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# Surgent's Individual Income Tax Update

BIT4/22/V1

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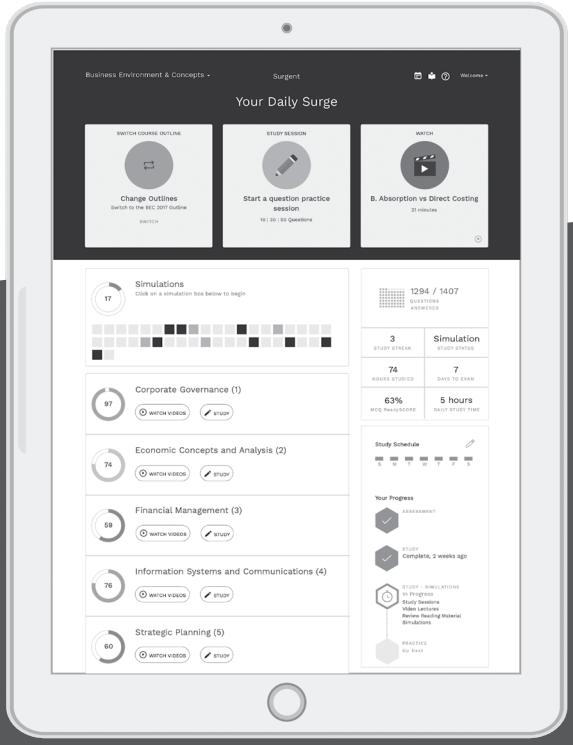


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Revised May 2022

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# Individual Taxation Issues

# Individual Taxation Issues

## *Learning objectives*

Upon reviewing this material, the reader will be able to:

- Understand what practitioners may expect in the future, and what they will expect in 2022;
- Identify areas the Professional Practice may encounter within the next year;
- Understand some of the penalties and how to protect against them in a professional practice.

***Note: Forewarned, forearmed; to be prepared is half the victory***

**Why does Surgent Professional Education occasionally look forward?** Accounting and tax professionals have a tendency to look toward the past, and not toward the future. What is on your desk, last year's tax returns, last quarter's financial statement, last month's compliance or write up work?
**What Washington is talking about or thinking about (NOT politically, but fiscally and financially) is worth a short discussion.**

**What is around the next corner? Preparation is half the victory!**

# *I. Donor-Advised Funds*

## A. Overview

In the realm of tax planning for high-net worth taxpayers and families ("HNW"), clients are asking more questions or pursuing investment tools known as donor-advised funds ("DAF") as a means of receiving tax benefits for charitable giving without the current burden of designating gifts and executing funding to various organizations. In a general sense, a DAF is a charitable giving investment vehicle used to manage charitable funds for families, individuals, and organizations. The investment vehicle is administered and operated by §501(c)(3) public charities known as sponsoring organizations.

Taxpayers can participate with a DAF by opening an account with the sponsoring organization by making contributions to the account in the form of cash or other financial instruments. Once the funds are contributed to the account, the contributions are owned and controlled by the sponsoring organization; however, the taxpayer retains advisory privileges over the account with respect to how the funds are invested and both how and when distributions to charities are made.

Contributions to the DAF are irrevocable, and as a result, the contributions to the DAF are usually qualified charitable deductions for tax purposes, though the final destination of the funds is undetermined. In a practical sense, DAFs represent a convenient and flexible means to make contributions to charities without the need to give directly to organizations or creating a private foundation. As a practical consideration, private foundations are more costly and administratively burdensome making them a less attractive means in executing planned charitable giving.

## B. DAFs, Private Foundations and Supporting Organizations

The first DAF is noted to have been created in 1931 by the New York Community Trust, though the DAF term was not codified until the Pension Protection Act of 2006.[1] As codified in §4966(d)(2), a DAF is a fund or account, owned and controlled by a sponsoring organization ("SO"), that is separately identified by reference to contributions of a donor or donors who retain advisory rights over the account with respect to the distribution of or investment of amounts held in such fund or account by reason of the donor's status as a donor.

As noted above, the funds of a DAF are owned and controlled by an SO, and for purposes of a DAF, SOs are defined as any organization described in §170(c), is not a private foundation under §509(a), and maintains 1 or more DAFs.[2] Section 170 distinguishes types of donors between individuals and corporations, donees between public charities and private foundations, property contributed, the applicable limitations regarding charitable contribution deductions, and the carryover of the excess contributions related to excess charitable contribution deductions.

In general, §501(c)(3) provides tax-exempt charity status to both public charities and private foundations, including SOs. Though SOs can sometimes look like private foundations, they are separate and distinct from private foundations in that they are specifically treated as public charities for tax purposes under §509 with applicability of all relevant regulations as well as the tax benefits available to donors. With that, organizations funded by only a few donors exercising control usually are private foundations. Organizations funded by many donors with limited advisory privileges and no control tend to be considered supporting organizations.

The distinction between public charities and the private foundations relates primarily to the oversight of the organization and the extent to which public support provides for the operation of the entity. Some key distinctions are highlighted below.

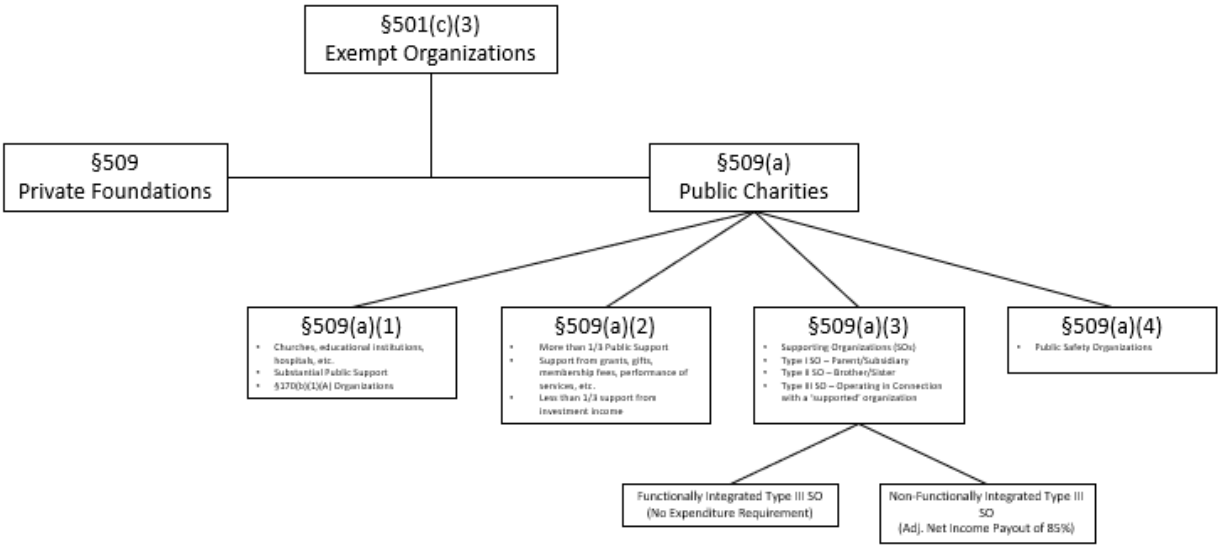
| Features | Public Charity | Private Foundation |
|---|---|---|
| **Mandatory Distribution Requirements** | Generally, No | Yes |
| **Limitations on Contribution Deductions** | Generally 60% through 2027 | 30% Limitation |
| **Excise Tax** | No for qualifying distributions | Yes |
| **Restrictions on investments and distributions** | No | Yes |
| **Donor control of Investments and Distribution** | No | Yes |

SOs in a general sense qualify as public charities under §501(c)(3) because of the relationship the organization shares with other charities that carry out more traditional tax-exempt activities. SOs keep their tax-exempt status by passing tests based on organization, operation, control, and relationship tests. Section 509 provides definitions of different types of SOs, and the underlying requirements for each type

[1] See Victoria B. Bjorklund, "The Emergence of the Donor-Advised Fund," 3 Paul Streckfus' EO Tax J. 15 (May 1998) and Victoria B. Bjorklund, "Choosing Among the Private Foundation, Supporting Organization and Donor Advised Fund," (May 2003), p. 27.

[2] §4966(d)(1)

of charitable organization, and the structure of charitable organizations can generally be thought of as is illustrated graphically below.




### *1. Regulation of Donor-Advised Funds and Supporting Organizations*

As noted above, prior to 2006, there was no formal definition of a DAF, and because of this, abusive practices arose in the industry. A mainstay example can be found in the *New Dynamics Foundation v. U.S.* case of 2006.

New Dynamics Foundation (NDF) was a California, public benefit, nonprofit entity granted state tax exemption in California. The entity, when formed, planned to work with tax and other financial professionals to establish individual accounts where the funds could be directed for charitable purposes. This was consistent with the NDF's articles of incorporation that indicated its purpose was to promote and contribute to public good causes as defined §170(c). The issues arose both in marketing materials as well as in the oversight and administration of the funds. Several promotional materials of NDF sought investment by marketing "tax-free" growth of funds within a public charity.

As funds were contributed to NDF and operational manuals were reviewed by contributors, several nuances demonstrated inconsistencies with the entity's purpose of public benefit with how the funds were actually administered. Operational manuals outlined that directors of the funds could be contributors themselves (resulting in conflicts of interests) and that administrative expenses could include personal expenses of the contributors and fund directors. Further, the NDF founder indicated on several occasions to donors that the administrative/personal expenses could account for 95% of the money contributed to the funds, indicating the identified purpose of the organization and the actual administration were inconsistent.

NDF filed an application with the IRS for federal, tax-exempt status under §501(c)(3). Section 501(c)(3) requires entities to be organized and operated for religious, education, or charitable purposes exclusively, and no part of the earnings can be directed for private individual or shareholder benefit. Entities unable to meet the requirements will not be granted tax exemption. In the case of NDF, the IRS found insufficient cause for tax-exempt status and denied the application.

Subsequently, NDF filed suit to have the IRS's determination overturned on the grounds of it being a DAF as upheld in the National Foundation, Inc. case of 1987. The court agreed with the IRS citing an intent from formation to accrue inappropriate tax benefits by reducing and eliminating estate taxes, avoiding taxes on capital gains, and using the funds as a tax-free vehicle for accruing retirement benefits. Furthermore, while some of the contributed funds were eventually used to fund legitimate and recognized tax-exempt organizations, these donations represented fewer than 5% of contributions. In the National Foundation, Inc. case, it was demonstrated that great efforts were taken to ensure expenditures of the fund were legitimate and not personal in nature. Similar facts were not present in the NDF case.

These abusive practices were curtailed with the Pension Protection Act of 2006 (PPA) codifying DAFs. The goal was to take steps in regulating the supporting organizations owning and controlling the accounts. This came about by amending §509 of the code, which as noted, above, provides the framework for tax-exempt entities along with the general responsibilities applicable to maintain tax-exempt status. The PPA defined SOs along with the distinction of applicable regulations for Type I, II, and III SOs; provided guidance on functionally and non-functionally integrated SOs; and imposed excess business holdings excise taxes on non-functionally integrated Type III SOs along with certain Type II SOs. To the extent practitioners are advising supporting organizations, the regulations are complex and require specialized experience to appropriately navigate compliance.

## C. Tax planning and DAFs

As a review, contributions to a DAF are generally treated the same as donations to any other public charity as defined under §501(c)(3) and are generally subject to the general charitable contributions limitations as outlined §170. Strategies around charitable giving are most often highly subjective to the goals of the taxpayer, but general strategies exist during the donate, growth, and support phases of a DAF.

- **Donate** -- As many practitioners know, taxpayers become much more interested in total taxes and taxes expected to be due at the end of a tax year and often seek to implement tax reduction strategies when it is somewhat after-the-fact. The general advice to generate more deductions, usually through charitable contributions, is the same for nearly every filer with taxable income. However, to the extent a taxpayer appreciates a more proactive approach, a DAF is a good way to automate charitable donations without having to make specific charitable giving decisions throughout the year. This can be done by setting up automatic drafts to the DAF. With contributions made throughout the year rather than just at year-end, there is greater potential for compounding and growth on the contributed funds, which provides greater funding opportunities for charitable causes.

  DAFs also provide charitably minded taxpayers the opportunity to pre-fund charitable giving to be executed in retirement years and or to pre-fund charitable giving in tax years of higher income. To the extent a taxpayer is aware of higher income years, this becomes a greater planning opportunity, and educating our clients on economic events triggering higher income years can be an effective strategy in planning. Taxpayers that may be selling a business, selling appreciated real estate, or exercising stock options are great candidates for considering DAFs.
- **Grow** -- As a contributor to a DAF, the donor usually has input into how the funds are invested and can make recommendations for capital preservation. The funds in the DAF

grow tax-free according to the investment strategy implemented by a specific DAF. The strategies can range from money market, growth, emerging markets, fixed-income, etc.

Because there are investment opportunities with DAFs, it can sometimes be used to rebalance a portfolio of assets while also securing charitable contribution deductions. In the rebalancing process, a donor can select the most appreciated assets in a portfolio, contribute them to DAF for a deduction of the fair value of the assets (subject to limitations), and avoid the capital gain that would have been generated if the asset had been sold. This allows the donor to realign their portfolio with the overall strategy, gain access to charitable contribution deductions, and fund future charities with tax-free growth.

Additionally, taxpayers trying to avoid §1091 wash sale transaction rules may consider using charitable deductions to dispose of securities and subsequently purchasing the stock for a different basis in a loss-harvesting strategy for capital gains.

With the investment component of DAFs, there is great potential for tax efficiency, but there is also potential for loss on investments resulting in a reduction in ability to fund future charitable grants. This reminds advisors and taxpayers alike to remember the market exposure on DAF accounts and to plan accordingly for down markets.

- **Support Charitable Operations and Grants** -- As individuals are so inclined, they can make recommendations regarding when and how those funds are paid out. Because of this, DAFs are a great opportunity to provide charitable support to organizations when needed most in economic downturns without pressuring the cash-flow of individual taxpayers also subject to the same economic environment. In a sense, the charitable support is prepaid and available when a cause close to a taxpayer is in need.

