).
4. Taxpayer who drives a taxicab during the day and leases the cab to another driver at night (under one year lease) is engaged in a rental activity to the extent of the lease income (Example 9).

Vacation Homes

If a residence is rented and is also used more than 14 days or more than 10% of rental days (whichever is greater) for personal purposes, the rental is not a passive activity (Reg. §1.469(e)(5)). That is, vacation home rentals subject to the §280A(c)(5) deduction limitations are not also subject to the passive activity deduction rules. However, if the residence is not used the greater of more than 14 days or more than 10% of rental days for personal purposes, then any rental loss would be a passive activity loss subject to the §469 limits since the vacation home deduction limitations do not apply.

The \$25,000 Rental Real Estate Relief Provision

Rental Real Estate: \$25,000 Rule

Even though rental activities are generally presumed to be passive under §469, individuals may deduct up to \$25,000 annually (\$12,500 on a separate return if they do not live with their spouse at any time during the tax year, \$0 if the spouses live together) of passive activity losses (to the extent they exceed income from passive activities) that are attributable to “**rental real estate activities**” in which the taxpayer **actively participates**. The \$25,000 offset is not available to corporations or trusts. The \$25,000 is available to any estate for tax years ending less than two years after death if the decedent actively participated prior to his death. The \$25,000 amount is reduced (but not below zero) by 50% of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds \$100,000.

Active Participation: 10%

A taxpayer is not treated as actively participating in a rental real estate activity if he has less than a 10% interest in the activity at any time during the year. However, the difference between “active participation” and “material participation” is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of **management decisions** or **arranging for others to provide services** (such as repairs), in a **significant** and **bona fide** sense. Management decisions that are relevant in this context include: 1) approving new tenants, 2) deciding on rental terms, 3) approving capital or repair expenditures, and 4) other similar decisions.

Material Participation

General Rule. Reg. §1.469-5(f)(1) generally provides that all work done in an activity by an individual who owns an interest in the activity at the time the work is done shall be treated as participation by the **individual** in the activity, without regard to the capacity in which the individual does such work. Thus, work performed by an individual as an employee of a C corporation in connection with an activity in which the **individual owns an interest** is taken into account as participation by the individual in the activity.

Exceptions To General Rule. Reg. §1.469-5T(f)(2) includes two exceptions to this general rule. **First**, under Reg. §1.469-5T(f)(2)(i), work that is **not customarily done by an owner** is not taken into account if a **principal purpose** for the performance of such work is to avoid the disallowance of a passive activity loss or credit. **Second**, under Reg. §1.469-5T(f)(2)(ii), work done by an individual in connection with an activity in the individual's capacity as an **investor** in the activity is **not taken into account unless the individual is directly involved in the day-to-day management or operations of the activity**.

Work Done as an Investor. Work done by an individual in the individual's capacity as an investor in an activity includes:

- Studying and reviewing financial statements or reports on operations of the activity;
- Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and
- Monitoring the finances or operations of the activity in a non-managerial capacity.

Married Individuals. In the case of a married individual, Reg. §1.469-5T(f)(3) provides that the **participation of the individual's spouse is treated as participation by such individual for purposes of the passive loss and credit limitations, without regard:** **1)** to whether the participation of the spouse is material participation in its own right, **2)** whether the spouse owns an interest in the activity, or **3)** whether the individual and the individual's spouse file a joint return for the taxable year.

What Constitutes "Material" Participation?

General. Regs. §1.469-5T(a) states that an individual is treated as materially participating in an activity for a taxable year **if, and only if,** the individual **meets one of seven tests.** The first four tests (contained in Regs. §1.469-5T(a)(1) through (4)) are quantitative, and are based on the number of hours spent participating in the activity during the year. The fifth and sixth tests (contained in Regs. §1.469-5T(a)(5) and (6)) are based on material participation by the taxpayer in prior years. The seventh test (contained in Regs. §1.469-5T(a)(7)) is a facts-and-circumstances test.

- 1. More Than 500 Hours Test.** Under Regs. §1.469-5T(a)(1), an individual is treated as materially participating in an activity for a taxable year if the individual participates in the activity for **more than 500 hours** during the year. The Service believes that the 500-hour test will have the effect of restricting deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a taxable year to any such investment.
- 2. Substantially All Participation By Taxpayer.** Under Regs. §1.469-5T(a)(2), an individual is treated as materially participating in an activity for a taxable year if the individual's participation in the activity for the year constitutes "substantially all" of the participation in the activity for the taxable year.
- 3. More Than 100 Hours Test.** Regs. §1.469-5T(a)(3) treats an individual as materially participating in an activity for a taxable year if the individual participates in the activity for **more than 100 hours** during the taxable year, and the individual's participation in the activity for the year is **not less than that of any other individual** (owners and nonowners). These rules are included because the Service recognizes that the operation of some activities may not require more than 500 hours of participation, or may not require more than 500 hours of participation by any one individual during a taxable year.
- 4. Significant Participation in All Activities More Than 500 Hours.** Under Regs. §1.469-5T(a)(4), an individual is treated as materially participating in **all** of the individual's "significant participation activities" for a taxable year if the individual's **aggregate participation in "significant participation activities" for the year exceeds 500 hours.**

For purposes of this rule, a "significant participation activity" is a trade or business activity in which the individual participates for more than 100 hours during the taxable year but in which the individual does not materially participate for the year (without regard to this rule). This rule is included because the Service believes that an individual who devotes more than 500 hours during a taxable year to several activities, each of which is a significant activity of such individual, should be treated similarly to an individual who devotes an equivalent amount of time to a single activity.

Practice Pointer! The "significant participation activities" **do not have to be** similar business activities.

- 5. Five Out of 10 Rule.** Under Regs. §1.469-5T(a)(5), an individual is treated as materially participating in an activity for a taxable year if the individual materially participated in such activity for any five of the 10 taxable years that immediately precede the taxable year.

6. **Personal Service Activity: Three-Year Rule.** Under Regs. §1.469-5T(a)(6), an individual is treated as materially participating in a personal service activity for a taxable year if the taxpayer materially participated in the activity for any three taxable years (whether or not consecutive) that precede the taxable year. For purposes of this rule, an activity is a personal service activity if it principally involves the performance of personal services in **1) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or 2) any other trade or business in which capital is not a material income-producing factor.**
7. **Facts-and-Circumstances Test.** Regs. §1.469-5T(a)(7) provide that an individual may be treated as materially participating in an activity for a taxable year if, based on all of the facts and circumstances, the individual participates on a **regular, continuous, and substantial basis.**
 - a. **Management.** An individual's participation in **management** of an activity is not taken into account in applying the facts-and-circumstances test to the individual **if a paid manager participates in the activity** or if the management services performed by such individual are exceeded by those performed by any other individual.
 - b. **Must Participate More Than 100 Hours.** An individual who does not participate in an activity for more than **100 hours** during the taxable year **cannot satisfy the facts-and-circumstances test** for the year.

See Regs. §1.469-5T(k) for examples.

Anti-Abuse Rule: Recharacterization of Certain Passive Income

Rules Preventing the Conversion of Non-Passive Income Into Passive Income

Significant Participation Rule. Regs. §1.469-2T(f)(2) requires the netting of the income and loss from all the taxpayer's "significant participation passive activities" in which the taxpayer **does not materially participate.** If the result is net income, this net income from all the significant participation activities for the year **is not passive income.**

Activities Involving the Rental of Property Developed by the Taxpayer. Under Regs. §1.469-2T(c)(2), **gain from the disposition of property used in a passive activity generally is treated as passive activity gross income.** The Service says it is not appropriate, however, to treat a taxpayer's gain from the sale of a rental property as passive activity gross income if **the taxpayer materially or significantly participated in the development of the property** and the gain is predominantly attributable to the development of the property rather than to appreciation during the rental period. Accordingly, Regs. §1.469-2(f)(5) provides that, in certain situations, an amount of a taxpayer's gross income from renting and selling an item of property equal to the taxpayer's net passive income from such rental and sale is treated as not from a passive activity. This rule applies if: **1) Any gain from the sale, exchange, or other disposition of the property is included in the taxpayer's income for the taxable year, 2) During any taxable year the taxpayer materially or significantly participated in a trade or business activity involving the performance of services for the purpose of enhancing the value of the property, AND 3. A binding contract for the sale or exchange was entered into less than 12 months after the rental of the property commenced.**

Practice Pointer! The effect of this rule is that property developed by the taxpayer must be rented for at least 12 months prior to selling the property or contracting for its sale or the taxpayer's gain from the sale (and rental income for the year of sale) will not be treated as passive activity gross income.

Self-Rented Property. In the absence of regulations, a taxpayer could derive passive activity gross income from an active business in which tangible property is used by renting the property to an entity conducting the activity (or by causing an entity holding the property to rent the property to the taxpayer). Accordingly, **Regs. §1.469-2(f)(6) provides that an amount of the taxpayer's gross income from renting an item of property equal to the taxpayer's net passive income from such rental is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year.**

Practice Alert! In determining material participation for this purpose, the fact that the taxpayer is a limited partner is disregarded.

Rules Preventing Conversion of Portfolio Income Into Passive Activity Gross Income

Activities Involving the Rental of Non-Depreciable Property. Under the regulations, income from a rental activity is subject to this recharacterization rule if the unadjusted basis of the **depreciable property** rented in the activity is **less than 30% of the unadjusted basis of all property** rented in the activity. **See Regs. §1.469-2T(f)(3) for an example of this rule.**

Equity-Financed Lending Activities. Under Regs. §1.469-2T(c)(3)(ii)(A), interest income from loans made in the ordinary course of a trade or business of lending money is not portfolio income. Absent a regulation expressly treating income from such an activity as nonpassive income, taxpayers could derive passive income from investments substantially similar to mutual fund investments by becoming passive investors in partnerships or S corporations that engage in a trade or business of lending equity funds contributed by the taxpayers. Accordingly, Regs. §1.469-2T(f)(4) treats as nonpassive income an amount of the taxpayer's gross income from an **equity-financed lending activity** equal to the **lesser of 1) the taxpayer's equity-financed interest income from the activity or 2) the taxpayer's net passive income from the activity**. This rule applies to lending activities in which the average balance of **debt** incurred in the activity (determined at the entity level) **does not exceed 80%** of the average balance of interest-bearing assets held in the activity. **See Regs. §1.469-2T(f)(4)(viii) for a detailed example.**

Passthrough Entities Licensing Intangible Property. Regs. §1.469-2T(c)(3)(iii)(B) provides that royalty income received by a passthrough entity from the licensing of intangible property may be treated as income derived in the ordinary course of a trade or business if the entity **1) created the property or 2) performed substantial services or incurred substantial costs with respect to the development or marketing of the property**. This treatment is appropriate in the case of a taxpayer who owns an interest in such an entity at the time that the entity creates such property, performs such services, or incurs such costs. **If, however, a taxpayer acquires an interest in such an entity after the entity creates the property**, performs such services, or incurs such costs, the taxpayer's royalty income resembles portfolio income rather than income derived in the ordinary course of a trade or business. Accordingly, Regs. §1.469-2T(f)(7) provides that an amount of the taxpayer's gross income from such property equal to the taxpayer's net passive income from such property is generally treated as **not from a passive activity**. See Regs. §1.469-2T(f)(7)(v) for an example.

Exception to Recharacterized Income Rule for Passive Loss Carryovers. The recharacterization of income rules will not deny a deduction for suspended losses from a prior year.

Dispositions of Passive Activities

General Rules

When a taxpayer disposes of his entire interest in a passive activity, the actual economic gain or loss on his investment can be finally determined. Thus, any overall loss from the activity realized by the taxpayer is recognized and allowed against income (whether active or passive income). This result is accomplished by triggering suspended losses upon disposition. The triggered losses are used in the following order to offset: **1) the gain on the disposition; 2) net income or gain for the taxable year from all passive activities; then 3) any other income or gain.**

Credits Not Subject to Rule

Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, **credits**, which are not related to the measurement of such loss, **are not allowable by reason of a disposition.**

Fully Taxable Dispositions of Interest in Activity

The type of disposition that triggers full recognition of any loss from a passive activity is a **fully taxable disposition** of the taxpayer's interest in the activity to an unrelated person.

