THE TAX ADVISER®

THE MAGAZINE OF PLANNING, TRENDS & TECHNIQUES ■ OCTOBER 2022

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24 10 good reasons why LLCs should not elect to be S corporations

By Paul N. Iannone and Danny A. Pannese

The owners of an LLC may be tempted to have the LLC elect to be treated as an S corporation for federal tax purposes. However, there are a host of issues that should be considered before making this move. In this article, the authors discuss 10 reasons why it may not be beneficial for an LLC to make an S corporation election.

34 Publicly traded partnerships: Investors' tax considerations

By Laura Hinson and Kathryn Neely

Interests in publicly traded partnerships (PTPs) can be a valuable part of an investor's portfolio, but because these investments are partnership interests, the tax reporting for them can be complex, and losses passed through by PTPs may be limited. This article discusses the tax compliance and loss limitation issues involved with, and tax planning considerations for, holding interests in PTPs.

On the cover On the cover and above: Images by Hector Roqueta Rivero/Getty Images

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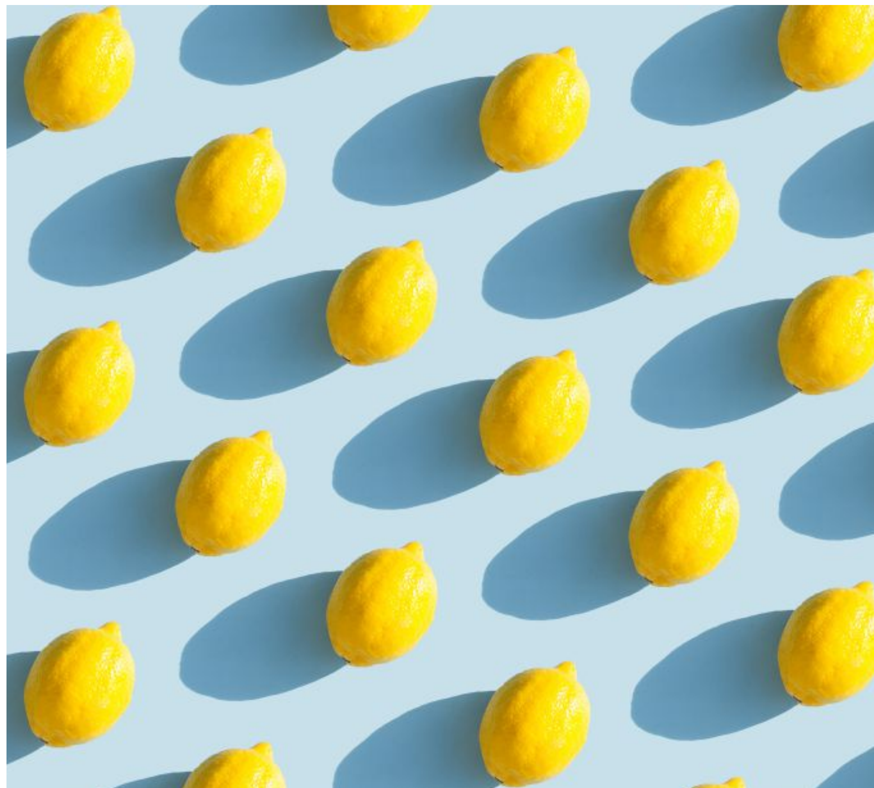

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A Publication of the American Institute of CPAs

The Tax Adviser (ISSN 0039-9957) October 2022. Published monthly. Volume 53, Number 10. Publication, editorial, and business office, 220 Leigh Farm Road, Durham, NC 27707.

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TAX CLINIC

Practical advice on current issues.

Editor:
Mark Heroux, J.D.

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Employee retention credit: Navigating the suspension test

Establishing eligibility for the employee retention credit (ERC) by satisfying the business operations suspension test (suspension test) is similar to venturing into remote parts of the world: The payoff from a successful journey can be tremendous, but the road is arduous. Complexity adds uncertainty, guidance is lacking, and what appears to be an easy path may lead you off a cliff.

While the ERC program has fully sunset, employers may still file claims for any credits they were entitled to in 2020 through the third quarter of 2021, and interest remains strong. Like a sign on a path warning of danger ahead, this item is intended to help mitigate risk for those still pursuing the ERC by (1) breaking down the suspension test into its core components and (2) shedding light on areas to proceed with caution. As an aside, this is a complex analysis with many moving parts, most of which are beyond the scope of this discussion, and consulting someone with experience is advisable.

The suspension test overview

Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, and Notice 2021-20, an employer can be eligible for the ERC if it experiences a full or partial suspension or modification of operations due to COVID-19-related orders from an appropriate governmental authority. This is the suspension test, and it is one of three means for eligibility, the others being relatively objective determinations of whether a business experienced a "significant decline" in gross receipts or qualifies as a "recovery startup business." Unlike those other methods of qualifying for the ERC, the suspension test is highly subjective, based on facts and circumstances, lacks a significant amount of guidance, and is subject to additional limitations. To help understand the test, it is best broken down into its core components.

The suspension test is a two-part test, applied on a quarterly basis, in which an employer must establish:

1. It is subject to a governmental order in effect, and
2. The order has more than a nominal impact on its business operations, either due to suspending them or requiring modifications to them.

IMAGE BY NATAPONG SUPALERTSOPHON/GETTY IMAGES

The ERC rules are complex, and guidance, while limited, includes substantial warnings for employers that aggressively interpret the rules or fail to conduct appropriate due diligence before reporting the credit.

For establishing that suspensions and modifications of business operations have occurred, Notice 2021-20 provides employers with safe-harbor tests, as will be discussed in more detail later. For a suspension, employers must show that *more than a nominal portion* of business operations were affected. For a modification (for example, a change made to satisfy social-distancing requirements), employers must show that the modification caused *more than a nominal effect* on business operations. It is critical to distinguish between whether a suspension or modification has occurred in order to apply the relevant safe-harbor test. Employers with one or more components of their operations suspended or modified should strive to meet the applicable safe harbor, as failure to do so increases the risk that the IRS may challenge their eligibility. In the event an employer cannot meet a safe harbor, it still may be eligible for the ERC if it can otherwise show that the governmental order impacted business operations more than nominally.

Test 1: Governmental order

The first part of the suspension test is whether the employer is subject to a relevant governmental order. Eligibility for

the ERC under the suspension test requires an order, proclamation, or decree from a federal, state, or local government that limits commerce, travel, or group meetings due to COVID-19. The level of enforcement of the government order is irrelevant for these purposes. Notice 2021-20 indicates that an issuing state or local government must have jurisdiction over the employer's operations.

Satisfactory examples of a government order include a state governor's mandating that all nonessential businesses must close until further notice, a city mayor's requiring all businesses to limit occupancy to 50% of legal capacity, and a local health department's ordering all establishments to close four hours early to clean and disinfect the premises to mitigate the spread of COVID-19. Critically, note that in each instance, compliance is *mandatory*; conversely, government action that does not qualify would include a government official merely encouraging diligence in maintaining social distancing or avoiding unnecessary travel or guidance issued by the Centers for Disease Control and Prevention (CDC), as compliance is voluntary.

It is highly recommended that employers save copies of the applicable governmental orders, identify the effective date ranges of the orders and the applicable language impacting the employer, and provide a robust narrative detailing the specific impacts of the order on their operations. As noted above, while an employer can still be eligible for the ERC under the suspension test if it does not meet either of the safe harbors, discussed below, that scenario demands a detailed and compelling narrative that establishes that the government order imposed more than a nominal impact on business operations.

Test 2.a: Suspension: More-than-nominal portion

The second part of the suspension test is whether the government order has more than a nominal impact on business operations. There are two available safe harbors for demonstrating this. To the extent an employer's operations are *suspended*, the employer should utilize the more-than-nominal *portion* safe-harbor test. Under this test, the impacted portion of an employer's operations will be deemed "more than nominal" for the quarter in which the employer is testing eligibility if either:

- The gross receipts from that portion of the business make up at least 10% of the employer's total gross receipts (both determined using the gross receipts from the same calendar quarter in 2019); or
- The hours of service performed by employees in that portion of the business make up at least 10% of the employer's total employee service hours (both determined using the service hours performed by employees in the same calendar quarter in 2019).

> ***Example 1:*** A restaurant must close (i.e., a suspension of business) its on-site dining due to a governmental order (test 1 met). The restaurant is allowed to continue sales to the public via carryout and delivery. Because it can no longer offer on-site dining, which represented 30% of the restaurant's total gross receipts in the same quarter of 2019, a more-than-nominal portion of operations has been impacted (test 2.a met). As both parts of the suspension test are met after applying the appropriate safe harbor, the restaurant is eligible for the ERC.

Caution: This "lookback" test considers historical information from 2019. While at face value it seems simple, the guidance is not clear on how the factors (i.e., numerator and denominator) should be considered for complex organizational structures (e.g., franchises in multiple jurisdictions with varying levels of suspension, aggregated employers with multiple separate and distinct trades or businesses, etc.). Without clearer guidance on how to utilize the safe harbor for these complex scenarios, questions remain as to how to apply the test properly.

Test 2.b: Modification: More-than-nominal effect

To the extent an employer's operations are *modified*, the employer should utilize the more-than-nominal *effect* safe-harbor test. Under this test, a modification will have more than a nominal effect if it results in a 10% or more reduction in an employer's ability to provide goods or services in its normal course of business.

Examples of ordered modifications that *may* result in a more-than-nominal effect (note the authors' caution below) include:

- Requiring occupancy restrictions and six-foot distancing; and
- Requiring performance of services only on an appointment basis.

Examples of modifications that likely do not result in a more-than-nominal effect include:

- Requiring employees and customers to wear face coverings; and
- Installing plexiglass or other barriers.

> ***Example 2:*** Assume the same facts as Example 1, except three months later under a further governmental order (test 1 met), the restaurant is permitted to offer indoor dining service, subject to a 50% capacity restriction (modification). This capacity restriction results in the restaurant having to turn away customers from eating indoors, and indoor sales are down considerably compared with the normal course (25% decrease in customers served, compared with the same quarter in 2019, showing a more-than-nominal effect (test 2.b met)). As both parts of the suspension test

are met after applying the appropriate safe harbor, the restaurant is eligible for the ERC.

Caution: The mere existence of a modification, including occupancy restrictions and requiring appointments for services, is insufficient. An employer must still establish that the mandated modification had more than a nominal effect on business operations, which can be demonstrated by showing a 10% or more reduction in the employer's ability to provide goods or services in its normal course of business. Unfortunately, Notice 2021-20 fails to provide quantifiable parameters by which this 10% reduction can be measured. As stated above, without clearer guidance, questions remain as to proper administration of the safe-harbor test.

Other considerations

There are also additional matters to consider in determining whether an employer qualifies for the ERC.

Comparable operations via telework: Some employers found themselves subject to governmental orders closing their workplaces entirely. At face value, this may seem like a clear-cut case to establish eligibility, yet this too requires additional analysis. In these situations, the employer still must establish that it was unable to continue comparable operations via telework. Notice 2021-20 provides four factors to consider when determining whether the employer could continue comparable operations via telework:

- Employer's teleworking capabilities;
- Portability of employees' work;
- Need for presence in employee's physical workspace; and
- Difficulty or delays in transitioning to telework operations.

Limitations on qualified wages: Two often-overlooked limitations apply to the suspension test:

- *Limitation to the period the order was in effect:* An employer may only count as qualified wages those wages for the period that the order was in effect. For example, an employer's operations may have been temporarily suspended for two weeks in the second quarter of 2020. Only wages pertaining to that two-week period can be treated as qualified, not all wages for the second quarter of 2020.
- *Limitation on trade or business:* The law and guidance appear to limit qualified wages to the specific trade or business that was suspended, and not all wages paid to all employees of the employer if the employer comprises multiple trades or businesses. Unfortunately, available guidance does not appear to contemplate this scenario, and the analysis is further complicated for employers spanning multiple jurisdictions.

Be cautious about taking aggressive positions

Where clear guidance is unavailable, ERC positions should be based on reasonable interpretations of current law and supplemental authority. The ERC was intended to provide relief to employers from the impact of COVID-19 but was not intended to be universally available. It seems clear the IRS will be examining credits claimed with intense scrutiny, as evidenced by Congress's extending the statute of limitation for assessment of payroll tax returns on which the ERC is claimed to five years (Sec. 3134(l)) and the issuance of Treasury regulations directing erroneous ERC claims to be treated as underpayments of payroll taxes and subject to assessment (T.D. 9904). Interest and penalties can additionally be assessed on erroneously claimed credits.

Employers deciding on their ERC position should also consider the significant cumulative costs of a failure to sustain the ERC upon audit, including costs to calculate the credit, compliance costs related to amended filings for claims and subsequent amendments to repay, costs to defend the position upon audit or in court, and the actual repayment. Further, it is possible that the ERC audit might not conclude until after the statute of limitation has expired for the income tax return on which the employer appropriately did not claim deductions for wages giving rise to the credit, as required by CARES Act, Section 2301(e), and Sec. 3134(e). In this case, the employer would be unable to amend its income tax return to take the deductions, meaning it effectively paid tax on a credit it had to repay. Employers should consider these risks carefully and determine whether they are comfortable with the levels of exposure before proceeding.

Some ill-advised arguments when pursuing the ERC under the suspension test include:

- The employer was following nonmandatory guidance issued by the CDC and/or the Occupational Safety and Health Administration;
- The employer relied on the narrowly applicable suspended-supplier exception on account of macro-level supply chain bottlenecks (including supply shipments stuck at ports); and
- There were increases in costs in order to successfully maintain pre-pandemic levels of operation.

Seek all available resources

The ERC rules are complex, and guidance, while limited, includes substantial warnings for employers that aggressively interpret the rules or fail to conduct appropriate due diligence before reporting the credit. The AICPA has many resources to help members understand the rules (see Employee Retention Credit Guidance and Resources). The authors recommend that you use all available resources when it comes to the ERC.

From Devin Tenney, J.D., Overland Park, Kan., and Michael Wronsky, CPA, MST, Washington, D.C.

PHOTO BY TERRY VINE/GETTY IMAGES

Employee Benefits & Pensions

Key proposed provisions of 'SECURE 2.0'

The Securing a Strong Retirement Act of 2022, H.R. 2954, also called "SECURE 2.0," is the most prominent recently proposed legislation concerning retirement plans. It builds upon changes enacted by the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, P.L. 116-94. In addition, the Senate introduced its own version of the legislation, S. 4353, formally known as the Retirement Improvement and Savings Enhancement to Supplement Healthy Investments for the Nest Egg (RISE & SHINE) Act of 2022. This item discusses a few key provisions of SECURE 2.0 and differences between it and the RISE & SHINE Act.

SECURE 2.0 was introduced May 4, 2021, by Rep. Richard Neal, D-Mass. It received bipartisan support and was passed by the House on March 29, 2022, by a vote of 414–5. This bill focuses on three main areas: expanding coverage and increasing retirement savings, preserving income, and simplifying and clarifying retirement plan rules.

Some key provisions of the bill are:

Title I: Expanding coverage and increasing retirement savings

For plan years beginning after Dec. 31, 2023, automatic enrollment in 401(k) and 403(b) plans would be required once an employee is eligible. The minimum contribution percentage begins at 3% and increases by 1% annually until reaching 10%, but employees can elect out of the increase. Exceptions apply for SIMPLE plans, plans established or contracts purchased before the date of enactment, certain multiemployer plans, and governmental and church plans, as well as new business and small business plans (Title I, §101).

For tax years beginning after Dec. 31, 2022, there is a proposed increase to the Sec. 45E small employer pension plan startup cost credit for certain smaller employers. An eligible employer with no more than 50 employees may claim up to 100% of qualified startup costs. There is an additional credit for employer contributions by certain eligible employers. The allowed credit is increased by a percentage of employer contributions to an eligible plan. This credit amount may not exceed $1,000 per employee and is phased out if the number of employees exceeded 50 in the prior tax year (Title I, §102).

A focus is placed on increasing public awareness of the Sec. 25B qualified retirement savings contributions, or "saver's," credit, and its currently tiered applicable percentages based on adjusted gross income (AGI) are modified to a single percentage of 50%, subject to a higher AGI phaseout range, for tax years beginning after Dec. 31, 2026 (Title I, §§103 and 104).

The applicable age for required minimum distributions (RMDs) is increased from the current 72, based on the taxpayer's date of birth, as follows:

- For an individual who attains age 72 after Dec. 31, 2022, and age 73 before Jan. 1, 2030, the applicable age is 73.
- For an individual who attains age 73 after Dec. 31, 2029, and age 74 before Jan. 1, 2033, the applicable age is 74.
- For an individual who attains age 74 after Dec. 31, 2032, the applicable age is 75.

This gradual increase applies to RMDs made after Dec. 31, 2022, by taxpayers who reach the age of 72 after that date (Title I, §106).

For tax years beginning after Dec. 31, 2023, the Sec. 219(b)(5) $1,000 individual retirement account (IRA) catch-up contribution amount for individuals age 50 and older is increased, based on a cost-of-living adjustment. Additionally, the Sec. 414(v) catch-up contribution amount is increased for participants age 62 through 64, in SIMPLE plans from $3,000 for 2021, adjusted for inflation, to $5,000 and from $6,500 (for 2021) to $10,000 for all other plans (Title I, §§107 and 108).

Qualified student loan payments are considered a matching contribution under Sec. 401(m)(4)(A) (Title I, §111).

Retirement plan incentives are enhanced for certain part-time workers. Clarification is provided on the definition of part-time workers and vesting

requirements. Also, the period of service is reduced from three years to two years (Title I, §116).

Title II: Preservation of income

The proposed legislation amends the RMD rules for life annuities to permit certain additional kinds of payments (Title II, §201).

For qualifying longevity annuity contracts, the 25% premium limit is repealed. Joint and survivor benefits are enhanced. A "free-look" period allowing recension of the contract within 90 days is permitted (Title II, §202).

Title III: Simplification and clarification of retirement plan rules

The accidental overpayment of retirement plan benefits will not result in noncompliance with plan requirements, and fiduciaries may exercise their discretion not to seek recovery of the overpayment from participants and/or beneficiaries (Title III, §301).

A "retirement savings lost and found" online database managed by the U.S. Department of Labor will allow individuals to search plans and contact the administrator of any plan in which they are a participant or beneficiary (Title III, §306).

Several revenue provisions included within the bill would go into effect for tax years beginning after Dec. 31, 2022. The proposed legislation allows for an election to be made to treat Roth IRA contributions as SIMPLE IRA contributions and for simplified employee pension (SEP) plan contributions to be designated as Roth contributions. Clarification is provided on withdrawal rules for hardship under 403(b) plans. There is also an option to treat employer matching contributions as Roth IRA contributions.

RISE & SHINE Act

Once SECURE 2.0 passed the House, it was sent to the Senate for its review and revision process.

In response to SECURE 2.0, the Senate Health, Education, Labor, and Pensions Committee introduced its own version of the legislation on June 7, 2022, the RISE & SHINE Act.

The RISE & SHINE Act introduces several of its own provisions. Most notably, the included Emergency Savings Act of 2022 would allow participants and employers to contribute to a pension-linked savings account, limited to the lesser of $2,500 or a predetermined amount by the plan sponsor.

The RISE & SHINE Act does not include changes to the saver's credit or the small business retirement plan credits, such as are included in SECURE 2.0. It also does not include modifications of the catch-up contribution amounts. The RISE & SHINE Act does require employers at least once every three years (but not more than once annually) to automatically re-enroll eligible employees who have previously opted out of the arrangement in a qualified automatic contribution arrangement, unless the employees elect to opt out again.

Several provisions within the proposed legislation would take effect for tax years beginning after Dec. 31, 2022. As such, they could affect tax planning for clients in the upcoming tax year. As of this writing, the Senate is in its review process, and the final legislation is likely to be different from the current drafts. Regardless of any law that eventually passes, tax preparers need to understand the many changes it could make to the retirement plan rules and relay those changes to their clients to allow them to maximize those benefits.

From Casey Daderko, CPA, and Tim Cotter, CPA, J.D., LL.M., Wilkes-Barre, Pa.