  Donors should remember that the contributions are irrevocable, and the funds are ultimately controlled and liquidated as the discretion of the board overseeing the supporting organization and/or the underlying DAFs, though most supporting organizations and DAF boards executing giving as directed if permissible under IRS regulations. This leaves all due diligence and reporting responsibilities to the supporting organization and simplifying the reporting requirements of individual donors. Taxpayers utilizing DAFs will receive consolidated contribution support for contribution deductions from the DAF directly rather than need to obtain and retain documentation charitable activities for each organization supported. With annual fees sometimes less than 1% and some individual donor entry points as low as $5,000, DAFs have become and continue to be tools growing in popularity for all levels of income and assets.

### *1. Tax efficiency example*

A donor has long-term appreciated stock in Publicly Traded, Inc. with a basis of $125,000 and market price of $200,000. The donor is interested in making a charitable donation to DAF, Inc., his donor-advised fund, with a value of $200,000. He approaches his tax advisor to understand what the best way is to maximize the deduction, and the tax advisor demonstrates the following scenario.

| | Sell Stock / Donate Cash | Donate Stock |
|---|---|---|
| (A) FMV | $200,000 | $200,000 |
| (B) BASIS | $125,000 | $125,000 |
| (C) Capital Gain | $75,000 (A - B) | $0 |
| (D) Applicable Capital Gain Rate | 20% | 0% |
| (E) Capital Gain Tax | $15,000 | $0 |
| (F) Charitable Deduction | $200,000 | $200,000 |
| (G) Marginal Tax Rate | 37% | 37% |
| (H) Tax Saved with Charitable Contribution | $74,000 (F * G) | $74,000 (F * G) |
| (I) Total Cost to Donor | $141,000 (E + F – H) | $126,000 (E + F – H) |
| *This example assumes marginal tax rate of 37% and no applicable limitation of contribution deductions of capital gain property.* | | |

As illustrated above, there can be a notable advantage to donating stock rather than selling stock and donating the cash. Because some charitable organizations are not set up to receive stock, a DAF can be great to donate stock, liquidate the stock within the DAF tax-free, and subsequently donate the funds to the desired charitable organization.

## D. What legislators are considering

On June 9, 2021, the Accelerating Charitable Efforts Act ("ACE Act") was introduced to the Senate and proposed several changes to DAFs and PFs. The bill was introduced to the House on February 3, 2022. As previously mentioned, one of the primary differences between private foundations and DAFs is the requirement for minimum distributions to operating charitable organizations from private foundations. There is no such requirement for DAFs. This bill attempts to shorten the gap between when donors to DAFs receive charitable deductions and when the funds are provisioned to operating charities. Specifically, the legislation would create two types of DAFs: a 15-year DAF and a 50-year DAF.

- **15-year DAFs**: For the 15-year DAF, donors would receive immediate charitable deductions if all the contributed funds are distributed within 15 years of donation. The 15-year DAF would also limit the current charitable deduction related to complex assets to the amount of cash made available to DAF after sale of the asset rather than based on FMV upon donation (a potential problem if the contributed asset depreciates significantly after contribution but before being converted to cash inside the DAF).
- **50-year DAFs**: For the 50-year DAF, there would be no deduction until the DAF distributed the contributed funds, but the contribution would still benefit by avoiding capital gain and estate taxes. All funds would be required to be distributed within 50 years accordingly.

The ACE Act would make FIFO accounting mandatory for all assets managed by the DAF. Additionally, for private foundations paying out at least 7% of net FMV of assets (excluding assets for operation), the annual excise tax would be waived. While it appears DAFs will remain in place for future tax years, the specifics regarding the ongoing management of the assets may change amidst legislative considerations.

# II. New Form 7203

In prior years, the Form 1120-S, Schedule K-1 instructions contained a 3-part worksheet, *Worksheet for Figuring a Shareholder's Stock and Debt Basis*. Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations,* is new for the 2021 tax year, and it is used to determine a shareholder's share of the S corporation's deductions, credits, and other items deducted on his or her return.

Form 7203 must be filed by the following S corporation shareholders:

- Shareholders that are claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations);
- Shareholders that received a non-dividend distribution from an S corporation;
- Shareholders that disposed of stock in an S corporation (whether or not gain is recognized); or
- Shareholders that received a loan repayment from an S corporation.

Even though all shareholders are not required to file Form 7203, it may be beneficial for them to complete it, as it ensures that their basis is consistently maintained throughout the years. It is important to emphasize that shareholders, not S corporations, are required to prepare Form 7203. Shareholders who are required to file Form 7203 should attach it to their individual tax return. No forms are attached to Form 1120-S, as S corporations do not prepare Form 7203.

An individual who is a shareholder in multiple S corporations must file a separate Form 7203 for each S corporation. If spouses are shareholders in the same S corporation, each spouse must file a separate Form 7203.

**Components of Form 7203** - Part I: Shareholder Stock Basis

**Part I Shareholder Stock Basis**

| | | | |
|---|---|---|---|
| 1 | Stock basis at the beginning of the corporation's tax year | | 1 |
| 2 | Basis from any capital contributions made or additional stock acquired during the tax year | | 2 |
| 3a | Ordinary business income (enter losses in Part III) | 3a | |
| b | Net rental real estate income (enter losses in Part III) | 3b | |
| c | Other net rental income (enter losses in Part III) | 3c | |
| d | Interest income | 3d | |
| e | Ordinary dividends | 3e | |
| f | Royalties | 3f | |
| g | Net capital gains (enter losses in Part III) | 3g | |
| h | Net section 1231 gain (enter losses in Part III) | 3h | |
| i | Other income (enter losses in Part III) | 3i | |
| j | Excess depletion adjustment | 3j | |
| k | Tax-exempt income | 3k | |
| l | Recapture of business credits | 3l | |
| m | Other items that increase stock basis | 3m | |
| 4 | Add lines 3a through 3m | | 4 |
| 5 | Stock basis before distributions. Add lines 1, 2, and 4 | | 5 |
| 6 | Distributions (excluding dividend distributions) | | 6 |
| | **Note:** If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions. | | |
| 7 | Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15 | | 7 |
| 8a | Nondeductible expenses | 8a | |
| b | Depletion for oil and gas | 8b | |
| c | Business credits (sections 50(c)(1) and (5)) | 8c | |
| 9 | Add lines 8a through 8c | | 9 |
| 10 | Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15 | | 10 |
| 11 | Allowable loss and deduction items. Enter the amount from line 47, column (c) | | 11 |
| 12 | Debt basis restoration (see net increase in instructions for line 23) | | 12 |
| 13 | Other items that decrease stock basis | | 13 |
| 14 | Add lines 11, 12, and 13 | | 14 |
| 15 | **Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0- | | 15 |

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 13 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | | |
| 4 | Interest income | | |
| 5a | Ordinary dividends | | |
| 5b | Qualified dividends | 14 | Schedule K-3 is attached if checked ▶ ☐ |
| 6 | Royalties | 15 | Alternative minimum tax (AMT) items |
| 7 | Net short-term capital gain (loss) | | |
| 8a | Net long-term capital gain (loss) | | |
| 8b | Collectibles (28%) gain (loss) | | |
| 8c | Unrecaptured section 1250 gain | | |
| 9 | Net section 1231 gain (loss) | 16 | Items affecting shareholder basis |
| 10 | Other income (loss) | | |
| | | 17 | Other information |
| 11 | Section 179 deduction | | |
| 12 | Other deductions | | |

Stock basis is **increased** by the following items:

- Contributions of cash or property;
- Ordinary business income;
- Separately stated income;
- Tax-exempt income; and
- Excess depletion.

Stock basis is **decreased** by the following items:

- Ordinary business loss;
- Separately stated losses;
- Nondeductible expenses;
- Non-dividend distributions*; and
- Depletion for oil and gas.

*Note: Dividend distributions do not decrease stock basis.

Stock basis is adjusted annually in the following order:

1) Increased for income items and excess depletion;
2) Decreased for distributions;
3) Decreased for non-deductible, non-capital expenses and depletion; and
4) Decreased for items of loss and deduction.

**Components of Form 7203** - Part II: Shareholder Debt Basis

**Part II** **Shareholder Debt Basis**

**Section A—Amount of Debt** (If more than three debts, see instructions.)

| | Description | Debt 1<br>☐ Formal note<br>☐ Open account debt | Debt 2<br>☐ Formal note<br>☐ Open account debt | Debt 3<br>☐ Formal note<br>☐ Open account debt | Total |
|---|---|---|---|---|---|
| 16 | Loan balance at the beginning of the corporation's tax year | | | | |
| 17 | Additional loans (see instructions) | | | | |
| 18 | Loan balance before repayment. Combine lines 16 and 17 | | | | |
| 19 | Principal portion of debt repayment (this line doesn't include interest) | ( ) | ( ) | ( ) | ( ) |
| 20 | Loan balance at the end of the corporation's tax year. Combine lines 18 and 19 | | | | |

**Part II** **Shareholder Debt Basis** *(continued)*

| | Section B—Adjustments to Debt Basis | | | | |
|---|---|---|---|---|---|
| | **Description** | **Debt 1** | **Debt 2** | **Debt 3** | **Total** |
| **21** | Debt basis at the beginning of the corporation's tax year | | | | |
| **22** | Enter the amount, if any, from line 17 | | | | |
| **23** | Debt basis restoration (see instructions) | | | | |
| **24** | Debt basis before repayment. Combine lines 21, 22, and 23 | | | | |
| **25** | Divide line 24 by line 18 | | | | |
| **26** | Nontaxable debt repayment. Multiply line 25 by line 19 | | | | |
| **27** | Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24 | | | | |
| **28** | Nondeductible expenses and oil and gas depletion deductions in excess of stock basis | | | | |
| **29** | Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0- | | | | |
| **30** | Allowable losses in excess of stock basis. Enter the amount from line 47, column (d) | | | | |
| **31** | **Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0- | | | | |
| | **Section C—Gain on Loan Repayment** | | | | |
| **32** | Repayment. Enter the amount from line 19 | | | | |
| **33** | Nontaxable repayments. Enter the amount from line 26 | | | | |
| **34** | **Reportable gain.** Subtract line 33 from line 32 | | | | |

Debt basis is increased by loans made to the S corporation and decreased by loan repayments made to the shareholder by the S corporation. Per the Form 7203 Instructions, shareholders must account for each formal note, defined as a note with a written instrument, made to the S corporation. Each loan must be reported in a separate column. Open Account Debt is defined as loans made to the S corporation not evidenced by a written instrument and not separately tracked. If an open account debt has a year-end balance of more than $25,000, it will be classified as a formal note at the beginning of the next tax year and must be separately tracked.

Loans that a shareholder guarantees or co-signs are not part of the shareholder's loan basis, except to the extent that the shareholder makes a payment on the guaranteed or co-signed loan. In other words, merely guaranteeing a loan for the S corporation does not increase basis but making a payment on a guaranteed loan increases basis.

**Components of Form 7203: Part III**: Shareholder Allowable Loss and Deduction Items

| **Part III** Shareholder Allowable Loss and Deduction Items | | | | | |
|---|---|---|---|---|---|
| **Description** | **(a)** Current year losses and deductions | **(b)** Carryover amounts (column (e)) from the previous year | **(c)** Allowable loss from stock basis | **(d)** Allowable loss from debt basis | **(e)** Carryover amounts |
| **35** Ordinary business loss | | | | | |
| **36** Net rental real estate loss | | | | | |
| **37** Other net rental loss | | | | | |
| **38** Net capital loss | | | | | |
| **39** Net section 1231 loss | | | | | |
| **40** Other loss | | | | | |
| **41** Section 179 deductions | | | | | |
| **42** Charitable contributions | | | | | |
| **43** Investment interest expense | | | | | |
| **44** Section 59(e)(2) expenditures | | | | | |
| **45** Other deductions | | | | | |
| **46** Foreign taxes paid or accrued | | | | | |
| **47** **Total loss.** Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30 | | | | | |

Corporate losses and deduction items are limited to the sum of the shareholder's stock and debt basis. If loss and deduction items exceed a shareholder's stock basis, the shareholder may deduct the excess up to the shareholder's debt basis. If a shareholder claims losses and deduction items in excess of stock basis against his or her debt basis, the debt basis of the shareholder is reduced by the claimed losses and deductions. If there are different types of losses and deduction items that exceed stock or debt basis, the allowable loss and deduction items must be allocated pro rata based on the amount of the particular loss and deduction items. When determining current year allowable losses, current year loss and deduction items are combined with suspended loss and deduction items carried over from the prior year. Losses and deductions in excess of basis are suspended and carried forward to the following tax year. Such losses may only be deducted when basis is increased. Losses and deductions in excess of stock and debt basis retain their character.

# *III. Residency and domicile*

As a result of the COVID-19 remote work trend, many individuals have been prompted to reevaluate their living situation.