Sale. A fully taxable disposition generally includes a sale of the property to a third party at arm's length, and thus, presumably, for a price equal to its fair market value. **Gain realized upon a transfer of an interest in a passive activity generally is treated as passive, and is first offset by the suspended losses from that activity.**

- Where the taxpayer transfers an interest in a passive activity in a transaction in which the form of ownership merely changes, suspended losses generally are not allowed, because the gain or loss realized with respect to the activity has not been finally determined. Such suspended losses are allowed, however, to the extent that any gain recognized on such transfer, together with other income from passive activities for the year exceeds losses from passive activities for the year.
- **Entire Interest.** §469(g) expressly provides that the taxpayer must dispose of his entire interest in the activity in order to trigger the recognition of loss. A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in **all entities that are engaged in the activity**, and to the extent held in proprietorship form, **of all assets** used or created in the activity. **See final Regulations §1.469.**

Practice Pointer! These regulations allow suspended losses to be freed up when a taxpayer disposes of "substantially all" of an activity.

If a partnership or S corporation conducts two separate activities, a fully taxable disposition by the entity of all the assets used or created in one activity constitutes a disposition of the partner's or shareholder's entire interest in the activity. Similarly, if a grantor trust conducts two separate activities, and sells all the assets used or created in one activity, the grantor is considered as disposing of his entire interest in that activity. If the taxpayer has adequate records of the suspended losses that are allocable to that activity, and includes in income the gain (if any) allocable to his entire interest in the activity, such losses are allowed in full upon the disposition.

Installment Sale

An installment sale of the taxpayer's entire interest in an activity in a fully taxable transaction triggers the allowance of suspended losses. The losses are allowed in each year of the installment obligation, in the **ratio** that the **gain recognized** in each year bears to the total gain on the sale.

Death

A transfer by reason of death causes suspended losses to be allowed to the extent they exceed the amount, if any, by which the basis of the interest in the activity is increased at death under §1014. Suspended losses are eliminated to the extent of the amount of the basis increase and are not allowed in any year. The **losses allowed** generally would be reported on the **final return** of the deceased taxpayer.

Gifts: Lose Losses

A gift of all or part of the taxpayer's interest in a passive activity **does not trigger suspended losses.**

- **Entire Interest.** If the taxpayer gives away his entire interest, he cannot make a future taxable disposition of it. Suspended losses are therefore **added to the basis of** the property immediately before the gift.
- **Partial Interest.** If the taxpayer gives away less than all of his interest, an allocable portion of any suspended losses are added to the donee's basis.
- **Consequences.** Suspended losses of the donor are eliminated when added to the donee's basis, and the remainder of the losses continue to be suspended in the donor's hands.
- **Donee's Deduction.** The treatment of subsequent deductions from the activity, to the extent of the donee's interest, depends on whether the activity is treated as passive in the donee's hands. For purposes of determining the donee's loss in a subsequent transaction, however, the donee's basis may not exceed the fair market value of the gift at the time it was received. See §1015(a). Losses attributable to unrealized depreciation in value of the property in the hands of the donor at the time of the gift are not deductible.

Nonrecognition Transactions

An exchange of the taxpayer's interest in an activity in a nonrecognition transaction, such as an exchange governed by §§351, 721, or 1031 in which no gain or loss is recognized, **does not trigger suspended losses.**

Related-Party Transactions

The taxpayer is not treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses, if she disposes of it in an otherwise fully taxable transaction to a related party (within the meaning of §267(b) or §707(b)(1), including applicable attribution rules). In the event of such a related party transaction, because it is not treated as a disposition for purposes of the passive loss rule, suspended losses are

not triggered, but rather remain with the taxpayer. Such suspended losses may be offset by income from passive activities of the taxpayer.

When the entire interest owned by the taxpayer and the interest transferred to the related transferee in the passive activity are transferred to a party who is not related to the taxpayer (within the meaning of §267(b) or §707(b)(1), including applicable attribution rules) in a fully taxable disposition, then to the extent the transfer would otherwise qualify as a disposition triggering suspended losses, the taxpayer may deduct the suspended losses attributable to his interest in the passive activity.

Abandonment

A **disposition** under the passive loss rule **includes an abandonment**, constituting a fully taxable event under present law, of the taxpayer's entire interest in a passive activity. Thus, for example, if the taxpayer owns rental property which is abandoned in a taxable event which would give rise to a deduction under §165(a), the abandonment constitutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule.

General Rule: Characterization of Gain at the Time of the Disposition

Gain from a disposition of property used in an activity or of an interest in an activity held through a partnership or S corporation generally is treated as gross income from that activity. The nature of the activity, passive, nonpassive, etc., is determined for the year of the disposition.

For purposes of this rule, the gain recognized upon the disposition of a partnership interest or S corporation stock is treated as gain from the disposition of an interest in the activities in which the partnership or S corporation has an interest.

If portions of a property are used in different activities for the tax year of the disposition, then the various portions are treated as separate activities. The amounts realized for the property and the adjusted basis of the property must be allocated among the separate portions in a **reasonable manner**.

Disposition of Interests in Partnership or "S" Corporation

Although the IRS regulations provide exceptions, the general rule of Regs. §1.469-2T(e)(3) is that if a holder of an interest in a pass-through entity disposes of his interest, a ratable portion of any gain or loss from the disposition is to be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which the entity owned an interest on what is termed **"the applicable valuation date."** The term **"applicable valuation date"** generally refers to whichever of the following dates is selected by the entity: **1)** the beginning of the tax year of the passthrough entity in which the disposition occurs, or **2)** the date on which the disposition occurs.

Passive Loss Relief for "Qualified Real Estate Professionals" (§469(c)(7))

Certain Taxpayers Allowed to Use Material Participation Rules to Remove Rental Properties From Passive Limitations

§469(c)(7) treats a taxpayer's rental real estate activities in which he "materially participates" as not subject to limitation under the passive loss rule if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. Whether a taxpayer materially participates in his rental real estate activities is determined as if each interest of the taxpayer in rental real estate is a separate activity unless the taxpayer elects to treat all interests in rental real estate as one activity. The provision applies to individuals and closely-held C corporations.

Real Property Trade or Business

Real property trade or business means any real property **development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage** trade or business.

Individuals And Closely-Held C Corporations Eligible to Show Material Participation

- **Individuals.** An individual taxpayer meets the eligibility requirements if **1) more than half** of the personal services the taxpayer performs in a trade or business are in **real property trades or businesses in which he materially participates, and 2) the taxpayer performer more than 750 hours of services** during the taxable year in real property trades or businesses in which the taxpayer materially participates.
- **In the case of a joint return,** the eligibility requirements are met only if one spouse separately satisfies both requirements. Thus, **one of the spouses separately must satisfy** the requirement with respect to **half** of such spouse's personal services **and** the requirement with respect to **750 hours** of services, without regard to services performed by the other spouse. In determining "material participation," however, the participation of the spouse of the taxpayer is taken into account.
- **Services As An Employee.** Personal services performed as an employee are not treated as performed in a real estate trade or business unless the person performing services has **more than a 5% ownership interest** in the employer (within the meaning of Sec. 416(i)(1)(B)). §416(i)(1)(B) generally uses the §318 attribution rules.
- **Closely-Held C Corporation.** A closely-held C corporation meets the eligibility requirements if more than 50% of its gross receipts for the taxable year are derived from real property trades or businesses in which the corporation materially participates (within the meaning of Sec. 469(h)(4)). §469(h)(4) says a corporation materially participates if shareholders owning **more than 50%** of the stock materially participate **or** the corporation meets the requirements of §465(c)(7)(c).

Material Participation

In applying §469(c)(7), "material participation" has the same meaning as otherwise defined in §469. The election permitting a taxpayer to aggregate his rental real estate activities for purposes of determining whether such activities are treated as not passive under this provision is not intended to alter present law with respect to material participation through limited partnership interests.

Treatment of Suspended Losses

Suspended losses from any rental real property activity that is treated as not passive **by reason of §469(c)(7)** are treated as **losses from a former passive activity**. Thus, such suspended losses are **limited to income from the activity**, and are not allowed to offset other income. When the taxpayer **disposes of his entire interest** in the activity in a fully taxable transaction with an unrelated party, any remaining suspended losses allocable to the activity are allowed in full.

Modified AGI Calculation

Modified adjusted gross income is determined **without regard** to any loss allowable by reason of §469(c)(7), for purposes of the present-law \$25,000 allowance of losses and deduction-equivalent credits from active rental real estate activities.

Regulations 1.469-9

These regulations provide additional clarification relating to the treatment of rental real estate activities of certain taxpayers under the passive activity loss and credit limitations of §469. **OBRA 1993** added a new §469(c)(7), which provides that rental real estate activities of "qualified real estate professionals" (QREP) (i.e., who meet the greater than 50% test and the greater than 750 hours test) are not subject to the rule that treats all rental activities as passive. **Thus, a rental real estate activity of a qualifying taxpayer is not passive if the taxpayer materially participates in the activity.**

These rules provide that each of a qualifying taxpayer's interests in rental real estate is treated as a separate activity unless the taxpayer elects to treat all interests in rental real estate as a single activity.

Qualifying Activity Still Passive Unless Taxpayer Materially Participates

The regulations provide that a rental real estate activity of a QREP will remain passive for a taxable year unless the taxpayer “materially participates” in the activity. This rule applies to all rental real estate activities of a QREP, including those giving rise to expenses described in §212 of the Code.

Rental Real Estate

Rental real estate is any real property used by customers or held for use by customers in a rental activity within the meaning of §1.469-1T(e)(3). However, any rental real estate that the taxpayer grouped with a trade or business activity under §1.469-4(d)(1)(i)(A) or (c) is not an interest in rental real estate for purposes of this section. The previous sentence means that any rental real estate that is properly treated as a trade or business activity **1)** because it is insubstantial and part of an “appropriate economic unit” consisting of one or more trade or business activities **or 2)** because the property is rented to the trade or business activity, is not a rental real estate property under these rules.

Personal Services

Personal services mean any work performed by an individual in connection with a trade or business. However, personal services **do not include** any work performed by an individual in the individual's capacity as an **investor** as described in §1.469-5T(f)(2)(ii).

Material Participation

Material participation has the same meaning as under §1.469-5T. A taxpayer **must materially participate** in a real property trade or business in order for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the more than 50% and the more than 750 hours requirements. **Note!** The final regulations confirm that a taxpayer may participate in a rental real estate activity through participation in a management activity. This could include management work performed by a taxpayer who owns his rental real estate interest through a closely-held C corporation that is subject to §469.

Treatment of Spouses

Spouses filing a joint return are qualifying taxpayers **only if one spouse separately satisfies both the more than 50% and the more than 750 hours requirements of §469(c)(7)(B)**. In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under §1.469-5T(f)(3), regardless of whether the spouses file a joint return for the year.

Services Performed as an Employee

For purposes of these rules, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer **is a five-percent owner** (within the meaning of §416(i)(1)(B)) in the employer. **Note! The final regulations clarify that if a taxpayer is a 5% owner for only part of a tax year, he can count the services during that part of the year.**

Determining Real Property Trades or Businesses

General Rule. The determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists of one or more trade or business. A real **property trade or business** is defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. **Note!** The final regulations clarify that a taxpayer's grouping of activities under Reg. §1.469-4 does not control the determination of the taxpayer's real property trades or businesses.

Consistency Requirement. Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of these rules, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has

been a material change in the facts and circumstances that makes the original determination clearly inappropriate. See the effective date rules "regrouping heading" for exceptions to this rule.