Rembrandt and retirement: The pitfalls of collectibles and self-directed IRAs

Many investors may be eager to explore alternative investments to diversify their portfolios. One approach is by using a self-directed individual retirement account (IRA). While this approach allows IRA owners to invest in a variety of nontraditional asset classes, the inherent flexibility of self-directed IRAs may also pose serious tax risks as retirement savers venture into the alternative investment space. Some of these alternative investments seek to provide a return on capital by investing in entities that hold specific types of collectibles, such as classic cars and art. This item explores how certain

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tax provisions may affect potential investors planning to indirectly invest in collectibles.

Self-directed IRA

Most traditional IRAs set up through large financial services companies have a standard menu of investment options including stocks, mutual funds, and bonds. Should individuals want to invest outside those prescribed options, they must take matters into their own hands.

When individuals want to use pretax dollars to invest in assets that are not offered in a traditional IRA plan, they must establish a self-directed IRA. Companies that specialize in such offerings will act as a custodian of a self-directed IRA. Once the self-directed IRA is established, the owner funds it and selects the investments.

When individuals want to use pretax dollars to invest in assets that are not offered in a traditional IRA plan, they must establish a self-directed IRA.

Collectibles

Sec. 408(m)(2) prohibits individuals from directly investing in items defined as "collectibles." Pursuant to Sec. 408(m)(2), collectibles include:

- Any work of art;
- Any rug or antique;
- Any metal or gem;
- Any stamp or coin;
- Any alcoholic beverage; or
- Any other tangible personal property specified by the IRS for purposes of this subsection.

It is important to note that the broad category of tangible personal property is not defined by the Code or the regulations.

While the Code prohibits IRA investments in these collectibles, Sec. 408(m)(3) carves out an exception for certain coins and bullion that may be held in a self-directed IRA. Secs. 408(m)(3)(A) and (B) require that these items must meet certain metallurgical specifications and must be held in trust for the account.

The penalties for investing in prohibited collectibles are severe. Upon acquisition of the collectible, the IRA owner is deemed to have received a distribution equal to the cost of the collectible (Sec. 408(m)(1)). Additional penalties may apply for early withdrawal, depending on the age of the account holder. Overall, these transactions can result in significant penalties and require careful vetting by tax professionals.

Plan asset rules

The Department of Labor (DOL) has promulgated rules that expand the potential application of penalties for direct investments in prohibited collectibles by treating certain assets of an investment entity in which the self-directed IRA invests as assets owned by the self-directed IRA. The plan asset rules, also known as lookthrough rules, determine when an underlying asset of the investment entity would be treated as an asset that is directly owned by the self-directed IRA. These lookthrough rules apply to a plan benefit investor such as a self-directed IRA (see 29 C.F.R. §2510.3-101(f)(2)(ii); see also Sec. 4975(e)(1)(B)). As a result, the self-directed IRA's owner should consider the underlying assets of the investment entity when making investments.

Lookthrough rules

Generally, the self-directed IRA will be considered a plan benefit investor in two scenarios. First, if the self-directed IRA owns greater than 25% of an investment entity that is not a publicly offered security or a mutual fund, the underlying assets of the investment entity are deemed plan assets owned by the plan (29 C.F.R. §2510.3-101(a)(2)). Similarly, if the self-directed IRA owns 100% of an operating company, the lookthrough rules apply. An operating company is defined as "an entity that is primarily engaged, directly … in the production or sale of a product or service other than the investment of capital" (29 C.F.R. §2510.3-101(c)(1)).

If either scenario is present and the self-directed IRA is considered a plan benefit investor, the lookthrough rule will apply, and the underlying assets of the investment entity or operating company would be deemed as owned directly by the self-directed IRA. There are certain exceptions to these rules, but they are beyond the scope of this analysis.

These rules are consistent with IRS guidance regarding exchange-traded funds (ETFs) backed by precious metal. In Legal Advice Issued to Program Managers Memorandum 2008-01809, the IRS Chief Counsel's Office states:

> [I]nvestors in a "physically backed metal ETF" are considered to own undivided beneficial interests in the underlying physical metal. If a trustee of a "physically backed metal ETF" treated as a trust sells some of the metal held by the trust, the investors are treated as having sold the metal.

Taken together, these rules demonstrate that the IRS and DOL are willing to impute the ownership of underlying assets to the entities that indirectly invest in those assets. This practice can have grave consequences for investors using self-directed IRAs to make alternative investments.

Collectibles held in alternative investment partnerships

This section explores examples of investments where an underlying asset is a prohibited collectible and illustrates

potential problems that may occur without proper tax planning.

Classic cars: Using the self-directed IRA to invest in an investment entity that holds classic cars as assets may trigger the lookthrough rules and could pose issues for certain self-directed IRA investors. These types of investment entities offer an equity stake in a company whose underlying business is the purchase, ownership, and sale of classic cars. Whether a classic car would be considered a prohibited collectible per Sec. 408(m) is unclear, but taking a conservative approach, it likely would be. The pitfall of this investment is that the classic car is imputed to the self-directed IRA, likely resulting in the loss of the tax advantages of the self-directed IRA, plus penalties. Nevertheless, the existence of these investment funds indicates taxpayers' appetites for alternative investments.

Fine art: Another type of alternative investment is art funds. Like classic car funds, these funds allow individuals to invest indirectly in works of fine art. While some of these funds may use limited liability companies to hold each individual piece of art, potential self-directed IRA investors looking to emulate this investment strategy must proceed with caution. Here, potential investors face similar challenges as those posed in the classic-car example; however, unlike classic cars, art is directly identified as a collectible in Sec. 408(m)(2)(A). As such, a potential investor seeking to invest in art using a self-directed IRA would be wise to speak with a tax professional, given the potential negative tax results and penalties.

Challenging investment environment

The imputation of underlying assets to a self-directed IRA creates serious challenges for tax-advantaged alternative investments. However, with proper planning and tax advice, a potential investor can stay abreast of all the current changes in this evolving landscape.

An additional consideration is the application of the prohibited-transaction rules under Sec. 4795, not specifically discussed here, but which would also be relevant when considering a self-directed IRA.

From Matthew T. Marcellino, J.D., Washington, D.C., and Christine Faris, J.D., Philadelphia

Foreign Income & Taxpayers

US clients with international tax issues: Five helpful tips

U.S. persons (citizens and permanent residents) whose financial matters extend overseas may face a tax situation that virtually no other country's nationals do. The United States imposes federal income tax reporting and payment obligations based on citizenship status rather than — as is common in the rest of the world — physical residency. Because of this, serving a U.S. client with international income, assets, and disclosures can be complex, even apart from the onerous regulations around the reporting of foreign assets and entities. Below are five tips for managing the compliance and taxation of these clients.

1. Not all due dates follow the 'traditional' deadlines

U.S. persons with foreign disclosures and resident aliens who live outside the United States will find themselves with some additional dates to contend with beyond the "traditional" federal due dates.

First, an automatic two-month extension is permitted to file *and* pay federal income tax for a U.S. citizen or resident alien who lives outside the United States and Puerto Rico and has a main place of business outside the United States/Puerto Rico. This extension applies for taxpayers filing married filing jointly if either spouse qualifies (if filing separately, only the qualified spouse receives the automatic extension). No late-payment penalty is assessed on tax paid by June 15; however, interest does accrue in this two-month period.

A U.S. citizen or resident alien living outside the United States who has properly extended his or her return to Oct. 15 may also be granted an additional extension for filing the federal tax return

IMAGE BY DA-KUK/GETTY IMAGES

to Dec. 15. A written request must be made with the IRS.

FinCEN Form 114 (formerly Form TD F 90-22.1), *Report of Foreign Bank and Financial Accounts* (FBAR), is extended automatically from April 15 to Oct. 15 (or Oct. 17, 2022, for 2021 filings), regardless of the status of the personal income tax return. There is no form to file or request to make with the IRS or the Financial Crimes Enforcement Network (FinCEN).

Finally, U.S. owners of foreign trusts who are obligated to file Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, must file the form or an extension (via Form 7004) annually by March 15 for a calendar-year trust. This is one month before the deadline for filing Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, which uses the due dates of an individual's personal income tax return and accepts extensions via Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*. Missing the March 15 deadline can result in substantial penalties for late filing. Advisers and taxpayers can be caught by surprise since this is a month earlier than the expected April 15 due date.

2. Beware the savings clause

Income tax treaties are in place to eliminate double taxation of individuals with income tax obligations in two countries. As noted above, a U.S. person residing outside the United States will often have income tax residency in two (or more) countries.

Each tax treaty contains language addressing which country has the primary or exclusive right to tax different types of income (such as dividends, gains, director's fees, and so on). When determining if a treaty provision applies to your client, after evaluating whether he or she is a qualified taxpayer covered by the treaty and the taxes in question are qualified under the treaty, the specific income provision should be reviewed.

Importantly, one must also take care to review the "savings clause," which can generally be found within the first articles or general scope article. Essentially, the savings clause gives the right to the United States to tax its citizens and resident aliens as if the treaty had not been in force. Other provisions of the tax treaty will identify those specific sections of the treaty containing benefits that are exempted from modification under the savings clause.

3. A treaty tie-break claim for income tax residency does not relieve FBAR filing obligation

Due to the unique approach of the United States in taxing citizenship status rather than physical residency, U.S. citizens and permanent residents who live outside the United States find themselves in an uncommon situation: They may be income tax residents in more than one country at the same time. A U.S. taxpayer who is a dual income tax resident might avail himself or herself of a treaty tie-break claim in the income tax treaty between the United States and the other home country. The tests set forth in the tie-break provision will be applied to determine, for instance, that the individual is considered resident in the other country and not the United States for income tax purposes. Generally, that individual would then file as a nonresident in the United States.

However, the above treaty claim of nonresidence would not exempt the taxpayer from the obligation to file an FBAR. The individual's FBAR is governed by Title 31 of the U.S. Code, not Title 26 of the U.S. Code.

Penalties for noncompliance with FBAR obligations can be substantial. However, there is a difference of opinion among the U.S. courts of appeal as to whether the nonwillful civil penalty amount is assessed per form or per account. In June, the Supreme Court announced that it will rule on the issue (*Bittner*, No. 21-1195 (U.S. 6/21/22) (*cert*. granted)).

4. Gifts received from non-US persons may be penalized if not disclosed to the IRS

While the United States will generally not impose federal income tax on receipt of foreign gifts, the Internal Revenue Code requires that taxpayers notify the IRS about the receipt of certain gifts. Any amount from a non-U.S. person that is treated as a gift or bequest exceeding $100,000 must be reported on Form 3520, Part IV, relating to the tax year in which the gift was received. A gift from a non-U.S. person can include transfers from a non-U.S. spouse to a U.S. citizen spouse. (It is also important to be mindful of gifts from a U.S. spouse to a non-U.S. spouse, which would be reportable on a gift tax return if the value exceeds $164,000 (the 2022 exclusion amount).)

The information reported about a foreign gift is not very detailed: date of receipt, description of the property received, and the fair market value of the property. Required reporting also includes amounts received from foreign corporations or partnerships that are treated as gifts.

The IRS can impose civil penalties of up to 25% for failure to disclose receipt of a gift or inheritance from a foreign person. The penalty is initially imposed at 5% of the gift for each *month* the failure to disclose continues.

As noted above, Form 3520 follows the due dates of an individual's personal income tax return and can be extended by a timely filed Form 4868.

5. Totalization agreements may relieve US citizens of double social security obligations

Since the 1970s, the United States has entered into agreements with other countries around the world to limit the imposition of double social security

taxes. Currently, 31 international social security agreements, often referred to as "totalization agreements," are in place to address employment and self-employment arrangements for social security taxation. These agreements are separate from the income tax treaties.

U.S. Social Security applies to all U.S. citizens and residents, whether their work is performed inside or outside the United States. By virtue of being a U.S. resident and resident of another country while living and working there, an individual may find that he or she has paid social security taxes to both countries.

In the case of self-employed individuals, the applicable totalization agreement between the United States and the other country should be reviewed to determine which country is entitled to assess social security taxes on self-employed earnings. Though the details of each client situation must be confirmed by reviewing the agreement, often the United States will permit an exemption from self-employment taxes where a taxpayer is resident in the other country and subject to the other country's self-employment tax system. In this instance, no self-employment taxes would be assessed on the individual's federal income tax return.

Mistakes can be expensive

The U.S. worldwide system of taxing its citizens and resident aliens creates problems for those who live outside of the United States. The rules are complex, and foot faults can be expensive. The better you know the rules, the better you can serve your clients.

From Kelly Young, CPA, Philadelphia

Gains & Losses

Capital loss rules limit deduction of fees paid to terminate merger agreement

In Chief Counsel Advice (CCA) 202224010, the IRS concluded that

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termination fees and capitalized transaction expenses paid in connection with a terminated merger agreement were capital losses to the extent the merger property consisted of capital assets. Generally, such capital losses may only be deducted by a corporate taxpayer to the extent of capital gains, with any excess loss carried over or back for a limited period.

Facts of the CCA

According to the heavily redacted CCA, the taxpayer entered into a merger agreement to acquire the assets of a target entity in an "A reorganization" under Sec. 368(a)(1)(A). Under the arrangement, the taxpayer or target could terminate the agreement if the acquisition was not consummated by a specified date. In the event a termination was triggered and certain other circumstances existed, the taxpayer was required to pay the target a termination fee. Prior to completion of the transaction, the taxpayer and target agreed to terminate the merger agreement, and the taxpayer paid the termination fee to the target. Additionally, the taxpayer paid a second termination fee to another transaction party (buyer) pursuant to a separate agreement to terminate a contract for the sale of certain of the taxpayer's assets. The taxpayer deducted the termination fees as ordinary Sec. 162 expenses on its Form 1120, *U.S. Corporation Income Tax Return*. On audit, the IRS sought to disallow the deductions and characterize all or part of the amounts as capital losses under Secs. 165 and 1234A.

The termination fees and capitalized transaction expenses were Sec. 165 losses

In the CCA, the IRS held that the termination of the agreements resulted in dispositions under Sec. 1001, which gave rise to losses under Sec. 165 rather than to business expenses under Sec. 162.

In support of its conclusion, the IRS cited multiple authorities that require a taxpayer's facilitative costs to be recovered as Sec. 165 losses if an acquisition is terminated or abandoned (see Rev. Rul. 73-580; Regs. Sec. 1.263(a)-5(l), Examples (3) and (4); *Santa Fe Pacific Gold Co.*, 132 T.C. 240 (2009); *Federated Department Stores, Inc.*, 171 B.R. 603 (S.D. Ohio 1994); and *A.E. Staley Manufacturing Co.*, 119 F.3d 482, 490–92 (7th Cir. 1997)).

Regs. Sec. 1.263(a)-5(a) generally requires capitalization of costs that facilitate capital transactions, including an acquisition of assets that constitute a trade or business. Significantly, the IRS noted that the regulations under Sec. 263(a) do not require or imply that transaction expenses are deductible as Sec. 162 expenses if they are not required to be capitalized under these regulations as facilitating the transaction. Rather, the taxpayer must look to other potentially applicable sections of the law to determine the appropriate treatment of the costs (e.g., capitalization provisions under Sec. 195, 263(g), 263(h), or 263A). Accordingly, the IRS rejected the taxpayer's interpretation of the "mutual exclusivity" rule in Regs. Sec. 1.263(a)-5(c)(8). Under this rule, termination payments are generally

required to be capitalized when paid to terminate an agreement so that a second, mutually exclusive capital transaction may be pursued.

The taxpayer argued that capitalization was not required and the payments were therefore deductible Sec. 162 expenses because there was no second, mutually exclusive transaction that caused the merger agreement to be terminated. In rejecting this interpretation of the rule, the IRS noted that the absence of a mutually exclusive transaction simply means that this particular rule does not apply, and the taxpayer must look to other provisions of the law to determine the treatment of termination payments.

Similarly, the CCA concluded that the *Santa Fe* and *Federated* cases cited by the taxpayer did not support treating the termination fee payments as deductible Sec. 162 business expenses under the taxpayer's facts. According to the IRS, these cases do not address the key issue of whether the taxpayer's termination payments were properly classified as losses versus expenses. Furthermore, the conclusion reached in these cases that the termination payments might be deductible Sec. 162 expenses was based on facts that did not apply to the taxpayer's situation because the taxpayer's fees were not ordinary and necessary business expenses of defending against unwanted attacks on the taxpayer's trades or businesses (e.g., hostile takeover attempts).

Finally, the IRS determined that the taxpayer provided "little evidence" to support its claim that the termination payments were solely intended to compensate the parties for their transaction costs and were therefore Sec. 162 business expenses deductible under the "origin of the claim" doctrine established in *Gilmore*, 372 U.S. 39 (1963). The IRS consequently dismissed this argument and further noted that, even if a portion of the payment may have compensated the target for its transaction costs, this did not alter the fact that the taxpayer paid the termination fees to dispose of its rights and obligations arising from capital transactions, which brought the amounts within the scope of Sec. 1234A, discussed below.

The losses were capital under Sec. 1234A

The CCA summarized the requirements for a transaction to be subject to Sec. 1234A as:

- There is gain or loss attributable to an extinguishing event (i.e., cancellation, lapse, expiration, or other termination);
- That event extinguishes a contractual right or obligation;
- The contractual right or obligation concerns underlying property that is a capital asset in the taxpayer's hands (or that would be a capital asset if the property were acquired by the taxpayer); and
- There is a "with respect to" nexus or connection between the right or obligation and the underlying capital asset.

As applied to the taxpayer's facts, the CCA concluded that these "plain language" Sec. 1234A requirements were satisfied. Specifically, as indicated in the facts, the transaction agreements created contractual rights and obligations that were extinguished upon termination of those agreements. Pursuant to the authorities summarized above, the termination of those rights and obligations resulted in Sec. 165 losses equal to the termination fees and the capitalized expenses incurred to facilitate the transactions.

Furthermore, the extinguished contractual rights — and the Sec. 165 losses that resulted from them — pertained all or in part to assets that were or would have been capital in the taxpayer's hands had the agreements not been terminated. Accordingly, the taxpayer's Sec. 165 losses resulting from the termination of the transaction agreements were treated as capital under Sec. 1234A to the extent the losses were attributable to property that was or would have been capital assets in the taxpayer's hands had the transactions been completed.

The amount of capital loss is determined by dividing the value of the property that was or would have been capital assets in the taxpayer's hands by the total value of the property and then multiplying the loss by that fraction (see *Watson*, 345 U.S. 544 (1953), and *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945)). Importantly, the CCA notes that, for purposes of applying Sec. 1234A, the term "capital asset" does not include certain trade or business property described in Sec. 1221(a)(2) even if the property is subject to Sec. 1231, which might shield a significant portion of the losses from potentially unfavorable capital loss treatment, depending on the taxpayer's facts (see *CRI-Leslie, LLC*, 882 F.3d 1026 (11th Cir. 2018)).

Implications

This CCA serves as an important reminder to take transaction costs, including significant contingent amounts such as termination fees, into account when structuring and planning mergers and acquisitions. While the tax treatment of transaction costs should not be the sole or primary consideration when structuring mergers and acquisitions, the ability to deduct or accelerate the deduction of transaction costs is often a key negotiating point between the parties when the amounts involved are significant. Although it may not be used or cited as precedent, this CCA provides valuable insight to taxpayers planning or negotiating merger-and-acquisition transactions as to how the IRS applies the rules to termination fees paid in connection with an abandoned asset acquisition.

Significantly, the CCA confirms that a transaction structured as an asset acquisition may allow all or a significant portion of losses stemming from some transaction costs to be classified as ordinary and currently deductible, depending on the facts (e.g., the nature of the assets

transferred and taxable income available to absorb the loss). Conversely, earlier guidance addressing the treatment of fees paid to terminate a stock acquisition agreement concluded that, because the payments were made in connection with a capital asset (i.e., stock), the entire loss was capital in nature and therefore subject to the capital loss limitation rules, which can significantly limit a corporate taxpayer's loss deductions (see Legal Advice Issued by Field Attorneys 20163701F and CCA 201642035).

From Kathleen Meade, CPA, Austin, Texas

Partners & Partnerships

Partnership examinations: Imputed underpayment modification

The Bipartisan Budget Act of 2015, P.L. 114-74, complicated partnership examinations by adopting the centralized partnership audit regime (CPAR), which has lengthened examinations and created convoluted traps, all while shifting the administrative onus from the IRS to partnerships and their representatives. Congress and the IRS made the burden shifting clear in specifying the procedures to close a CPAR exam.