- *Should I buy a bigger house with a dedicated home office space?*
- *Should I move further away from my employer's physical office?*
- *Should I move to a lower tax state?*
- *Should I move somewhere with a lower cost of living?*
- *Should I move somewhere with a better climate?*
- *Should I move somewhere that is better suited for my personal interests outside of work?*

These questions are further complicated by a historic real estate market, with mortgage rates and housing inventory hitting historic lows in 2020 and 2021. These factors led to surging house prices, with "hot" areas of the country experiencing double-digit year-over-year growth. Individuals with substantial home equity may be thinking – *Maybe I should consider moving…*

According to Zillow's Housing Analysis, the following cities are the 10 hottest real-estate markets in 2022:[3]

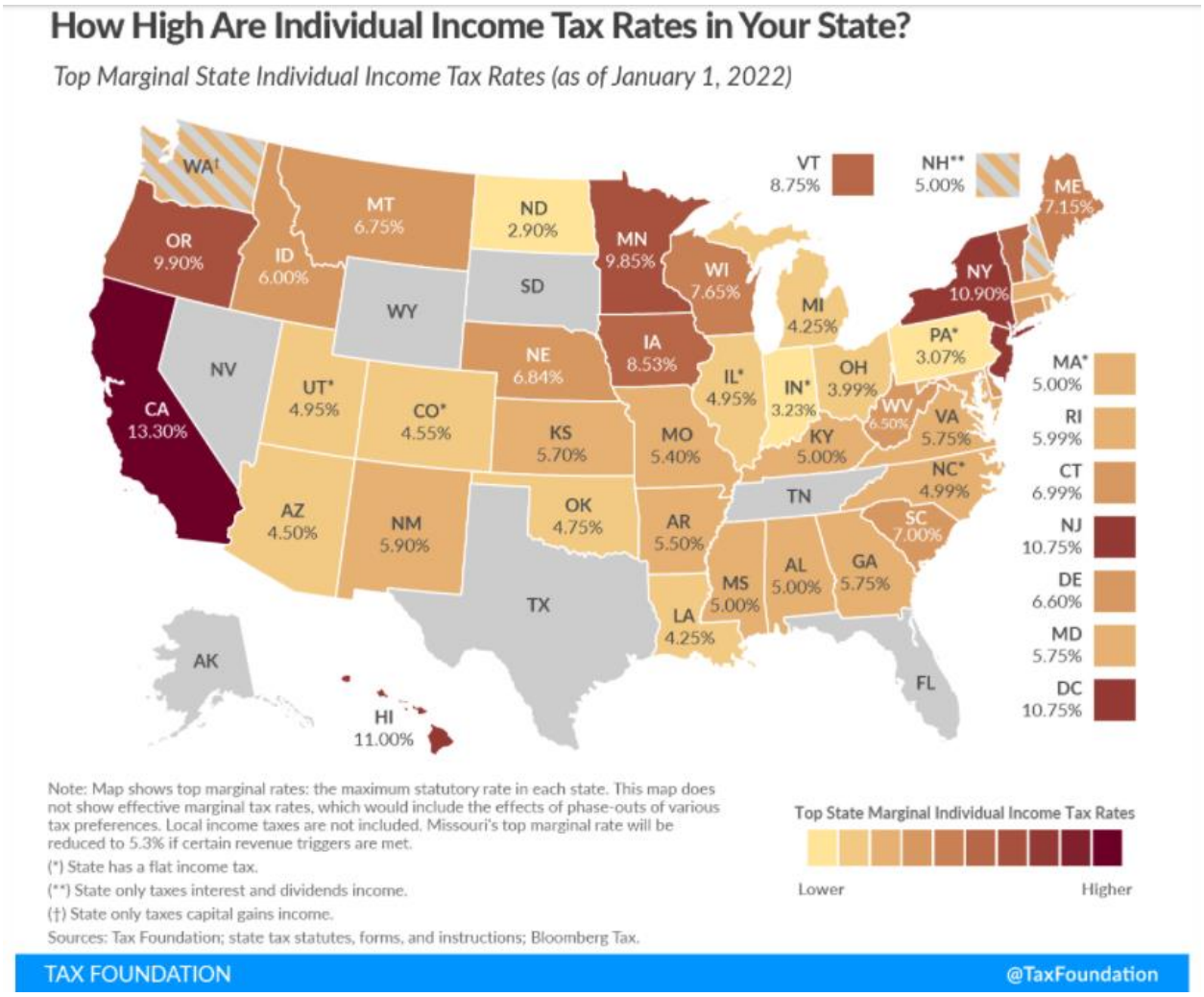
1. Tampa, FL
2. Jacksonville, FL
3. Raleigh, NC
4. San Antonio, TX
5. Charlotte, NC
6. Nashville, TN
7. Atlanta, GA
8. Phoenix, AZ
9. Orlando, FL
10. Austin, TX

Out of these 10 hottest markets, over half are in states with no personal income tax. There are eight states with no personal income tax:

1. Alaska (no sales tax);
2. Florida;
3. Nevada;
4. South Dakota;
5. Tennessee;
6. Texas;
7. Washington; and
8. Wyoming.

New Hampshire taxes interest and dividend income over a certain threshold but does not tax income from wages and does not have a sales tax. Tennessee previously taxed investment income, but as of the end of 2020, they completely phased out this tax. The following map shows the top marginal state individual income tax rates as of January 1, 2022:

[3] Zillow, "*10 Hottest Housing Markets in 2022.*" January 10, 2022.



[4]

With the ability to work remotely, the appeal of owning multiple houses grows. Some individuals may even consider purchasing a second home, or a vacation home, to split their time between states. It is important for practitioners to understand domicile and residency in order to properly assist their clients.

This section will address domicile and residency. Please check your state's rules and requirements for establishing residency and domicile. Most state laws are similar with minor delineations. This material will use the Pennsylvania law as its framework; but again, check your state's statute before advising your client.

## A. Domicile and residency -- Hallmarks for inclusion in state taxation

### *1. In general*

The hallmarks for subjecting an individual to state taxation are residency and domicile. The Pennsylvania law states that individuals domiciled in Pennsylvania or who are statutory residents of Pennsylvania are subject to Pennsylvania personal income tax on income, regardless of where the income was earned.

- If there is no domicile or statutory residency within Pennsylvania, the Commonwealth can only tax the individual's income from sources within Pennsylvania.

[4] The Tax Foundation, *State Individual Income Tax Rates and Brackets for 2022,* February 15, 2022.

- Again, these provisions are typical of the statutes in many states. So, we have to take a closer look at both domicile and residency.

***2. Definition of domicile***

Typically, domicile is defined as where an individual maintains his or her permanent abode and where that person intends to return from any absence. An individual only has one domicile at any one time.

***3. Definition of permanent abode***

States usually codify the definition of permanent abode as a house, apartment, or other structure maintained as a dwelling. Usually, if it's occupied only for a fixed amount of time for a particular purpose, it would not qualify as a permanent abode. Thus, military and student housing are not permanent abodes. Employer-provided housing for a definite period of time is not a permanent abode.

***4. Taxpayers with homes in two states***

A large percentage of domicile and residency audits involve the situation where the taxpayer maintains more than one permanent abode. Say a client purchases a home in Florida and splits time between the Florida property and the home that has been maintained for many years in a state with an income tax. The income tax states have a lot of revenue to lose in this situation; and as such, they will be inclined to assess the taxpayer as their state resident first then force the taxpayer to prove domicile elsewhere, in Florida, for example.

Two factors are usually looked at in this scenario:

a. Which state does the taxpayer intend to be his domicile?
b. Where does the taxpayer have the greatest connections?

## B. Keeping taxpayer's domicile unchanged

Herein lies an opportunity for the practitioner to really be of service to the taxpayer. There are a number of facts the practitioner can point out to the state revenue officer attempting to keep the taxpayer's domicile unchanged.

Knowing the following items to introduce for the benefit of the client will often make the difference and force the revenue officer to recognize the change of domicile away from his or her income-taxing state to one hopefully more tax friendly.

The following tend to show the state with the greatest connections for a taxpayer:

1. The state where taxpayer is registered to vote. Voter registration is usually only switched when taxpayer intends to make a permanent home in the new state. Thus, a taxpayer seeking to establish domicile should immediately register to vote in the new jurisdiction.
2. The state where taxpayer maintains a driver's license and vehicle registration. The driver's license will often be the first thing looked at by the state revenue officer. It would be difficult to establish Florida domicile if the taxpayer still maintains the previous state's license.
3. The state where taxpayer obtains a homestead exemption. There is probably no stronger evidence of domicile than the granting of a homestead exemption. In Florida, for instance, a taxpayer must separately apply for the homestead exemption and provide documentation that the property is the permanent residence, which is defined in Fla. Stat. 196.012(17) as "that place where a person has his or her true, fixed, and permanent

home and principal establishment to which, whenever absent, he or she has the intention of returning." Once a state has made its own independent finding of domicile in this manner, it is Check & Mate.

4. The state where taxpayer has active banking accounts. In an effort to deny the change in domicile, a resourceful state revenue agent will always check which bank the taxpayer's last state payment came from and whether taxpayer still maintains an account there.
5. The state where taxpayer spends the greatest amount of time.
6. The state where taxpayer maintains television and internet connections.
7. The state where taxpayer supports a spouse and children.
8. The state where taxpayer gathers for family and social events.
9. The state where taxpayer has doctors, lawyers, and accountants.
10. The state where taxpayer is listed in the telephone directory. Yes, that relic of bygone times will often make a difference.
11. The state where taxpayer houses pets.
12. The state where taxpayer owns a cemetery plot. Yes, it makes sense that the final contemplated resting place resonates with the place taxpayer intends to return to in this life.
13. The state where taxpayer worships regularly.
14. The state where taxpayer maintains safe deposit boxes.
15. The state where taxpayer participates in social, fraternal, or athletic organizations.
16. The state where taxpayer was domiciled at birth.
17. The state where taxpayer keeps works of art, furniture, family pictures or heirlooms.
18. The state where taxpayer records address for insurance, deeds, mortgages, leases, passport, federal and local tax returns, etc. So please make sure the intended domicile is on the last filed Form 1040 or a change of address was filed.
19. The state where taxpayer is employed.
20. The state where taxpayer receives unemployment compensation.
21. The state where taxpayer owns property fit for year-round living.
22. The state where taxpayer maintains professional licenses.
23. The state where taxpayer receives mail.
24. The state where taxpayer maintains union membership.
25. The state where taxpayer conducts business.
26. The state where taxpayer declares residency for hunting or fishing licenses or school tuition. This has become a potential trap. Many taxpayers are inclined to visit their former state for a hunting or fishing excursion. The few dollars they save by checking the box for state resident on the license applications could potentially cost them big money when the state revenue officer asks why they admitted to still being a resident of the former state. **DO NOT LET YOUR CLIENTS FALL FOR THIS** as state revenue officers know to specifically check hunting and fishing license applications and other in-state preferential programs such as tuition.

These 26 triggers are obviously not intended to be exclusive. However, clients moving to Florida or any other income-tax-free state would be well advised to take a look at these items and conduct their affairs so as to pass potential scrutiny. States are constantly looking for ways to augment their tax base, and there is a movement afoot to reel back in the ostensibly well-heeled taxpayers seeking to shed state income taxes by moving to localities such as Florida and Texas. Arm your clients with this information so that does not happen.

## C. Statutory residency

Besides domicile, the other hallmark for subjecting an individual to state taxation is residency. Certain states also subject statutory residents to their taxes. Often, a statute will consider an individual a statutory resident simply based on the amount of time spent in the state. A rather typical provision considers an individual a statutory resident unless the person spends more than a certain number of days of the year (181 to 183) outside the state or has no permanent abode in the state.

- Taxpayers should keep meticulous records of the time spent in each state by way of flight information and receipts of money spent in each locality so as not to be ensnared into the definition of a statutory resident.
- Taxpayers should not mail anything to the state department of revenue from the state they are attempting to prove is no longer their domicile or statutory residence. In fact, all such mailings should emanate from the practitioner's office. It is very common for a well-meaning client to mail something in response to a notice, perhaps even before a practitioner is retained. And such a mailing is easily rationalized as being sent from convenience when the client just happened to be away from their true domicile. But that postmark is evidence of exactly what the state government wants to show. It will leave a bad taste in the mouth of the state agent and is best avoided when possible.

Taxpayers hold the burden of proof of establishing what states they spend time in during the year. During state residency audits, state auditors look to the previous list of 26 factors, as well as some of the following supporting evidence, if accessible, to determine whether an individual is a statutory resident:

- State toll road charges, such as E-ZPass;
- Credit card statements detailing the location of transactions;
- Airline ticket records; and
- ATM withdrawals.

Clients that frequently move between residences should be advised to maintain meticulous logs or records that clearly document exactly what days were spent in which state.

***Practice Note:***

As noted above, clients may be tempted to purchase a "state resident" hunting or fishing license in a former state. Many states offer discounts to individuals who purchase a resident license as opposed to individuals who purchase a non-resident license. Practitioners beware! State revenue agents will question the client why they classified themselves as a "state resident" for purposes of attaining a hunting or fishing license.

Similarly, clients may be tempted to declare residency in a former state for purposes of attaining preferential in-state college tuition rates. Practitioners beware! State revenue agents will question the client why they claimed residency for purposes of in-state tuition programs.

Remember, the burden of proof falls to the taxpayer to prove their residency status, and conflicting facts/circumstances work against taxpayers.

States are **ALWAYS** looking to augment their tax base!

### *1. How does an individual establish a new domicile?*

Domicile does not change until the person moves to another state or country. The person must intend to make a new permanent home there, therefore abandoning the previous domicile. As such, if a person

moves somewhere but intends to stay there only for a fixed or limited time (regardless of how long), domicile does not change.

There are exceptions for military service members and other circumstances, but generally domicile will be established with the intent to make a new home in a jurisdiction for an indefinite period of time. Two examples of such exceptions are:

- When a worker leaves to find new employment, only intending to stay in the new location if employment is secured, there is no change in domicile; and
- Students studying abroad or in a different state will seldom change domicile since there is usually no intent on making a permanent home there. Moreover, the permanent abode usually remains in the home country.

In order to change domicile, an individual must show intention to abandon the previous domicile, provide evidence of making the new domicile their primary home base, and obtain physical presence and abode in the new location. Similar to the list of factors that substantiate domicile, an individual can take the following actions to establish a new domicile:

- Obtain a driver's license (or professional license, if applicable) in the new state;
- Register to vote in the new state;
- File a state income tax return in the new state (if applicable);
- Register any vehicles in the new state and update insurance information;
- Open savings or checking accounts in the new state;
- Join organizations in the new state (charitable, religious, social, etc.);
- Apply for a homestead exemption on his or her new residence (if applicable) and revoke any previous homestead exemptions on his or her prior state residence; and
- Update all billing/mailing addresses to his or her new state address.

Note that the above list is not all-inclusive, and it is often challenging for taxpayers to prove that they severed ties with their previous home state. This is especially true if a taxpayer has homes in multiple states.

## *IV. Sale of a principal residence*

As discussed in the prior section, the COVID-19 pandemic led to an unprecedented number of individuals contemplating their living. Lured by the promise of remote work, many individuals considered selling their house and moving to their "dream home." This increased demand, coupled with historically low interest rates, led to soaring home prices since 2020. As a result of soaring housing prices, more individuals may consider selling their primary or secondary home. Even individuals who purchased their home only a year or two ago may have significant equity in their home.