Practice Alert! The consistency rule places a premium on properly treating "gray areas" for the first year subject to these rules.

Each Rental Real Estate Property Is Separate Activity Unless Elect Otherwise

Each interest in rental real estate of a QREP will be treated as a separate rental real estate activity unless the taxpayer makes an election under Reg. 1.469-9(g) (next paragraph) to treat all interests in rental real estate as a single rental real estate activity. **Note!** The final regulations make it clear that a taxpayer cannot group a rental real estate activity with a non-rental real estate activity in determining whether the taxpayer has materially participated in the rental real estate activity. Furthermore, "construction" and/or "development" of rental real estate must be treated as a separate activity from the rental of the real estate.

Election to Treat All Rental Real Estate Interests as One Activity

Election. A QREP may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This **election is binding** for the taxable year in which it is made and for **all future years** in which the taxpayer is also a QREP. **Note!** The final regulations make it clear that this election is binding for all purposes of §469(f) and §469(g). **Also Note!** This election is not binding for any tax year in which the taxpayer is **not** a QREP.

Statement Required to Make Election. A QREP makes the election to treat all interests in rental real estate as a single rental real estate activity by **filing a statement with the taxpayer's original income tax return for the taxable year**. This statement must contain a declaration that the taxpayer is a QREP for the taxable year and is making the election pursuant to §469(c)(7)(A). The taxpayer may make this election for any taxable year in which §469(c)(7) is applicable. An example of an election is included at the end of this section.

Revocation of Election. If there is a **material change in a taxpayer's facts and circumstances**, the taxpayer may revoke the election using the procedure described below. The fact that an election is **less advantageous to the taxpayer** in a particular taxable year is **not, of itself, a material change** in the taxpayer's facts and circumstances. Similarly, **a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances**.

Statement Required to Revoke Election. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for that year. This statement must contain a declaration that the taxpayer is revoking the election under §469(c)(7)(A) and an explanation of the nature of the material change in the facts and circumstances.

Practice Pointer! If the only way we can deduct the losses from rental real estate properties is to make the aggregation election, then our first impulse will be to make the election. **However, there are certain ramifications of the election that should be considered:**

- If the rental real estate activities have prior year suspended passive losses, by aggregating all activities together, a complete disposition of a particular rental real estate property will probably not "free-up" those previously suspended losses because there has not been a disposition of the "entire" activity. However, any gain upon the disposition of a rental real estate property would utilize losses to the extent of the gain.
- If the rental real estate properties later produce income, we cannot revoke the aggregation election just to fail the material participation test and create passive income.
- Even with an election to aggregate, the taxpayer must still satisfy one of the seven material participation tests.

Practice Alert! The regulations say the fact that the election is no longer advantageous is not a valid reason for a revocation.

Rules for Grouping Real Estate Properties Owned by Partnership or S Corporation

General. Except as provided below, a QREP's interest in rental real estate held by a partnership or an S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity under §1.469-4(d)(5). If the passthrough entity groups its rental real estate into separate rental activities under §1.469-4(d)(5), each rental real estate activity of a passthrough entity will be treated as a separate interest in rental real estate of a QREP. However, a taxpayer may elect, as provided above, to treat all interests in rental real estate, **including the rental real estate interests held through passthrough entities**, as a single rental real estate activity.

Special Rule Where Taxpayer Owns At Least 50% Of Entity. If a QREP holds a **50% or greater interest** in the capital, income, gain, loss, deduction, or credit of a passthrough entity **at any time during the taxable year**, each interest in rental real estate held by the passthrough entity will be treated as a separate interest in rental real estate of the QREP, regardless of the passthrough entity's grouping of activities under §1.469-4(d)(5). However, the taxpayer may elect, as provided above, to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

Suspended Passive Activity Losses

The regulations clarify the treatment of suspended losses and credits allocable to a nonpassive rental real estate activity. They provide that the former passive activity rules of §469(f) apply. Thus, the suspended loss or credit may be used to offset income from, or tax liability allocable to, the rental real estate activity, and any **remaining loss or credit is still treated as a loss or credit from a passive activity**.

Application Of \$25,000 Rule For Rental Real Estate Activities Of QREPs

A QREP's passive losses and credits from rental real estate activities (including suspended passive activity losses and credits from rental real estate activities in which the taxpayer materially participates) are allowed to the extent permitted under §469(i) (the \$25,000 rule).

Example 1. Taxpayer A owns building X and building Y, both interests in rental real estate. In 2023, A is a QREP within the meaning §469(c)(7). A does not elect to treat X and Y as one activity under §469(c)(7)(A) and the regulations. As a result, X and Y are treated as separate activities pursuant to §469(c)(7)(A)(ii). A materially participates in X which has \$100,000 of passive losses disallowed from prior years and produces \$20,000 of losses in 2023. A does not materially participate in Y which produces \$40,000 of income in 2023. A also has \$50,000 of income from other nonpassive sources in 2023. A otherwise meets the requirements of §469(i).

Because X is not a passive activity in 2023, the **\$20,000 of losses produced by X in 2023 are nonpassive losses** that may be used by A to offset part of the \$50,000 of nonpassive income. Accordingly, A is left with \$30,000 (\$50,000 – \$20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of X to offset any income from X and passive income from other sources. Therefore, A may offset the \$40,000 of passive income from Y with \$40,000 of passive losses from X.

Because A has \$60,000 (\$100,000 – \$40,000) of passive losses remaining from X and meets all of the requirements of §469(i), A may offset up to \$25,000 of nonpassive income with passive losses from X pursuant to §469(i). As a result, A has \$5,000 (\$30,000 – \$25,000) of nonpassive income remaining and disallowed passive losses from X of \$35,000 (\$60,000 – \$25,000) in 2023.

Practice Pointer! The final regulations clarify that adjusted gross income for purposes of §469(i) is not reduced by any losses from rental real estate that are allowed as a result of §469(c)(7).

Sample Election

Election to Treat All Rental Real Estate Interests as One Activity

Taxpayer is a qualifying taxpayer under Code §469(c)(7)(B) and hereby makes the election pursuant to Code §469(c)(7)(A) to treat all rental real estate interests as a single rental real estate activity.

Selected Cases, Rulings, Etc.

A. COD Income Traced to Passive Activity Is Passive Income (Rev. Rul. 92-92, Nov. 9, 1991)

In Rev. Rul. 92-92, the IRS ruled that COD income will constitute “passive” income for purposes of §469 to the extent, at the time the debt is discharged, the debt is allocable to passive activity expenditures under the interest tracing rules of Reg. 1.163-8T.

B. Distributions in Excess of Basis in a Partnership or S Corporation Are Treated as a Disposition of a Proportionate Part of Each Passive Activity Owned by the Partnership or S Corporation (Rev. Rul. 95-5, IRB 1995-2, Jan. 9, 1995)

The IRS points out in this ruling that a partnership or S corporation distribution to owners in excess of basis is treated as a gain from the disposition of an interest in the entity. Also, there is deemed to be a disposition of a proportionate part of each passive activity owned by the entity. **Therefore, if there is a distribution to owners of an S corporation or a partnership and the distribution results in a gain, there will be passive activity gain to the extent the partnership or S corporation owns one or more passive activities.**

C. Condominium Rental Where Average Rental Period Was Seven Days or Less Was Not Rental Property for Purposes of the \$25,000 Passive Allowance for Rentals (PLR 9505002)

The taxpayers were involved in an activity of providing a condominium for use by customers **for an average period of seven days or less**. IRS pointed out that, since the activity was not a rental activity (since it was rented for an average period of seven days or less) the taxpayers did not qualify for the \$25,000 active rental loss deduction. Also, since the taxpayers did not materially participate in the activity, it was a passive activity.

D. Passive Losses Allowed for Income Tax Purposes Also Reduce Self-Employment Income If From Activity Subject to Self-Employment Tax (PLR-9750001):

In this technical advice, IRS ruled that current passive losses generally reduce self-employment income to the same extent that they are allowable for current-year income tax purposes. It similarly ruled that **prior-year disallowed passive losses** that are allowable in a **current year** for income tax purposes also can reduce **current-year self-employment income**.

E. IRS Allows Rental Activity to be Grouped With Non-Rental Activity Under §469 Because Rental Income Was Insubstantial (TAM 200747018)

Facts. For the years at issue (Y1, Y2, and Y3), SH owned 100% of S Corp, an S corporation. S Corp owned several qualified subchapter S subsidiaries (QSubs), including QSub1 and QSub2. **QSub2 and the QSubs other than QSub1 generally sell new and used heavy trucks and trailers, and have locations in City1 and City2. QSub1, located in City1, primarily leases heavy trucks and trailers via leveraged net leases.** QSub1 and QSub2 are located in the same building. QSub1 maintains its own set of accounting records, computer accounting programs, and books and records. **For the years at issue, S Corp has grouped all of the activities conducted by the QSubs into one activity for purposes of §469 and has consistently used this grouping through the years. SH reported consistently with the grouping of activities shown on the K-1s issued by S Corp. The combined activities of S Corp represent an appropriate economic unit under Reg 1.469-4(c).**

Conclusion. The IRS ruled that the truck leasing activity conducted by QSub1 may be grouped with the activities of the other QSubs under Reg 1.469-4(d)(1)(A). IRS said that it **conceded** that the **activities of QSub1 and the other QSubs constitute an appropriate economic unit** under Reg 1.469-4(c). In addition, based upon all of the facts and circumstances, the IRS concluded that the **rental activity of QSub1 is insubstantial** in relation to the trade or business activities conducted by the other QSubs of S Corp.

F. Tax Court Concludes That Real Estate “Agent” Could Be a “Real Estate Professional” Under §469(c)(7) (Agarwal, TC Summ. Op. 2009-29, March 2, 2009 — Pursuant to §7463(b), Cannot Be Cited as Precedent for Any Other Case)

Facts. During 2001 and 2002, Mr. and Mrs. Agarwal (Shri and Sudha) owned two rental properties. Shri worked full-time as an engineer and his **wife Sudha worked full time as a real estate agent for a brokerage firm (Century 21) under an independent contractor arrangement.** Her entire compensation was based on

commissions. **Sudha spent a total of 1,400 and 1,600 hours managing the couple's rental properties and selling real estate in 2001 and 2002, respectively.**

Conclusion. The Tax Court ruled that Sudha was engaged in “brokerage” because she sold, exchanged, leased, or rented real property and solicited listings. Therefore, the Court said Sudha was engaged in a “brokerage” trade or business within the meaning of §469(c)(7)(c) and was a “qualified real estate professional” under §469(c)(7). Consequently, the rental losses for 2001 and 2002 were allowed.

G. IRS Releases Procedure Requiring Taxpayers To Report Passive Activity Groupings to the IRS (Rev. Proc. 2010-13, Jan. 6, 2010)

Background. Reg. 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules. However, Reg. 1.469-4 does not apply to the rental real estate activities (as defined in Reg. 1.469-9(b)(3)) of a taxpayer in a year in which the taxpayer is a “qualifying real estate professional” under §469(c)(7)(B) and Reg. 1.469-9(b)(6), if the taxpayer has made the election to treat all interests in rental real estate as a single rental real estate activity as provided in Reg. 1.469-9(g).

Reporting Requirements for Passive Activity Groupings. Effective for tax years beginning on or after Jan. 25, 2010, this revenue procedure **requires taxpayers to file a written statement with their tax returns with respect to the following events.** This statement must identify **the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity.** In addition, any statement reporting a grouping or regrouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped **activities constitute an appropriate economic unit** for the measurement of gain or loss for purposes of §469.

New Groupings. Effective for tax years beginning on or after Jan. 25, 2010, a taxpayer must file a written statement with the original return for the first tax year in which two or more trade or business activities or rental activities are originally grouped as a single activity or as separate activities. This statement must identify **the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity.** The statement must contain a declaration that the grouped activities **constitute an appropriate economic unit** for the measurement of gain or loss for purposes of §469.