Once the IRS completes its field procedures, it issues a summary report to the partnership representative containing the preliminary audit results and the imputed underpayment computation. If the partnership representative indicates he or she does not agree with the proposed changes or does not respond to the summary report, the IRS will issue a 30-day letter package to the partnership representative, which provides information for the partnership representative to request an Appeals conference and protest proposed changes.

The revenue agent must issue a Notice of Proposed Partnership Adjustment (NOPPA) after the 30-day letter. The NOPPA contains the revenue agent's imputed underpayment calculation and a Form 886-A, *Explanation of Items*, to explain the calculation. The partnership has 270 days from the date of the NOPPA to submit a request for imputed underpayment modification and supporting documents. Thus, the partnership's representative has a specified time to consider the IRS's changes, how it affects all the partners, and how to best modify the imputed underpayment to minimize the burden on the partnership.

If a partnership elected to modify the imputed underpayment by filing amended returns, then each partner would file amended tax returns, pay the additional tax, and submit confirmation of each to the IRS.

Unless the proposed partnership adjustment is modified, the partnership must pay the highest marginal tax rate on any positive adjustments (IRS-favorable) and defer negative adjustments (taxpayer-favorable) to the current year's tax return. The partnership's representative has an ethical obligation to his or her client to understand the CPAR's nuances and end the examination advantageously.

This item discusses how to request modification of an imputed underpayment.

Imputed underpayment: The basics

The imputed underpayment is equal to the total netted partnership adjustment multiplied by the highest rate of federal income tax in effect for the reviewed year, increased or decreased by the net credit grouping adjustment (Regs. Sec. 301.6225-1(b)(1)).

The partnership first categorizes each of the IRS's adjustments as either positive or negative. Then the partnership groups the adjustments into (1) the reallocation grouping, (2) the credit grouping, (3) the creditable expenditure grouping, or (4) the residual grouping. A majority of adjustments fall under the residual grouping, as this group encompasses any

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change in income or loss that is not reallocated among the partners.

Next, the partnership subgroups the positive and negative adjustments in each grouping. Specifically, the partnership reviews the items in each grouping to determine if any positive and negative adjustment can net together. Subgrouping is appropriate if the adjustments would be aggregated for purposes of Sec. 702(a). Any adjustment that *may be* subject to a preference, limitation, or restriction is placed in separate subgroupings. Thus, subgrouping is not allowed if any provision in the Internal Revenue Code would treat an adjustment as a preference, limitation, or restriction. This specific step in the calculation is responsible for imposing the "worst-case scenario" imputed underpayment.

> ***Example:*** *XYZ* partnership is under examination for the 2019 tax year. The IRS determines that *XYZ* should have reported a $100 capital gain as ordinary income and that *XYZ* could not substantiate $10 of expense that it used to calculate the research-and-development credit. *XYZ* has a $100 positive adjustment to ordinary income, a $10 positive adjustment as a result of the decrease in the research-and-development credit, and a $100 negative adjustment due to the decrease in capital gain. *XYZ* will group each $100 adjustment in the residual grouping and the $10 negative adjustment in the credit grouping. *XYZ* cannot subgroup any of the adjustments because each is separately stated under Sec. 702(a).

The imputed underpayment is $47. *XYZ* first multiplies the $100 positive adjustment to ordinary income by 37%, or the highest marginal tax rate for tax year 2019. Then *XYZ* adds the $10 positive credit adjustment to arrive at the final imputed underpayment. *XYZ* will push out the $100 negative adjustment to its partners, who will take the capital loss on their current-year tax return.

Types of modifications

XYZ's imputed underpayment calculation provides a glimpse into the importance of requesting a modification of the imputed underpayment. *XYZ*'s partners paid tax on the capital gain in 2019. Assuming *X* is an individual, his capital in *XYZ* decreases by his share of the imputed underpayment, and he is subject to the capital loss limitations. *X* is in a net negative position when considering the time value of money because he pays today on the increase to ordinary income adjustment, while benefiting from the decrease to capital gain adjustment over time.

XYZ can request to modify the imputed underpayment and affect how the adjustments affect its partners. Regs. Sec. 301.6225-2(d) provides the list of potential modifications applicable at the end of a CPAR exam:

- Modifications to take into account amended pull-in returns by relevant partners;
- Modifications to take into account partner-level adjustments under an "alternative procedure" that mimics the results of amended partner pull-in returns;
- Modifications to take into account a partner's tax-exempt status;
- Modifications based on a rate of tax lower than the highest applicable rate;
- Modifications with respect to certain passive activity losses of publicly traded partnerships;
- Modifications with respect to qualified investment entities (regulated investment companies and real estate investment trusts);
- Modifications attributable to closing agreements (Regs. Sec. 301.6225-2(d)(8));
- Modifications to apply treaty provisions (Regs. Sec. 301.6225-2(d)(9)); and
- Any other modification approved by the IRS.

In most cases, multiple modifications may apply. Some of these will be readily apparent and necessary. For example, if *Y* of *XYZ* partnership is a tax-exempt entity, it would not make sense or be fair for *XYZ* to pay an imputed underpayment for adjustments that would otherwise be nontaxable to *Y*. Assuming no adjustment is unrelated business income to *Y*, *XYZ*'s modification would result in a $31 imputed underpayment. The modification automatically reduces the $100 positive adjustment to $66, for an initial payment of $24.40 when multiplied by 37%. Then, *XYZ* increases the payment by $6.60, for approximately $31.

Other readily apparent modifications include modifying the rate of tax (if all partners are corporations, for example) or applying a treaty provision (for foreign partners). However, many partnerships will benefit from the pull-in return procedures or alternative amended return procedures. Under the amended return procedures, the partners prepare and file amended returns for the examined tax year with the IRS's adjustments. The partners can account for positive and negative adjustments and avoid the punishing assumptions of the imputed underpayment. *XYZ*'s partners, for example, can report the increase in ordinary income while also paying less than the marginal tax rate because they already paid tax on the capital gain.

The alternative procedures are similar to the amended return procedures. The partners bear the burden of the IRS's adjustments without needing to file amended returns. While the procedures are simpler in some respects, the partners do not receive a refund if there is a net negative adjustment.

The amended return procedures and push-out statements both require partners to account for any positive or negative adjustment resulting from an IRS examination, with one key difference. Typically, partners must defer negative

adjustments to the current-year tax return. However, the Treasury regulations reverse this assumption for the amended return, alternative amended return, changes in the composition of the imputed underpayment, and the catch-all modifications. This difference may be beneficial for partnerships if, for example, there is a decrease in capital gain that an individual partner may not take in full due to capital loss limitations.

How to request a modification

The process to request modification of the imputed underpayment seems deceptively simple. A partnership must electronically file Form 8980, *Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)*, and supporting documents, utilizing IRS Publication 5346, *Instructions for Form 8980*. The supporting documentation provides the main source of complexity. The Treasury regulations provide only that the IRS must be satisfied that the modification is appropriate under the circumstances.

If a partnership elected to modify the imputed underpayment by filing amended returns, then each partner would file amended tax returns, pay the additional tax, and submit confirmation of each to the IRS. Congress was vague when stating whether the IRS must approve the modification request after the partners have filed their amended returns. Sec. 6225 provides that partnerships may modify the imputed underpayment "only upon approval" by the IRS, without saying whether the IRS necessarily must accept a modification if the partnership meets all requirements. Additionally, the broad language that Congress used in requiring IRS approval may limit judicial review of the IRS's determination to deny an imputed underpayment modification.

The CPAR's relentless punishment of partners is only beginning as the first wave of IRS examinations after the COVID-19 pandemic end. Over the next decade, partnerships will be forced to navigate the inconsistency, vagueness, and nuance of the CPAR. Many battles with the IRS will go to court, where partners will soon discover the limited scope of judicial review. Center stage will be the imputed underpayment and its modifications, which will be the single largest area of procedural dispute within the CPAR.

From Derek Reuter, J.D., Pittsburgh

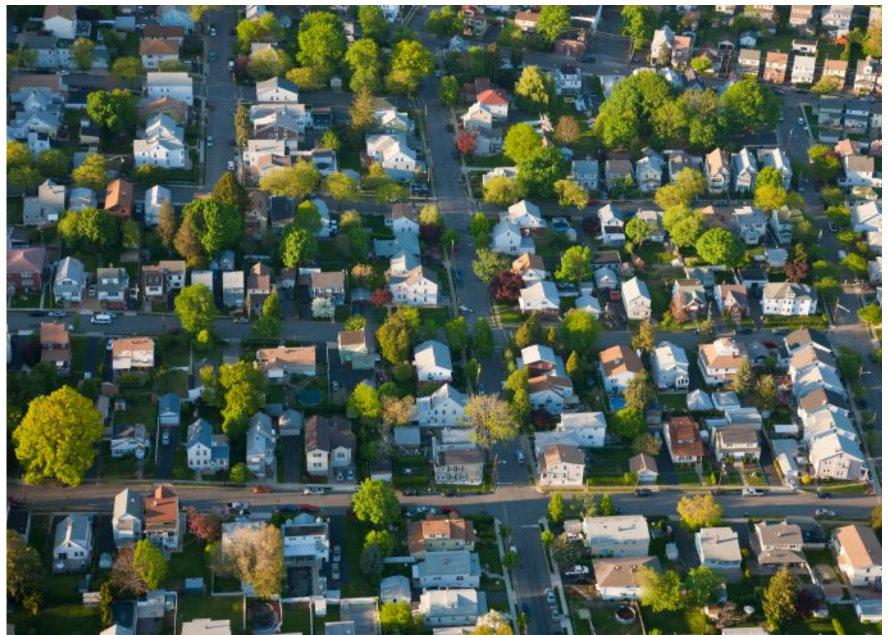
Real estate partnership restructuring and potential disguised sales

Instead of having a single real estate property housed under a stand-alone partnership entity, there is a trend toward diversification in a real estate portfolio with multiple properties. This can be accomplished by contributing property to a real estate fund or to an umbrella partnership real estate investment trust (UPREIT) that traditionally holds multiple real estate properties, in exchange for a partnership interest in that entity. With these restructuring transactions, careful consideration is needed to prevent the transaction from being deemed a disguised sale.

Under Sec. 721, the general rule is "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." However, there is the potential of a disguised sale under Regs. Sec. 1.707-5 when encumbered property is contributed. Under this regulation, if a partnership assumes or takes property subject to a liability other than a *qualified liability*, the partnership is treated as transferring consideration to the partner. As such, when transferring encumbered property in a partnership restructuring transaction, care must be taken to determine whether the liability transferred is considered qualified.

As defined in Regs. Sec. 1.707-5(a)(6), a qualified liability is:

- A liability incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership, and that has encumbered the transferred property the entire time;
- A liability that was not incurred in anticipation of the transfer of



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The stand-alone real estate partnership entity should avoid giving its partners cash in addition to a partnership interest in either the real estate fund or the UPREIT to prevent a disguised sale on the qualified liabilities.

the property to a partnership but that was incurred by the partner within the two-year period previously mentioned;

- A liability that is allocable under the rules of Temp. Regs. Sec. 1.163-8T ("tracing rules") to capital expenditures (as described under Regs. Sec. 1.707-4(d)(5)) with respect to the property;
- A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all the material assets related to the trade or business are transferred to the partnership; and
- A liability not incurred in anticipation of the transfer of the property to a partnership but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the material assets related to that trade or business are transferred to the partnership.

If any consideration is given to the partner as part of the restructure transaction, a portion of the qualified liability can also be regarded as consideration. This would be calculated only to the extent of the lesser of:

- The amount of consideration if the liability were not a qualified liability; or
- The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to that property.

As such, the stand-alone real estate partnership entity should avoid giving its partners cash in addition to a partnership interest in either the real estate fund or the UPREIT to prevent a disguised sale on the qualified liabilities.

Moreover, to further help avoid consideration of a qualified liability as nonqualified, the partner can make a capital contribution to the partnership prior to the restructure partnership transaction's taking effect. This will reduce the amount of consideration the partner is deemed to have received.

Lastly, four exceptions can alleviate the impact of a disguised sale when a partner receives cash or other consideration from the partnership, even if the disguised sale is made within two years of a transfer by a partner to the partnership. These exceptions include reasonable guaranteed payments for capital, reasonable preferred returns, operating cash flow distributions, and reimbursements for preformation expenditures.

For real estate partnership restructure transactions, most often, the exception for preformation capital expenditures is used. Such expenditures can include costs incurred to acquire, construct, or improve land, buildings, and equipment. What qualifies for this exception is the amount incurred during the two-year period before the transfer by the partner to the partnership, limited to 20% of the fair market value (FMV) of such property at the time of the transfer. The 20% limitation does not apply if the FMV does not exceed 120% of the adjusted basis of the property at the time of the transfer. This is applied on a property-by-property basis.

With the desire for greater diversification in real estate holdings, stand-alone real estate partnerships are moving toward contributing their property, in exchange for a partnership interest, to a real estate fund or an UPREIT that holds multiple real estate properties. Most often, the property contributed is encumbered by debt. In this case, careful attention is needed to evaluate the liability to determine whether it is considered qualified or nonqualified. Also, the partnership should avoid providing the contributing partner additional consideration on top of a partnership interest in the new partnership entity. These measures will help prevent the partnership restructuring transaction from being deemed a disguised sale.

From Brenda Graat, CPA, MBA, Milwaukee

Target capital account allocations in 11 easy steps

The purpose of this item is very simple: To provide tax practitioners with a step-by-step guide they can use and replicate in their practice to successfully deal with the inherent complexities they encounter when working with partnership allocations under a target capital structured operating agreement. Although this item does not break any new ground *per se*, it provides something many tax practitioners struggle with: a consistent process for ensuring correct income/loss allocations. In the age of centralized partnership audit regime exam implications and exit transaction due-diligence examinations, tax practitioners need more than ever to implement procedures that avoid allocation process errors.

During the past decade, the target capital allocation structure has clearly become the most prominent structure used in the process of drafting a partnership operating agreement. This structure allows attorneys to more easily draft the agreement and enhances limited liability company (LLC) owners' certainty in their understanding of the ultimate cash

flow expectations and the economics of the underlying business deal. Unfortunately, however, the tax practitioner who needs to correctly allocate LLC income and loss pursuant to the terms of an operating agreement that might be somewhat less than clear and straightforward is left alone to deal with the complexities the target capital allocation structure creates. Gone are the days of simply multiplying an LLC owner's percentage share of units by the separately stated items of income/loss/deduction, etc. for the purpose of populating the individual Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc*.

Despite the fact that every LLC and its related operating agreement is unique, a process for creating profit and loss allocations can be applied to every partnership with a target capital allocation structure. Not only will the use of a consistent process improve a practitioner's overall quality, it also will enhance efforts to efficiently train young staff on the process of creating LLC allocations in a manner that assures a quality product is produced and the risk of incorrect allocations is minimized.

Outlined below are 11 clearly delineated steps that must be followed when creating tax allocations for a target capital allocation structured partnership. It is important to note that these steps assume that proper Sec. 704(b) capital account maintenance rules are undertaken and followed. This is consistent with the vast majority of agreements that require capital account maintenance and limitations on deficit capital account balances and that also include a qualified income offset provision. If proper capital account maintenance is not being implemented (as required in the agreement), any allocations made under a target capital allocation structure are problematic and cannot be assured of any level of accuracy. This leaves both the client/taxpayer and the return preparer subject to the risks associated with not following the dictates of the agreement and/or the applicable tax regulations. The 11 steps are as follows:

Despite the fact that every LLC and its related operating agreement is unique, a process for creating profit and loss allocations can be applied to every partnership with a target capital allocation structure.

1. Complete the federal taxable income determination for the entity; i.e., finalize the tax provision.
2. Adjust the federal taxable income from Step 1 to create what would be referred to as Sec. 704(b) income. This represents profit/loss as defined in the agreement and must be used for making allocations consistent with the terms outlined in the operating agreement. Differences between income in Steps 1 and 2 typically involve assets that have a gross asset value for Sec. 704(b) purposes that differs from tax basis, often referred to as Sec. 704(c) differences. If such differences exist, it is imperative that Step 2 be clearly and separately completed because it will drive the remainder of the process.
3. Update beginning-of-the-year Sec. 704(b) capital accounts for any contributions, distributions, or ownership change activity that occurred during the year. This step creates a "preliminary capital" amount for each member as well as for the total entity.
4. Using the Sec. 704(b) income from Step 2, identify total end-of-year capital for the full entity, not by individual member, by adding the income to the updated total capital for the entity from Step 3.
5. Determine end-of-year cash waterfall distribution priority under the terms of the agreement (the distributions that must be made when there are tiered partnerships in the entity structure), assuming a liquidation would occur at the end of the year.
6. Using the cash waterfall priority (Step 5), allocate total entity capital (Step 4) among the partners to determine the end-of-year target capital for each member. This step allocates among the partners the total end-of-year capital they would be entitled to receive under the terms of the cash distribution provisions.
7. Compare the target capital for each member from Step 6 to each member's preliminary capital from Step 3 to determine the correct allocation of income/loss needed to achieve the desired capital account targets and create the necessary allocations for each member.
8. After the completion of Step 7, if any capital accounts have a deficit, analyze and/or calculate the correct application of minimum gain principles to determine whether any such deficit capital accounts are proper. If not, the income/loss allocations may need to be adjusted.
9. Make any Sec. 704(c) adjustments if needed to arrive at final tax allocations.
10. Determine the proportions of total (i.e., bottom-line) income allocations to allocate all separately stated items. Finalize Schedule K-1 details.
11. Complete the year-end tax basis and capital roll for each member based on the final allocations.

There are a few key components to this process. First, the entire allocation process is driven by the determination and allocation of Sec. 704(b) income. Sec. 704(c) allocations are driven by the Sec. 704(b) allocations and cannot be

properly determined without first determining Sec. 704(b) income. Second, it is important to first determine a preliminary capital account for each member and the LLC before the final targets can be determined. Attempting to shortcut any of these steps will lead to problems for any allocations that have any level of complexity.

Finally, it is worth discussing Step 7. This is the step in which the allocations to each member will first be determined. The agreement will need to be carefully analyzed to determine whether allocations will be made of bottom-line net income/loss, or whether the agreement provides for the use of gross revenue or expense items for the purpose of bringing the capital accounts fully into sync with the hypothetical year-end distribution. A good deal of uncertainty surrounds this particular topic that is well beyond the scope of this discussion. It is within this Step 7 that a practitioner would need to make judgments regarding the manner in which these rules will be applied.

Following these 11 steps in the order presented — and avoiding shortcuts in the process — is a sound strategy for managing this aspect of your tax practice.

From Joseph Schlueter, CPA, J.D., Minneapolis

IMAGE BY PHOTOALTO/SANDRO DI CARLO DARSA/GETTY IMAGES

S Corporations

Rolling over shares upon S corporation's acquisition

S corporations are widely used throughout the country, primarily by privately held businesses. As there has been an increase in merger-and-acquisition (M&A) activity in recent years, there has also been a disproportionately large number of S corporations selling as they become part of larger investment groups. A few typical structures are used when buying S corporations, depending on the desired result. Certain buyers may want to maintain flowthrough status but are not eligible to be S corporation shareholders, while others may want to own a C corporation as a result. However, one issue that continually arises is the desire for certain shareholders to roll a portion of their equity into the buyer, while other shareholders do not roll any equity. This item discusses some ways to effectuate this and the corresponding tax implications. This item does not address the family attribution rules.

The first thing to note is that there are no perfect solutions for this situation, and the rolling shareholder will be adversely affected primarily through the timing of gain recognition and cash. For the examples below, it is assumed that there is one S corporation that is owned equally by two shareholders. Shareholder *A* intends to roll over his entire interest into the buyer, while Shareholder *B* intends to sell her entire interest. The transaction structure with the buyer is simple: all cash, with no earnouts or seller notes. Additionally, the S corporation does not have any unrecognized built-in gain or residual earnings and profits from any time previously structured as a C corporation.

When the desire is for the target to maintain flowthrough status, one of the typical structures in the M&A space is performing an F reorganization under Sec. 368(a)(1)(F). In this structure, a new S corporation holding company is formed by the owners of the target S corporation, and the owners' target stock is transferred to this new S corporation. The target S corporation is converted to a disregarded entity or an LLC taxed as a partnership. Then, the new S corporation sells a portion of the target (which is now a disregarded entity or

partnership). This sale is a deemed asset sale for tax purposes under Rev. Rul. 99-5 or the sale of a partnership interest. The portion not sold is considered a rollover interest. Some buyers may prefer to purchase a partnership interest in order to receive the Sec. 743 deductions rather than purchasing a disregarded entity and negotiating such tax items as how depreciation will be allocated between the parties. That issue, however, is outside the scope of this discussion.