A Congressional Research Service report notes that 29% of home sale prices in 2021 were at $500,000 or more and 43% were at prices of $250,000 to $500,000, with approximately 1/3 of sales involving single individuals.[5] Of these sales, 43% could be exposed to capital gain taxes depending on the seller's basis. Individuals who sold a home that they lived in for a significant period of time are more likely to have a lower basis, and therefore, a higher likelihood of exposure to capital gain taxes.

[5] Congressional Research Service, "The Exclusion of Capital Gains for Owner-Occupied Housing" February 2, 2022.

## A. Background and overview

Generally, under §121(a), a taxpayer may **exclude up to $250,000** ($500,000 for joint returns) of **gain realized on the sale** or exchange of the taxpayer's **principal residence** if the taxpayer **owned and used** the property as the taxpayer's principal residence for **at least two years during the five-year period** ending on the date of the sale or exchange. This is often referred to as the **ownership test** and the **use test.**

- The use test does not have to occur over a single block of time, rather, the two years of residence may occur anytime within the five-year period. If the taxpayer becomes physically or mentally unable to care for themselves and used the residence as their principal residence for 12 months in the 5 years preceding the sale or exchange, any time they spent living in a care facility counts toward their two-year use/residence requirement.
- If the taxpayers are married and filing a joint return, only one spouse must meet the ownership test. However, each spouse must meet the use test to qualify for the full exclusion.
- The taxpayer's principal residence need not be a single-family home in order to qualify for the exclusion. It may be a townhome, condominium, a cooperative apartment, a mobile home, or even a houseboat. Generally, the residence must have sleeping, cooking, and toilet facilities.
- Taxpayers may only take advantage of the home sale exclusion of gain (maximum or partial) on their principal residence. A taxpayer's principal residence is their main home. Taxpayers may have more than one home, but they may only have one main home at a time. Such taxpayers must apply a "facts and circumstances" test to determine which of their properties is considered their main home. This "facts and circumstances" test utilizes many of the factors previously discussed regarding residency and domicile, including:
    - The taxpayer's address listed on their U.S. Postal Service address;
    - The taxpayer's address on their voter registration card;
    - The taxpayer's address on their federal and state tax returns; and
    - The taxpayer's address on their driver's or car registration.

Section 121(c) provides that a taxpayer who fails to meet any of these conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced exclusion amount. Examples of these unforeseen circumstances include the following:

- The taxpayer's home was condemned or destroyed.
- The taxpayer's home suffered a casualty loss due to a natural or man-made disaster.
- The taxpayer, his or her spouse, a co-owner of the home, or anyone else for whom the home was his or her residence:
    - Died;
    - Became divorced or legally separated;
    - Gave birth to two or more children from the same pregnancy;
    - Became eligible for unemployment compensation;
    - Became unable, due to a change in employment status, to pay basic living expenses for the household (including food, clothing, housing, medication, transportation, taxes, court-ordered payments, and expenses reasonably necessary for making an income); and

- Any other event determined to be an unforeseeable event per IRS published guidance.

For purposes of determining whether a situation is an unforeseen circumstance, the following factors are often considered:

- The taxpayer sold the home not long after the situation arose.
- The taxpayer began to experience significant financial difficulty maintaining the home as a result of the situation.
- The situation that caused the sale of the home arose during the time the taxpayer owned and used the property as their residence.
- The taxpayer was unable to reasonably anticipate the situation.
- The situation caused the taxpayer's home to become significantly less suitable as a main home for the taxpayer and/or their family.

A health-related move must meet the following requirements in order to be eligible for a partial exclusion of gain:

- The taxpayer moved to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of a disease or illness of themselves or a family member.
- The taxpayer moved to obtain or provide medical or personal care for a family member suffering from a disease, illness, or injury.
- The taxpayer's doctor recommended a change in residence because they were experiencing a health problem.
- Any of the above statements are true for the taxpayer's spouse, co-owner of the home, or anyone else from whom the home was his or her residence.

A change in place of employment must meet the following requirements in order to be eligible for a partial exclusion of gain:

- The taxpayer accepted a new position in a work location at least 50 miles farther from their home than the previous work location. For example, the taxpayer's previous work location was 10 miles from their home, and their new work location is 60 miles from their home.
- The taxpayer had no previous work location and began a new job at least 50 miles away from their home.
- Either of the above bullet points is true of the taxpayer's spouse, co-owner of the home, or anyone else for whom the home was his or her residence.

## B. Spousal considerations

A sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, shall be entitled to the entire **$500,000 exclusion** (rather than $250,000 for single filers) if the date of sale occurs **not later than two years after** the date of death of such spouse, and the requirements were met immediately before such date of death.

A taxpayer that was separated or divorced prior to the sale of the home may treat the home as his or her residence if:

- The taxpayer was the sole or joint owner; and
- The taxpayer's spouse or former spouse was allowed to live in the home under a divorce or separation agreement and used the home as his or her main home.

If the residence was transferred to the taxpayer by a spouse or ex-spouse, the taxpayer can count any time when the spouse owned the house as time when the taxpayer owned it (ownership test). However, the taxpayer must still meet the "use" test on his or her own.

## C. Planning strategies

### *1. Converting rental property to owner-occupied property*

Taxpayers who own rental property may consider converting it to owner-occupied property to take advantage of the capital gain exclusion. This strategy is especially useful for taxpayers who own both a primary property and a rental property that substantially increased in value. However, for purposes of determining the exclusion of gain, periods of nonqualifying use must be considered. **Nonqualifying use** is defined as any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse. Examples of nonqualifying use include periods that the property was used as a rental property, investment property, or vacation home. The following formula is used to determine the amount of gain ineligible for exclusion due to periods of nonqualified use:

$$Gain\ Ineligible\ for\ Exclusion = Total\ Gain \times \frac{Sum\ of\ all\ periods\ of\ nonqualified\ use\ during\ ownership\ period}{Entire\ ownership\ period}$$

***Example:*** In January 2020, Aiden and Audrey purchased a "fixer-upper" primary residence for $400,000 as well as a rental property for $220,000. Aiden and Audrey lived in the primary residence property full-time from January 1, 2020, through January 1, 2022. They made $150,000 of capital improvements during their ownership, bringing their total basis to $550,000 ($400,000 initial basis + $150,000 capital improvements). Aiden and Audrey sold the primary residence property for $1,050,000 on January 1, 2022, resulting in $500,000 of gain ($1,050,000 sale price less $550,000 adjusted basis). Aiden and Audrey can exclude the entire $500,000 gain on their residence since they met the use and ownership tests.

Aiden and Audrey move into the former rental property on January 1, 2022. They live in that property full-time until January 1, 2024, at which time they sold the property for $700,000. They made no improvements during their ownership, but the area in which the property was purchased became very popular, and home prices skyrocketed in value. Aiden and Audrey took $20,000 of depreciation deductions when the property was a rental property. Of the $500,000 gain on the sale of the former rental property ($700,000 purchase price less $200,000 adjusted basis), only 50%, or $250,000, is eligible for the gain. See calculation as follows:

$$Gain\ Ineligible\ for\ Exclusion = Total\ Gain \times \frac{Sum\ of\ all\ periods\ of\ nonqualified\ use\ during\ ownership\ period}{Entire\ ownership\ period}$$

$$\$250{,}000 = \$500{,}000 \times \frac{2\ years}{4\ years}$$

The first $20,000 of the gain is subject to depreciation recapture (unrecaptured §1250 gain up to 25% tax rate).

The remaining $480,000 of gain is allocated between qualifying and non-qualifying use:

- $240,000 is eligible for the §121 exclusion and the remaining $240,000 is subject to capital gains taxes.

### *2. Like-kind exchanges*

As a result of the TCJA, §1031 like-kind exchanges are limited to real property held in a trade or business. There are a few ways in which taxpayers may utilize §1031 like-kind exchanges:

- Taxpayers that own a rental property may consider utilizing a like-kind exchange transaction to acquire a different rental property of similar value to defer paying taxes on any gain on their rental property.
- Taxpayers may consider converting their primary residence into a rental property and later utilize a §1031 exchange.
- Taxpayers may consider converting replacement property received in a §1031 exchange to their primary residence.

Rev. Proc. 2008-16 provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualified as a property held for productive use in a trade or business for purposes of §1031.

a. ***Taxpayers that convert their primary residence into a rental property and later utilize a §1031 exchange*** -- Per Rev. Proc. 2008-16, the relinquished property qualifies as property held for productive use in a trade or business or for investment in a §1031 exchange if:
   - The dwelling unit was owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and
   - Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:
     - The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
     - The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

b. ***Taxpayers that convert their replacement property received in a §1031 exchange to their primary residence*** -- Per Rev. Proc. 2008-16, the replacement property qualifies as property held for productive use in a trade or business or for investment in a §1031 exchange if:
   - The dwelling unit was owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and
   - Within the qualifying use period, in each of the two 12-month periods immediately after the exchange:
     - The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
     - The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

Taxpayers should follow these requirements prior to converting the replacement property into a primary residence, or else they face the risk of invalidating the §1031 exchange. Taxpayers must show intent that the replacement property was to be used in a trade or business for purposes of the §1031 exchange.

### *3. Vacant land*

If the taxpayer sold vacant land next to the home, he or she can include the sale of vacant land adjacent to the land on which the home sits as part of the home sale if all of the following requirements are met:

- The taxpayer owned and used the vacant land as part of their home;
- The taxpayer's sale of the vacant land and sale of the home occurred within two years of each other; and
- Both the sale of the home and the land meet the eligibility tests for the exclusion of gain.

Vacant land meeting the above requirements must be treated as a single transaction (along with the sale of the home) for tax purposes. In other words, the taxpayer may only apply the exclusion of gain once. The maximum exclusion (i.e., $250,000 or $500,000 MFJ) applies to the aggregate gain on sale of the dwelling unit and the vacant land.[6]

It is the sale of the dwelling unit itself which triggers the $250,000 ($500,000 MFJ) gain exclusion. If the dwelling unit is sold first, the gain is excluded in the year sold. If the vacant land is sold within two years after, any additional exclusion up to the maximum will be reported in the later year. If vacant land is sold in one tax year and the dwelling unit is not sold before the return is filed, report the gain on vacant land as taxable income when the return is originally filed. If the dwelling unit is subsequently sold within the statutory time period (and the gain thereon does not exceed the maximum exclusion amount), file an amended return and exclude the gain on sale of the vacant land.

# *V. Fractional ownership of vacation homes*

As discussed, with the increased ability to work from anywhere, more individuals may consider purchasing vacation homes. Some individuals may desire a beachfront getaway or luxurious estate on a bargain budget. Fractional ownership allows individuals to attain that "dream" getaway for a fraction of the cost of sole ownership.

## A. What is fractional ownership?

Individuals who purchase fractional ownership of a property enter into an ownership agreement in which the co-owners share the costs and benefits of the property. Fractional ownership for purposes of a vacation home allows an individual to pay a "fraction" of the cost for the home, allowing them to purchase a potentially larger or more desirable property than had they purchased a property as a sole owner.

Fractional owners share in the property's costs, including maintenance, insurance, repairs, property taxes, HOA fees, etc. However, fractional owners are only responsible for a fraction of such costs. For example, if an individual is a 15% fractional owner in a property, he or she would generally be responsible for 15% of the total expenses. One expense deduction that can vary by jurisdiction is the deductibility of real estate taxes. Some jurisdictions may only allow a taxpayer to deduct his or her share of taxes owed, regardless of the amount paid. In other jurisdictions, a taxpayer may be allowed to deduct the amount of tax that he or she actually paid, even if in excess of his or her proportionate share.

Fractional owners of a property have reduced or limited rights to use the property as opposed to if they were the sole owner of a property. For example, certain properties may prohibit smoking or pets. The terms of the fractional ownership purchase agreement stipulate how often the fractional owner can use the vacation home or whether the fractional owner can rent the property.

[6] Treas. Reg. §1.121-1(b)(3)(ii)(A).

## B. Ownership structure

Fractional ownership is not a timeshare. Timeshares only provide an individual with usage rights, not ownership rights. Fractional owners have a tenants in common ownership structure. This type of ownership structure is between two or more parties. Each fractional owner has concurrent ownership for a fraction of the property. Fractional owners may have different ownership interests in the property. In other words, each fractional owner does not need to hold the same ownership percentage. The right to use the property is typically proportional to the ownership interest. Fractional owners hold an undivided interest in the property, meaning each fractional owner does not own a specific physical portion of the property. Each fractional owner is entitled to use of the entire physical property.

***Example:*** *Ten fractional owners own a 10-room property, and each fractional owner has a 10% ownership interest. Each owner does not own a specific physical portion of the property in proportion to their ownership percentage (i.e., 1 of the 10 rooms). Rather, each owner is a co-owner of the entire 10-room property, and each fractional owner has equal right to use the entire physical property.*

Fractional owners may dispose of their share of the property without consulting with the other tenants. Similarly, if a fractional owner dies, his or her fractional interest is transferred to his or her estate, not the other fractional owners. This is an important distinction from a joint tenancy with right of survivorship ownership structure. In a joint tenancy ownership structure, joint tenants have a right of survivorship, meaning when one of the tenants dies, the remaining tenants receive a proportional increase in their share of the property.

## C. Tax considerations of vacation homes – In general

Taxpayers may use the fractional ownership vacation property solely for personal use, partially for personal use and partially for rental use, or fully for rental use.

### *1. Personal use*

Personal use occurs in the greater of the following situations:

- The taxpayer rents the vacation property for less than 15 days at fair market value; or
- The taxpayer uses the property for more than 10% of the number of days it is rented.

If the taxpayer qualifies for personal use:

- Up to 14 days of rental income is excluded from income.
- No deduction is allowed for expenses other than mortgage interest and property taxes (i.e., itemized deductions on Schedule A).