Addition of New Activities to Existing Groupings. Whenever a taxpayer adds a new trade or business activity or a rental activity to an existing grouping **within a tax year beginning on or after Jan. 25, 2010,** the taxpayer must file a written statement with the original return for the tax year in which the new trade or business activity or rental activity is added to the existing grouping. This statement must identify **the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping.** In addition, the statement must contain a declaration that the grouped activities constitute an **appropriate economic unit** for the measurement of gain or loss for purposes of §469.

Re-Groupings. If, for a tax year beginning on or after Jan. 25, 2010, it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and file a written statement with the original return for the tax year in which the regrouping occurs. This statement must identify **the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped.** If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.

Preexisting Groupings Grandfathered. Generally, no reporting is required for groupings of trade or business activities and rental activities that were made in a **tax year beginning before Jan. 25, 2010** (but reporting

will be required if the taxpayer makes a change to the grouping). **Please consult** the Revenue Procedure for additional details.

Partnerships and S Corporations. Generally, no reporting is required under this Revenue Procedure for partnerships and S corporations, which must instead comply with the existing disclosure instructions for grouping activities provided for on Form 1065 and on Form 1120-S, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1.

However, the partner or shareholder is required to comply with the disclosure rules of items 2 a, 2 b, and 2 c, (above) where the partner or shareholder: 1) groups together any of the activities that the entity does not group together, **2)** groups the entity's activities with activities conducted directly by the partner or shareholder, **or 3)** groups the entity's activities with activities conducted through other §469 entities. Pursuant to Reg. 1.469-4(d)(5)(l), a shareholder or partner may not treat activities grouped together by a §469 entity as separate activities.

Qualified Real Estate Persons. Reg 1.469-4 and the **grouping disclosure rules of this revenue procedure do not apply to the rental real estate activities** (as defined in Reg. 1.469-9(b)(3)) of a taxpayer in a year in which the taxpayer is **a qualifying real estate professional under §469(c)(7)(B)** and Reg. 1.469-9(b)(6), if the taxpayer has made the election to treat all interests in rental real estate as a single rental real estate activity as provided in Reg. 1.469-9(g).

Failure to Report. In general, if a taxpayer fails to report a grouping under Reg. 1.479-4, **then each trade or business activity or rental activity governed by Reg. 1.469-4 is treated as having been grouped as a separate activity for purposes of applying the passive activity loss and credit limitation rules.** However, a timely disclosure is deemed to have been made by a taxpayer who **has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer.** If the failure to disclose is first discovered by IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures.

H. Tax Court Says “Qualifying Real Estate Professional’s” Aggregation of Profits and Losses of Multiple Rental Properties on Schedule E Does Not Constitute §469(C)(7) Aggregation Election (Shiekh, TC Memo 2010-126, June 10, 2010)

Summary. The Tax Court concluded that a “qualifying real estate professional” under §469(c)(7) who owned multiple real estate rental properties was subject to the §469 passive activity limitations because the taxpayer failed the material participation requirements for the loss generated by the rental property under dispute. The taxpayer would have passed the material participation test if all of the rental real estate properties were aggregated. However, the Court held that: **1)** Taxpayer failed to file a valid election to treat his rental properties as single activity; **2)** Taxpayer’s *aggregate treatment of his rental properties on his return (1040 Schedule E) was insufficient* to provide notice to IRS that he had elected to treat all of his rental properties as a single real estate activity; and **3)** nowhere on his return did Taxpayer exhibit his *unequivocal agreement* to accept the benefits and burdens of such an election. Several months earlier, the Tax Court reached a similar conclusion in **Trask, TC Memo 2010-78, April 15, 2010.**

I. Tax Court Says That Casualty Loss on Rental Property Is Not Passive Loss (Agosto, TC Summ. Op. 2009-191, Dec. 14, 2009, Pursuant to §7463(b), This Opinion May Not Be Treated as Precedent for Any Other Case)

In this case, Taxpayer incurred a **loss of approximately \$44,000 caused by fire damage to a residential home that she rented to a tenant.** Taxpayer fully deducted the loss on her tax return. Since the rental home was a passive activity, the **IRS argued that Taxpayer’s casualty loss deduction was limited to \$25,000 under §469(i).** Subject to certain income phase-out thresholds, §469(i) permits a passive activity loss of up to \$25,000 attributable to a rental real estate activity in which an individual *actively* participates.

In allowing the entire \$44,000 casualty loss, the Tax Court noted that §469 does *not apply* to casualty and theft losses. The Court stated that: **“Regulations 1.469-2(d)(2)(xi) provides that certain casualty and theft losses are not passive activity deductions.**

J. IRS Passive Activity Audit Issue: Grouping Activities Under REG 1.469-4

1. **The Audit Issue – Have We Grouped Undertakings for Purposes of Reg 1.469-4(e) When We Keep Them Separate?** If a taxpayer does not group two or more undertakings (i.e., businesses) together under **Reg 1.469-4(a)** when they are first begun, can the taxpayer group the businesses together (all or some combination) on a future return? **Reg 1.469-4(e)** provides that the taxpayer may change a grouping only if the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping inappropriate. ***Have we grouped undertakings when we keep them separate?***
2. **Passive Activity Loss Audit Technique Guide.** In Chapter 8 of the ***Passive Activity Loss Audit Technique Guide***, the IRS says under the heading “**Consistency Requirement**”

“The **Reg. §1.469-4(e)** imposes a consistency requirement. Once the taxpayer has selected his grouping, he must use that same grouping in future years unless the original group is [clearly] inappropriate or there is a material change in facts and circumstances.

A decision not to group, i.e., to treat each activity separately, is a grouping decision. This decision generally should have been made starting in 1994 when Reg. §1.469-4 was finalized or, if subsequent to that date, at the time the activity was first reflected on a return. A taxpayer cannot pick and choose each year what his grouping is. The taxpayer must maintain the grouping he originally chose under the consistency rules in **Reg. §1.469-4(e).** [Emphasis added]

Practice Alert! It has been reported that in certain audits the IRS agents have argued that where the taxpayer failed to group a rental activity with a trade or business activity (i.e., an S corp was renting equipment from the owner of the S corp) in the first year of the rental, but, the taxpayer grouped the rental with the S corp business during the second and subsequent years, keeping the rental and the S corp business activity separate was a “grouping election” and this election cannot be changed since keeping the businesses separate was not clearly inappropriate.

This appears to be stretching Reg 1.469-4(e) beyond its flush language. Reg 1.469-4(e) says “Except as provided in paragraph (e)(2) of this section and §1.469-11, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years.” There is no caution or clear indication in the Reg that a taxpayer “has grouped” activities when the activities are kept separate. In addition, “grouping” is not defined in the statute or in the regulations. When a term is not defined, the courts generally look to the common definition of the term. **Merriam-Webster defines “group” as “two or more figures forming a complete unit in a composition.”** There are also alternative definitions, however, they all mention the combination or bringing together of two or more items. Merriam-Webster defines a “grouping” as “the act or process of combining in groups” or “a set of objects combined in a group.” Clearly, based upon this definition, a grouping does not include keeping items separate.

Caution! Even though it is arguable that the IRS has overreached the regs in the Passive Activity Loss Audit Technique Guide, IRS agents generally rely on the guide. So, we can expect more audit adjustments related to this issue. We should therefore, examine a client’s “grouping” options anytime a new passive or potentially passive business activity is begun and make sure we select the optimum option in that first year.

K. Survey of Several Cases Addressing “Qualified Real Estate Professional” Issues

The following are highlights from selected recent cases addressing issues involving the “qualified real estate professional” (QREP) classification under §469(c)(7):

1. **In Merino, TC Memo. 2013-167 (July 16, 2013)**, the Tax Court concluded that the owner of multiple businesses (including a home loan processing business) and various rental properties was not a “*qualified real estate professional*” under §469(c)(7) because he could not prove that he satisfied the 50%/750-hour test. With respect to documenting time spent on real estate trades or businesses, the Court said: “*the taxpayer may use methods including, but not limited to, the identification of services performed over a period of time and the approximate number of hours spent based on appointment books, calendars, or narrative summaries. For the purposes of §469, the regulations do not allow a post event ballpark guesstimate.*” [Emphasis added].

2. **Taxpayer Was Not a QREP Even Though Her Husband Was A QREP - Because She Filed A Separate Return (*Oderio v. Commissioner*, TC Memo 2014-39, March 10, 2014).** Wife owned loss producing rental real estate, and was married to a QREP. Although Wife was not a QREP in her own right, her husband was properly classified as a QREP. Wife argued that since she was married to a QREP, she likewise was a QREP and she could deduct her rental real estate losses because she “materially participated” in those rental activities. Wife filed as “married filing separately.” The Court concluded that **Julie was not a QREP** and, therefore, her rental real estate losses were automatically passive losses under the §469(c)(2) presumption. The Court pointed out that **Reg. 1.469-9(c)(4) provides** that: “*Spouses filing a joint return are [QREPs] only if one spouse separately satisfies both requirements of §469(c)(7)(B). In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose [in determining QREP status]), work performed by the taxpayer’s spouse in a trade or business is treated as work performed by the taxpayer under §1.469-5T(f)(3), regardless of whether the spouses file a joint return for the year.*” [Emphasis added]. Thus, since Wife filed “separate,” her husband’s QREP status could not be attributed to her.

3. **Tax Court Says That Hours Spent Preparing “Principal Residence” For Rental Is Not Counted In Determining “Qualified Real Estate Professional” Status (*Smith*, TC Summ. Op. 2014-13, Feb. 19, 2014).** In this case, during 2009, John Smith (a full-time software engineer) owned 5 real estate rental properties. Also, during the entire 2009 tax year, John owned a sixth dwelling that he used as his principal residence. He hoped to eventually move out and convert the principal residence to rental property. John argued that during 2009, he spent approximately 1,000 hours fixing up his “Principal Residence” in anticipation of later converting it to rental property. John then argued that these 1,000 hours should be added to the 353.2 hours he worked on his other rental properties in determining whether he satisfied the 750 hour/more-than-50% test for qualifying as a QREP. The Court said that the principal residence was not a real estate trade or business during 2009 because the property **was not actually rented out or held out for rent** at any time in 2009.

4. **Tax Court Rules Stockbroker Is “Qualified Real Estate Professional” and Was Entitled to Deduct All Rental Losses Even Though She Failed To Make The Aggregation Election Under §469(c)(7)(A) (*Windham*, TC Memo 2017-68, April 24, 2017).** Taxpayer (Patricia) was a stockbroker who worked at her brokerage office from 12:30 p.m. until the stock markets closed, and worked only during days the market was open (she was able to satisfy the Court that for the year at issue [2010], she worked in her **stockbroker business** a total of **577.5 hours**). She also owned 12 rental properties and she satisfied the Court that in 2010 she had worked an **aggregate of 889.25 hours** in those **rental properties**. The Court concluded that Patricia was a “*Qualified Real Estate Professional*” (i.e., she satisfied the 750 hour/50% tests), and that she was entitled to deduct the aggregate losses of \$307,933 from her rental properties because she showed that she “*materially participated*” in each rental property.

Practice Alert! This case is notable in part because Patricia was allowed by the Tax Court to deduct all of the rental losses even though she had failed to make the “*aggregation*” election under §469(c)(7)(A). Instead she was able to show that: **1)** She “*materially participated*” in each of 3 of her rental properties because she worked more than 100 hours in each specific property and no other single person worked more hours than she did, and **2)** Even though she did not work more than 100 hours in each of her remaining 9 rental properties, she “*materially participated*” in each of those 9 rental properties because her services constituted “*substantially all*” of the participation in each of the 9 rental properties. **Please consult** the case for the Court’s detailed analysis of these provisions.