The gain from the sale is then allocated to the shareholders based on their ownership percentage of the new S corporation. However, in the examples discussed here, Shareholder *B* wants to exit the investment entirely and not roll any equity, which means that the cash proceeds should not be distributed pro rata. In these situations, the sellers have a couple of options, none of which get the shareholders to where they would be if they were selling a partnership or C corporation interest.

They could adjust the ownership immediately prior to the transaction or immediately after the transaction. Either way, this would be treated as a separate transaction from the acquisition of the target by the buyer.

Pre-transaction ownership adjustment

Prior to the transaction, the shareholders could adjust ownership through one shareholder buying the other out, or they could distribute the equity of the target (which is now a disregarded entity). If Shareholder *A* buys out Shareholder *B*, then both shareholders will have a taxable event. Shareholder *B* will be taxed on the gain associated with the sale to Shareholder *A*. Shareholder *A* will step up his basis in his stock in an amount equal to the price paid *B* and will be taxed when he sells 50% of the target to the buyer, as the intent is to roll his initial ownership. Shareholder *A* will receive the benefit of the stepped-up basis when he finally exits the investment, which results in a timing issue. This does not impact the basis of the underlying assets. It should be noted that this would effectively shift all Sec. 1245 recapture to Shareholder *A* (of course, the purchase price Shareholder *A* pays Shareholder *B* could be adjusted to compensate for this impact).

Alternatively, the new S corporation could distribute a portion of the target to Shareholder *A* in a redemption under Sec. 302. This would trigger a Sec. 311(b) gain within the new S corporation, which would be split between the shareholders. However, it would also allow Shareholder *A*, rather than the S corporation, to now own 50% of a partnership directly (the disregarded entity would automatically convert to a partnership), with a stepped-up basis. This could also potentially trigger a taxable event for both shareholders. Shareholder *A* could have taxable income if the basis of the assets distributed exceeds the basis of the stock; however, Shareholder *A* may not take a loss on this redemption.

Once the transaction happens, Shareholder *A* may contribute his interest in the target to the buyer under Sec. 721 if the buyer is a partnership. If the buyer is a C corporation, then the contribution would be subject to tax unless it qualifies under Sec. 351 as a tax-free contribution. Of course, Shareholder *A* could also simply hold his interest as a direct partner in the target. Note that Shareholder *A*'s otherwise tax-free rollover is taxed pursuant to Sec. 311(b) when distributed, which results in a timing issue for Shareholder *A* similar to that created in the first pre-transaction ownership adjustment option.

Post-transaction ownership adjustment

If the shareholders adjust the ownership after the transaction, the same two options still exist — one shareholder buying out the other or a distribution of property in redemption of Shareholder *B*. Once the sale transaction happens, the gain from the sale of 50% of the target will be split equally between the two shareholders regardless of what happens after the transaction. However, cash will shift from Shareholder *A* to Shareholder *B* either through Shareholder *A*'s purchase of Shareholder *B*'s stock or the new S corporation redeeming Shareholder *B*'s interest entirely for cash. This creates a timing issue for Shareholder *A* where gain is recognized but a portion of the associated cash goes to Shareholder *B*.

The alternative to a redemption or one shareholder buying out the other is a straight stock sale. In the straight stock sale, the buyer purchases the stock from the S corporation shareholders in the percentages they want to sell. Shareholder *B* would sell 100% of her stock and would report the gain on her tax return. Shareholder *A* would simply hold his stock or contribute his stock to the buyer in exchange for stock in the buyer. Depending on the buyer's legal structure, this could convert the target to a C corporation. Additionally, the buyer would not receive a step-up in the underlying assets without a valid election to the contrary (Secs. 338(h)(10), 336(e), etc.).

Ultimately, practitioners need to be aware of nonprorated S corporation rollovers and understand the unexpected tax consequences. Modeling to help quantify the impact could identify the adverse tax effect to the rolling shareholder; however, there will be a tax effect for each shareholder. Utilizing Secs. 301, 302, 311, 351, and 721, advisers can determine which method is best for selling shareholders.

From Jonathan Drysdale, CPA, and Matthew Coscia, CPA, Plano, Texas ■

Editor

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IMAGE BY HECTOR ROQUETA RIVERO/GETTY IMAGES

10 good reasons why LLCs should not elect to be S corporations

By: Paul N. Iannone, CPA, J.D., and Danny A. Pannese, CPA/ABV/CFF

Since 2004, the IRS has administratively made S elections for limited liability companies (LLCs) very easy. An LLC that is otherwise eligible to be an S corporation that is classified as a partnership or a disregarded entity can simultaneously elect to be classified as both a corporation and an S corporation by timely filing Form 2553, *Election by a Small Business Corporation*, without the need to also file Form 8832, *Entity Classification Election*. The Treasury regulations treat the "one-stop-shop" rule as a "deemed election" under the entity classification regulations.[1]

The authors find that tax advisers frequently recommend an S election due to the uncertainty under the law regarding what portion of LLC earnings (i.e., LLCs that are treated as partnerships or disregarded entities for tax purposes) are subject to self-employment tax to its member(s). Provided that the salary of a shareholder in an S corporation is not unreasonably low and is considered "reasonable," payroll taxes, including Federal Insurance Contributions Act and Medicare taxes are imposed on the amount of salary only rather than the entire amount of the trade or business income that would otherwise be subject to self-employment tax.

Further, many tax advisers find Subchapter K of the Internal Revenue Code too complex and prefer to deal with Subchapter S. Many corporate attorneys find that organizing an entity as an LLC under state law is much simpler and less expensive, requiring only a state organizational certificate and a simple operating agreement, than an actual incorporation that requires bylaws, corporate resolutions, and stock certificates. The corporate attorneys then leave the tax classification to the tax advisers. For these reasons and possibly additional ones, many LLCs have elected to be classified as S corporations.

Many tax advisers find Subchapter K of the Internal Revenue Code too complex and prefer to deal with Subchapter S.

This article discusses some of the negative aspects of electing S corporation tax classification for LLCs and the practical problems the election can present. This article is not intended to be a comprehensive and thorough discussion of the proper choice of business entity. It is limited to those situations where the accountant or attorney is making a choice whether to elect Subchapter S status for an LLC. For purposes of this article, LLCs with more than one member will be emphasized.

The following are 10 good reasons why LLCs should think twice before electing S corporation tax classification.

Reason 1: Operating agreements can invalidate the S election

Many LLC operating agreements can result in the termination of the S election. Even if the LLC operating agreement does not terminate the S election, many of its provisions are inapposite to a corporation, as explained below.

An LLC operating agreement is the foundational governing document for LLCs, similar to the articles of incorporation and the bylaws for corporations. In many cases, the tax adviser is not the first professional who is consulted for the choice of business entity. Business clients concerned with personal liability seek the advice of an attorney who invariably recommends and organizes an LLC for the client and prepares the operating agreement. In the authors' experience, it seems in recent years, for small to medium-size business, LLCs are the chosen legal vehicle rather than corporations.

The default tax classification for a domestic multimember LLC is a partnership.[2] The default classification for a domestic single-member LLC is a disregarded entity.[3] LLC operating agreements are written under the applicable state statute and tend to conform to partnership tax law in the case of a multimember LLC. Operating agreements for single-member LLCs are typically much shorter without much of the partnership tax language but can still

1. "An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under §301.7701-3(c)(1)(i), to be classified as other than an association" (Regs. Sec. 301.7701-3(c)(1)(v)(C)). See also the instructions to Form 8832, *Entity Classification Election*, and the instructions to Form 2553, *Election by a Small Business Corporation*.
2. Regs. Sec. 301.7701-3(b)(1)(i).
3. Regs. Sec. 301.7701-3(b)(1)(ii).

contain language that is not appropriate for corporations.

The important issue here is that operating agreements written with partnership tax law in mind have provisions that can invalidate an S election due to the Subchapter S prohibition of having more than one class of stock.[4] It is critical that before making the S election for an LLC, the tax adviser read and provide recommendations for revisions to the operating agreement to conform to the S corporation rules. This article is not intended to create a comprehensive list of provisions in an operating agreement that would require review and revision; it highlights some of the more common provisions.

First, a corporation that has more than one class of stock is ineligible to become an S corporation.[5] The Treasury regulations provide that "a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds."[6] Further, the Treasury regulations provide that:

> The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).[7]

Therefore, the operating agreement is the governing instrument of the LLC for purposes of establishing

4. Sec. 1361(b)(1)(D). However, voting and nonvoting common stock are permitted (Sec. 1361(c)(4)).
5. Id.; Regs. Sec. 1.1361-1(l)(1).
6. Id.
7. Regs. Sec. 1.1361-1(l)(2)(i).

EXECUTIVE SUMMARY

- Although an LLC's election to be classified as an S corporation for tax purposes can have certain advantages, such as payroll tax savings, there are often significant downsides. The following are 10 reasons for not electing S corporation tax classification.

- Reason 1: Many LLC operating agreements contain language that can inadvertently result in the termination of the S election. If the operating agreement's language is not revised beforehand, the LLC's Subchapter S election may end up being involuntarily terminated.

- Reason 2: An S election can result in gain recognition at the time of the election.

- Reason 3: A new member that contributes property to an LLC that has made an S election may recognize taxable gain as though the property were sold to the LLC.

- Reason 4: S corporations have no flexibility with respect to allocating items of income and deduction not in proportion to the shareholders' ownership interests.

- Reason 5: While a significant advantage of partnership taxation is the ability to include entity-level indebtedness in the partner's tax basis of his or her interest in the partnership, a shareholder of an S corporation cannot include entity-level indebtedness in the shareholder's tax basis of his or her stock.

- Reason 6: While a partnership that distributes appreciated property to a partner generally does not recognize gain, an S corporation's distributions of appreciated property to a shareholder can result in gain recognition.

- Reason 7: Unlike the rules for partnerships, there is no provision in Subchapter S that permits the inside tax basis of the corporation's assets to achieve a step-up in tax basis when a shareholder dies, when a person acquires the stock of a shareholder, or when there is a distribution of property or cash to a shareholder.

- Reason 8: S corporations have other restrictions, such as a 100-shareholder limit and a rule that corporations and partnerships cannot be shareholders.

- Reason 9: The one-class-of-stock rule can make it difficult for an S corporation to attract new rounds of investment funds.

- Reason 10: Tax issues can arise for S corporations in the context of a merger or acquisition, although a possible workaround exists that relies on an F reorganization.

whether the LLC has only one class of stock.

Most, if not all, operating agreements that are not structured for the S election have many references to capital accounts, which can be problematic. Equity interests in corporations are represented by capital stock and paid-in capital; not capital accounts. Partnerships are required to maintain capital accounts for the partners in order to meet the safe-harbor provisions of the substantial-economic-effect regulations under Sec. 704(b).[8] Capital accounts can be the measuring device that determines which members receive distributions, the amount of the distributions, and when distributions are made.

For example, many operating agreements, for both business reasons and to meet the safe harbors under the substantial-economic-effect regulations under Sec. 704(b), provide that upon liquidation of an LLC, liquidating distributions are to be made to members according to the positive balance in their capital accounts.[9] Such positive balances do not always correspond to the members' proportionate membership interest in the LLC. Such a provision would violate the single-class-of-stock rule and would invalidate the S election.

For an LLC electing S status, liquidating distributions are required to be made in proportion to the owners' membership interests in the LLC in order to satisfy the requirement to "confer identical rights to distribution and liquidation proceeds." If the operating agreement is silent with respect to liquidating distributions, the state LLC statute will be the default, which may not always be proportional.[10] Accordingly, for LLCs treated as S corporations, all references to capital accounts should be removed from the operating agreement, and liquidating distributions should be proportionate to the ownership percentages.

Other provisions that will cause distributions, income, and deductions to be made or allocated disproportionately to the member's ownership percentage should also be removed. Many of these provisions are tax boilerplate and are critical for entities classified as partnerships but, nevertheless, present serious problems for LLCs classified as S corporations. For example, some of the more complex operating agreements have distribution "waterfalls" that provide for priority of distributions to certain members before other members receive distributions or provide for a guaranteed rate of return on capital. These provisions could result in a second class of stock. Operating agreements that create more than one class of membership interest are problematic (see reason No. 9, "Investor Opportunity Is Limited," for further discussion).

Examples of other provisions that should be removed include any special allocations of income and deductions, references to Sec. 754 elections, allocations of contributed built-in gains or losses under Sec. 704(c), the deficit restoration obligation and qualified income offset under the Sec. 704(b) substantial-economic-effect regulations,[11] and provisions dealing with allocations of nonrecourse deductions.[12]

Another issue that arises is whether a multimember LLC that makes an S election, but fails to qualify as an S corporation because of a defective operating agreement, would be classified as a partnership or a C corporation. The regulations under the one-stop-shop procedure of merely filing a Form 2553 and the preamble to the temporary regulations issued in 2004 suggest that the LLC would default to the partnership classification rather than a C corporation.[13] Query whether the filing of Form 8832 and then subsequently filing Form 2553 (two-step method) would change that result to a C corporation.[14] Nevertheless, although better than a C corporation, defaulting to a partnership presents procedural issues related to employment taxes and self-employment tax. Because partners of a partnership cannot also be employees, the tax adviser would need to wrestle with incorrect payroll tax returns and self-employment tax issues at the member level for prior tax years that have already been filed.

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8. Regs. Sec. 1.704-1(b)(2)(ii)(b)(1); Regs. Sec. 1.704-1(b)(2)(iv).
9. Regs. Sec. 1.704-1(b)(2)(ii)(b)(2).
10. For example, if the operating agreement is silent with respect to liquidating distributions, the Connecticut LLC statute requires distributions to be first made to members in an amount equal to the respective values of the member's unreturned contributions and then proportionate to their membership interests (Conn. Gen. Stat. §34-267f). Such a provision could confer differing distribution rights among members and, thus, invalidate the S election.
11. Regs. Sec. 1.704-1(b)(2)(ii)(b)(3); Regs. Sec. 1.704-1(b)(2)(ii)(c); Regs. Sec. 1.704-1(b)(2)(ii)(d).
12. Regs. Sec. 1.704-2. See also Hamill, "Avoiding Traps When Electing S Corporation Status for an LLC," *RIA Checkpoint* (March 28, 2013).
13. See fn. 1; "However, if the eligible entity's election is not timely and valid, the default classification rules provided in §301.7701-3(b) will apply to the entity unless the Service provides late S corporation election relief or inadvertent invalid election relief. If the late or invalid election is not perfected, the default rules will maintain the passthrough taxation treatment by classifying the entity as a partnership or a disregarded entity" (T.D. 9139 (July 19, 2004)). See also Hamill, "Avoiding Traps When Electing S Corporation Status for an LLC," *RIA Checkpoint* (March 28, 2013).
14. For an excellent discussion see Hamill, "Avoiding Traps When Electing S Corporation Status for an LLC," *RIA Checkpoint* (March 28, 2013).

The failure to review the operating agreement for provisions incompatible with Subchapter S can result in the termination of the S election.

An LLC that determines that its S election was terminated due to a defective operating agreement may avail itself of the inadvertent termination relief of Sec. 1362(f). The request for relief is in the form of a private ruling request to the IRS national office and requires a significant user fee be paid.[15] For example, in IRS Letter Ruling 202111011, an LLC that elected S status applied for inadvertent termination relief under Sec. 1362(f). The LLC's operating agreement included partnership provisions that failed to provide identical distribution and liquidation rights to its members. The operating agreement required the LLC to make liquidating distributions to its members in accordance with the members' positive balances in their capital accounts rather than in proportion to their membership interests. The LLC was able to demonstrate that the circumstances surrounding its invalid election were inadvertent and unintended. Hence, the IRS granted relief.

Reason 2: Potential gain recognition at time of election

The second reason why LLCs should think carefully before electing to be S corporations is that an S election can result in gain recognition at the time of the election. The tax treatment of a change in classification of an entity for federal tax purposes by making an entity classification election is "determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine."[16]

If an LLC classified as a partnership elects to be classified as an "association" (the term the relevant regulations use for an S corporation),[17] the LLC is treated as though it has contributed its assets to an association in exchange for stock in the association. Immediately after the deemed contribution, the LLC is deemed to liquidate (for tax purposes only) and distribute the stock of the association to its members.[18] If an LLC classified as a disregarded entity elects to be classified as an association, the member of the LLC is deemed to contribute all of the assets and liabilities to the association in exchange for stock in the association.[19] The regulations refer to "stock" even though under state law an LLC's equity ownership is normally represented by a membership interest.[20]

Whether a transferor recognizes gain or loss upon a transfer or contribution of assets to a corporation is governed by Sec. 351 and Sec. 357.[21] Sec. 351 provides that no gain or loss is recognized (to a transferor(s)) if property is transferred to a corporation solely in exchange for stock in the corporation if immediately after the exchange, the transferor(s) are in "control" of the corporation.[22] Unlike a transfer of property to an existing corporation where the transferor may not be in control of the corporation immediately after the transfer (and, hence, Sec. 351 would not apply and gain or loss could be recognized), an S election by an LLC should not theoretically present the same 80% control issue. In case of an LLC treated as a partnership, the partnership should be in control of the S corporation immediately after the deemed transfer of property. In the case of an LLC entity treated as a disregarded entity, the member of the LLC should be in control of the S corporation immediately after the deemed transfer of property.

Gain, but not loss, is recognized to the transferor(s) if money or other property ("boot") is received in the exchange in addition to stock of the transferee corporation.[23] Because this is an election with a deemed exchange and not an actual exchange, it may be difficult to conceive of a situation involving an

15. Regs. Sec. 1.1362-4(c). See the first issued revenue procedure of the year for the list of user fees, e.g., Rev. Proc. 2022-1.
16. Regs. Sec. 301.7701-3(g)(2)(i).
17. See Regs. Sec. 301.7701-2(b)(2). See also Sec. 7701(a)(3), which provides that "[t]he term 'corporation' includes associations, joint-stock companies, and insurance companies."
18. Regs. Sec. 301.7701-3(g)(1)(i). The tax effects of the deemed liquidation would need to be considered. For example, in the partnership context, if there is LLC debt that is deemed relieved and is treated as a deemed distribution of money to the members under Sec. 752, gain at the member level could be recognized under Sec. 731(a)(1) if the deemed cash exceeds a member's tax basis of its membership interest.
19. Regs. Sec. 301.7701-3(g)(1)(iv).
20. "The term 'stock' includes shares in an association, joint-stock company, or insurance company" (Sec. 7701(a)(7)).
21. For purposes of this article, it is assumed that the entity is not an investment company as defined in Sec. 351(e).
22. Sec. 351(a). "Control" is defined as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation" (Sec. 368(c)).
23. Sec. 351(b).

election by an LLC that could involve the receipt of boot by the transferor for purposes of Sec. 351(b). Nevertheless, where the corporation assumes liabilities of the transferor and the liabilities assumed exceed the adjusted tax basis of the assets transferred, gain is recognized to the transferor to the extent of such excess.[24]

It is important to have a definitive tax basis balance sheet before the LLC elects S status. Recognized partnership gain could result if the liabilities of the LLC exceed the tax basis of the assets at the effective date of the S election. Recognized individual gain could result if the liabilities of the disregarded entity exceed the tax basis at the effective date of the S election.

Reason 3: Potential gain recognition to new members contributing property

A new member that receives a membership interest in exchange for property contributed to an LLC that has elected S status may recognize taxable gain as though the property were sold to the LLC. New members of the LLC who contribute property to an LLC that has elected S status will need to consider the 80% control requirement of Sec. 351 rather than the more lenient requirements of Sec. 721 under the partnership provisions of Subchapter K. As referenced above,[25] a transferor(s) of property to a corporation will generally not recognize gain or loss if the transferor(s) obtains the requisite 80% control of the corporation immediately after the transfer. In the partnership context, Sec. 721[26] does not contain any such control requirement.