Taxpayers are limited to a maximum $10,000 SALT deduction on Schedule A, provided they itemize on their return. Prior to the TCJA, fractional ownership was more cost-effective, as there was no limitation to the amount of SALT taxes a fractional owner could deduct on Schedule A. Taxpayers who itemize deductions may only deduct qualified mortgage interest incurred on debt secured by their primary and/or secondary properties, up to acquisition debt of $750,000 (post-2017 acquisitions). Taxpayers with acquisition debt in excess of $750,000 may be limited in their qualified mortgage interest deduction.

***Practice Note:***

With the inflationary real estate market and the increased levels of transactions, the acquisition indebtedness rule may become more relevant than ever, so be sure to review all relevant documents received and/or document confirmations from clients.

### *2. Partial rental use*

Partial Rental Use occurs if the taxpayer has both significant personal use (i.e., the property is used for personal purposes for more than the greater of 14 days or 10% of the rental days) and significant rental use of the vacation property (i.e., rented at least 15 days). Under this scenario:

- All rental income is included in income.
- Deductions are permitted for ordinary and necessary expenses, but the taxpayer must allocate expenses between rental and personal use.
- Losses are not permitted.

### *3. Rental use*

Rental Use occurs if the taxpayer has insignificant personal use of the vacation property (i.e., the property is not used by the taxpayer more than the greater of 14 days or 10% of the rental days and is rented at fair market value for 15 days or more). Under this scenario:

- All rental income is included in income.
- Full deductions are permitted for ordinary and necessary expenses, including depreciation (mortgage interest and SALT are not limited by the $10,000 SALT cap or acquisition indebtedness).
- Losses may be deductible (subject to passive activity rules).

Though rental activities are categorically passive, taxpayers who actively participated in the rental real estate activity may be able to deduct up to $25,000 in losses each year. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Married taxpayers who file separately and live apart for the entire tax year can only deduct up to $12,500 in losses each year if they actively participated in the rental real estate activity. The maximum special allowance of $25,000 ($12,500 for married filing separately taxpayers) is reduced by 50% of the amount of the taxpayer's modified adjusted gross income that is more than $100,000 ($50,000 if the taxpayers are married filing separately). If the taxpayer's modified adjusted gross income is $150,000 or more ($75,000 or more if the taxpayers are married filing separately), the taxpayers generally cannot use the special allowance.

### *4. Other tax considerations*

In the case of fractional ownership, the fractional owner should consider both the days he or she used the property, as well as all of the days the property is used by all fractional owners. Per Prop. Reg. 1.280A-3(f)(3), since the property is owned as tenants in common, the taxpayer must consider usage by all other fractional owners.

***Example 1:*** Rob is a fractional owner of a beachfront vacation home and owns a 1/10 interest. He uses the vacation home for 20 days of personal use and 20 days of rental use. The other fractional owners use the property for 160 days of personal use. None of the other fractional owners rent the property.

As a result, 10% of the home is used for rental purposes (20/200 days) and 90% of the home is used for personal purposes (180/200 days).

***Example 2:*** Rob is a fractional owner of a beachfront vacation home and owns a 1/10 interest. He uses the vacation home for 20 days of personal use and 20 days of rental use. The other fractional owners use the property for 80 days of personal use and 80 days of rental use.

As a result, 50% of the home is used for rental purposes (100/200 days) and 50% of the home is used for personal purposes (100/200 days).

***Example 3:*** Rob is a fractional owner of a beachfront vacation home and owns a 1/10 interest. He uses the vacation home for 20 days of personal use and 20 days of rental use. The other fractional owners use the property strictly for rental use of 160 days. None of the other fractional owners use the property for personal purposes.

As a result, 90% of the home is used for rental purposes (180/200 days) and 10% of the home is used for personal purposes (20/200 days).

In all the previous examples, Rob had to consider not only his personal and rental use of the vacation home, but also the use of the other fractional owners. Fractional ownership allows an individual to have an ownership stake in a property they otherwise may be unable to afford; however, it is imperative to be aware of both the tax and non-tax consequences of being a fractional owner.

# *VI. Proposed Regulations – SECURE Act*

The SECURE Act, signed into law in December 2019, was the most significant retirement legislation passed in over a decade and included thirty provisions primarily aimed at expanding access to retirement savings programs. The IRS issued proposed regulations on February 24, 2022, to reflect these changes made by the SECURE Act.[7] The effective date of these proposed regulations is for tax years beginning on or after January 1, 2022.

Under pre-SECURE Act rules, a nonspousal beneficiary of an IRA could “stretch” the receipt of RMDs over his or her remaining actuarial life expectancy with payouts starting in the year immediately after the decedent’s death. The SECURE Act stipulates that upon death of the retirement plan account holder, all distributions must be made within 10 years of death to an eligible designated beneficiary, provided the account holder dies after December 31, 2019. This provision eliminated “stretch” IRAs that could be stretched over the life of the beneficiary and grow tax-free.

If a beneficiary inherits an IRA in which the account holder did not reach his or her required beginning date before death, the non-eligible beneficiary must withdraw the entire IRA balance within 10 years of the original account holder’s date of death, but there is no requirement to take required distributions during the 10-year period.

The proposed regulations state that if both the original account holder and designated beneficiary die *before* the required beginning date, the beneficiary of the original designated beneficiary is subject to the 10-year rule.

The proposed regulations clarify that if the original account holder dies after the required beginning date, distributions to the account holder’s beneficiary for calendar years after the calendar year in which the account holder died must satisfy §401(a)(9)(B)(i) as well as §401(a)(9)(B)(ii). In order to satisfy both

[7] REG-105954-20.

requirements, the proposed regulations provide for the same calculation of the annual required minimum distribution that was adopted in the existing regulations but with an additional requirement that a full distribution of the entire IRA balance be made on the 10th year. In other words, RMDs are required for the first nine years, as calculated under existing regulations, with a required distribution of the remaining balance on the tenth year.

Per SECURE Act §401(a)(2), the following are exceptions to the 10-year payout rule:

- Surviving spouses;
- Individuals not more than 10 years younger than the original account owner;
- Chronically ill;
- Disabled; and
- Minor children.

These individuals are **not** subject to the 10-year distribution rule and are considered "eligible designated beneficiaries." These individuals are eligible to withdraw inherited IRAs over their life expectancy, bypassing the 10-year rule. It is important to acknowledge that while eligible designated beneficiaries are exempt from the SECURE Act 10-year payout rule, subsequent beneficiaries are subject to the SECURE Act 10-year payout rule.

Designated beneficiaries include any person (i.e., not an entity or institution) subject to the 10-year rule. While the SECURE Act made major changes to the distribution rules for designated beneficiaries, it did not address distribution rules for non-designated beneficiaries. Non-designated beneficiaries include legal entities, estates, trusts that do not qualify as "see-through," charities, institutions, and any human who for whatever reason is not considered a designated beneficiary. Non-designated beneficiaries have up to 5 years to distribute the entire account balance of an inherited IRA if the original account holder died prior to making Required Minimum Distributions. If Required Minimum Distributions began before the non-designated beneficiary inherited the IRA, the non-designated eligible beneficiary can use the deceased original account holder's life expectancy as the distribution period if that period is longer than 5 years. This is often referred to as the owner's "ghost life expectancy."

For purposes of the SECURE Act, surviving spouses are eligible designated beneficiaries, and as such, they are entitled to spousal rollover of IRAs not subject to the 10-year rule. If the surviving spouse does not choose the rollover option, the spouse becomes an eligible designated beneficiary of the inherited IRA and is eligible to receive RMDs over his or her life expectancy. The proposed regulations clarify that age 72 is the required beginning date for surviving spouses, regardless of when they inherited their interest.

For purposes of the SECURE Act, minor children of the account owner are eligible designated beneficiaries. They can utilize the "stretch" IRA strategy until reaching the age of majority. Upon reaching the age of majority, the child becomes subject to the 10-year rule. If the beneficiary has no need for the funds, the IRA balance may be left to compound until December 31 of the tenth year. Prior to the release of the proposed regulations, there was ambiguity as to what age constituted the age of majority. The proposed regulations clarify that the age of majority takes place on the child's 21st birthday.

For purposes of the SECURE Act, a disabled individual is considered an eligible designated beneficiary and can stretch RMDs from an inherited IRA over his or her lifetime. The proposed regulations provide two definitions of a disabled individual, depending on if the child is age 18 or older or less than age 18.

- **Less than age 18**: If on the date of the employee's death, the beneficiary is younger than age 18, the proposed regulations apply a comparable standard that requires the beneficiary to have a medically determinable physical or mental impairment that results in marked and severe functional limitations, and that can be expected to result in death or to be of long-continued and indefinite duration.
- **Age 18 or older**: If on the date of the employee's death, the beneficiary is age 18 or older, the proposed regulations state an individual is disabled if he or she is unable to engage in substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.

The proposed regulations require, with respect to a beneficiary who is disabled or chronically ill as of the date of the original account holder's death, that documentation of the disability or chronic illness is provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the original account holder's death. Per the proposed regulations, the determination of whether a beneficiary is disabled is made as of the date of the original account holder's death.

***Example:*** Jon passed away on February 15, 2022. Aiden, his 10-year-old son, is his designated beneficiary. Aiden is not disabled as of February 15, 2022, but 5 years later, he is in a bad car accident and becomes disabled. Aiden's disability is not taken into account, as he was not disabled on the date of Jon's death, and he will cease to be an eligible designated beneficiary on his 21st birthday.

For purposes of the SECURE Act, a chronically ill individual is considered an eligible designated beneficiary and can stretch RMDs from an inherited IRA over his or her lifetime. If an individual is considered chronically ill, the proposed regulations state that the documentation also must include a certification from a licensed health care practitioner that, as of the date of the certification, the individual is unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for an indefinite period that is reasonably expected to be lengthy in nature. The proposed regulations clarify that the period must be "lengthy in nature" and not merely 90 days.

For purposes of the SECURE Act, individuals who are not more than 10 years younger than the IRA account owner qualify as eligible designated beneficiaries. As such, these individuals are eligible to "stretch" the inherited IRA balance and RMDs over their lifetime. The proposed regulations clarify that whether a designated beneficiary is not more than 10 years younger than the employee is determined based on the dates of birth of the employee and the beneficiary rather than just the year of birth.

***Example***: If the employee's date of birth is September 1, 1950, then the employee's beneficiary is not more than 10 years younger than the employee if the beneficiary was born on or before September 1, 1960.

The SECURE Act proposed regulations have an effective date of January 1, 2022. It is possible that changes could be made to the SECURE Act proposed regulations if finalized.

# *VII. Getting caught watching the paint dry – Failing to look ahead*

## A. Is the "Employee vs. Independent Contractor" conundrum ready to explode?

### *1. Serve Cold - Federal Issues – findings favoring independent contractor status*

In 2013, Uber Technologies, Inc. (the "Employer" or "Uber"), based in San Francisco, California, released a smart-phone application allowing consumers to request personal transportation by car and for drivers to fulfill those requests (the "App"). Since that time, rides through the App have become available in an increasing number of regions throughout the United States and abroad. **Uber has always asserted that the drivers providing those rides are independent contractors.**

Three cases were submitted to the National Labor Relations Board (NLRB) for advice as to whether drivers providing personal transportation services using the Employer's app-based ride-share platform were employees of the Employer or independent contractors.[8]

The burden of proving that workers are independent contractors rests with the party asserting independent contractor status. To determine whether workers are employees or independent contractors, the Board applies the common-law agency test. The inquiry involves application of ten non-exhaustive common-law factors:

a. The extent of control which, by the agreement, the master may exercise over the details of the work.
b. Whether or not the one employed is engaged in a distinct occupation or business.
c. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision.
d. The skill required in the particular occupation.
e. Whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work.
f. The length of time for which the person is employed.
g. The method of payment, whether by the time or by the job.
h. Whether or not the work is part of the regular business of the employer.
i. Whether or not the parties believe they are creating the relation of master and servant.
j. Whether the principal is or is not in business.

The Board's analysis of these factors is "qualitative" rather than "strictly quantitative." There is no "shorthand formula" and "all of the incidents of the relationship must be assessed and weighed with no one factor being decisive." However, "an important animating principle by which to evaluate those factors **. . . is whether the position presents the opportunities and risks inherent in entrepreneurialism."**

***Note:***

> Where the common-law factors, considered together, demonstrate that the workers in question are afforded significant entrepreneurial opportunity, [the Board] will likely find independent contractor status, as it did in this case.

[8] United States Government National Labor Relations Board OFFICE OF THE GENERAL COUNSEL Advice Memorandum April 16, 2019; Cases 13-CA-163062, 14-CA-158833, and 29-CA-177483.

**Three features of the Uber system afforded drivers significant opportunities for economic gain and, ultimately, entrepreneurial independence.**

- **First, drivers had virtually unfettered freedom to set their own work schedules**—they chose when to log in to the App to receive trip requests and how long to remain online. Drivers needed only to fulfill one trip request per month, and there was no upper limit. For any reason or no reason, the driver could simply log off.

- **Second, drivers controlled their work locations** by choosing where to log in to the App, within the broad confines of a geographic market, rather than being restricted to assigned routes or neighborhoods. Even though drivers' later locations over the course of an outing depended on riders' destinations, drivers could predict likely destinations from particular origins and choose their log-in locations accordingly.

- **Third, drivers could, and often did, work for competitors**. In fact, drivers could toggle between different ride-sharing apps at will over the course of an outing. Moreover, Uber placed no limits on this freedom such as restrictions on drivers' use of their cars or fees that drivers must pay even if they perform no Uber rides.

Drivers' entrepreneurial independence is also apparent in contractual requirements that they indemnify Uber and hold it harmless for liability based on their own conduct. To similar effect is a provision through which Uber disclaimed responsibility for the conduct of riders. These contractual provisions greatly lessened Uber's motivation to control drivers' actions, since Uber was not liable for drivers' or riders' negligent or intentionally harmful acts.

Although Uber maintained minimum service standards and customer feedback channels to learn of and respond to any relevant customer service issues, none of these facts indicate significant employer control nor interfere with the drivers' economic opportunities.

Three of the remaining factors support independent-contractor status.