L. **Case and Ruling Addressing Whether Foreclosure of a Rental Property Constitutes a “Disposition” That Releases a §469 Suspended Loss**

Background. Under §469(g)(1)(A), if during the tax year a taxpayer **disposes of the taxpayer’s entire interest in any passive activity, and all gain or loss realized on such disposition is recognized**, the excess of **1)** Any loss from such activity for such tax year (determined after the application of §469(b)), over **2)** Any net income or gain for such tax year from all other passive activities (determined after the application of §469(b)), is treated as a loss which is not from a passive activity. The caption to §469(g)(1) refers to such a disposition as a “fully taxable transaction.” The following two cases addresses this rule in the context of foreclosure proceedings:

1. **IRS Concludes That Losses Suspended Under §469 Are Released on Foreclosure of Rental Property Despite §108 COD Income Exclusion (CCA 201415002, Feb. 11, 2014).** In this Chief Counsel Advisory, consistent with previous case law, the IRS concluded that a foreclosure on rental real property subject to recourse debt qualified as a “fully taxable disposition” for purposes of releasing suspended passive losses under §469, even though the foreclosure generated cancellation of debt (COD) income that was excluded under §108(a)(1)(B) because the taxpayer was insolvent. The IRS also concluded that the released passive losses did not have to be reduced by the amount of the excluded COD income.
2. **Foreclosure of Rental Property Was Not a Complete Disposition That Freed Up Suspended Passive Losses While the Taxpayer Was in Dispute With Mortgage Company (Herwig, TC Memo 2014-95, May 20, 2014).** The Court said that a foreclosure sale normally constitutes a disposition of property for purposes of §1001(a). (Hammel, (S Ct 1941) 24 AFTR 1082). However, contrary to the taxpayer’s argument, the Court held that a foreclosure action that is being appealed, is not “final” in the normal sense of that word. Thus, the suspended loss was not released while the foreclosure proceeding was being contested by the taxpayer.

M. District Court Explains How §469 Rules Are Analyzed and Applied to Multiple Real Estate Activities (Stanley, DC AR, 116 AFTR 2d 2015-6766, Nov. 12, 2015)

1. **Overview.** This case is a recent example of the types of arguments the IRS is making against owners of rental real estate claiming to be “*Qualified Real Estate Professionals*” (QREPs). This case is notable in that it contains a detailed analysis of the various elements that must be satisfied to attain QREP status, as well as a detailed analysis of several critically important fine points regarding the “activity” grouping rules. Please consult this case for details.
2. **Article On This Stanley Case.** For a recent article analyzing the *Stanley* case, see *Grace, “Analysis Of Relationship Between Passive Loss Rules And Qualifying Real Estate Professionals In Stanley,” CCH Tax Weekly (Nov. 27, 2015 issue).* The author of this article, Michael J. Grace, JD, largely agrees with the District Court’s analysis and conclusions in the case. Mr. Grace’s view of this case carries more weight than usual on this topic because he was the Principal Author of several of the regulations the Court analyzed in *Stanley*. Consequently, Michael Grace has long been considered a national expert on interpreting the regulations under §469.
3. **IRS Non-Acquiesces/AOD 2017-7 Nov. 2, 2017).** On Nov. 2, 2017, the IRS issued Action on Decision 2017-7 generally stating that it will not acquiesce to the holding in *Stanley*.

N. Tax Court Ruled Plastic Surgeon’s Income From Minority Interest on Surgery Center Partnership Was Passive Income (Hardy, TC Memo 2017-16, Jan. 17, 2017)

Summary. This case concludes that the pass-through income from a physician’s 12.5% interest in a Surgery Center was “passive” under §469 and exempt from S/E tax.

O. Tax Court Holds That Mortgage Broker Did Not Qualify as a Real Estate Professional (Kurt Hickam, TC Summary Opinion, 2017-66, Aug. 17, 2017)

DEVELOPMENTS

A. IRS Grants Individual Extension of Time to File Election to Treat All Rental Real Estate Property Interests as One Activity (PLR 202223011, June 10, 2022)

Background. §469(c)(2) provides that a rental activity is generally considered a passive activity for which loss deductions are allowed only up to a taxpayer’s passive activity income. However, §469(c)(7) provides a limited exception to this presumption that rental activities are passive for taxpayers in a real property trade or business (i.e., real estate professionals). Specifically, §469(c)(7)(A) provides that if a taxpayer is a real estate professional (REP), the taxpayer’s rental real estate activity will not be presumed to be a passive activity. Therefore, real estate rental losses of a real estate professional (REP) are not subject to the passive activity limitations of §469 if the taxpayer materially participates in the rental real estate activity.

For determining if a REP materially participates in a rental real estate activity, each interest of the REP in rental real estate is treated as a separate activity. However, a taxpayer may elect to treat all interests in rental real estate as a single activity. Practice Alert! If the taxpayer does not materially participate in each separate rental real estate activity with a loss, it is generally advantageous to elect to treat all rental real estate activities as one activity unless the taxpayer has sufficient passive activity income to absorb the passive activity losses. If the aggregation election is made and the REP materially participates in one rental real estate activity the REP will be treated as materially participating in the combined activity (i.e., in all the rental real estate property interests).

- a. **Real Estate Professional.** To qualify as a real estate professional (REP) under §469(c)(7)(B), a taxpayer must meet **two requirements**. **First, more than half of the personal services performed by the taxpayer in the taxable year must be “performed in real property trades or businesses in which the taxpayer materially participates.”** **Second, the taxpayer must perform “more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.”** If a joint return is filed, either spouse may meet the more than 50% and the more than 750-hour requirement. However, the qualifying spouse must separately meet the 50% and 750-hour test on his or her own.
- b. **Real Property Trade or Business.** For determining if a taxpayer is a REP, the term “real property trade or business” means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
- c. **Election to Treat All Rental Real Estate Properties as One Activity.** Regulation 1.469-9(g)(3) provides that a qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by **filing a statement with the taxpayer’s original income tax return for the taxable year**. Regulation 1.469-9(g)(3) describes the information that must be contained in the statement. An election to treat all interests in rental real estate as a single rental real estate activity is binding for the tax year made and for all subsequent tax years in which the taxpayer is a REP unless there is a material change in the taxpayer’s facts and circumstances.
- d. **Rev. Proc. 2011-34 Provides Procedures for Making Late Aggregation Election Without Requesting a Private Letter Ruling.** Rev. Proc. 2011-34 provides a procedure allowing taxpayers to make late elections to treat all interests in rental real estate as a single rental activity **without paying a user fee**. To obtain this relief, the taxpayer must attach the statement required by Reg 1.469-9(g)(3) to an amended return for the most recent tax year and mail the amended return to IRS service center where the taxpayer will file its current year return. The statement must identify the tax year for which the taxpayer seeks the late election, must explain the reason for the failure to file a timely election, and must include representations under penalties of perjury as specified in §4.01 of Rev. Proc. 2011-34.

Taxpayers Eligible for Relief Under Rev. Proc. 2011-34. A taxpayer is eligible for an extension of time to file a Regulation 1.469-9(g) election under Rev. Proc. 2011-34 if the taxpayer represents on a statement that satisfies the procedural requirements of §4.02 of the Rev. Proc. and states under penalties of perjury that it meets all of the following requirements:

- 1) the taxpayer failed to make an election under Regulation 1.469-9(g) solely because the taxpayer failed to timely meet the requirements in Regulation 1.469-9(g);
- 2) the taxpayer filed consistently with having made an election under Regulation 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years;
- 3) the taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions;

4) the taxpayer has reasonable cause for its failure to meet the requirements in Regulation 1.469-9(g).

e. Requesting Extension of Time to Make a Late Aggregation Election Via a Private Letter Ruling.

Under Regulation 301.9100-1(c), the Commissioner may grant a reasonable extension of time to make a regulatory election, or a statutory election (but no more than six months for a statutory election except in the case of a taxpayer who is abroad), under all subtitles of the Code except subtitles E, G, H, and I. Regulation 301.9100-1(b) defines the term "regulatory election" as an election where the due date is prescribed by a regulation published in the Federal Register. Regulations 301.9100-1 through 301.9100-3 provide the standards the Commissioner is to use to determine whether to grant an extension of time to make an election. Regulation 301.9100-2 provides an automatic **12-month extension** of time for making certain regulatory elections (e.g., elections under §754, §444, §472 to use LIFO), and an automatic **six-month extension** from the due date of a tax return (excluding extensions) where the statutory or regulatory due date is the due date of the return or the due date of the return including extensions. This automatic six-month extension does not apply where the statutory or regulatory election must be made by the due date of the return excluding extensions. Where Reg 301.9100-2 does not apply, Reg 301.9100-3 provides that relief will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.

Facts:

- A was engaged in a real property business as defined under §469(c)(7)(c) and was qualified under §469(c)(7)(B) to make an election to treat all interests in rental real estate as a single rental real estate activity.
- A's former tax return preparer did not advise A about the election under §469(c)(7). As a result, A filed his Federal income tax return for the year involved without the required statement under Regulation 1.469-9(g)(3) to make an election under §469(c)(7) to treat all rental real estate as a single rental real estate activity.

Conclusion. The IRS concluded that the requirements of Regulations 301.9100-1 and 301.9100-3 were satisfied. As a result, it granted the taxpayer an extension of time of 120 days from the date of the private letter ruling to make an election under §469(c)(7)(A) to treat all interests in rental real estate as a single rental real estate activity for the taxable year requested. IRS said the election must be in the form of the statement required by Regulation 1.469-9(g)(3) and attached to an amended return for the year requested and that a copy of the ruling letter should be attached to the election.

Practice Alert! Real Estate Professional status is a factual determination, not an election. The taxpayer must meet the requisite requirements to qualify. Also, it is possible for someone to have this status in some years but not others. It is very important that taxpayers are able to document the required number of hours worked.

IRS FORMS (Located At www.irs.gov)

Form 8582 (Passive Activity Loss Limitations)

IRS PUBLICATIONS (Located At www.irs.gov)

Publication 925 (Passive Activity and At-Risk Rules)

PLANNING IDEAS

A. Create Passive Activity Income: Invest in "passive" trade or business activities producing income and cash flow. Consider selling passive activity properties (if economically profitable) to: **1)** create passive activity income (gain on sale), **2)** free-up otherwise suspended losses of that activity by selling entire interest or substantially all of the interest in the passive activity.

B. Loans to or From Passive Activities" Regulations 1.469-7 allow for the reclassification of portfolio (interest) income into passive activity income. This reclassification occurs for two types of transactions: **1)** Where a partner or S corporation shareholder loans funds to a partnership or S corporation in which he/she is passive,

and 2) Where a partnership or S corporation loans funds to an owner and the owner invests the funds in a passive activity.

C. Qualified Real Estate Professionals

Real estate rental losses are “deemed passive” unless the taxpayer is a qualified real estate professional. To be a “qualified real estate professional,” the taxpayer must spend more than 50% of the time spent performing services during the tax year, performing services in real estate trades or businesses in which the taxpayer materially participates. Also, the taxpayer must spend more than 750 hours working in these real estate businesses. Recently, the Courts have denied losses from rental real estate properties because the taxpayers could not document (using records, the testimony of others, etc.) that they spent more than 50% of their working hours in real estate businesses and worked more than 750 hours in real estate businesses. **We should encourage clients to keep records to document hours worked on their rental properties, etc.**

To remove the rental losses from the passive activity limitations, even a qualified real estate professional must “materially participate” in the rental activities. If the real estate professional owns several rental properties, he or she may need to make the election to aggregate the rental properties for purposes of determining if he or she materially participates in those rental real estate activities. Otherwise, the individual may not pass the qualified real estate professional test. The election to aggregate the properties should be made on a timely filed return (including extensions). The IRS has granted extensions of time for making this aggregation election. The request for an extension of time to make the election is made using the private letter ruling request procedures and requires the payment of a user fee. For example, see **PLR 200834020** where IRS granted an extension of time to make the election. However, the taxpayer may qualify for an **automatic late election** under **Rev. Proc. 2011-34** without a private letter ruling request and without paying a user fee.