> ***Example 1:*** For example, assume CPA firm *XY* LLC elected to be treated as an S corporation. *X* and *Y* each own 50%. *Z* has his own CPA firm, a single-member LLC treated as a disregarded entity. *XY* LLC has offered to admit *Z* as a 10% member in exchange for *Z*'s contribution or transfer of his clients (represented by goodwill with no tax basis). *XY* LLC does not want to own *Z*'s LLC or assume any of his liabilities. Immediately after the transfer to *XY* LLC, *Z* will only own 10% and thus fail the 80% control requirement. *Z*'s contribution or transfer of clients to *XY* LLC will result in gain recognition to *Z* as though *Z* sold the clients, with a potential zero tax basis, to *XY* LLC in exchange for a membership interest. If *XY* LLC did not make an S election and was classified as a partnership for tax purposes, no gain or loss to *Z* would result upon *Z*'s contribution or transfer of clients to *XY* LLC under Sec. 721(a).[27]

Reason 4: No special allocations

An S corporation offers no flexibility with respect to allocating items of income and deduction that are not in proportion to the shareholders' stock ownership interest. Sec. 1366 provides that "there shall be taken into account the shareholder's *pro rata share* of the corporation's (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and (B) nonseparately computed income or loss." (Emphasis added.)

The pro rata share is calculated on a per share, per day basis under Sec. 1377(a). Possibly the nearest concept to a special allocation would be through shareholder compensation adjustments; but there are limits to this technique, including reasonableness tests.

On the other hand, partnership taxation offers greater flexibility in allocating items of income and deduction. Provided that the allocations meet the substantial-economic-effect tests of Sec. 704(b) and the regulations promulgated thereunder, a partnership can allocate items of income and deduction among its partners without regard to the partners' ownership interest percentages. A comprehensive discussion of "substantial economic effect" is beyond the scope of this article. Only the highlights are presented below.

Determining whether an allocation meets the substantial-economic-effect test requires a two-part analysis. First, the allocation must have economic effect, and second, the allocation must be substantial.[28] The regulations provide

24. Sec. 357(c). Further, if the principal purpose of the taxpayer with respect to an assumption of liabilities is tax avoidance of federal income tax or there is no bona fide business purpose for the assumption of liabilities, the total amount of the liabilities assumed (not merely the excess of liabilities over tax basis of assets) is treated as boot for purposes of calculating gain under Sec. 351(b). The burden of proof is on the taxpayer to prove by the clear preponderance of the evidence that the principal purpose did not involve the avoidance of federal income tax and that there was a bona fide business purpose for the assumption of the liabilities (Sec. 357(b)).
25. See fn. 22.
26. "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership" (Sec. 721(a)).
27. As a potential workaround, *Z* can also elect S status for his LLC prior to the transaction, and merge his LLC/S corporation into *XY* LLC under the corporate reorganization provisions of Sec. 368. However, under this structure, *XY* LLC would be succeeding to *Z*'s entity (including liabilities) rather than merely the assets. In addition, there is an issue whether the "pre-incorporation" step violates the "immediately after test" of Sec. 351 under a step-transaction analysis due to the existence of a preconceived plan of a merger into the transferee S corporation.
28. Regs. Sec. 1.704-1(b)(2)(i).

An LLC's election to be classified as an S corporation results in a hybrid entity with state law characteristics that align in many respects with a partnership while being treated for tax purposes as a corporation.

three safe harbors (all three must be met) to satisfy the economic-effect analysis and require that these be included in the partnership agreement or LLC operating agreement:

1. Partner capital accounts must be maintained in accordance with the rules prescribed by the regulations;
2. Liquidating distributions are required to be made in accordance with the partners' positive capital account balances; and
3. There exists either a deficit restoration obligation or, in the alternative, a qualified income offset.[29]

The second part of the analysis requires that the allocation be "substantial." Substantiality essentially looks to the ultimate tax consequences of the allocation and whether there is an after-tax benefit to the allocation or allocations. The regulations provide that:

> the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement …[30]

Reason 5: S corporation member/shareholder tax basis excludes entity-level indebtedness

A significant advantage of partnership taxation versus S corporation taxation is the ability to include entity-level indebtedness in the partner's tax basis of his or her interest in the partnership.[31] Most real estate investments are held in entities that are classified as partnerships principally for this reason. This leverage allows a partner to deduct losses in excess of contributed capital (subject, of course, to other limitations, such as tax basis, at-risk, the passive-activity-loss limitations, and the excess-business-loss limitation of Sec. 461(l)). It also allows a partner to receive nontaxable cash distributions, provided the cash distributions do not exceed the partner's tax basis of its interest in the partnership.

In contrast, a shareholder of an S corporation cannot include entity-level indebtedness in the shareholder's tax basis of his or her stock. Subchapter S of the Code does not have a counterpart to Sec. 752. Further, it is relatively settled law that a shareholder guaranty of corporate debt does not increase the shareholder's stock basis until, and unless, the shareholder is required to personally pay on the guaranty.[32]

Reason 6: Gain recognition for distributions of appreciated property

Distributions of appreciated property by an S corporation to a shareholder can result in gain recognition. In general, Subchapter C of the Code applies to S corporations and its shareholders. Accordingly, both current and liquidating distributions of appreciated property by the S corporation to its shareholders result in gain recognition at the S corporation level that passes through to its shareholders.[33] The distribution of property is treated as if the property were sold to the distributee shareholder at its fair market value.[34] In addition, a corporate-level tax could result for recognized built-in gains for an S

29. Regs. Secs. 1.704-1(b)(2)(ii)(b) and (d) (dealing with the qualified income offset).
30. Regs. Sec. 1.704-1(b)(2)(iii)(a). See Regs. Sec. 1.704-1(b)(2)(iii)(b) for allocations that have "shifting tax consequences" and Regs. Sec. 1.704-1(b)(2)(iii)(c) dealing with "transitory allocations."
31. Partnership-level debt is accorded treatment under the aggregate theory (as opposed to the entity theory) of partnership taxation whereby a partner is deemed to "own" a pro rata share of assets and liabilities of the partnership. "Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership" (Sec. 752(a)). Conversely, "[a]ny decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership" (Sec. 752(b)).
32. See, e.g., *Brown,* T.C. Memo. 1979-220; *Albert,* T.C. Memo. 1980-567; *Estate of Leavitt,* 875 F.2d 420 (4th Cir. 1989).
33. Secs. 311(b) and 336(a).
34. Id.

corporation that converted from a C corporation, or for an S corporation that receives a transfer of assets from a C corporation in a nonrecognition transaction, during the five-year recognition period.[35]

On the other hand, a partnership that distributes appreciated property to a partner generally does not recognize gain.[36] An exception to this general rule exists with respect to disproportionate distributions to a partner relating to certain ordinary income assets.[37] Further, distributions of property in kind (not cash) generally do not result in a partner-level gain. Except as provided in Sec. 751(b) mentioned above, in the case of a distribution by a partnership to a partner, gain is only recognized to the extent that any cash distributed exceeds the adjusted basis of the partner's interest in the partnership.[38]

In the case of a current distribution, the tax basis of the distributed property in the hands of the partner is the same as the basis of the property to the partnership immediately before the distribution, limited to the adjusted tax basis of the partner's interest in the partnership reduced by any cash received in the same transaction.[39] In the case of a liquidating distribution, the tax basis of the distributed property in the hands of the partner is equal to the adjusted basis of the partner's interest in the partnership, reduced by any cash received in the same transaction.[40] In addition, there is no counterpart for partnerships with respect to entity-level taxation that exists for S corporations under Sec. 1374.

Therefore, partnerships offer significantly more flexibility and planning opportunities. For example, partnership breakups where partners divide up partnership assets can be accomplished without immediate tax consequences (subject to Sec. 751 discussed above). Also, partnerships offer planning opportunities for distributions of real estate to the partners to be held as tenants in common where there is not unanimous agreement regarding a like-kind exchange under Sec. 1031.

Reason 7: No inside asset tax basis step-up when members change or exit

There is no provision in Subchapter S that permits the inside tax basis of the corporation's assets to achieve a step-up in tax basis when a shareholder dies, when a person acquires the stock of a shareholder, or when there is a distribution of property or cash to a shareholder.[41] Conversely for partnerships, an election under Sec. 754 permits adjustment of the inside tax basis of assets with respect to an acquisition of a partner's interest by another, upon the death of a partner, or upon certain distributions of cash or property to a partner.[42]

Reason 8: Other S corporation restrictions and limitations

In addition to restrictions discussed above regarding the one-class-of-stock rule and pro rata allocations, S corporations have other qualifications and restrictions as follows:[43]

- The number of shareholders is limited to 100.
- S corporations restrict the type of shareholders to individuals and only certain trusts and to estates. Corporations and partnerships cannot be shareholders in an S corporation.
- Nonresident aliens are not eligible shareholders of an S corporation.[44]
- S corporations can be subject to entity-level taxation under Sec. 1374 (the built-in gains tax) and Sec. 1375 (excess passive investment income).

Reason 9: Investor opportunity is limited

Except for differing rights with respect to voting, an S corporation cannot have different classes of owners under the one-class-of-stock rule.[45] Many modern-day LLCs are structured with different membership classes (or C corporations with varying preferred and common stock classes) to entice investors that have disparate investment needs and requirements. Varying classes of membership, e.g., Class A, Class B,

35. Sec. 1374. Sec. 1374 is not likely implicated when an LLC initially elects S corporation status. Nevertheless, Sec. 1374 may be implicated for possible subsequent nontaxable transfers of assets from a C corporation.
36. Sec. 731(b).
37. Sec. 751(b).
38. Sec. 731(a). This result is aligned with the aggregate theory of partnership taxation.
39. Sec. 732(a).
40. Sec. 732(b).
41. A step-up in tax basis of the inside tax basis of assets of an S corporation can be achieved, however, when there is an 80% acquisition of the stock by a purchasing corporation making an election under Sec. 338(h)(10) or a sale of 80% of the stock of the corporation by a seller making an election under Sec. 336(e).
42. The operative Code sections are Sec. 743(b), dealing with acquisitions of a partner's interest or death of a partner, and Sec. 734(b), dealing with partnership distributions.
43. See Sec. 1361 for rules relating to S corporation qualifications.
44. But see Sec. 1361(c)(2)(B)(v), as amended by the law known as the Tax Cuts and Jobs Act, P.L. 115-97, permitting nonresident aliens as potential current beneficiaries of an electing small business trust, effective Jan. 1, 2018.
45. An S corporation can maintain voting and nonvoting common stock (Sec. 1361(c)(4)).

etc., that contain legal characteristics that offer the members priorities as to distributions and/or a rate of return on their investment would run afoul of the one-class-of-stock rule if the LLC were to elect S status. Therefore, an S corporation is not an attractive investment vehicle if the corporation is seeking new rounds of investment funds from individual investors that require an investment other than plain-vanilla common stock.

An S corporation is not an attractive investment vehicle if the corporation is seeking new rounds of investment funds from individual investors that require an investment other than plain-vanilla common stock.

Reason 10: Maintaining passthrough treatment in an M&A transaction

Maintaining passthrough treatment and single-level taxation can be challenging for an acquirer that is not an eligible shareholder of S corporation stock. A corporate acquirer or a multimember LLC acquirer of S corporation stock would terminate the S election because they are ineligible S shareholders. There are no member eligibility rules for LLCs classified as partnerships for tax purposes.

There is, however, a possible workaround to this problem that has become popular in recent years due to the IRS's issuance of Rev. Rul. 2008-18. The workaround involves a pre-acquisition restructuring using an F reorganization.[46] The downside is that with any legal restructuring, there are several steps along with associated fees and costs. In Rev. Rul. 2008-18, the IRS ruled that the following facts meet the requirements of a nontaxable F reorganization:

1. *B*, an individual, owns all of the stock in *Y*, an S corporation.
2. In year 1, *B* forms Newco.
3. *B* contributes all of the *Y* stock to Newco.
4. Newco meets the requirements for qualification as an S corporation.
5. Newco timely elects to treat *Y* as a qualified Subchapter S subsidiary (QSub).[47] *Y* then becomes a disregarded entity.[48]
6. In year 2, Newco sells a 1% interest in *Y* to *D*.

The IRS ruled that *Y*'s original S election does not terminate but continues for Newco. *Y* retains its employer identification number (EIN). Newco must obtain a new EIN. Upon the sale of 1% of *Y*, *Y*'s QSub election terminates (because it is not 100% owned after the sale of 1% to *D*).

Tax advisers have added another step to this transaction. Immediately after the QSub election for *Y*, *Y* is converted to an LLC under a state law conversion statute. *Y* will then become a single-member LLC and a disregarded entity. This step should be nontaxable because a disregarded entity (the QSub) is converting to another disregarded entity (the single-member LLC). After the conversion to an LLC, an investor purchases a membership in the LLC either from Newco or directly from the LLC under Sec. 721. *Y* would then transform into a multimember LLC treated as a partnership with Newco and the acquirer as members/partners. The acquirer could also purchase 100% of Newco's membership interest in *Y*. This would be treated as a deemed asset purchase, and *Y* would become a disregarded entity to the acquirer. In either case, the acquirer has preserved the passthrough treatment without causing *Y* to convert to a C corporation.

Often overlooked considerations

The discussion above offers at least 10 reasons why LLCs should not elect S status. There may be more. An LLC's election to be classified as an S corporation results in a hybrid entity with state law characteristics that align in many respects with a partnership while being treated for tax purposes as a corporation. This can create traps and can result in adverse tax consequences, including the disqualification of the S corporation election. In our view, in many cases, the payroll tax savings are outweighed by the disadvantages of Subchapter S. The failure to review the operating agreement for provisions incompatible with Subchapter S can result in the termination of the S election. When making the choice whether to elect S status for an LLC,

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46. An F reorganization is a nontaxable reorganization and is defined as "a mere change in identity, form, or place of organization of one corporation, however effected" (Sec. 368(a)(1)(F)).
47. See line 14 of Form 8869, *Qualified Subchapter S Subsidiary Election,* which includes a question whether the QSub election is being made in combination with an F reorganization described in Rev. Rul. 2008-18.
48. Sec. 1361(b)(3)(A).

a longer timeline should be considered that takes into account other "life events" of the entity and its members. Considerations of the ultimate and potential tax consequences of this choice should be reviewed carefully. ■

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Articles

Diakovasilis, "Tax Planning and Considerations: S Corporation Targets," 53 *The Tax Adviser* 19 (May 2022)

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Webcasts

Choice and Formation of Entity,
Dec. 1, Noon–5 p.m. ET

Tax Fundamentals of LLCs and Partnerships,
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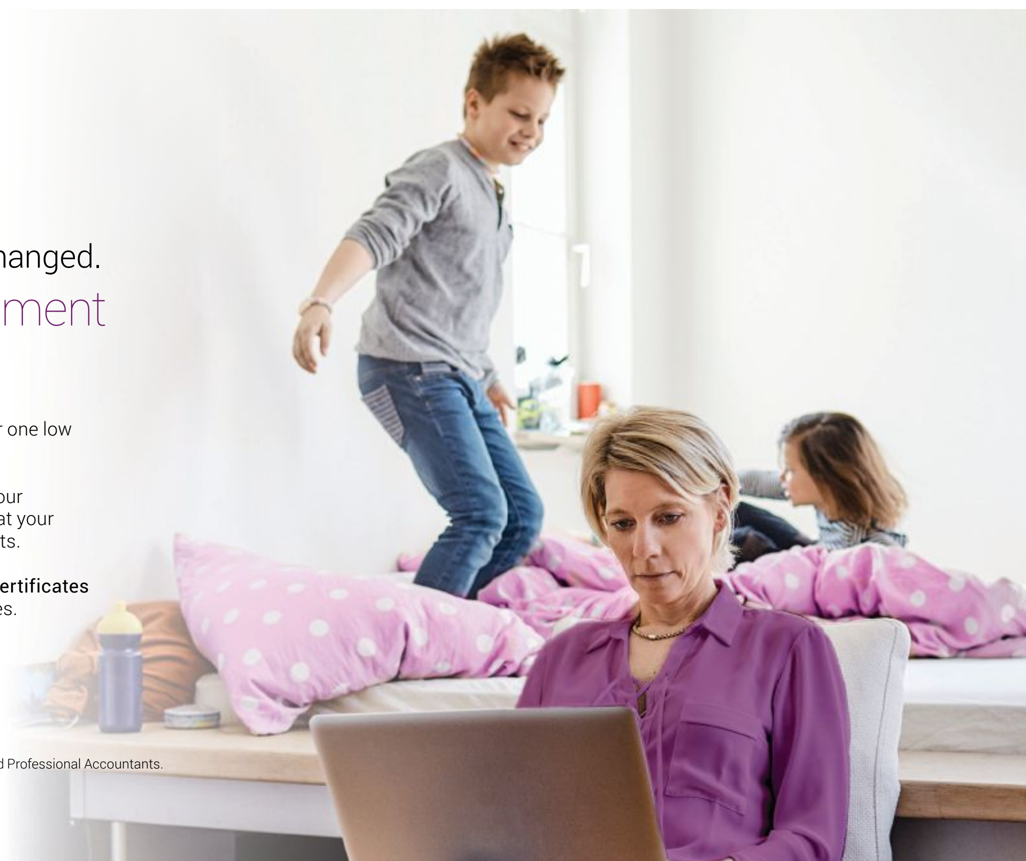

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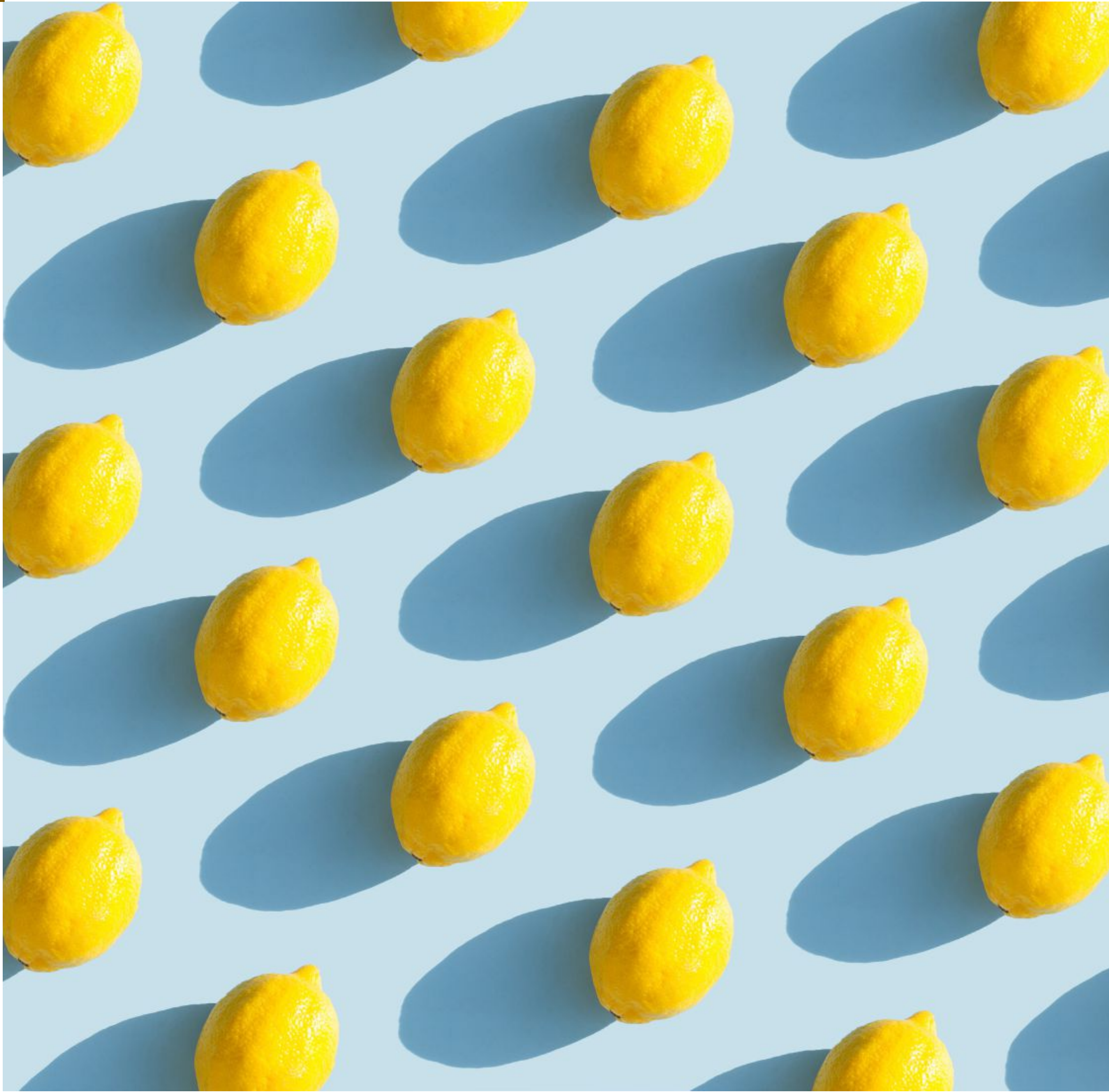

IMAGE BY TANJA IVANOVA/GETTY IMAGES

Publicly traded partnerships: Investors' tax considerations

By: Laura Hinson and Kathryn Neely

Imagine that you are a fairly sophisticated investor and your broker has added a publicly traded partnership (PTP) to your portfolio. You trust your broker to invest wisely on your behalf, but you have heard that owning a PTP is a little different than typical stock ownership and presents unique challenges. You wonder whether this will be a fruitful investment.