- Drivers provided the "principal instrumentality" of their work, the car, the control of which afforded them significant entrepreneurial opportunity. Drivers were also responsible for chief operating expenses such as gas, cleaning, and maintenance for their cars. Uber provided only the App, commercial liability insurance, and minor assistance such as reimbursement for the costs of cleaning spills and repairing damage caused by riders. Drivers shouldered significant risk of loss, since they invested significant capital and time to use the App, and fare earnings could fluctuate depending on where and when drivers logged in. Given that the drivers provided the cars and incurred most of the expenses associated therewith, the instrumentalities factor strongly favors independent-contractor status.

- With regard to the "supervision" factor, drivers operated without supervision by Uber. They did not report to supervisors and generally interacted with Uber agents only when a problem arose. Uber did not "assign" trips through the App as drivers maintained the right to reject any particular trip. Although, as discussed above, Uber maintained minimum service standards to the extent necessary to address specific customer complaints, which could affect drivers' relationship with Uber and earnings opportunities, those customer-driven standards do not amount to the kind of supervision normally indicative of

employee status. Overall, drivers had “near-absolute autonomy in performing their daily work without supervision,” supporting independent-contractor status.

- With regard to the parties’ self-assessment of their relationship, both parties understood their relationship to be one of independent contractors. Drivers’ contracts explicitly characterized the relationship this way. Uber withheld neither taxes nor social security and provided drivers with IRS 1099 forms. Uber provided no benefits, paid leave, or holiday pay. These facts support independent-contractor status.

Although there are several factors that point toward employee status, the strength of the evidence supporting independent-contractor status overwhelms those factors. One factor that supports employee status is that no special skills or experience were required to begin driving for Uber. In addition, although Uber disagrees, we assume arguendo that drivers did not work in a distinct occupation or business but worked as part of the Employer’s regular business of transporting passengers. But the Board has not deemed this to be a strong or dispositive factor. Indeed, there are a number of decisions in which individuals were held to be independent contractors, even though their services were integral to the business of the company that engaged them, given the extent of entrepreneurial opportunity afforded them. Whereas, in situations of greater company control, this factor has been cited in favor of employee status.

**Considering all the common-law factors through “the prism of entrepreneurial opportunity,” NLRB concluded that Uber drivers were independent contractors.** Drivers’ virtually complete control of their cars, work schedules, and log-in locations, together with their freedom to work for competitors of Uber, provided them with significant entrepreneurial opportunity.

***Practice Note: A New Pathway?***

In the Uber case it appears the NLRB has reversed course from rulings with similar facts finding employer-employee status issued as recently as 2016.[9]

In addition, on April 29, 2019[10] the Department of Labor Wage and Hour Division appears to have reversed course from a previous 2015 ruling.

- This case involved a virtual marketplace company (VMC) that operates in the so-called "on-demand" or "sharing" economy. Generally, a VMC is an online and/or smartphone-based referral service that connects service providers to end-market consumers to provide a wide variety of services, such as transportation, delivery, shopping, moving, cleaning, plumbing, painting, and household services.
- Prior to allowing service providers to use a platform, the VMC required them to provide certain basic information, self-certify their experience and qualifications, complete a background check, and complete an identity check through a different vendor.
- The VMC also required service providers to acknowledge and accept a terms of use agreement and a service agreement, which states that the VMC provides only a platform for connecting providers with customers and disclaims any employment relationship. The agreements also classify the service providers as independent contractors.
- Upon consideration of "the circumstances of the whole activity," WHD does not see any indication that the service providers are economically dependent on the VMC within the meaning of the FLSA.

**Practitioners must consider that future rulings may reverse these current findings. See Elements of Engagement Discussion, below.**

### *2. Simmering - State Issues – findings favoring Employee Status*

Two individual delivery drivers, suing on their own behalf and on behalf of a class of allegedly similarly situated drivers, filed a complaint against Dynamex Operations West, Inc. (Dynamex), a nationwide package and document delivery company, alleging that Dynamex had misclassified its delivery drivers as independent contractors rather than employees.[11]

In determining whether, under the suffer or permit to work definition, a worker is properly considered the type of independent contractor to whom the wage order does not apply, it is appropriate to look to a standard, commonly referred to as the **"ABC" test,** that is utilized in other jurisdictions in a variety of contexts to distinguish employees from independent contractors. **Under this test, a worker is properly considered an independent contractor to whom a wage order does not apply only if the hiring entity establishes each of the following:**

a. That the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;

b. That the worker performs work that is outside the usual course of the hiring entity's business; and

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9 United States Government National Labor Relations Board OFFICE OF THE GENERAL COUNSEL Advice Memorandum September 19, 2016; Postmates, Inc. ("Employer") operates a website and a software application available on smartphones, through which customers can order food from restaurants or other items from stores, and have them delivered within a short period of time by one of the Employer's couriers. This case involves a charge filed by a courier that worked for the Employer in 2015.

10 Keith E. Sonderling, Acting Administrator, U.S. Department of Labor Wage and Hour Division, FLSA 2019-6; April 29, 2019.

11 Dynamex Operations West, Inc. v. Superior Court of Los Angeles; SUPREME COURT OF CALIFORNIA, April 30, 2018.

c. That the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

A recap of some of the pertinent facts of the case include:

- Dynamex is a nationwide same-day courier and delivery service that operates a number of business centers in California. Dynamex offers on-demand, same-day pickup and delivery services to the public generally and also has a number of large business customers — including Office Depot and Home Depot — for whom it delivers purchased goods and picks up returns on a regular basis.
    - Prior to 2004, Dynamex classified its California drivers as employees and compensated them pursuant to this state's wage and hour laws.
    - In 2004, Dynamex converted all of its drivers to independent contractors after management concluded that such a conversion would generate economic savings for the company. Under the current policy, all drivers are treated as independent contractors and are required to provide their own vehicles and pay for all of their transportation expenses, including fuel, tolls, vehicle maintenance, and vehicle liability insurance, as well as all taxes and workers' compensation insurance.
- Dynamex obtains its own customers and sets the rates to be charged to those customers for its delivery services. It also negotiates the amount to be paid to drivers on an individual basis.
- Drivers are generally free to set their own schedule but must notify Dynamex of the days they intend to work for Dynamex.
    - Drivers performing on demand work are required to obtain and pay for a Nextel cellular telephone through which the drivers maintain contact with Dynamex.
    - On-demand drivers are assigned deliveries by Dynamex dispatchers at Dynamex's sole discretion; drivers have no guarantee of the number or type of deliveries they will be offered.
    - Although drivers are not required to make all of the deliveries they are assigned, they must promptly notify Dynamex if they intend to reject an offered delivery so that Dynamex can quickly contact another driver; drivers are liable for any loss Dynamex incurs if they fail to do so.
- In the absence of any special arrangement between Dynamex and a customer, drivers are generally free to choose the sequence in which they will make deliveries and the routes they will take, but are required to complete all assigned deliveries on the day of assignment.
- Drivers hired by Dynamex are permitted to hire other persons to make deliveries assigned by Dynamex.
- Drivers are ordinarily hired for an indefinite period of time but Dynamex retains the authority to terminate its agreement with any driver without cause, on three days' notice.

In applying the ABC test, the Supreme Court of California found Dynamex did not meet its burden to establish that the drivers were independent contractors:

> *First, with respect to part B of the ABC test, it is quite clear that there is a sufficient commonality of interest with regard to the question whether the work provided by the delivery drivers within the certified class is outside the usual course of the hiring entity's business to permit plaintiffs' claim of misclassification to be resolved on a class basis. In the present case, Dynamex's entire*

*business is that of a delivery service. Unlike other types of businesses in which the delivery of a product may or may not be viewed as within the usual course of the hiring company's business, here the hiring entity is a delivery company and the question whether the work performed by the delivery drivers within the certified class is outside the usual course of its business is clearly amenable to determination on a class basis.*

*Second, with regard to part C of the ABC test, it is equally clear from the record that there is a sufficient commonality of interest as to whether the drivers in the certified class are customarily engaged in an independently established trade, occupation, or business to permit resolution of that issue on a class basis. … Here the class of drivers certified by the trial court is limited to drivers who, during the relevant time periods, performed delivery services only for Dynamex. The class excludes drivers who performed delivery services for another delivery service or for the driver's own personal customers; the class also excludes drivers who had employees of their own….For this class of drivers, the pertinent question under part C of the ABC test is amenable to resolution on a class basis.*

### *3. Festering - Localities jumping into the game? Practitioners beware*

Unlocking a potential slippery slope, three of the largest cities in Texas (Austin, San Antonio and Dallas[12]) have each recently passed legislation requiring almost all employers to provide paid sick leave to any employee. The provision applies to any employee (including temporary or employment agency) who performed at least 80 hours of work for pay within the city in a year. Even if the employer does not have a location within the city, if their employee(s) works within the city, they must be awarded this benefit.

One hour of earned paid sick leave is inured for every 30 hours the employee worked within the city. Employees working for smaller companies may earn 48 hours of paid sick benefit per year, and those working for larger employers may earn 64 hours per year.

Senate Bill 14 would have banned cities and counties from requiring companies to provide mandated sick leave; however, the bill ultimately failed to pass the House. It is possible that new legislation could once again target the local sick leave mandates.

***Practice Note:***

In the ever-changing world of responsibility, practitioners are the trusted advisor many companies rely upon for compliance. For many smaller or closely held clients, practitioners are the only advisor regarding compliance issues.

Should this trend of localities promoting local ordinances regarding employment issues continue, which seems undoubtable, practitioners must expand their purview and know exactly where each employee of a client works and have the time and ability to research local laws.

## B. Employee vs. independent contractor – 2022 Updates

### *1.* California's Assembly Bill No. 5

California Assembly Bill No. 5 was introduced December 3, 2018. After nine months of discussion with minor amendments, the bill was passed September 11, 2019 and signed by Governor Newsom September 18, 2019. Most of its provisions took effect January 1, 2020.

[12] The Austin statute has been enjoined and deemed unconstitutional. However, the Dallas and San Antonio versions are both set to take effect August 1, 2019.

Existing California law, as established in the case of Dynamex (see above) creates a presumption that a worker who performs services for a hirer is an employee for purposes of claims for wages and benefits. The (Dynamex) law requires a 3-part test, commonly known as the "ABC" test, to establish that a worker is an independent contractor for those purposes.

Assembly Bill 5 states the intent of the Legislature to codify the decision in the Dynamex case and clarify its application. The bill provides that for purposes of the provisions of the Labor Code, the Unemployment Insurance Code, and the wage orders of the Industrial Welfare Commission, a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that the person is free from the control and direction of the hiring entity in connection with the performance of the work, the person performs work that is outside the usual course of the hiring entity's business, and the person is customarily engaged in an independently established trade, occupation or business.

- The bill exempts specified occupations from the application of Dynamex and would instead provide that these occupations are governed by *Borello*.[13]
- These exempt occupations include, among others, licensed insurance agents, certain licensed health care professionals, registered securities broker-dealers or investment advisers, direct sales salespersons, real estate licensees, commercial fishermen, workers providing licensed barber or cosmetology services, and others performing work under a contract for professional services, with another business entity, or pursuant to a subcontract in the construction industry. Also, any individual who holds an active license from the State of California and is practicing one of the following recognized professions: lawyer, architect, engineer, private investigator, or accountant.

Assembly Bill 5 also redefines the definition of "employee" for purposes of unemployment insurance provisions, to include an individual providing labor or services for remuneration who has the status of an employee rather than an independent contractor, unless the hiring entity demonstrates that the individual meets all of specified conditions, including that the individual performs work that is outside the usual course of the hiring entity's business.

- Because this bill increases the categories of individuals eligible to receive benefits from, and thus would result in additional moneys being deposited into, the Unemployment Fund, a continuously appropriated fund, the bill would make an appropriation.
- The bill also states that specified Labor Code provisions of the bill apply retroactively to existing claims and actions to the maximum extent permitted by law while other provisions apply to work performed on or after January 1, 2020.
- The bill additionally provides that its provisions do not permit an employer to reclassify an individual who was an employee on January 1, 2019, to an independent contractor due to the bill's enactment.

Existing provisions of the Labor Code make it a crime for an employer to violate specified provisions of law with regard to an employee. The Unemployment Insurance Code also makes it a crime to violate specified provisions of law with regard to benefits and payments. By expanding the definition of an

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[13] *S. G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 Cal.3d 341, is California case which followed common law tradition, that the principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired.

employee for purposes of these provisions, the bill expands the definition of a crime, thereby imposing a state-mandated local program.

***Practice Note: Practitioners working with Independent Contractors***

California has been referred to as the birthplace of app-based business. Assembly Bill No. 5 is expected to directly hit Uber and Lyft. During the progression of this bill, Uber and Lyft proposed a special category for their drivers, tucked between employer and independent contractor status. That carve out proposal was not favorable to unions and legislators, each worried about future side effects.

After passage of Assembly Bill No. 5, Uber's chief legal officer indicated that Uber would not treat its drivers as employees, indicating their business model was not a riding service but **"serving as a technology platform for several different types of digital marketplaces."**

If that quote sounds familiar, it is almost identical to the April 29, 2019 phraseology used by Keith E. Sonderling, Acting Administrator, U.S. Department of Labor Wage and Hour Division, regarding a virtual marketplace company (VMC) that operates in the so-called "on-demand" or "sharing" economy – see above.

***Element of Discussion:***

**How many states legislatures will follow this lead? Secondly, how long will it take?**

California has been a leader in progressive policies. One can imagine many states legislators desire to ensure exploited workers have the basic workplace rights of employee status. Rights and protections to provide a level of economic security, including a minimum wage, workers' compensation if they are injured on the job, unemployment insurance, paid sick leave, and paid family leave.

For practitioners, we must continue to be the trusted professional, and stay ahead of this quickly changing area.

As one can imagine, some groups were quick to challenge Assembly Bill 5 once it was signed into law.

In November 2019, the California Trucking Association, representing over 70,000 truck drivers in California, filed suit in the U.S. District Court for the Southern District of California, challenging both the *Dynamex* ruling and Assembly Bill 5. The California Trucking Association argued that the U.S. Constitution commerce clause and supremacy clause take precedence over Assembly Bill 5. They also argued that the Federal Aviation Administration Authorization Act of 1994 preempts Assembly Bill 5. Many truck drivers chose to be treated as independent contractors for perks such as choosing their own work hours or driving their personal trucks (owner-operators). Assembly Bill 5 would force these individuals to be treated as employees.