D. Other Planning Ideas

Real Estate Rentals. If a client's vacation home is rented on the average for seven days or less, it is not deemed rental property (Regs. §1.469-1T(e)(3)(ii)).

1. If the client is "active" but does not "materially participate" in the rental activity and AGI is less than \$150,000, the average use should be **more than seven days** so the property will be rental property subject to the \$25,000 allowance.
2. If the client materially participates in the rental activity, the average use should be **seven days or less**. Then, the property would be deemed non-rental, trade or business property and deductions would be allowed in full (except for possible vacation home limitations).

Rentals: General Rules

Significant Services. If the average use of the property is greater than seven days but not greater than thirty days and if "significant personal services" are provided, the property will not be rental property. The regulations at §1.469-1T(e)(3)(iv) indicate that if payments for personal services (e.g., maid and linen service) are less than 10% of gross rents, they are not significant.

Rental Property Held Principally For Appreciation, Etc. If rental property is held principally for **appreciation**, or for use in a **trade or business**, it will not be deemed rental property unless the rentals equal or exceed 2% (2%) of the lesser of the adjusted basis or the fair market value of the property. So, if clients need passive rental income to offset passive activity losses they should charge at least the 2% amount or the rentals will not automatically be deemed passive (Regs. §1.469-1T(e)).

Material Participation Rules

Generally. If a client has losses from an activity, plan (if possible) to meet one of the material participation tests at Regs. §1.469-5T(a)(1) to avoid the passive activity loss limitations.

Have Spouse Participate. Generally, if the owner of a passive activity does not materially participate, but the owner's spouse does, the owner is deemed to materially participate. However, Regs. §1.469-5T(f)(2)(I) says if the participation is not work of a type customarily done by an owner it will not count. For example, if the

spouse was employed by the activity to perform a clerical function, that may not constitute material participation. Have the spouse perform a function normally performed by owners (management, etc.).

Rental Property Developed by the Taxpayer. If a client develops rental property and needs the sale proceeds to be passive income, the property must be rented for at least 12 months before the sales contract is signed (Regs. §1.469-2T(f)5)).

Rental Income From Non-Depreciable Property Is Not Passive. Regs. §1.469-2T(f)3) provide that net rental income will not be passive if the unadjusted basis of depreciable property rented in the activity is less than 30% of the unadjusted basis of all property rented in the activity. Therefore, where clients are renting both improved and unimproved property and the property is producing income (to be used to offset passive losses), this 30% test must be met or the income will not be passive.

Limited Partners — Presumptive Rules. Generally, income from a limited partnership interest in an activity is presumed passive. However, if the limited partner also owns a general partnership interest, the presumption does not apply (Regs. §1.469-5T(e)). The presumption also does not apply if the limited partner participates in the activity for more than 500 hours during the tax year or during five of the last ten years or for a personal service activity during any three prior years.

Publicly Traded Partnerships. Careful! Advise clients that income from publicly traded partnership interests cannot be offset against passive activity losses.

Gain From Sale as Passive Activity Income

General Rule. Property that has been used in both passive and non-passive activities must be used in the passive activity for 12-months preceding the date of sale for the entire gain to be deemed passive. If the 12-month rule is not met, the gain must be prorated among the various uses during the 12-month period (Regs. §1.469-2T(c)(2)(ii)).

Substantially Appreciated Property Exception. If the property sold is used in a passive activity and the FMV of the property is more than 120% of its adjusted basis, a special rule applies. The gain from the property will be characterized as 100% passive income only if the property was used in the passive activity for 20% of the taxpayer's holding period for the property or the entire 24-month period before the disposition (Regs. §1.469-2T(c)(2)(iii)).

E. Miscellaneous Suggestions

1. Income from publicly traded partnerships cannot offset losses from other passive activities. Don't invest in these activities if the sole purpose of the investment is to use the income to offset passive activity losses, it won't work.
2. Consider liquidating portfolio income investments and using these funds to reduce passive activity debt (e.g., rental real estate). This reduces passive losses (by reducing interest expense).
3. Use proceeds from qualifying residence loans to reduce passive activity debt.
4. Review the allocation of deductible common expenses between material participation businesses and passive businesses.

Rental Property Issues

A. When Is Rental Income Subject To S/E Tax (CCA 202151005)?

1. **Background: S/E Tax.** §1401(a) imposes a tax on an individual's net earnings from self-employment (i.e., the S/E tax). However, under §1402(a)(1), "net rental income," generally isn't subject to S/E tax unless the income is received in the course of a trade or business as a "real estate dealer." Reg 1.1402(a)-4(c)(1) provides that rentals from living quarters, where no services are rendered for the occupants, are generally considered rentals from real estate under §1402(a)(1), except in the case of real estate dealers who receive rentals in the course of their trade or business as a real estate dealer. However, Treas. Reg. §1.1402(a)-4(c)(2) provides that payments for the use or occupancy of rooms or other space where services are also rendered to the occupant are included in determining net earnings from self-employment. **Generally, services are considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.** Reg 1.1402(a)-4(c)(2) says that examples of rentals where substantial services are rendered for the occupants' convenience include hotels, boarding houses, warehouses, and storage garages. However, in *Hopper v Commissioner*, 94 T.C. 542, 548 (1990), the Tax Court held that net rental income from storage units where the landlord also provided a soft drink machine and sold locks, packaging materials, pallets, and insurance, was excluded from the owners' S/E income because the services provided for the convenience of the occupants of the storage units were not substantial.

Rev. Rul. 57-108 suggests that, in the case of vacation property, the services for the convenience of the occupants must be substantial, such as maid services, swimming and fishing instructions, and furnishing local transportation schedules. In addition, in **Rev. Rul. 57-10** the IRS ruled that a landlord who rented furnished vacation beach dwellings and rendered services "for the comfort and convenience of his guests in connection with their recreational activities"—including maid services, swimming and fishing instruction, mail delivery, furnishing of bus schedules, and information about local churches—rendered services primarily for the occupants' convenience. Consequently, the net rental income from the vacation beach dwellings was subject to S/E tax.

To summarize, rental income is not generally subject to S/E tax unless **1)** the income is received by a real estate dealer in the course of the real estate dealer's trade or business **or 2)** substantial services are provided to the occupants for the occupants' convenience.

2. **CCA 202151005.** This Chief Counsel Advice analyzes two situations. In Situation 1, the CCA concludes the rentals are subject to S/E tax. In situation 2, it concludes the rentals are not subject to S/E tax.

CCA 202151005 says the following: "*In situations not involving a real estate dealer, net rental income from the rental of living quarters is considered "rentals from real estate" excluded from NESE [net earnings from self-employment] when no services are rendered for the occupants. However, if services are rendered for the occupants and the services rendered (1) are not clearly required to maintain the space in a condition for occupancy, and (2) are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent, then the net rental income received is not excluded under §1402(a)(1) and is included in NESE.*"

Situation 1 From CCA: Rentals from Vacation Property Subject to S/E Tax

Facts. The taxpayer is an individual who **directly and solely owns and rents**, in the course of a trade or business, a fully furnished vacation property **via an online rental marketplace** (e.g., Airbnb). The taxpayer is not a real estate dealer within the meaning of Treas. Reg 1.1402(a)-4(a) and the taxpayer does not use the property personally during the year. **The taxpayer provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant.** In addition, the taxpayer **provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest business district.**

Conclusion. The IRS Chief Counsel concluded the rental income in this case is subject to the S/E tax "**because the taxpayer provides substantial services beyond those required to maintain the space**

in a condition suitable for occupancy. See Bobo, 70 T.C. at 710; Rev. Rul. 83-139. Whether services are considered rendered for the occupant is based on the particular facts and circumstances in each case. See Hopper, 94 T.C. at 548 (1990). Here, the payments made to the taxpayer for these services are for the convenience of the property's occupants. The services go beyond those clearly required to maintain the space in a condition for occupancy and are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent. Thus, the payments are not excluded under §1402(a)(1) but rather are included in NESE.” [Emphasis added]

Situation 2 From CCA: Rentals from Vacation Property Not Subject to S/E Tax

Facts. The taxpayer is an individual who **directly and solely owns and rents**, in the course of a trade or business, a fully furnished room and bathroom in a dwelling **via an online rental marketplace**. The taxpayer is not a real estate dealer and the taxpayer does not use the property personally during the year. Occupants only have access to the common areas of the home to enter and exit the room and the bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer **cleans the room and bathroom in between each occupant's stay**.

Conclusion. The Chief Counsel concluded the rental income is not subject to the S/E tax **“because the taxpayer does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy. See Bobo, 70 T.C. 706 at 710; Rev. Rul. 83-139. Services the taxpayer provides to clean and maintain the property to bring it to a suitable condition for occupancy are not relevant in applying Treas. Reg. §1.1402(a)-4(c)(2) because such services are not furnished primarily for the convenience of the property's occupants. See Hopper, 94 T.C. at 547. Further, services provided for the convenience of occupants must be substantial, and whether provided services are substantial depends on the facts and circumstances of each case. See id. at 548. Specifically, the services provided for the convenience of the occupants must be of such a substantial nature that compensation for them can be said to constitute a material part of the payments made by the occupants. See id. at 546 (citing Delno, 347 F.2d at 166). No such services are provided in Fact Situation 2.”** [Emphasis added]

Planning Pointer. This CCA provides a listing of authorities that can be very helpful in determining if rentals are subject to S/E tax. However, it's clear that each case turns on its own facts!

B. Are Real Estate Rentals Reported on Schedule E Or Schedule C?

1. IRS Q&A 60 Included In IRS §199A FAQ.

“Q60. If rental real estate is treated as a trade or business for purposes of the QBID (discussed in Q&A 56), do I report the rental real estate on Schedule C of my Form 1040, and is it subject to self-employment tax?

A60. In general, the answer to both questions is no. How rental real estate is reported on Form 1040 has not changed due to the QBID. Rental real estate is usually reported on Schedule E, Part I, and is not subject to self-employment tax.

Even if rental real estate rises to the level of a §162 trade or business, it is generally reported on Schedule E, Part I, because rental real estate is generally excluded from self-employment taxable income under §1402(a)(1).

However, some rental real estate is subject to self-employment tax (e.g., boarding house, hotel or motel, and bed and breakfast, where substantial services are rendered for the convenience of the occupants). Rental real estate subject to self-employment tax is reported on Schedule C.” [Emphasis added]

C. When Does Rental Income Qualify for §199A QBI Deduction?

For the income from rental property, or any other business, to be QBI, Reg 1.199A-1(b)(14) requires the business to be a §162 trade or business. There are three ways to show the rental of real property is a §162 trade or business: 1) Qualifying under the §162 trade or business safe harbor outlined in Rev. Proc. 2019-38, 2) Qualifying under the Self-Rental safe harbor under Reg 1.199A-1(b)(14), or 3) Based upon facts and circumstances.

1. Rev. Proc. 2019-38 Deemed §162 Trade or Business Safe Harbor for Rental Real Estate Enterprise.

Generally, an individual or pass-through entity meets the §162 safe harbor under Rev. Proc. 2019-38 and may treat a rental real estate enterprise as a §162 trade or business if 1) the owner of the rental real estate “enterprise” or someone else (e.g., employees, independent contractors, etc.) provides at least 250 hours of the types of services recognized under Rev. Proc. 2019-38 with respect to the rental real estate enterprise for the year; 2) separate books and records are maintained for each rental real estate enterprise; 3) for taxable years beginning after 2019, the taxpayer or pass-through entity keeps contemporaneous records, including time reports, logs, or similar documents, documenting the hours for all services performed, a description of the services performed, dates the services were performed, and who performed the services; 4) the lease is not a “triple net lease” as defined in Rev. Proc. 2019-38, and 5) a statement is attached to the tax return stating that the requirements of the safe harbor have been satisfied (including the contemporaneous records requirement for tax years beginning after 2019).