Let us compare a PTP investment to the time the sister of one of the authors brought her 15 pounds of lemons from the tree in her backyard. It was nice of her to share the fruits of her labor, but what is a person supposed to do with 15 pounds of lemons? Lemons are great, but what happens when you are tired of lemonade?

A similar issue may arise with a PTP investment: Is investing in a PTP prudent? Is having it more trouble than it is worth? If your investment adviser proposes a PTP as part of your investment strategy, what should you be thinking through from a tax perspective? PTPs may offer the opportunity to diversify a portfolio and provide cash flowthrough distributions, but, unlike simpler investments such as stocks, they have the added complexity of partnership reporting requirements.

This article explores tax planning aspects of holding interests in PTPs. These investments have become popular since their introduction in 1981. Sec. 469(k)(2) defines a PTP as any partnership where the "interests in such partnership are traded on an established securities market" or "are readily tradable on a secondary market (or the substantial equivalent thereof)." In response to the popularity of PTPs, the Revenue Act of 1987[1] added Sec. 7704 to prevent most PTPs from being treated as flowthrough entities. Sec. 7704 provides that a PTP is taxed as a corporation unless 90% of its gross income consists of "qualifying income," which can generally be thought of as passive income or income from certain oil and gas endeavors. As a result, PTPs are common in the real property or natural resource industries because they produce "qualifying income" that allows the PTP to be taxed as a partnership.

There is an argument that a PTP can be a wise investment. But some people may feel these assets are like 15 pounds of lemons because of tax compliance and other issues. This article begins by addressing general implications of PTP investments for Form 1040, *U.S. Individual Income Tax Return*, then discusses considerations for monetizing the tax losses these partnerships often generate, and finally explores tax issues that arise when gifting or donating a PTP interest.

General implications for Form 1040

Understanding how PTP investments are taxed is crucial. Whereas stocks return cash to investors in the form of dividends, PTPs return cash to investors through partnership distributions. Partners in a PTP are taxed on their share of the partnership's income and deductions, while stock investors are taxed on their share of dividends received. To be clear, as with any flowthrough entity, a PTP's investors are not taxed based on the cash they receive; they are taxed based on the income allocated to them. The income is reported on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*

Often, the Schedule K-1 packages are lengthy, containing not only federal information that needs to be accounted for on the investor's tax return but also foreign reporting and state income tax reporting. Investments in PTPs can

> **There is an argument that a PTP can be a wise investment.**

cause investors to file additional foreign reporting forms such as Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*, or Form 965, *Inclusion of Deferred Foreign Income Upon Transition to Participation Exemption System*. Further, a single PTP investment can result in the need for multiple state income tax filings per year, when the partner's share of income is allocated across the various states in which the PTP operates or invests. Some PTPs also invest in underlying PTPs, which, for reasons discussed later in this article, can significantly complicate loss tracking and income tax reporting.

Sec. 199A: The Sec. 199A qualified business income deduction has added complexity to PTP K-1s. Sec. 199A attributes have to be reported on an activity-by-activity basis, and PTPs can have many underlying activities (many of which may be PTPs that the PTP has invested in) that then must be accounted for on the individual's tax return.

Basis: The cash distributions from PTPs may make this all worth the effort, but investor beware: You should make sure you are not out of basis. When a PTP reports a loss to its partner in a tax year, loss limitation rules need to be considered, just as they must be for any partnership investment. Routinely, in their practice, the authors have seen PTPs generate losses and make distributions year after year, which can cause Sec. 704(d) tax basis and Sec. 465 at-risk basis issues. If the PTP makes a distribution in excess of the partner's basis, there will be gain

1. Revenue Act of 1987, Title X of the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203.

to report under Sec. 731. Additionally, to the extent the PTP allocates the partner losses in excess of basis, those losses will be limited. Or if a partner's at-risk amount has gone to zero and the partner later has a distribution, making the partner's at-risk amount negative, the partner may have at-risk recapture under Sec. 465(e).

Passive-activity-loss rules: Assuming a taxpayer has enough tax basis and at-risk basis to allow a loss from a PTP, he or she still has an additional limitation under Sec. 469. PTPs are subject to the passive-activity-loss (PAL) rules under Sec. 469 just like other partnership investments but with added limitations. The PAL rules generally limit the deductibility of losses from passive activities to the extent of income from passive activities. However, each PTP is viewed separately for applying the PAL rules under Sec. 469(k). This means that a PAL from a PTP can be offset only against other income/gain from that specific PTP. PALs from PTPs must be tracked separately and reported on Worksheet 5, 6, or 7 of Form 8582, *Passive Activity Loss Limitations*. The practical problem is that PTPs usually generate tax losses year after year. Without offsetting income, PALs remain suspended and provide an investor no current tax deduction.

As a result, losses allowable for tax and at-risk basis but limited under Sec. 469 are carried forward to future years and are allowable to the extent of passive income from the PTP. Note that even if a loss is allowed under Sec. 469, it could be further limited by the Sec. 461(l) excess business loss rules; however, that topic is beyond the scope of this article. Given that losses from a PTP can be offset only by income or gain from that specific PTP, how could an investor go about monetizing a loss? One answer involves getting rid of those extra pounds of lemons.

Monetizing passive activity losses

One option for monetizing PALs from a PTP is to fully dispose of the PTP investment in a taxable transaction. Then, the PALs will be allowed as a current tax deduction under Sec. 469(g) and Sec. 469(k)(3). However, by disposing of the asset, the investor loses any additional appreciation that may occur by continuing to hold the property. Investors should consider whether disposing of a PTP investment to recognize a tax loss is a better strategy than holding the investment for further appreciation and cash flow.

When disposing of a PTP investment, be aware, too, that selling a PTP interest with "hot assets" — unrealized receivables or inventory items of the partnership — may result in ordinary income. Sec. 751 requires the gain attributable to disposition of these assets to be characterized as ordinary, meaning that the preferential capital gains tax rates will not apply; this may come as a surprise to investors. Sec. 751(c) defines "unrealized receivables" and Sec. 751(d) defines "inventory" to include items that if sold by the partnership would result in ordinary income, such as tangible and intangible personal property held by a business (Sec. 1245 depreciable property).

Also be aware that, due to the nature of the business of most PTPs, depreciation can be a big factor in creation of the losses that flow through to investors. This ordinary income recapture is reported on the sales statement

EXECUTIVE SUMMARY

- A publicly traded partnership (PTP) is any partnership with interests in the partnership that are traded on an established securities market or with interests in the partnership that are readily tradable on a secondary market or its substantial equivalent.

- PTPs are by default taxed as corporations; however, if the gross income of a PTP consists of 90% or more of certain types of passive income, it is treated as a partnership.

- A PTP owner, as an owner of a partnership interest, receives a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, which lists the various items flowing through to the owner from the PTP.

- Investments in PTPs can cause investors to be required to file additional foreign reporting forms. They can also require multiple state income tax filings.

- PTPs often generate tax losses year after year. An investor's deduction of these losses may be limited by the basis, at-risk, and passive-activity-loss rules.

- Gifts of interests in PTPs to charities are subject to the bargain-sale rules and may also be limited if the PTP has "hot asset" ordinary income recapture items.

- Gifts of PTPs to private foundations are generally limited to the lesser of the investor's basis or fair market value and may expose the investor to the excise tax on acts of self-dealing with a private foundation by a qualified person.

Taxpayers sometimes think that they will be able to realize the passive activity losses by making a gift of the PTP interest. However, gifting the units will not allow the losses to be recognized currently.

attached to the PTP's Schedule K-1. For example, in the situation illustrated in the table "Ordinary Income Recapture" on p. 38 the individual thinks she has a capital gain from the sale of her 50,000 PTP units of $175,000 ($200,000 proceeds less $25,000 basis). She assumes the tax on the sale is $35,000, based on a 20% preferential capital gain rate (ignoring for this example the 3.8% net investment income tax and state taxes). What she might not realize is that $100,000 of the gain is related to recapture property. This results in ordinary income rather than capital gain for that portion. If the taxpayer's ordinary income tax rate is 37%, this means that the total tax on the sale is $52,000 ([$100,000 × 37%] + [$75,000 × 20%]). The extra $17,000 of tax can come as an unwelcome surprise.

Depletion (like depreciation and amortization) is also a recapture item that results in ordinary income and, because many PTPs are in the natural resource industry, is a common issue for sales of PTP interests. If the benefit of selling a PTP investment is simplifying tax reporting, the recapture component is an additional loss on an already complicated endeavor.

Gifting or transferring the PTP interest

Taxpayers sometimes think that they will be able to realize the PALs by making a gift of the PTP interest. However, gifting the units will not allow the losses to be recognized currently; instead, PALs on gifted PTP units will be added to the basis of the PTP interest in the donee's hands under Sec. 469(j)(6). Further, when gifting units encumbered by liabilities, a taxable event may occur. The donor will recognize gain if the amount of liabilities assumed by the donee exceeds the transferor's basis in the units (including liabilities). At least the gain can be offset by a PAL of the same amount.

The investor's death: There are similar problems with unrealized PALs at the investor's death. If income is never realized to offset the limited losses, then upon death, the PALs are recognized on the investor's final tax return to the extent that the losses exceed the difference between the date-of-death fair market value (FMV) and the investor's basis prior to death (the step-up in basis). If the PALs do not exceed the step-up in basis, they are lost and never provide a tax benefit.

Donating a PTP interest to a charity or a private foundation

Can you get a tax benefit from donating a PTP interest? Many taxpayers are charitably inclined, and so when life gives them lemons, they make lemonade by making a donation to charity. A donation of a PTP investment to a public charity may be an effective way to dispose of the investment with the added benefit of assisting a public charity; however, additional tax implications should be considered when donating PTP units.

When gifting a partnership interest to a charity, the donor is deemed to have proceeds equal to the amount of liabilities on the partnership interest gifted, resulting in a transaction that is part sale and part gift (commonly referred to as a "bargain sale"). Under Sec. 1011(b) and Regs. Sec. 1.1011-2(b), the donor's basis is allocated to the sale portion in proportion to the sale/gift amount, so in most cases, a donation of partnership units will result in some gain recognition on the transfer. This is not what most people would expect — it is not the same as giving publicly traded stock.

For example, say a client wants to gift PTP units he has held for over one year with an FMV of $40,000 and a basis of $25,000 (including $10,000 of allocated debt). The amount of the gift in this instance would be $40,000, the actual FMV of the interest, or 80% of the value of the assets on a lookthrough basis ($40,000 gift ÷ $50,000 total gross FMV of assets). The amount realized on the $10,000 of debt relief is then reduced by an allocation of basis of $5,000 (20% (ratio of debt relief to FMV of assets) × basis of $25,000). As a result, the client would recognize $5,000 of gain (which would represent 20% of the total gain had the entire interest been sold) from the donation. This gain may be partially or fully offset by the suspended PALs.

Additionally, when donating a PTP interest to a charity, the charitable deduction will be limited due to "hot asset" ordinary income recapture items under Sec. 751, such as depreciation recapture or depletion recapture. The charitable deduction for the contribution of a PTP interest to a charity is the remainder of the FMV for the units, less liabilities, less ordinary income recapture, and less any short-term capital gain. In effect, this could limit the deduction to basis in the units given.

Let us continue the example above and say that there is $15,000 of ordinary income recapture related to the PTP unit contribution. Because 20% of the gain is recognized in the bargain sale, 20% of the ordinary income recapture would be recognized, so $3,000 ($15,000 ordinary income recapture × 20% (ratio

PTPs are subject to the passive-activity-loss rules just like other partnership investments but with added limitations.

of debt relief to FMV of assets) of the $5,000 gain would be ordinary. In this instance, the charitable deduction would be limited to $28,000 ($40,000 FMV, less $12,000 remaining ordinary income recapture). Modeling is key to determining the deduction allowable from a donation of a PTP interest to a charity — and whether it makes sense.

Taxpayers gifting partnership interests to private foundations are subject to greater limitations on their deductions. The deduction for a donation of appreciated property to a private foundation is limited to the lesser of the donor's basis or the FMV of the interest, unless the property is qualified appreciated stock under Sec. 170(e)(5). Despite the fact that PTPs are often thought of as marketable securities, PTP interests are not considered to be qualified appreciated stock under Sec. 170(e)(5)(B). Remember, PTP units are not stock but rather partnership interests. As a result, gifts of appreciated PTPs to a private foundation are limited to the donor's basis.

In addition, private foundations are prohibited under Sec. 4941 from engaging in acts of self-dealing (directly or indirectly) with a disqualified person. Thus, the contribution of partnership units to a private foundation that includes a bargain-sale component requires the donor to consider whether he or she is a disqualified person in relation to the private foundation. The definition of disqualified persons is broad and encompasses many contributors and individuals related to a foundation under Sec. 4946(a)(1), including someone who is a substantial contributor to the foundation; the foundation manager; an owner of more than 20% of a corporation, partnership, or enterprise that is a contributor to the foundation; or a family member of one of these people. Under Regs. Sec. 53.4941(d)-2(a)(1), if a disqualified person makes a gift of a PTP interest to a private foundation and there is a bargain-sale component, then the transaction will be a prohibited transaction — resulting in the transaction having to be unwound and excise taxes owed.

Given that losses from a PTP can be offset only from income or gain from that specific PTP, how could an investor go about monetizing a loss?

Be aware, too, that donations of a PTP interest will not result in the recognition of PALs other than to offset any gain/income recognized on the contribution. Any suspended PALs will be added to the basis of the interest gifted to charity. Also, these donations are subject to extensive and complex substantiation requirements, including a qualified appraisal, qualified acknowledgment letter from the charity, and completion of Form 8283, *Noncash Charitable Contributions*. The requirements above should not necessarily prevent charitably inclined persons from considering donating their PTP units. But the complications noted above require careful planning and modeling to determine the implications of a gift of a PTP interest to a charitable organization. As you can see,

Ordinary income recapture

	Units sold	Sale date	Sales proceeds	Purchase price/initial basis amount	Cumulative adjustments to basis	Cost basis	Gain subject to recapture as ordinary income
	50,000	01/01/2020	$200,000	$100,000	($75,000)	$25,000	$100,000
References			**Form 8949, column D**			**Form 8949, column E**	**Form 4797, Part II, line 10; Form 8949, column G**

PTP units can be challenging assets to give away due to the extensive reporting requirements. These complexities may deter many taxpayers from gifting PTP units.

Recent legislative proposals

Changes might lie ahead for PTP investments. On March 28, 2022, Treasury released its Green Book[2] proposals to accompany the Biden administration's budget. Included in the Green Book was a proposal to eliminate the corporate income tax exception for PTPs that realize qualifying income or gains from fossil fuels beginning after Dec. 31, 2027. While no specifics related to the proposal are currently available, it would presumably require PTPs with income or gains from fossil fuels to be taxed as corporations, and thus the investor's reporting requirements would likely follow that of a public corporation versus a complicated PTP. However, the ideas contained in the Green Book are only proposals at this time. The recent Inflation Reduction Act[3] notably did not contain a similar provision to the Green Book, so it appears this proposal may be less of a legislative priority at this time. Regardless of any proposals, congressional legislation is required to enact a change in tax law. PTP investors should be on the lookout for new developments and reach out to their tax advisers for guidance if new tax legislation is enacted that includes a provision like that proposed in the Green Book.

A worthwhile investment?

A PTP investment is a complex investment that may present opportunities to individual investors but requires tax planning to achieve an investor's goals. Holding the units of a PTP requires basis tracking and planning for passive losses from the investment. The sale of PTP units necessitates planning around the type and treatment of gain but presents investors the opportunity to recognize suspended losses. Gifting units to a charitable organization may be desirable from a nontax perspective, but planning should be done to consider potential gain recognition on donation and the reporting requirements. If you make careful choices and plan wisely, a basket of lemons may not be a bad thing. ■

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2. Treasury Department, *General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals.*
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AICPA RESOURCES

Articles

Drnevich and Sternburg, "Publicly Traded Partnerships: Tax Treatment of Investors," 50 *The Tax Adviser* 276 (April 2019)

Hagy, "Reporting Publicly Traded Partnership Sec. 751 Ordinary Income and Other Challenges," 49 *The Tax Adviser* 252 (April 2018)

Webcast

Tax Fundamentals of LLCs and Partnerships," Nov. 4, 9 a.m.–5 p.m. ET, or Dec. 7, 10 a.m.–6 p.m. ET

Tax Section materials (for members)

SALT Roadmap — State and Local Tax Guide

Schedule K-2 and K-3 resources

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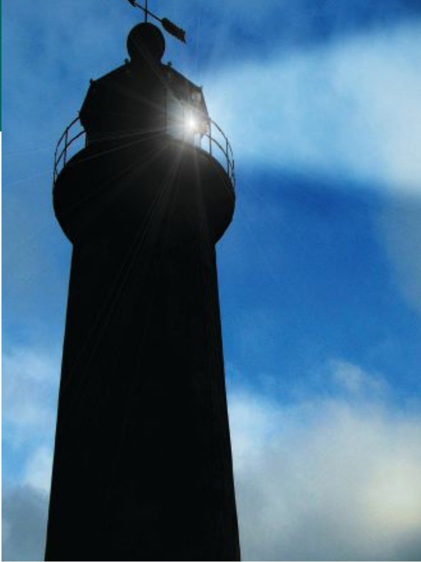

Updates and guidance on key IRS practice developments.

Editor:
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The IRS strives to expand online service offerings while balancing convenience with the need to keep taxpayer data safe from hackers.

How to submit third-party authorization forms online (and use ID.me)

As if contacting the IRS by telephone for assistance was not already difficult enough, the recent pandemic shutdowns made it almost impossible to accomplish any basic task that required IRS assistance. Well aware of this problem, the government, to its credit, has been making more and more services available online so that a practitioner need not sit on the telephone on hold for hours waiting for the inevitable recorded message to "try again later." Allowing online access to taxpayers' confidential information through new online services, of course, must be balanced against the fear of hackers and identity theft. With this concern in mind, the IRS in November 2021 announced the launch of an improved identity verification and sign-in process to obtain secure access to the IRS's online tools. The Service announced that for this purpose it would be using a third-party technology provider, ID.me.

The new, mobile-friendly verification procedure through ID.me was designed to allow taxpayers and their representatives easy access to valuable online services, including the Child Tax Credit Update Portal, Online Account, Get Transcript Online, Get an Identity Protection PIN (IP PIN), and Apply Online for a Payment Plan. The IRS also created a portal for tax professionals who want to submit a Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*, online, rather than using the traditional methods of mailing or faxing in such forms.

This column first discusses ID.me and then describes how practitioners can use the "Submit Forms 2848 and 8821 Online" portal to send clients' third-party authorization forms to the IRS. The Service also has created a separate, all-digital, non–form-based method, through Tax Pro Account, for tax professionals to initiate a request for a third-party authorization from their account that is then sent to the client's online account for an electronic signature. This column, however, focuses on how to upload the forms themselves using the "Submit Forms 2848 and 8821 Online" portal.

ID.me

The IRS's initial intention was that by the summer of 2022, ID.me would replace the old system and usernames currently in place to log in to IRS online services. The old system was going to remain available as a parallel access method until then, after which everyone would be forced to create an ID.me account in order to access any online services. These plans have changed because of a controversy over the use of biometric verification.