On December 31, 2019, U.S. District Court Judge Hon. Roger Benitez issued a temporary restraining order to keep officials from enforcing Assembly Bill 5 against truck drivers and motor carriers. Subsequently on January 16, 2020, Judge Benitez granted a preliminary injunction, preventing the enforcement of Assembly Bill 5 against California truck drivers on the basis that the Federal Aviation Administration Authorization Act of 1994 preempts Assembly Bill 5. [14] The California Trucking Association currently has a petition for writ of certiorari pending before the U.S. Supreme Court.

[14] *California Trucking Association et al v. Attorney General Xavier Becerra, et al, and the International Brotherhood of Teamsters, Case Number 3:18-cv-02458-BEN-BLM.*

Following the lead of the California Trucking Association, the American Society of Journalists and Authors (ASJA) and the National Press Photographers Association (NPPA) filed suit in the United States District Court for the Central District of California, Western Division on December 17, 2019. These organizations specifically challenged the provision of Assembly Bill 5 that prevents an individual from submitting more than 35 pieces to a publication per year unless it employs him or her. They claimed that Assembly Bill 5 was unconstitutional as it restricts free speech of writers and photographers, without placing the same restrictions on similar professionals such as graphic designers, marketers, fine artists, and grant writers. ASJA and NPPA argued that Assembly Bill 5 specifically violated the First and Fourteenth Amendments to the U.S. Constitution. [15] In October 2021, the Ninth United States Circuit Court of Appeals ultimately rejected the First Amendment challenge by the ASJA.

It should not come as a surprise that Uber and Postmates filed suit along with two of their drivers in United States District Court for the Central District of California, Western Division on December 30, 2019. The plaintiffs argued that Assembly Bill 5 "violates the Equal Protection and Due Process Clauses of the Fourteenth Amendment to the United States Constitution, the Ninth Amendment to the United States Constitution, and the Contracts Clause of Article I of the United States Constitution, as well as the Equal Protection Clause, Inalienable Rights Clause, Due Process Clause, Baby Ninth Amendment, and Contracts Clause of the California Constitution." They further argued that Assembly Bill 5 unfairly targets "gig-economy" or freelance workers, as the bill specifically excludes some professions, such as doctors, psychologists, dentists, accountants, lawyers, stock brokers, etc. Uber and Postmates (along with DoorDash, not involved in the aforementioned lawsuit) pledged $90 million in campaign contributions for a November 2020 ballot measure to overturn Assembly Bill 5. All eyes will certainly be on these companies as 2020 progresses.

On August 10, 2020, a California state judge ordered both Uber and Lyft to reclassify their California drivers from independent contractors to employees with benefits. Both companies were accused of violating California Assembly Bill 5, which provides that an individual shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that the person is free from the control and direction of the hiring entity in connection with the performance of the work, the person performs work that is outside the usual course of the hiring entity's business, and the person is customarily engaged in an independently established trade, occupation or business. Uber and Lyft, along with DoorDash, Postmates, and Instacart, spent more than $200 million combined to campaign for the passage of Proposition 22, a ballot measure to overturn CA Assembly Bill 5. On November 3, 2020, 58.6% of California voters approved the measure to classify app-based drivers as contractors.

Unsurprisingly, there have already been lawsuits filed in relation to the passage of Proposition 22. On January 12, 2021, the Service Employees International Union (SEIU), along with four workers, sued the CA Supreme Court, arguing that Proposition 22 should be declared unconstitutional, invalid, and unenforceable. The petitioners argued that although Proposition 22 was titled the "Protect App-Based Drivers and Services Act," it does not live up to its namesake, as it actually withdrew several minimum employment protections from thousands of California workers. Moreover, the petitioners stated that Section 4 of Article XIV of the California Constitution provides the Legislature with the power to establish and enforce a complete system of workers' compensation. They argued that Proposition 22 conflicts with Article XIV, section 4, by removing certain workers from California's workers' compensation system and limiting the legislature's authority to extend workers' compensation benefits to this group in the future. Additionally, the plaintiffs asserted that Proposition 22 deceived voters who were not informed that they

[15] American Society of Journalists and Authors Inc. et al v. Becerra.

were voting to prevent the Legislature from granting certain workers collective bargaining rights. On February 3, 2021, the CA Supreme Court rejected the case for direct review. The plaintiffs subsequently filed the lawsuit in the Alameda County Superior Court on February 11, 2021. On August 20, 2021, the Alameda County Superior Court ultimately ruled that Proposition 22 was unconstitutional and declared the entire ballot measure unenforceable. This decision will likely be appealed by those in favor of Proposition 22.

### *2. U.S. Department of Labor Final Rule*

On September 22, 2020, the Department of Labor (DOL) issued a proposed rule to clarify the definition of employee under the Fair Labor Standards Act (FLSA) as it relates to independent contractors.[16] On January 7, 2021, the DOL announced a final rule, largely substantiating the September 2020 proposed rule with additional clarifications. The final rule outlined an "economic reality" test, centered around the idea of whether the worker is economically dependent on the potential employer for work in order to determine worker classification. For example, an individual may be considered to be economically dependent if they rely on others to provide work opportunities, whereas an individual would be less likely to be considered economically dependent if he or she was able to create work opportunities for himself or herself. If the final rule was adopted, the economic reality test factors would have been used to determine whether the individual was economically dependent on a potential employer, and therefore classified as an employee, or whether the individual was in business for himself or herself, and therefore classified as an independent contractor. The economic reality test outlines the following two "core" factors to determine worker status:

1. **The nature and degree of the worker's control over the work:** If an individual has the ability to exercise substantial control over key aspects of the performance of work, as opposed to the potential employer, the individual is more likely to be considered an independent contractor than an employee.
    a. Activities that demonstrate an individual's substantial control over key aspects of the performance of work include setting one's own work schedule, working with little to no supervision, choosing work assignments, and being able to work for others, including the potential employer's competition.
    b. Activities that demonstrate a potential employer's substantial control over key aspects of the performance of work include requiring an exclusive working relationship with the individual, setting the individual's work schedule, requiring the individual to work with significant supervision or oversight, and assigning work to the individual.
2. **The worker's opportunity for profit or loss**: This factor analyzes whether the individual has the ability to earn profits or incur losses based on his or her personal initiative, managerial skill, or business acumen.

There are three other factors that make up the "economic reality" test, but these factors are given less weight in the analysis of determining worker status:

1. **Degree of Skill Required**: This factor considers the degree of skill required to perform the work. An individual would be more likely to be considered an independent contractor if the work performed required specialized skills or training that was not provided by the employer.
2. **Permanence of the Working Relationship**: This factor considers the permanence and duration of the working relationship between the individual and potential employer. An

[16] DOL Proposed Rule (85 FR 60600).

individual is more likely to be classified as an independent contractor if his or her working relationship with the potential employer is definitive in nature or sporadic. On the other hand, an individual is more likely to be classified as an employee if his or her working relationship with the employer is continuous and indefinite. It is important to note that seasonal work does not preclude an individual from being classified as an employee if the individual has completed the same type of work throughout multiple seasons and the individual's position is permanent throughout the duration of such season.

3. **Integrated Unit**: This factor considers the extent to which services rendered by an individual are an "integral part" of the potential employer's business and production. An individual is more likely to be considered an independent contractor if the performance of services is not integrated into the potential employer's production process. An individual is more likely to be considered an employee if the work that he or she performs is an integral part of the potential employer's business.

The DOL emphasizes that the worker's actual day-to-day practice is more relevant in the determination of worker status than what may be theoretically possible. Upon analyzing the worker's status using the "economic reality" test, if the two "core" factors arrived at the same conclusion as to the worker's classification, the combined weight of these factors would outweigh the other three factors of less importance. If the two "core" factors did not arrive at the same worker classification conclusion, the remaining three factors could help determine the correct worker classification. The remaining three factors would always be evaluated in the context of the two core factors.

The final rule outlined six examples (below) to demonstrate how factors can be analyzed in the context of certain facts and scenarios.

***Example 1:*** An individual is the owner and operator of a tractor-trailer and performs transportation services for a logistics company. The owner-operator substantially controls the key aspects of the work. However, the logistics company has installed, at its own expense, a device that limits the maximum speed of the owner-operator's vehicle and monitors the speed through GPS. The company limits the owner-operator's speed in order to comply with federally mandated motor carrier safety regulations and to ensure that she complies with local traffic laws. The company also requires the owner-operator to meet certain contractually agreed-upon delivery deadlines, and her contract includes agreed-upon incentives for meeting, and penalties for missing, the deadlines.

***Application:*** The owner-operator exercises substantial control over key aspects of his or her work, indicating independent contractor status. Contractually agreed-upon delivery deadlines, incentives, and penalties are typical of business relationships and do not constitute control. Having a company-installed device that monitors the owner-operator's vehicle does not change this conclusion.

***Example 2:*** An individual accepts assignments from a company that provides an app-based service linking those who need home-repair work with those who perform home-repair work. The individual is able to meaningfully increase his earnings by exercising initiative and business acumen and by investing in his own equipment. The company, however, has invested millions of dollars in developing and maintaining the app, marketing itself, maintaining the security of information submitted by actual and prospective customers and workers, and monitoring customer satisfaction with the work performed.

***Application:*** The individual controls his or her meaningful opportunity for profit or loss. The value of the investments made by each party is not relevant in determining

whether the individual has a meaningful opportunity for profit or loss through his or her initiative, investment, or both.

***Example 3:*** An individual worker works full time performing home renovation and repair services for a residential construction company. She is also the part owner of a food truck, which she operates on weekends. In performing the construction work, the worker is paid a fixed hourly rate, and the company determines how many and which tasks she performs. Her food truck recently became very popular and has generated substantial profits for her.

***Application:*** The individual does not have meaningful opportunity for profit or loss with respect to the construction work, as she is paid a fixed hourly rate and the company determines the assignment of work. She is unable to increase her earnings by exercising initiative or managing investments, indicating employee status. The food truck business is separate from her construction work and is not relevant as to whether she was an employee of the construction company or in business for herself.

***Example 4:*** A housekeeper works for a ski resort every winter. At the end of each winter, he stops working for the ski resort because the resort shuts down. At the beginning of each of the past several winters, the housekeeper returned to his prior position at the ski resort without formally applying or interviewing. The fact that the housekeeper returns to his prior position each new season indicates that his or her relationship with the ski resort is indefinite as a matter of economic reality.

***Application:*** The housekeeper has a long-term, indefinite work relationship with the ski resort under the permanence factor, which weighs in favor of employee status. The seasonal nature of the ski industry is not indicative of a sporadic relationship.

***Example 5:*** An editor works part-time for a newspaper. The editor works from home and is responsible for assigning and reviewing many articles published by the newspaper. Sometimes she also writes or rewrites articles. The editor is responsible for determining the layout and order in which all articles appear in the newspaper's print and online editions. She makes assignment and layout decisions in coordination with several full-time editors who make similar decisions with respect to different articles in the same publication and who are employees of the newspaper.

***Application:*** The editor is part of an integrated unit of production of the newspaper, as she is involved in the entire production process, including assigning and reviewing work, writing articles, and determining the article layout. She also works in coordination with other employees. The editor's part of an integrated unit of production of the newspaper indicates employee classification. Although she does not physically work in the office, the integrated unit factor outweighs this consideration.

***Example 6:*** A journalist writes articles for a newspaper on a freelance basis. The journalist does not have an office and generally works from home. He submits an article to the newspaper once every 2 to 3 weeks, which the newspaper may accept or reject. The journalist sometimes corresponds with the newspaper's editor regarding what to write about or regarding revisions to the articles that he submits, but he does not otherwise communicate or work with any of the newspaper's employees. The journalist never assigns articles to others, nor does he review or revise articles that others submit. He is not responsible for determining where his article or any other articles appear in the newspaper's print and online editions.

***Application:*** The journalist is not part of an integrated unit of production of the newspaper, which indicates independent contractor status. The journalist's work is limited to

specific articles and is segregated from other parts of the newspaper's processes. The fact that the journalist works from home is not indicative of either employee or independent contractor status, as the nature of a journalist's work makes the physical work location largely irrelevant.

On January 20, 2021, the Biden administration took office and issued a memorandum, directing federal agencies to postpone the effective dates of rules that had been published in the Federal Register but had not yet taken effect. This was known as the "Regulatory Freeze" Memorandum. On the same day, the Office of Management and Budget issued guidance regarding the implementation of the Regulatory Freeze Memorandum. Agencies were asked to consider the following actions:

- Postponing the effective date of rules that had not yet become effective for 60 days;
- Opening a 30-day comment period to allow interested parties to provide comments about issues of fact, law, and policy raised by such rules; and
- Pending petitions for reconsideration involving such rules.

On February 5, 2021, the DOL issued a notice of proposed rulemaking to propose a 60-day delay of the Independent Contractor Rule's effective date, and it included a 19-day comment period. On March 4, 2021, the DOL issued the final rule, "Independent Contractor Status Under the Fair Labor Standards Act (FLSA): Delay of Effective Date" (the "Delay Rule"), which was effective immediately and postponed the effective date of the Independent Contractor Rule from March 8, 2021, to May 7, 2021. On March 12, 2021, the DOL Wage and Hour Division (WHD) announced a proposal to rescind the January 7, 2021 final rule outlining the economic reality test, stating that the final rules would minimize other factors traditionally considered by courts. It provided a 31-day comment period. The DOL stated that this would make it less likely that the worker would be classified as an employee under the FLSA, resulting in more workers being classified as independent contractors.