Practice Alert! A concern with using the safe harbor is whether the individual or pass-through entity owning the rental real estate enterprise will be willing to include a statement with the return that the individual or pass-through entity has contemporaneous records of the hours of rental services provided, the types of services provided, and who performed those services. “Contemporaneous” records were not required for 2018 or 2019. However, “contemporaneous” records are required for 2020 and subsequent years to use the safe harbor under Rev. Proc. 2019-38.

2. Self-Rental §162 Trade or Business Safe Harbor. Reg 1.199A-1(b)(14) provides that the rental or licensing of tangible or intangible property to a §162 trade or business is treated as a §162 trade or business if the rental or licensing activity and the §162 trade or business are commonly controlled under Reg 1.199A-4(b)(1)(i) and the lessee is not a C corporation. Reg 1.199A-4(b)(1)(i) provides that businesses are “Commonly Controlled” if the businesses are owned 50% or more by the same person or group of persons. In determining if there is 50% or more common ownership, the attribution rules under §267(b) or §707(b) apply.

3. Facts and Circumstances. If an individual or pass-through entity does not qualify for or chooses not to use the 250-hour safe harbor under Rev. Proc. 2019-38 and the self-rental safe harbor does not apply, whether the rentals constitute a §162 trade or business is a facts and circumstances determination.

Practice Pointer! If the owner of a rental “enterprise” or someone else (e.g., employees, independent contractors, etc.) provides at least 250 hours of the types of services recognized in the safe harbor under Rev. Proc. 2019-38 with respect to the rental real estate property or properties owned by an individual or pass-through entity, it is arguable that the rental real estate property or properties are §162 trade or business activities without the safe-harbor. If we can demonstrate the rental real estate activity is a §162 trade or business activity based upon facts and circumstances, the rental income would be QBI.

The Supreme Court said in *Groetzinger*, 59 AFTR 2nd 87-532, to be a §162 trade or business, the activity must be **conducted for profit and conducted with regularity and continuity**. In addition, to understand when the courts, in general, have recognized a rental activity as a §162 trade or business, your authors suggest reading the “trade or business” segment of a 2013 article in the Journal of Taxation by Todd Keator. Although Mr. Keator’s article focuses on the 3.8% net investment income tax under §1411, his discussion of whether renting real estate constitutes a §162 trade or business is relevant under §199A and his article analyzes the bulk of the case law on the issue. You can find the article by googling “Journal of Taxation, Todd Keator.” Mr. Keator concludes in the article “*the holding of real estate for rental usually (and perhaps ‘almost always’) constitutes a trade or business activity, even if the activity involves only a single rental and the taxpayer’s efforts with respect to the rental are modest in scale * * * Provided the taxpayer leases the property with continuity and regularity, and with the intent to earn a profit.*”

A review of the cases cited in this article (especially those discussed on pages 63, 64 and 65 of the article) confirms Mr. Keator's conclusions. However, on page 65 of the article Mr. Keator says, "a triple-net lease is the most likely candidate to fail the trade or business determination, although this may not be certain in every instance." Therefore, where rental properties do not qualify for any of the safe harbors, it would be preferable to avoid triple-net leases if possible.

IRS QBI FAQ 65 Speaks to Triple Net Leases. IRS FAQ 61 says the following

"Q65. Triple net leases do not qualify for the safe harbor of Revenue Procedure 2019-38. Does this mean that income, gains, deductions, and losses from a triple net lease can never be included in QBI?"

A65. No. As explained in Q&A 56, rental real estate is treated as a trade or business for purposes of the QBID if it rises to the level of a §162 trade or business, is a self-rental as described in Treas. Reg. §1.199A-1(b)(14) or is a rental real estate enterprise relying on the safe harbor described in Revenue Procedure 2019-38. Revenue Procedure 2019-38 only excludes triple net leases from being included in a rental real estate enterprise (and are therefore not eligible for the safe harbor).

A single triple net lease does not generally rise to the level of a §162 trade or business. See Notice 2006-77. However, if rental real estate involving a triple net lease is otherwise treated as a trade or business under §199A, then the income, gains, losses, and deductions would be included in QBI. [Emphasis added]

Practice Alert! FAQ 65 indicates that income from a single triple net lease could be QBI where the lease is a self-rental under Reg 1.199A-1(b)(14). Also, several triple net leases may constitute a §162 trade or business qualifying for the QBI deduction where the individual or pass-through entity owns multiple properties subject to triple net leases which require someone to manage the properties, etc., on a regular, continuing basis as required by the Supreme Court in *Groetzinger*. However, to be safe for triple net leases that are not self-rentals, taxpayers should consider renegotiating existing triple-net leases if possible so the owner must pay the taxes and insurance and is responsible for the lawn care and landscaping, janitorial service, garbage pickup, repairs, and maintenance. If this is done, there are two potential benefits: **1)** the owner will not be prohibited from using the 250-hours safe harbor under Rev. Proc. 2019-38, **and 2)** if the safe harbor is not used, the landlord has a more than fighting chance the rental activity is a §162 trade or business activity, even where the lease involves a single rental property.

D. IRS Has New "Interactive Tax Assistant" for Determining if Residential Rental Income Is Taxable and Expenses Are Deductible (IRS Website)

The IRS has developed an "Interactive Tax Assistant" at its website to assist individuals in determining if residential rental income is taxable and if expenses are deductible. Taxpayers make this determination by answering a series of questions. The interactive assistant can be found at the following URL:

<https://www.irs.gov/help/ita/is-my-residential-rental-income-taxable-and-or-are-my-expenses-deductible>

The next item in this segment outlines the tax rules utilized in this "Interactive Tax Assistant."

E. §280a(C) Limitations on Deductions For Dwelling Units Used for Both Business and Personal Purposes, AKA Vacation Homes (§280A(c)(5))

1. **Code Sec. 280A(c)(5)** limits the deductions attributable to the rental of a dwelling unit if the taxpayer personally uses the dwelling unit for more than the greater of:
 - a. **14 days, or**
 - b. **10% of the number of days** in the tax year for which the **dwelling unit is rented** at a fair rental.
2. If Sec. 280A(c)(5) applies, the deductions allowed with respect to the rental activity cannot generally exceed the gross rents. **Excess deductions allocable to rental use are carried over to subsequent years.**

3. Deductions must be prorated between personal and rental use, whether the taxpayer exceeds the 14-day-10% rule or not.
4. **§280A(g)** provides that if a dwelling unit is used during the taxable year as a residence (i.e., more than the greater of 1) 14 days or 2) 10% of rental days) and such dwelling unit is **rented for less than 15 days** during the year then, the income from the rental is not included in gross income and the deductions allowable because of the rental use are not deductible. Other expenses allowed regardless of rental are deductible as provided on Schedule A (e.g., interest and taxes).
5. **Dwelling Unit.** A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property; **but does not include that portion of a dwelling unit used exclusively** as a hotel, motel, inn, or similar establishment.
6. **Planning Considerations Involving Losses From Vacation Home.** The following are planning considerations resulting from using a residence for personal purposes.

If Owner's Personal Use Does Not Exceed The Greater Of: 1) 14 Days Or 2) 10% Of Rental:

- a. Losses are not subject to 280A limitation,
- b. If the average period rented is more than seven days, the losses are generally passive activity rental losses.
 - The losses may be allowed in full under the active rental real estate rule of §469(i) (maximum \$25,000), **or**
 - The losses are generally limited to passive income if not "active" or if AGI is over \$150,000.
- c. If the average period rented is seven days or less, the property is trade or business property.
 - If the client "materially participates" in the activity, any losses are not passive activity losses.
 - If the client does not materially participate in the activity, the losses are only allowed to the extent there is passive activity income.
 - The \$25,000 active rental rule is not available since the property is not classified as rental property because the average period rented is seven days or less.
- d. The personal use percentage of interest applicable to the vacation home will not be second home interest (since the residence is not used more than 14 days personally (§163(h)(4)). Apparently, the IRS will treat the interest allocated to Schedule A as personal interest which is not deductible. However, treatment as personal interest is not entirely clear.

Practice Alert! Under §163(h)(4)(A)(iii), if the owner does not rent the second home at all during the tax year, then the owner may treat the entire interest as qualified residence (second home) interest, even if the owner does not use the residence personally at all. **Example.** A client uses the vacation home 14 days personally and rents the home 20 days. In this case, (reading the law literally) 41% (14 days ÷ 34 days) of the interest on the vacation home mortgage would be allocated to Schedule A. The IRS will apparently argue that this is personal interest.

Practice Alert! Assuming this is the client's only home in addition to their principal residence, one additional day of personal use (i.e., at least 15 days) would ensure a deduction of 100% of the interest allocated to Schedule A. The interest allocated to Schedule A under these facts should be qualifying (2nd home), residence interest.

If more than 14 days (or 10% of rental days) of personal use:

- a. Losses are subject to the §280A limitations,
- b. Losses are not subject to the passive activity rules, and
- c. The interest allocable to the Schedule A will be qualified residence interest, if this is the client's only home other than a principal residence.

F. Tax Court Says No Deduction for Depreciation and Interest Related to Portion of Bed and Breakfast Used for Both Business and Personal Purposes (C.E. Anderson, TC Memo. 2006-33, Feb. 27, 2006)

1. Facts

- The Andersons operated a bed and breakfast (the Inn).
- The Inn had **5,664 square feet of useable floor space** and consisted of three floors: a **main floor**, an **upstairs floor**, and a **basement**.
- In 2000, the Inn had **289 separate room rentals** from which the Andersons received **rental income of \$26,476**.
- Of the Inn's **total 5,664 square feet**, **4,363 square feet were used exclusively in the business** of operating the bed and breakfast.
- **695 square feet** were used **exclusively** for their **personal** purposes.
- **606 square feet** were used for **both business and personal** purposes.
- In calculating the depreciation and interest deductions for the bed and breakfast on their 2000 return, the **Andersons multiplied the total 606 square feet dual-use portion of the Inn by 75%** (the percentage of time this portion of the Inn was used for business purposes), resulting in **455 square feet**.
- The Andersons then **added this 455 square feet to the 4,363 square feet** of the Inn used exclusively for business, and calculated that a total of **4,818 square feet** of the Inn was used in the business of the bed and breakfast. They then **calculated a business-use percentage of 85%** for the entire Inn by **dividing the total business square feet of 4,818 by the Inn's total square feet of 5,664**.
- On Schedule C of their 2000 joint return, the Andersons applied the above percentages (**85% business, 15% personal**) to the **total depreciation and interest expenses relating to the Inn**. The taxpayers argued that the Inn came under the Hotel exception of §280A(f)(1)(B) and therefore all business use counts even though it is not exclusively business use. (§280A(f)(1)(B) says that a "dwelling unit" subject to the §280A limitations does not include that portion of a unit which is used **exclusively** as a hotel, motel, inn, or similar establishment.)
- On audit, the **IRS** applied the exclusive-use limitation of §280A(f)(1)(B) and **disallowed all business deductions relating to the dual-use portion of the Inn**.
- The IRS allowed **77% of the depreciation and interest deductions [based on the 4,363 square feet of the Inn used exclusively in the business (4,363 divided by 5,664)]**.

2. Conclusion

- 1) The Tax Court concluded the **Andersons were not entitled to deductions related to the dual-use portion of the Inn**.
- 2) The court said that **once the personal use of a residence exceeds the 14-day or 10-percent trigger of §280A(d)(1), the only portion of a hotel, motel, inn, or bed and breakfast that is excepted from the general disallowance rule of §280A(a) is that portion that is used exclusively in the business**.
- 3) The court said that under §280A(f)(1)(B), however, the portions of a dwelling used exclusively as a hotel, motel, inn, or similar business, will not be considered part of the dwelling unit for purposes of the disallowance rule of §280A(a).