In order to use ID.me, as the Service explained back in November, taxpayers and practitioners had to first establish

PHOTO BY SEAN GLADWELL/HEMERA/THINKSTOCK

ID.me is also used by several other federal agencies, including the Social Security Administration and the Department of Veterans Affairs, and can be accessed using the same login information.

their identity using their Social Security number (SSN) and some form of government-issued photo identification, specifically a driver's license, a state-issued ID, or a passport. Then the person would have to verify their identity by taking a selfie with either a smartphone or a computer with an enabled webcam — and that selfie picture would be matched to their previously provided photo identification.

Numerous commentators, and several members of Congress, raised concerns about the use of facial-recognition technology and the collection of such biometric identification by the IRS. In response, in February 2022, the IRS announced the availability of an alternative method to verify a user's identity other than the "selfie" method. While taxpayers and practitioners still use ID.me to register for an online IRS account, they are now able to verify their identity via an alternative method through a live online interview with an ID.me agent rather than submitting photo identification. While the live interview with the ID.me agent is recorded, ID.me has stated that the video record is deleted after 30 days. Additionally, for those people who had signed up for ID.me prior to the implementation of this new verification procedure, there is an option to allow them to have their previously submitted selfie deleted from the ID.me files if they so choose.

Taxpayers and practitioners can elect to verify their ID.me account under either method. Note that submitting the photo identification and verifying with a selfie generally takes a few minutes, while working with an ID.me agent requires the applicant to produce at least two primary identification documents, and the wait time has been known to often exceed an hour.

Once individuals are registered and verified, not only can they access certain IRS information, but also 27 states use ID.me for their unemployment benefits and other programs. ID.me is also used by several other federal agencies, including the Social Security Administration and the Department of Veterans Affairs, and can be accessed using the same login information.

It should be noted that the IRS has been exploring the viability of rolling out an alternative to ID.me that would operate through the General Services Administration-run website login.gov.

Uploading Form 2848 and Form 8821

One major advantage of having an online account is that you can upload and submit a client's third-party authorization forms (Form 2848 and Form 8821) through the IRS's "Submit Forms 2848 and 8821 Online" portal. In order to take advantage of this alternative to faxing or mailing in the form, you must: (1) authenticate that your client is who he or she claims to be and (2) have the person properly execute the form. You also need to know how to upload the form to the portal and, if the situation arises, how to revoke or withdraw the form. These matters are discussed below.

Authentication: To use the "Submit Forms 2848 and 8821 Online" portal, you must first authenticate the taxpayer's identity if the individual is electronically signing the form remotely (meaning not in person) and you do not already have a personal or business relationship with him or her. A best practice is to routinely authenticate the taxpayer's identity even if he or she is signing in person. The objective behind this requirement is to ensure that the person signing the form is, in fact, the person they claim to be.

The IRS says that the Centralized Authorization File unit processes all of the forms that it receives, be it by online, mail, or fax, on a first-in, first-out basis.

In order to authenticate the taxpayer's identity, verification is done in a manner similar to that used by the ID.me registration platform. First, the taxpayer signing the form sends you for inspection a valid government-issued photo identification document. Then you have to compare the photo to the individual signing the form either via a selfie sent to you by the taxpayer or by videoconferencing with the taxpayer. Next, there is a further verification of the person's name, address, and SSN or individual taxpayer identification number through some form of secondary documentation. The recommended secondary information includes a federal or state tax return or IRS notice or letter and, possibly, also a credit card statement or current utility bill. The current credit card statement or utility bill is needed if the taxpayer has

One major advantage of having an online account is that you can upload and submit a client's third-party authorization forms (Form 2848 and Form 8821) through the IRS's 'Submit Forms 2848 and 8821 Online' portal.

moved since last filing a tax return and wants to use his or her updated address on the Form 2848 or Form 8821. In that situation, you will still need to see the tax return to verify the individual's SSN, but then you would use the utility bill to verify the address that the person wants to use on the form. This helps protect taxpayers from identity theft.

For business-entity taxpayers signing a Form 2848 or Form 8821 remotely, not only do you have to authenticate the identity of the person signing the return, as explained above for individual taxpayers, but you also need to make sure that the individual has the proper authority to sign the form on behalf of the business-entity taxpayer. Documentation such as corporate minutes or an operating agreement could be used to satisfy this requirement. After verifying the signer's identity, you would then need to record the name, employer identification number, and address of the business-entity taxpayer. This information must also be verified through secondary information, including a tax information reporting form, IRS notice or letter, or a utility bill issued to the business entity.

Execution: One advantage of submitting a Form 2848 or Form 8821 online is that the taxpayer does not have to physically sign a printed piece of paper and scan or fax it back to the practitioner. For this purpose, the IRS allows an electronic signature. The IRS provides several acceptable methods for affixing an electronic signature: a name that is typed on a signature block; a scanned or digitized image of a handwritten signature that is attached to an electronic record; a handwritten signature input onto an electronic signature pad; a handwritten signature, mark, or command input on a display screen with a stylus device; or a signature created by third-party software. The ability to use an electronic signature demonstrated its value during the pandemic with many taxpayers working from home without access to a printer and/or scanner, as Forms 2848 or 8821 that are mailed or faxed to the IRS must still be physically signed (i.e., a "wet signature").

Submitting the form: The first step to upload the form after logging in to the "Submit Forms 2848 and 8821 Online" portal is to start a session by inputting the taxpayer's taxpayer identification number (TIN). This number is used to track the progress of the authorization form. Then the completed form can be uploaded into the system in either a PDF, JPEG, JPG, or GIF file format. The IRS cautions not to upload any form that has already been submitted by fax or mail. The IRS says that the Centralized Authorization File unit processes all of the forms that it receives, be it by online, mail, or fax, on a first-in, first-out basis. Once the form is submitted, you will receive a confirmation email.

As the forms are tracked by TIN, only one form can be submitted at a time. You must start a new session each time you file an additional form, even if you are representing taxpayers who are married and file joint returns. This annoyance started a few years ago when the IRS stopped allowing married taxpayers to complete a joint Form 2848 and started requiring that each spouse prepare and sign a separate form.

You also need to know how to upload the form to the portal and, if the situation arises, how to revoke or withdraw the form.

Revoking or withdrawing the form: Generally, to revoke an authorization that is already in place, the taxpayer simply writes "REVOKE" across the top of the Form 2848 or 8821 and signs and dates below it. Similarly, a practitioner who wants to withdraw as a representative on a Form 2848 can write "WITHDRAW" across the top of the first page of the form and sign and date below it. Rather than having to mail or fax in the withdrawal or revocation, such form can now be submitted through the "Submit Forms 2848 and 8821 Online" portal by simply choosing "Revocation/withdrawal of an existing authorization" and following the instructions set out therein.

For more information about how to submit Forms 2848 and 8821 online, see the FAQs posted on IRS.gov. ■

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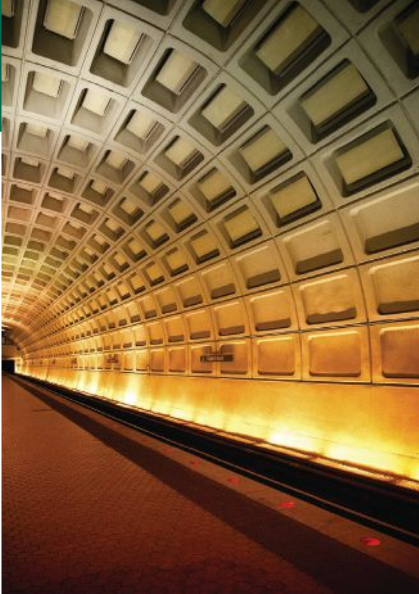

Newly released IRS *Data Book* numbers confirm decline in audit rates

Author:
Robert M. Caplan, CPA

Along with frustrating backlogs, declining audit rates have been the topic of many accountant discussions regarding how IRS budget constraints have affected taxpayers. The latest IRS statistics confirm the declining audit numbers.

On May 26, 2022, the IRS released its *Data Book, 2021 (Publication 55-B)*. The *Data Book*, published annually since 1863, contains statistical tables describing a full range of IRS activities, including returns, collections, refunds, enforcement, and the IRS workforce. The recent report covers the fiscal year ending Sept. 30, 2021. This is the first full tax year affected by COVID-19.

The first table, "Tax Year 2019 Audit Rates Over Time," shows IRS audit rates for tax year 2019 measured as of Sept. 30, 2021, and May 1, 2022. It includes the following types of audits:

A number of factors have led to a decline in IRS examinations over the past few years, and a dearth of IRS examiners could cause that trend to continue.

Tax year 2019 audit rates over time

Total positive income (TPI) ranges	Tax year 2019 audit rate in *Data Book*: Sept. 30, 2021	Tax year 2019 audit rate as of May 1, 2022
Returns with EITC	0.8%	0.8%
No TPI	0.8%	1.1%
TPI $1–$25,000	0.4%	0.4%
TPI $25,000–$50,000	0.2%	0.2%
TPI $50,000–$75,000	0.1%	0.2%
TPI $75,000–$100,000	0.1%	0.2%
TPI $100,000–$200,000	0.1%	0.2%
TPI $200,000–$500,000	0.1%	0.2%
TPI $500,000–$1 million	0.3%	0.6%
TPI $1 million–$5 million	0.6%	1.3%
TPI $5 million–$10 million	1.0%	2.0%
TPI >$10 million	2.0%	8.7%

Source: IRS, *Data Book, 2021*, Table 17, as referenced in IRS statement, "Updated IRS Audit Numbers" (May 26, 2022).

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- Office, field, large business, and international cases, including high-wealth individuals;
- Correspondence exams; and
- Underreporter inquiries (CP 2000).

Normally, a taxpayer who qualifies for the earned income tax credit (EITC) has income under $100,000. The relatively high audit rate for the EITC includes the IRS EITC anti-fraud initiatives.

To understand the significance of the 2019 audit rates, it is important to compare them with those of prior years. The table "Audit Rates Over Time" compares audit rates for tax years 2017 and 2010. Here we can see a dramatic decline in the percentage of taxpayers audited over the eight-year period, with the largest decreases in the highest income categories.

The IRS claims to aggressively audit high-income taxpayers and businesses; yet these statistics show that even by 2017 the overall audit rates had declined precipitously, with high-income returns seeing the greatest decline in audits. For example:

- Audit rates for individual income tax returns with total income between $200,000 and $500,000 declined by 82.1%.
- Corporations with assets between $250 million and $500 million had audit rates reduced by 66%.

The Transactional Records Access Clearinghouse (TRAC) at Syracuse University noted that in 2021, "out of over 160 million individual income tax returns that were filed, the IRS audited 659,003 — or just 4 out of every 1,000 returns filed (0.4%)" (Syracuse University TRAC, "IRS Audits Poorest Families at Five Times the Rate for Everyone Else" (March 8, 2022)).

"All but 100,000 of the 659,000 audits were conducted [by correspondence]" (id.). TRAC also notes that "over half of these correspondence audits were targeted at [EITC recipients]" (id.).

In fiscal year 2021, the number of those with over $1 million of positive

Audit rates over time

	Tax year 2017	Tax year 2010	Change in coverage
Individual income tax returns, total	0.5%	1.0%	-50.5%
Size of total positive income:			
No total positive income	6.8%	20.6%	-67.1%
$1 to under $25,000	0.6%	1.0%	-44.2%
$25,000 to under $50,000	0.2%	0.6%	-60.3%
$50,000 to under $75,000	0.3%	0.7%	-51.2%
$75,000 to under $100,000	0.4%	0.7%	-36.2%
$100,000 to under $200,000	0.4%	0.8%	-44.5%
$200,000 to under $500,000	0.4%	2.3%	-82.1%
$500,000 to under $1,000,000	0.9%	3.6%	-76.3%
$1 million to under $5 million	1.8%	8.2%	-77.5%
$5 million to under $10 million	3.1%	13.5%	-77.1%
$10 million or more	5.8%	21.5%	-73.1%
Returns with EITC	1.0%	1.8%	-44.8%
Corporation income tax returns, except Form 1120-S			
Returns other than Forms 1120-C and 1120-F, by size of balance sheet assets:			
$10 million to under $50 million	3.8%	8.8%	-56.3%
$50 million to under $100 million	9.0%	18.9%	-52.4%
$100 million to under $250 million	9.6%	21.6%	-55.5%
$250 million to under $500 million	8.2%	24.2%	-66.0%
$500 million to under $1 billion	10.6%	29.8%	-64.6%
$1 billion to under $5 billion	16.1%	46.1%	-65.0%
$5 billion to under $20 billion	31.4%	65.7%	-52.2%
$20 billion or more	56.5%	86.7%	-34.8%
Partnership returns	0.1%	0.5%	-79.3%
S corporation returns	0.2%	0.4%	-53.2%

Source: IRS, *Data Book*, *2021*, and *Data Book*, *2020*,Table 17. Individual returns include all Form 1040-series returns except Forms 1040-PR and 1040-SS, which are included in international returns. In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual income tax return and, thus, excludes losses.

income audited by the IRS did have a slight increase over fiscal year 2020 — from 11,331 to 13,725. However, the 2021 number was still below that of 2019 (13,970) (id.).

"Despite this modest improvement [in 2021], [the] IRS was still only managing to conduct about a third of the millionaire audits it had completed during fiscal year 2015" (id.).

Ashlea Ebeling, writing in *Forbes* this year, reached the conclusion that "[o]n average, individual tax returns were audited over three times more often for tax year 2010 (0.9%) than for tax year 2019 (0.25%)" (Ebeling, "IRS Tax Return Audit Rates Plummet," *Forbes Personal Finance* (May 18, 2022)).

The decline in audit rates can partially be explained by the reduction in full-time-equivalent (FTE) IRS revenue agents and tax examiners, which in fiscal year 2021 totaled 17,079 (IRS, *Data Book, 2021*, Table 32). For comparison, the number of FTE employees in these categories for fiscal year 2011 was 38% higher at 23,556 (IRS, *Data Book, 2012*, Table 30).

Ebeling also attributes the reduction in audit rates to IRS staff shortages resulting from decreased funding, and elaborates: "Since fiscal year 2011, the number of tax examiners who work basic audits, usually by mail, decreased by 18%, and the number of revenue agents who work on complex in-the-field audits decreased by more than 40%."

In conclusion, the IRS, primarily due to funding cuts, employs significantly fewer revenue agents and tax examiners than a decade ago. This has led to an overall decline in audit rates for individuals and corporations. High-income taxpayers have received the greatest reductions proportionately in audit rates. Indications are that the significant attrition of revenue agents and tax examiners will continue. Even with increases in funding, it appears that the IRS is years away from having a robust core of tax examiners and from having audit numbers comparable to 10 years ago. ■

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CASE STUDY

Self-employment tax and LLCs

Editor:
Shaun M. Hunley, J.D., LL.M.

An LLC member's distributive share of LLC income and loss from a trade or business is generally subject to self-employment tax, raising several issues around guaranteed payments, retirement payments, rental income, and members who are employees of the LLC.

This case study has been adapted from *Checkpoint Tax Planning and Advisory Guide's* Limited Liability Companies topic. Published by Thomson Reuters, Carrollton, Texas, 2022 (800-431-9025; tax.thomsonreuters.com).

Net income from self-employment is defined in Sec. 1402(a) as net income from any trade or business plus the distributive share (whether or not actually distributed) of income or loss (to the extent a loss is not limited by the basis, passive activity, at-risk, or other rules) from any trade or business carried on by a partnership (including a limited liability company (LLC) classified as a partnership for federal income tax purposes). Rev. Rul. 65-272 provides that items of income and allowable deductions attributable to any trade or business carried on by a partnership that are required to be taken into account separately under Secs. 702(a)(1) through (8), plus any distributive share of partnership income or loss, are considered as realized from a trade or business and used in computing an individual partner's net earnings from self-employment to the extent not otherwise excluded under Sec. 1402(a). This general rule implies that members of an LLC classified as a partnership are subject to self-employment (SE) tax on their share of the LLC's income from a trade or business. However, Sec. 1402(a)(13) provides an exception for limited partners.

Note: Since the existence of a single-member LLC (SMLLC) is disregarded for most federal tax purposes (unless the SMLLC elects to be classified as a corporation), an individual who owns a disregarded SMLLC that is engaged in a business clearly is subject to SE tax on the SMLLC's net income.

Related SE tax issues facing LLCs

Guaranteed payments

Guaranteed payments, whether received for services or for the use of capital, are included in an individual's net earnings subject to SE tax unless they are received from an LLC that is not engaged in a trade or business (Regs. Sec. 1.1402(a)-1(b)). With a few limited exclusions, "trade or business" has the same broad meaning for this purpose as it has in Sec. 162 (Sec. 1402(c); Regs. Sec. 1.1402(c)-1). The exclusions are those set forth in Secs. 1402(c)(1) through (6) and Regs. Secs. 1.1402(c)-2 through -7 (e.g., services performed as an employee covered by Social Security or the Railroad Retirement program, certain services performed as a public official, and certain services performed by ordained ministers and other religious personnel).

Planning tip: A limited partner is subject to SE tax on guaranteed payments only to the extent they are received for services (Sec. 1402(a)(13)).

A member's treatment of a payment for SE tax must be consistent with the treatment on the LLC's Form 1065, *U.S. Return of Partnership Income*. In *Howell*, T.C. Memo. 2012-303, the court concluded that payments treated as guaranteed payments on the return filed by the LLC were guaranteed payments

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subject to SE tax on the member's return, despite the member's argument that she provided only minimal services to the LLC.

An LLC may be considered to have a trade or business when classifying a guaranteed payment as SE income, even though the income and related deductions from certain activities are generally excluded from SE income. This would be the case, for example, when the LLC is engaged in a rental real estate activity that rises to the level of a trade or business. Although a member's distributive share of the LLC's income from the rental real estate is not subject to SE tax (provided the member is not a real estate dealer) under Sec. 1402(a)(1) and Regs. Sec. 1.1402(a)-4, a guaranteed payment received from such an LLC would be subject SE tax.

When the LLC's income is predictable, a member in this situation wishing to avoid SE income might rather receive a preferential allocation of LLC income than a guaranteed payment of the same amount. Even though the economic effect to all concerned would be generally the same, the income from the preferential allocation would be part of the member's distributive share of rental income and would be excluded from SE income, whereas the guaranteed payment would constitute SE income.

Caution: Under Sec. 707(a)(2), if a member performs services for an LLC and receives a related income allocation and distribution, the arrangement may be treated as a payment to a third party for services. Under proposed regulations, when this disguised-payment-for-services rule applies, it applies for all purposes of the Code, including SE taxes.

Planning tip: Although a guaranteed payment and a preferential income allocation followed by a distribution can be economically similar, guaranteed payments received by members are not qualified business income (QBI) for the Sec. 199A deduction. On the other hand, a preferential income allocation can be QBI, provided the arrangement is not recharacterized as a disguised payment for services. Note, however, that a preferential income allocation is not guaranteed, so the member is exposed to the risk that the LLC will have little or no income to allocate.

A guaranteed payment is SE income only if the recipient is an individual or a disregarded entity (such as an SMLLC or a grantor trust), the income of which is taxed to an individual. Other types of recipients, such as C corporations, S corporations, or partnerships, are not subject to SE tax. If a guaranteed payment is received by an LLC, the income will pass through to the members and may be subject to SE tax under generally applicable rules, but not because the income received by the LLC was a guaranteed payment (Sec. 1402(a)).

Retirement payments

Certain retirement payments to LLC members are not subject to SE tax, provided they meet specific requirements. The payments must be made under a written retirement plan that provides for bona fide retirement payments on a periodic basis to members generally, or to a class or classes of members, and the payments must continue at least until the member's death. To constitute bona fide retirement payments, the payments must be paid on account of retirement and measured by and based upon such factors as years of service and compensation received. Eligibility to receive such retirement payments generally must be based on age or physical condition or a combination of age or physical condition and years of service (Regs. Sec. 1.1402(a)-17(b)(1)).

Members as employees

Members of an LLC that is classified as a partnership for federal income tax purposes cannot be employees of the LLC for employment tax purposes (Rev. Rul. 69-184). Some taxpayers have attempted to avoid this rule by hiring a certified professional employer organization (CPEO) to treat partners/LLC members as employees. A CPEO is an employee leasing company that meets certain criteria (see Regs. Sec. 301.7705-1(b)(1)). A CPEO can be treated as the sole employer of any worksite employee who is included in a service contract between the CPEO and a customer (Sec. 3511).

Proposed regulations under Sec. 3511 led some practitioners to believe that, in some cases, a partner could be treated as an employee of a CPEO rather than as self-employed. But the IRS clarified in Chief Counsel Advice (CCA) 201916004 that payments made by a CPEO to a partner in a partnership under a contract between the partnership and the CPEO must always be treated as a payment to a self-employed individual.

Planning tip: LLCs sometimes grant a profits interest to employees as incentive compensation. The LLC and the individual might prefer that the individual retain employee status, especially if the profits interest is relatively small. CCA 201916004 indicates that the IRS considers Rev. Rul. 69-184 to apply without exception. Although the IRS has asked for comments in the past about situations where it might be appropriate to treat partners as employees, there is currently no basis for treating individuals who are partners as employees for employment tax purposes.

Rental income

As a general rule, rental income from real estate (including personal property leased with the real estate) is exempt from SE tax, unless the taxpayer is a dealer in real estate (Regs. Sec. 1.1402(a)-4(a)). This rule applies regardless of how the activity is characterized under the passive-activity-loss rules. However, income derived from renting living space (private residences or multiple-housing units such as condos)

is not considered income from real estate rental if services are also rendered to the occupant (Regs. Sec. 1.1402(a)-4(c)). Furnishing heat and light; cleaning public entrances, exits, stairways, and lobbies; or collecting trash are not considered to be services rendered to the occupant. But services rendered primarily for the occupant's convenience (such as maid service) do subject income from the rental activity to SE tax.

Whether services provided in connection with renting out a living space are for the occupant's convenience depends on the facts. CCA 202151005 provides two examples related to short-term rentals offered on an online marketplace (such as Airbnb or VRBO). In the first situation, the taxpayer rented fully furnished vacation property and provided daily maid service, access to dedicated Wi-Fi, recreational equipment for the occupants' use, and prepaid vouchers for ride-share services from the property to the nearest business district. Here, the IRS attorneys concluded that the services were provided for the occupants' convenience because they were not clearly required to maintain the space in a condition for occupancy and were so substantial that the compensation for them constituted a material portion of the rent. So, the net rental income from those properties was SE income.

In the second situation, the taxpayers rented a fully furnished room and bathroom in their home. Renters could access the home's common areas only to enter and exit their room and bathroom. They had no access to other common areas such as the kitchen and laundry room. The taxpayer cleaned the space between each occupant's stay. Here, the net rental income was not SE income because the services were not primarily for the occupants' convenience. Instead, the services (cleaning and maintaining the property) kept it suitable for occupancy.

Income from renting personal property is SE income if the taxpayer is in the trade or business of renting such property. Generally, based on the Supreme Court's decision in *Groetzinger*, 480 U.S. 23 (1987), a trade or business is an activity that the taxpayer engages in regularly and continuously with the primary purpose of generating income or profit. ■

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TAX TRENDS

Analysis of and reflections on recent cases and rulings.

Author:
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FBAR violation held to be willful; IRS cannot withhold disclosure of certain returns and return information in Tax Court whistleblower review case.

Procedure & Administration

Counsel's admission costly to taxpayer in FBAR case

The Third Circuit affirmed a district court's holding that a taxpayer's failure to report his foreign accounts on Financial Crimes Enforcement Network (FinCEN) Forms 114, *Report of Foreign Bank and Financial Accounts* (FBAR), was willful. However, while it did not agree with the district court that the IRS had proved the amount of the penalty assessed against the taxpayer, the Third Circuit nonetheless upheld the penalty amount because it found the taxpayer's counsel had admitted in the court proceedings that the balance in the taxpayer's undisclosed foreign account was enough to support the penalty assessed.

Background

Arthur Bedrosian is a U.S. citizen who has worked in the pharmaceutical industry since the 1970s. He has been highly successful in his career, rising to the position of CEO of a generic drug manufacturer. In the early 1970s, when he was still a manufacturer's sales representative, he opened a bank account with a Swiss bank that would later become United Bank of Switzerland (UBS). Sometime during 2005, he opened a second account with UBS, although Bedrosian claimed he considered them to be one account. Bedrosian met with a UBS banker once a year to review the accounts' performance. During 2007, the tax year at issue in the proceeding, both UBS accounts carried balances of significantly more than $10,000. He closed the accounts at the end of 2008.

Bedrosian did not tell his accountant about the existence of the two accounts until 2006, claiming he had failed to do so because the accountant had never asked about them. The accountant, upon learning of the accounts, told Bedrosian he was and had been required to report on his personal tax returns that he had the foreign bank accounts and file any FBARs for them. According to Bedrosian, on advice of the accountant, he did not report the accounts on his 2006 personal returns.

Bedrosian's accountant died in 2007 and, working with a new accountant, Bedrosian finally disclosed his foreign accounts on his 2007 tax return and a 2007 FBAR. However, his disclosure in the 2007 FBAR was somewhat less than complete. It listed only one of the UBS accounts with a balance of $240,000, even though the second account's balance was approximately $2.3 million. He did not report any of the income from the accounts in 2007 on his personal return.

The IRS found out about Bedrosian's account in the 2000s when the U.S. government negotiated an agreement with Swiss banks to provide it account information about their customers. The IRS opened an investigation of Bedrosian in 2011, and eventually the Service assessed the maximum penalty under the Bank

Secrecy Act against Bedrosian for willfully filing an inaccurate FBAR: 50% of the balance of the undisclosed account at the time of the violation. The IRS determined the balance in the account at the time of the violation was $1,951,578.34, and it calculated the 50% penalty to be $975,789.17. Bedrosian initially refused to pay the penalty but eventually did and then filed a refund suit in district court.

The district court sided with Bedrosian. After a one-day bench trial, the court determined that the IRS had failed to prove Bedrosian had willfully filed an inaccurate FBAR. It found that the evidence did not reflect "conduct meant to conceal or mislead or a conscious effort to avoid learning about the reporting requirements." According to the court, Bedrosian was at most negligent.

The IRS appealed the decision to the Third Circuit, which took a more expansive view of the scope of willfulness for an FBAR (*Bedrosian*, 912 F.3d 144 (3d Cir. 2018)), finding that it includes not only knowing but reckless conduct. The court stated that if the IRS could show Bedrosian (1) "clearly ought to have known" (2) "there was a grave risk" the FBAR filing requirement "was not being met," and if (3) he "was in a position to find out for certain very easily," it would satisfy the willfulness element (quoting *Carrigan*, 31 F.3d 130, 134 (3d Cir. 1994)). The court was, however, unsure whether the district court had applied the test, so it remanded the case "for further proceedings consistent with our opinion" and for the court to "render a new judgment."

On remand, the district court, after reevaluating the trial record from an objective viewpoint, determined Bedrosian acted willfully because he "recklessly disregarded the risk that his FBAR was inaccurate." The district court also ordered him to pay the penalty in the amount the IRS calculated (plus interest) because the agency had "not abused its discretion in the amount of the penalty imposed." Bedrosian again appealed the court's decision to the Third Circuit.

The Third Circuit's decision

The Third Circuit affirmed the district court's decision. It found that the court had correctly held that Bedrosian's conduct was willful and that while the IRS had not proved the balance in his accounts supported the penalty imposed, Bedrosian's lawyer had acknowledged that the balance was large enough to support the penalty assessed.

The Third Circuit explained the amount of a civil penalty for a violation of the Bank Secrecy Act depends on three things: (1) whether the violation was willful, (2) the calculation of the maximum penalty permitted by law, and (3) the IRS's discretionary decision whether to assess a penalty at or below the statutory maximum. Bedrosian, in his appeal, only challenged the district court's holding regarding the first two requirements.

Willfulness: Bedrosian challenged the district court's findings on two fronts: (1) the court exceeded the scope of the remand by making supplemental findings that led to its conclusion he acted willfully; and (2) his conduct was not willful.

On the first point, Bedrosian argued that the Third Circuit remanded only "to confirm that the district court's result would be the same under the now-settled standard," not for it to reopen the evidentiary record and make or reconsider factual findings. The Third Circuit disagreed, stating that it placed no limitation on the proceedings on remand. Instead, it noted, its opinion actually anticipated that the district court would reconsider its factual findings and its judgment. Though the opinion did not explicitly state that the district court could review the full record and make supplemental factual findings, the court found doing so was well within the "spirit of the mandate."

On the second point, reviewing the district court's decision under the clear error standard, the Third Circuit found the court had made a rational decision that was grounded in credible evidence. In its analysis, the district court made five supplemental findings to aid in its analysis, and the Third Circuit concluded that the trial record supported each of them. Applying the definition of willfulness it had set out in Bedrosian's earlier appeal to the facts, the Third Circuit held that the district court did not err in determining that Bedrosian acted willfully by failing to disclose his second Swiss bank account on the FBAR.

Maximum penalty: The maximum penalty amount — like willfulness — is an element of the cause of action to collect the penalty. So, similar to a determination of willfulness, it was a factual finding the district court must have made based on the evidence presented at trial. The IRS based its penalty calculation on information from a document — labeled Exhibit R — it introduced that purported to be a listing of the monthly balances in Bedrosian's undisclosed accounts. Bedrosian argued that Exhibit R was lacking any detail connecting the numbers on it to the undisclosed account, so it was inadmissible evidence that could not be relied on to prove that the penalty amount assessed was lawful.

The Third Circuit agreed with Bedrosian. Exhibit R contained no name on the page, no account number, and no bank name, and the numbers listed did not even indicate what currency they referred to. The court observed that the document only showed "someone's 'monthly balance' for something somewhere," and, because the IRS had entered the evidence without testimony from a witness laying a foundation for it, it was just a slip of paper with no relevance to Bedrosian's case. Thus, the exhibit could not be used to confirm that the penalty Bedrosian was charged was 50% of the undisclosed account balance.

Nonetheless, the Third Circuit found that the penalty amount was confirmed because Bedrosian's counsel had admitted that the account balance was at least $1,951,578.34 in the proceedings. In particular, the court pointed to the counsel's opening statement, in which he conceded that "there was about 2 million U.S. dollars" in the undisclosed account.

The court found that this concession was a judicial admission that did not need to be proved in litigation and, thus, Bedrosian was bound by that admission. Consequently, the court held that the penalty of $975,789.17 was below the statutory maximum amount (50% of the account balance).

Reflections

Why did the IRS think it could get away with a clearly inadequate document like Exhibit R? It claimed that Exhibit R was a self-authenticating business record that could be submitted into evidence without a live witness under Federal Rule of Evidence 902(12) because it was accompanied by a custodian certification. But, as the Third Circuit pointed out, authenticity (which was proved by the custodian certificate) and relevance are "two separate matters." As the court explained, a business record may be self-authenticating, but there must still be testimony linking a defendant with the documents to establish relevance. The IRS caught a break when Bedrosian's counsel conceded the amount in the account; otherwise, the IRS would have been out of luck.

Bedrosian, No. 21-1583 (3d Cir. 7/22/22)

Tax returns can be disclosed in whistleblower case

The Tax Court held that the exception in Sec. 6103(h)(4)(A) authorized disclosure of returns and return information that the IRS sought to withhold in a whistleblower case.

Background

An individual (whistleblower) provided information to the IRS regarding three individuals. The IRS pursued actions against all three individuals (including criminal actions with respect to two of the taxpayers) and ultimately collected proceeds from each of them. Nonetheless, the IRS Whistleblower Office (WBO) denied the whistleblower's claim for an award under Sec. 7623(b).

The WBO acknowledged to the whistleblower that the information he provided was reviewed as part of the IRS's investigation of the taxpayers, but the information did not result in the assessment of additional tax, penalties, interest, or other amounts with respect to the issues raised by the whistleblower. The IRS also said the information provided was not relevant to the issues for which additional tax, penalties, interest, or additional amounts were assessed against the taxpayers the whistleblower informed on. The whistleblower petitioned the Tax Court for a review of the WBO's determination.

In general, the Tax Court reviews whistleblower cases based on the administrative record, so the Tax Court ordered the IRS to file redacted and unredacted copies of the administrative record compiled by the WBO in the whistleblower's case. The IRS filed a redacted copy of the administrative record and requested that the court excuse it from filing an unredacted copy "to protect ... section 6103 information and ... other identifying information." Under Sec. 6103(a), returns and return information generally must be kept confidential unless disclosure is specifically authorized by the Code. The court then ordered the IRS to submit to the court, for review in camera, any documents that the Service wished to redact to preserve a privilege or protect taxpayer information.

The IRS, in turn, moved that the court modify its order by striking the portion of it that directed the Service to submit the entire unredacted administrative record for review in camera, arguing that there is no exception in Sec. 6103 that would permit the redacted information to be disclosed to the court. The whistleblower filed a response opposing the IRS's motion.

The Tax Court's decision

The Tax Court held that in the specific circumstances of this whistleblower's case, the exception to disclosure in Sec. 6103(h)(4)(A) permitted the IRS to disclose the taxpayers' returns and return information that the WBO included in the administrative record supporting its determination.

Sec. 6103(h)(4)(A) authorizes the disclosure of tax returns or return information in a federal judicial proceeding pertaining to tax administration if "the taxpayer is a party to the proceeding, or the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal liability." Accordingly, Sec. 6103(h)(4)(A) would apply only if the whistleblower's case "arose out of, or in connection with" determining the civil or criminal liabilities of the three taxpayers the whistleblower informed on, with respect to any tax imposed under the Code.

Because the phrase "in connection with" sweeps less broadly than "arose out of," the Tax Court focused on the meaning of "in connection with." Because the statute did not define this phrase, under the rules of statutory construction, the court looked to the phrase's ordinary meaning at the time Sec. 6103 was enacted. At that time, based on dictionary definitions, the court found that the phrase was defined broadly (and in relevant part) to mean any link, association, or relationship, and that this definition was consistent with past interpretations of the phrase by the Tax Court itself and various other courts.

However, the Tax Court also noted that the Supreme Court had found, in interpreting another statute involving the disclosure of personal information, that the phrase "in connection with" could be interpreted to be essentially indeterminate and, thus, the scope of the phrase must be contained within reasonable bounds. Thus, the Tax Court found that it must exclude from the scope of Sec. 6103(h)(4)(A) those proceedings that have only a "remote relation to" the determination of a taxpayer's liability.

Applying these principles in the context of Sec. 6103, the Tax Court had "no difficulty concluding that this case arose

'in connection with' … determining the civil or criminal liabilities of" the three taxpayers the whistleblower informed on. The court explained that "[w]hen, as here, a whistleblower provides information to the IRS on a target taxpayer and the IRS proceeds with an action and collects proceeds from that target taxpayer, the decision whether to grant the whistleblower an award — as well as [the Tax Court's] eventual review of that decision — is inextricably linked with determining the target taxpayer's civil or criminal liability for at least two reasons." Thus, the whistleblower's case was within the scope of Sec. 6103(h)(4)(A), and disclosure of the WBO's administrative record was authorized.

The IRS appeared to acknowledge that the plain text of Sec. 6103(h)(4)(A) supported the Tax Court's conclusion, conceding in its brief that its own interpretation is "narrower in scope than the plain language implies." The IRS contended that the legislative history of the provision and its statutory purpose supported its narrower interpretation.

The IRS argued that examples from the legislative history of a parallel provision in Sec. 6103(h) show that Congress had a more limited understanding of Sec. 6103(h)(4)(A). The Tax Court, however, found that this legislative history, being from a parallel provision, had no probative value in determining the meaning of Sec. 6103(h)(4)(A). Even if it did, the court found that the legislative history the IRS cited simply comprised some illustrative examples of circumstances that would fall under the parallel provision and there was no indication that the legislative history was intended to be an all-inclusive expression of what the parallel provision or Sec. 6103(h)(4)(A) meant.

Regarding the statutory purpose of Sec. 6103, the IRS argued that the Tax Court's interpretation of Sec. 6103(h)(4)(A) would allow "unfettered disclosure" of return information to "any whistleblower who might file a Tax Court appeal," resulting in "wholesale, unregulated access to return information of any taxpayer that a whistleblower might choose to target." This would be contrary to the overarching purpose of Sec. 6103, which the IRS claimed is to "restrict access to return information within well-defined limits." The Tax Court gave four reasons why it did not believe this was the case.

First, the Tax Court explained that the general rule of Sec. 6103 and its "numerous" exceptions already reflected Congress's balancing of the competing interests of taxpayers in maintaining the confidentiality of their returns and return information and the interests of others whose rights might be affected by that information. Second, the Tax Court noted that Congress had used a broad phrase in the provision and, if it intended to adopt a narrower standard, it could have easily used narrower language. Third, the flush text in Sec. 6103(h)(4) gives the IRS authority to prevent disclosure if it "determines that such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation." Thus, in the court's view, Congress did not leave the IRS powerless with respect to disclosures in judicial proceedings.

Finally, the Tax Court stated that it did not share the IRS's broad view of what it was holding. According to the court, a number of rules in addition to Sec. 6103 limit the information available to whistleblowers in Tax Court. Contrary to the IRS's contention, therefore, it was not holding that every whistleblower should receive unfettered access to the return information of every target the whistleblower names. Instead, the court stated it was holding that in the specific circumstances present in the whistleblower's case, Sec. 6103 does not prohibit disclosure of the taxpayers' returns and return information that the WBO included in the administrative record supporting its determination.

The court then addressed the IRS's contention that the current regulations were consistent with its position. To the extent the regulations allow limited return information disclosure to whistleblowers, in the IRS's eyes, these disclosures are authorized by Sec. 6103(h)(4)(B) or (C) and not Sec. 6103(h)(4)(A).

The Tax Court saw things differently, observing that Regs. Secs. 301.6103(h)(4)-1(b) and 301.7623-3(c)(4)(i)(B) authorize the WBO to disclose returns and return information to a whistleblower during the whistleblower administrative proceeding and that these regulations were based on Sec. 6103(h)(4)(A). Because the court saw no reason that Sec. 6103(h)(4)(A) would authorize broader disclosure in administrative proceedings than in judicial proceedings, it concluded that the regulations reinforced its conclusion that Sec. 6103(h)(4)(A) authorizes the disclosure of the administrative record.

Reflections

As the Tax Court pointed out in the conclusion to its opinion, its holding did not leave taxpayer information in a WBO administrative record without protection, citing for example its own rules that allow the Tax Court to require further redactions from the record or to issue a protective order. It further noted that under another of its rules, on a party's motion and for good cause shown, "the [Tax Court] may make any order that justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense." While the IRS can pursue redaction under these rules, it cannot claim that it is prohibited by Sec. 6103 from complying with Tax Court orders.

Whistleblower 972-17W, 159 T.C. No. 1 (2022) ■

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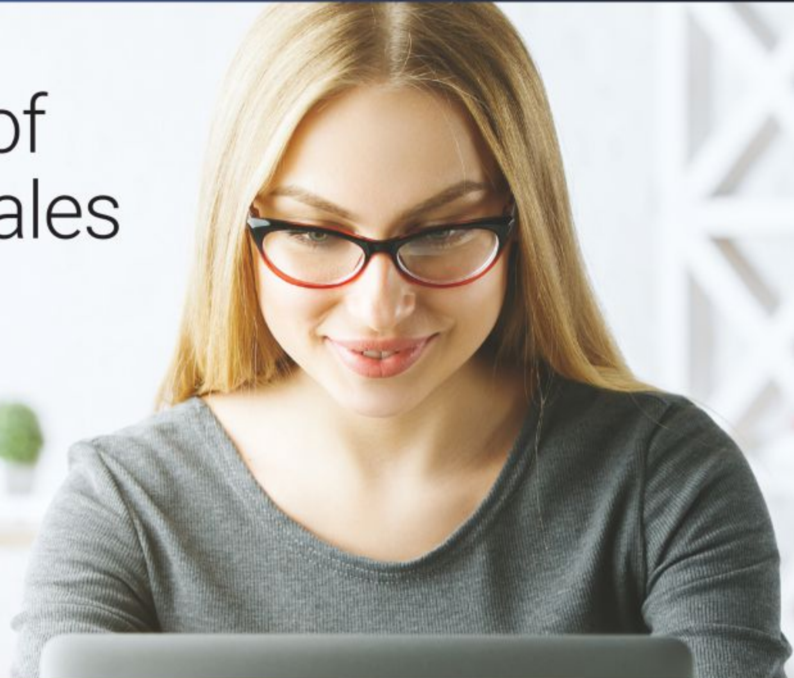

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