ESTATE AND GIFT TAX KEY ISSUES

A. IRS Provides Simplified Procedure to Make Late Portability Election (Rev. Proc. 2022-32, July 8, 2022)

1. **Background.** §2010(c)(2) provides that the applicable exclusion amount for estate and gift tax purposes is the sum of the basic exclusion amount, and, in the case of a surviving spouse, the deceased spousal unused exclusion amount (DSUE amount). §2010(c)(3) provides **the basic exclusion amount** available to the estate of every decedent. This amount is adjusted for inflation annually after calendar year 2011. For example, the basic exclusion amount **for 2022 is \$12,060,000.**

§2010(c)(4) defines the **DSUE amount** as the lesser of 1) the basic exclusion amount, or 2) the excess of — a) the applicable exclusion amount of the last deceased spouse of the surviving spouse, over b) the amount with respect to which the tentative tax is determined under §2001(b)(1) on the estate of such deceased spouse.

Estate Must Timely Elect For Surviving Spouse To Receive DSUE Amount. A decedent's estate must make a timely election to allow the surviving spouse to utilize any of the decedent spouse's unused exclusion amount. This is called a portability election. If the election is not made, the surviving spouse may not utilize any unused exclusion amount of the deceased spouse (DSUE amount).

- a. **Due Date of Portability Election Is Normally Due Date of 706 Including Extensions Per §2010(c).** §2010(c)(5)(A) provides that a **DSUE amount may not be taken into account by a surviving spouse unless the executor of the estate of the deceased spouse files an estate tax return (Form 706) on which such amount is computed and makes an election on the Form 706** that such amount may be taken into account by the surviving spouse. The election, once made, is irrevocable. Regulation 20.2010-2(a)(1) provides that **the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained).**
- b. **Rev. Proc. 2017-34 Generally Granted An Extension Until Second Anniversary of Decedent's Death.** Rev. Proc. 2017-34 provides that **executors who were not required to file Form 706 under §6018(a) but failed to timely file Form 706 to make the portability election may be eligible for an extension under Rev. Proc. 2017-34.** These executors could generally file Form 706 and elect portability on or before the second anniversary of the decedent's death.
- c. **Filing Private Letter Ruling Request For An Extension of Time To File Form 706 And Make a Portability Election.** Any estate that is filing an estate tax return only to elect portability and did not file timely or within the extension provided in Rev. Proc. 2017-34 could seek relief under Regulation 301.9100-3 to make the portability election. Under Regulation 20.2010-2(a)(1), an extension of time under Regulation 301.9100-3 to make a portability election may be granted in the case of an estate that is not required to file an estate tax return under §6018(a), as determined solely based on the value of the gross estate and any adjusted taxable gifts and without regard to any DSUE amount. Under Regulation 301.9100-1(c), the Commissioner has discretion to grant a reasonable extension of time under the rules in Regulations 301.9100-2 and 301.9100-3 to make a regulatory election, or a statutory election (but no more than six months for a statutory election except in the case of a taxpayer who is abroad), under all subtitles of the Internal Revenue Code except subtitles E, G, H, and I.

Regulation 301.9100-3 provides the standards the Commissioner will use to determine whether to grant an extension of time to make an election whose due date is prescribed by a regulation (and not expressly provided by statute). Requests for relief under Regulation 301.9100-3 will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.

How To Make Portability Election. A portability election is made **by properly completing Form 706 in accordance with the instructions for the Form.** Under the special rule of Regulation 20.2010-2(a)(7)(ii), executors of estates who are not required to file Form 706 under §6018(a), but who are filing to elect portability of the DSUE amount to the surviving spouse, are not required to report the value of certain property eligible for the marital deduction under §2056 or 2056A or the charitable deduction under §2055. However, the value of those assets must be estimated and included in the total value of the gross estate. See the Form 706 instructions for Part 5—Recapitulation, lines 10 and 23 for more information. Also, for more specific information, see the instructions for Schedules A through I of Form 706.

2. **Rev. Proc. 2022-32 Provides New Simplified Method For Obtaining Extension Of Time To Make DSUE Election Until Fifth Anniversary Of Decedent's Death.** Rev. Proc. 2022-32 supersedes Rev. Proc. 2017-34 and provides a simplified method for certain estates to obtain an extension of time under Reg 301.9100-3 to file a return on or before the **fifth anniversary of the decedent's death to elect portability of the deceased spousal unused exclusion (DSUE) amount** pursuant to §2010(c)(5)(A). This revenue procedure applies to estates that are not normally required to file an estate tax return because the value of the gross estate and adjusted taxable gifts is under the filing threshold in §6018(a).

The simplified method provided in this revenue procedure is **to be used in lieu of the letter ruling process. No user fee is required for submissions filed under this revenue procedure.**

The IRS says it continues to receive private letter ruling requests under Reg 301.9100-3 for extensions of time to file the DSUE election. The number of these requests continues to place a significant burden on the available resources of the IRS. The Service says it has observed that a significant percentage of these ruling requests have been from estates of decedents who died within five years preceding the date of the request. Therefore, Rev. Proc. 2022-32 supersedes Rev. Proc. 2017-34 by extending the period within which the estate of a decedent may make the portability election under a simplified method on or before the fifth anniversary of the decedent's date of death.

3. **Estates Qualifying For Extension. This extension of time provided by Rev. Proc. 2022-32 is available to the executor of an estate if the following requirements are met:**

- 1) The decedent:
 - a) was survived by a spouse;
 - b) died after Dec. 31, 2010; and
 - c) was a citizen or resident of the United States on the date of death;
- 2) The executor is not required to file an estate tax return under §6018(a) as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;
- 3) The executor did not file an estate tax return within the time required by Reg 20.2010-2(a)(1) for filing an estate tax return; **and**
- 4) The executor satisfies all requirements of §4.01 of Rev. Proc. 2022-32.

4. **Requirements For Obtaining Relief Under §4.01 Of Rev. Proc. 2022-32.** §4.01 of Rev. Proc. 2022-32 says that to obtain relief under Rev. Proc. 2022-32:

- 1) The executor of the estate, as described in Reg 20.2010-2(a)(6), must file a complete and properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on or before the fifth annual anniversary of the decedent's date of death. IRS says the Form 706 will be considered complete and properly prepared if it is prepared in accordance with Reg 20.2010-2(a)(7).
- 2) The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)."

5. **Executors that Timely Filed an Estate Tax Return Do Not Qualify For Rev. Proc. 2022-32 Relief.** The IRS says the simplified method for obtaining an extension of time to make a portability election under this

revenue procedure is not available to the estate of a decedent whose executor filed an estate tax return within the time prescribed by Reg 20.2010-2(a)(1). The IRS says such an executor either will have elected portability of the DSUE amount by timely filing that estate tax return or will have affirmatively opted out of portability in accordance with Reg 20.2010-2(a)(3)(i).

- 6. Impact Of Late Election Relief On Surviving Spouse.** §5 of Rev. Proc. 2022-32 explains the impact of a late DSUE election on the decedent's surviving spouse. §5 says **If the decedent's estate is granted relief under this revenue procedure so that the estate tax return is considered timely filed for purposes of electing portability, the DSUE amount of that decedent is available to the decedent's surviving spouse or the estate of the surviving spouse** for application to the surviving spouse's transfers made on or after the decedent's date of death in accordance with the rules prescribed for estate taxes under Reg 20.2010-3 and the rules prescribed for gift taxes under Reg 25.2505-2. However, if the increase in the surviving spouse's applicable exclusion amounts attributable to the addition of the decedent's DSUE amount results in an overpayment of gift or estate tax by the surviving spouse or his or her estate, **no claim for credit or refund may be made if the statute of limitations under §6511(a) for filing a claim for credit or refund has expired.**

Practice Alert! §5.03 of Rev. Proc. 2022-32 provides three examples of the use of the DSUE amount by the surviving spouse or her or his estate triggered by a late portability election under the revenue procedure. In example 1, the statute of limitations on refunds for the estate taxes on the surviving spouse's estate will run before the late election is filed under Rev. Proc. 2022-32. In that example the IRS says the surviving spouse's executor may file a protective claim for refund in anticipation of obtaining an extension of time under Rev. Proc. 2022-32 and the protective claim will keep the statute of limitations open up to the amount in the protective claim.

B. U.S. Supreme Court Holds That Obligation to Redeem Stock Does Not Reduce Value of Stock for Estate Tax Purposes (*Connelly v. United States*, No. 23-146, June 6, 2024)

- 1. Summary.** In a unanimous opinion June 6 in *Connelly v. United States*, the Supreme Court ruled that “a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares” in calculating estate tax. The taxpayers had argued that life insurance proceeds received by a closely held corporation to fund the redemption of a deceased shareholder's interest was reduced by the redemption obligation in valuing the stock in the corporation for estate tax purposes. However, the court ruled that life insurance proceeds increase the estate tax value of a closely held corporation and aren't offset by the corporation's obligation to redeem a deceased shareholder's interest.

This case should be considered when creating a redemption agreement funded by life insurance. More life insurance may be needed to accomplish the intent of the parties if a deceased shareholder is redeemed by the corporation. However, shareholders should consider having the remaining shareholder or shareholders purchase the deceased shareholder's shares and funding the individual obligation with life insurance. **Practice Alert!** A cross-purchase agreement would require each shareholder to pay the premiums for the insurance policy on the other shareholder or shareholders, creating a risk that one of the shareholders would be unable to do so.

- 2. Prior Court Decisions.** In 2004, the Tax Court ruled in *Estate of Blount*, T.C. Memo. 2004-116, that a redemption obligation funded by life insurance proceeds did not reduce the fair market value of the corporation for estate tax purposes. However, in 2005, the Eleventh Circuit Court of Appeals in *Estate of Blount v. Commissioner*, 428 F.3d 1338, overturned the Tax Court and held that life insurance proceeds shouldn't be included in the company's value when offset by a redemption obligation. In July, 2023, the Eighth Circuit Court of Appeals held in *Thomas A. Connelly et al. v. United States* that a redemption obligation funded by life insurance proceeds did not reduce the fair market value of the corporation for estate tax purposes. The U.S. Supreme Court has now agreed with the Tax Court and the Eighth Circuit Court of Appeals.

C. Final Regulations on Estate Tax Basis Reporting ([T.D. 9991](#)).

- 1. Background.** §2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (2015 Act), enacted §§1014(f), 6035, 6662(b)(8), 6662(k), 6724(d)(1)(D), and 6724(d)(2)(II) of the Code to require consistency between a recipient's basis in certain property acquired from a decedent and

the value of the property as finally determined for Federal estate tax purposes. §1014(f) sets forth the consistent basis requirement, while the procedural rules in §§6035, 6662, and 6724 set forth the applicable reporting requirements, penalties, and definitions. §1014(f)(1) provides that the basis of certain property acquired from a decedent cannot exceed that property's final value for purposes of the Federal estate tax imposed on the estate of the decedent, or, if the final value has not been determined, the value reported on a required Statement. This statutory rule is referred to as the *consistent basis requirement*.

- 2. Final Regs.** The final regulations have been issued on the consistency of the basis between an estate and a person acquiring property from the decedent under §1014(f) as well as the reporting by executors of estates required to file a return to provide basis information to the IRS and recipients of certain property under §6035. The regulations provide guidance on how to comply and vary very little from the proposed regulations ([REG-127923-15](#)) issued in March 2016. The final regulations are effective Sept. 17, 2024. **Practice Alert!** The final regs make it clear that the reporting requirements do not apply if no estate tax return is required to be filed under §6018 even if the executor files an estate tax return for other purposes, including without limitation to make a generation-skipping transfer tax exemption allocation or election, a portability election, or a protective filing to avoid a penalty if an asset value is later determined to cause a return to be required or otherwise.

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