In a turn of events, on March 14, 2022, the U.S. District Court for the Eastern District of Texas reinstated the Trump administration's rule and implements the "Economic Reality" test. In *Coalition for Workforce Innovation et al. v. Walsh*, the plaintiffs argued that the government violated the Administrative Procedure Act. The Administrative Procedure Act outlines a three-step procedure which must be followed:

- "First, the agency must issue a "general notice of proposed rule making," ordinarily by publication in the Federal Register."
- "Second, if "notice is required," the agency must "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments." The agency must consider and respond to "significant comments received during the period for public comment."
- "Third, when the agency promulgates the final rule, it must include in the rule's text a concise general statement of its basis and purpose." [17]

The Court noted that the Delay Rule required notice and comment because:

- It was substantive rulemaking; and
- The Independent Contractor Rule was a legislative rule and was promulgated using the notice-and-comment procedure.
    - The DOL must use the same procedures it used to issue a rule if it amends or repeals a rule.

[17] *Coalition for Workforce Innovation et al. v. Walsh, Case 1:21-cv-00130-MAC.*

Lastly, the Court ruled that the Biden administration's actions of withdrawing the rule violated the Administrative Procedure Act. The Court found that the 19-day notice-and-comment period was inadequate in providing the public with a meaningful opportunity to comment. The Court held that the Independent Contractor Rule became effective on March 8, 2021 and remains in effect. The DOL's final rule serves as the FLSA's sole and authoritative interpretation of independent contractor status under the FLSA and replaces any prior regulations and guidance.

# Miscellaneous Practice and Reporting Issues

# Miscellaneous Practice and Reporting Issues

## *Learning objective*

Upon reviewing this material, the reader will be able to discuss miscellaneous practice and reporting issues a practitioner currently may encounter.

## *I. Current overview*

### A. Status of COVID-19 relief provisions

In recent years, there has been significant relief provided to businesses and individuals as a result of the COVID-19 pandemic. Major COVID-19 relief legislation included:

- The CARES Act;
- ARPA; and
- The CAA 2021.

Many relief provisions were temporary in nature, but some provisions continue into 2022. While some provisions have expired, there may be opportunities to file an amended return.

#### *1. Business meals deduction*

The CAA 2021 temporarily increased the 50% limit on the business meals deduction to 100%. To qualify for the increased deduction, expenses must be paid or incurred in 2021 and 2022 for business meal food and beverage expenses, including delivery and carry-out meals, provided by a restaurant. Final §274 regulations confirm that the food and beverage expenses include the full cost of the meal, including any delivery fees, sales tax, or tips.

The IRS issued Notice 2021-25, clarifying when the increased 100% deduction applies. Notice 2021-25 defines a “restaurant” as “a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises.”

A restaurant does not include a business “that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.” For such businesses, a 50% deduction continues to apply.

Lastly, Notice 2021-25 clarifies that an employer may not treat as a restaurant:

- An eating facility located on the business premises of the employer and used in furnishing meals excluded from an employee's gross income; or
- Any employer-operated eating facility treated as a de minimis fringe benefit, even if such eating facility is operated by a third party under contract with the employer.

 

### *2. Executive compensation*

Prior to ARPA, the deduction for executive compensation was capped at $1 million for certain covered employees of publicly traded companies, including the CEO, CFO, and next three highest compensated officers. For purposes of the §162(m), these five covered employees are permanently considered covered employees, often referred to as the “once a covered employee, always a covered employee” rule. ARPA modifies §162(m) by capping the deduction at $1 million for the next five highest-paid employees in addition to the CEO, CFO, and next three highest compensated officers. These next five highest-paid employees are to be determined on an annual basis and are not subject to the “once a covered employee, always a covered employee” rule. As a result of this new modification, companies with highly paid non-officer employees may be subject to a disallowed deduction. Companies may also face increased recordkeeping requirements, as they will track their “permanent” covered employees, as well as the next five highest-paid covered employees on a yearly basis. Companies should begin to think about what systems they need to put into place in order to track this information. This provision takes effect for tax years beginning after December 31, 2026, providing companies with adequate time to prepare for the change. However, it would be wise for companies to begin reviewing compensation agreements sooner rather than later to determine the impact of the new ARPA provisions.

### *3. Employee Retention Tax Credit*

The CARES Act created a refundable Employee Retention Tax Credit (ERTC) for employers subject to closure due to COVID-19. The ERTC deadline was initially set to expire December 31, 2020, but The Consolidated Appropriations Act of 2021 (CAA 2021) extended it through June 30, 2021. The American Rescue Plan Act (ARPA) initially extended the ERTC through December 31, 2022, but the Infrastructure Investment and Jobs Act (IIJA) terminated the ERTC as of September 30, 2021. Recovery Startup Businesses were exempt from this provision and could continue to take the Employee Retention Tax Credit through December 31, 2021. Recovery startup businesses were defined as employers who: (i) began operations after February 15, 2020; (ii) who had average annual gross receipts for a three-taxable-year period ending with the taxable year which preceded such quarter not in excess of $1,000,000; and (iii) were not otherwise an eligible employer due to a full or partial suspension of operations or a decline in gross receipts.

The 2020 ERTC was equal to 50% of qualified wages, up to $10,000. In other words, the 2020 ERTC was worth up to $5,000 per employee. The CAA 2021 increased the credit from 50% to 70% of qualified wages in 2021 but maintained the wage limit on a per-employee basis of $10,000 per quarter. As a result, the ERTC was worth up to $7,000 per employee per quarter in 2021. Recovery startup businesses were eligible to receive a maximum ERTC of $50,000 in Q3 and Q4 of 2021.

While the covered period for ERTC qualified wages has ended, there is still opportunity for taxpayers to claim the ERTC by filing an amended return. When the ERTC was initially established by the CARES Act, a business could either receive the ERTC or a PPP loan, not both. The CAA 2021 allowed businesses to receive both the ERTC and a PPP loan. Taxpayers who were initially ineligible for the ERTC may now be eligible and should consider filing an amended return to claim the ERTC. Taxpayers have up to three years (from the due date of the original return) to file an amended Form 941 to claim the ERTC.

When determining whether or not to amend a return, it is important to consider the impact of the ERTC on the §199A deduction. Pass-through entities are eligible to take up to a 20% §199A deduction, provided certain conditions are met. The taxpayer must have an activity that is considered an active trade or

 

business in order to be eligible for the §199A deduction. If the taxpayer's income exceeds threshold amounts, the §199A deduction may be limited. In 2021, these threshold amounts were*:

- $329,800 for married filing jointly returns;
- $164,925 for married filing separately returns; and
- $164,900 for all other returns.

In 2020, these threshold amounts were*:

- $326,600 for married filing jointly returns;
- $163,300 for married filing separately returns; and
- $163,300 for all other returns.

*Note: Only 2020 and 2021 inflation-adjusted threshold amounts for purposes of the §199A deduction were listed, as the ERTC was only in effect during the 2020 and 2021 tax years.

Taxpayers considered to be Specified Service Trade or Businesses (SSTBs) are generally not eligible for the §199A deduction unless their taxable income is at or below the threshold amounts or within the phase-in range. An SSTB is a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners.

If the pass-through income is not related to an SSTB and the taxpayer's taxable income exceeds the threshold amounts, the §199A deduction is limited to the greater of:

- 50% of W-2 wages with respect to the trade or business; or
- 25% of W-2 wages with respect to the trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.
- The §199A deduction cannot exceed taxable income for the year over net capital gain plus aggregate qualified cooperative dividends.

As a result, if a taxpayer's pass-through income is not related to an SSTB and the taxpayer's taxable income exceeds the threshold amounts, the amount of W-2 wages becomes increasingly important, and the ERTC can have a significant impact on this W-2 wage amount.

The salaries and wages deduction must be reduced by the amount of ERTC claimed. Under §280C(a), a deduction is disallowed by the portion of wages paid equal to the sum of certain credits determined for the taxable year. Similarly, the amount of W-2 wages taken into account for purposes of the §199A deduction is reduced by the ERTC claimed. Since under §280C(a) the salaries and wages deduction must be reduced by the amount of ERTC claimed, it may not be taken into account for purposes of the §199A deduction, as the ERTC is not considered when determining taxable income. The following two examples demonstrate the impact of the ERTC on the §199A deduction.

 

***Example 1:*** ***No ERTC –***

Eli, an unmarried individual, is the sole owner of an S corp that is not an SSTB. In 2021, the S corp reported taxable income before wages of $2,000,000 and paid wages of $1,000,000. The S corp did not take the ERTC in 2021. For purposes of the example, assume Eli's tax rate is 37%. See below for the calculation of tax due after the §199A deduction:

| | **No ERTC** |
|---|---|
| Taxable Income (Before Wages) | 2,000,000 |
| Wage Deduction | 1,000,000 |
| Taxable Income before §199A Deduction | 1,000,000 |
| 20% §199A deduction | 200,000 |
| 50% Wage Limitation | 500,000 |
| Allowable §199A deduction | 200,000 |
| **Tax Due** | 296,000 |

***Example 2:*** ***ERTC –***

Eli, an unmarried individual, is the sole owner of an S corp. In 2021, the S corp reported taxable income before wages of $2,000,000 and paid wages of $1,000,000. The S corp took a $650,000 ERTC in 2021. For purposes of the example, assume Eli's tax rate is 37%. See below for the calculation of tax due after the §199A deduction:

| | **ERTC** |
|---|---|
| Taxable Income (Before Wages) | 2,000,000 |
| Wage Deduction less ERTC | 350,000 |
| Taxable Income before §199A Deduction | 1,650,000 |
| 20% §199A deduction | 330,000 |
| 50% Wage Limitation | 175,000 |
| Allowable §199A deduction | 175,000 |
| **Tax Due** | 545,750 |

When comparing Example 1 and Example 2, the allowable §199A deduction decreases by $25,000 when the ERTC is taken, and the tax due increases by $249,750. The ERTC must be weighed with the impact on the §199A deduction when determining whether to amend a return.

As noted in the previous examples, taxpayers must reduce their deduction of ERTC qualified wages by the amount of the ERTC they received for those wages. If taxpayers retroactively claim the ERTC, they must file an amended return to reflect the reduced wage deduction. Taxpayers may be unable to pay the increased tax as a result of the reduced wage deduction, since the IRS is still experiencing a backlog of adjusted Forms 941-X.

The IRS announced that in situations where taxpayers have unexpected tax liability due to retroactively claimed ERTC but have not yet received the ERTC refund, the IRS will waive the penalty for failure to timely pay these additional taxes, provided taxpayers can show reasonable cause and not willful neglect for failure to pay. [1] Penalty relief is also available from First Time Penalty Abatement program if the taxpayer:

- Did not previously have to file a return or had no penalties for the three prior tax years;
- Filed all currently required returns or filed an extension of time to file; and

[1] IR 2022-89, *IRS reminds employers of penalty relief related to claims for the Employee Retention Credit*.

 

- Paid, or arranged to pay, any tax due.

## B. Miscellaneous 2022 updates

### *1. Changes to Section 174 Research and Experimental Expenditures*

Under §174, research and experimental expenditures must:

- Be incurred in connection with the taxpayer's business.
- Represent a research and developmental cost in an experimental or laboratory sense.
  - This includes activities intended to discover information that would eliminate uncertainty concerning the development of an improvement or product.

Section 174 includes all costs incurred incident to the development or improvement of a product. Section 174 expenses must be reasonable under the circumstances. Section 174 is more expansive in scope than §41, as it comprises all costs related to the development of a product, including:

- Depreciation costs (not a qualified research expense under §41);
- Patent procurement costs (not a qualified research expense under §41); and
- Overhead costs (not a qualified research expense under §41).

**Expenses incurred before 1/1/2022:**

Under §174, taxpayers could typically treat Research and Experimental (R&E) Expenditures in any of the following ways:

- Deduct in current tax year paid or incurred (§174(a));
- Capitalize and amortize over a period not less than 60 months, beginning with the month in which the taxpayer first realizes benefits from such expenditures (§174(b)); or
- Capitalize and amortize over 10 years, beginning with the taxable year in which the expenditure was made (§59(e) election).

Rev. Proc. 2000-50 provided specific guidance on computer software costs. Taxpayers could generally:

- Expense the development costs in the year incurred;
- Capitalize and amortize over a period not less than 60 months, beginning the month the development is completed; or
- Capitalize and amortize over 36 months from the date the software is placed in service.

The following activities are **not** considered §174 R&E expenditures:

- The ordinary testing or inspection of materials or products for quality control;
- Efficiency surveys;
- Management studies;
- Consumer surveys;
- Advertising or promotions;
- The acquisition of another's patent, model, production or process; or
- Research in connection with literary, historical, or similar projects.

**Expenses incurred on or after 1/1/2022:**

The TCJA amended §174 to provide that R&E and software development costs must be capitalized and amortized over five years (15 years for foreign research) for tax years beginning after December 31, 2021. The amortization period begins with the midpoint of the taxable year in which the specified research

 

or experimental expenditures were paid or incurred. Software development costs are included in the definition of §174 R&E expenditures.

The change to the five-year amortization period is considered an accounting method change initiated by the taxpayer with IRS consent. There is no §481(a) adjustment as the provision is applied on a cutoff basis for expenditures incurred after December 31, 2021.

**Effects of TCJA §174 Changes:**

The changes that the TCJA made to §174 have widespread impacts:

- Taxpayers may no longer immediately expense R&E expenditures.
- Section 59(e) elections are no longer applicable.
  - Taxpayers could previously elect to amortize expenditures over 10 years.
- If property is sold, taxpayers can no longer recover R&E costs earlier than the end of the amortization period.

Life science companies, including biopharmaceutical companies, often have significant R&D expenses. As a result of the TCJA changes, these taxpayers will likely incur larger tax losses due to the longer amortization period.

***Example*:** Corporation XYZ incurs $1,000,000 of §174 expenditures in the U.S. in 2022. Below shows the yearly amounts recovered and overall tax impact:

| | Recovery Period | | | | | |
|---|---|---|---|---|---|---|
| | **2022** | **2023** | **2024** | **2025** | **2026** | **2027** |
| **Section 174 Expenditures** | 1,000,000 | | | | | |
| **Amount Recovered** | 100,000 | 300,000 | 500,000 | 700,000 | 900,000 | 1,000,000 |
| **Amount Capitalized** | 900,000 | 700,000 | 500,000 | 300,000 | 100,000 | |
| **Tax Impact (assume 21% corporate rate)** | 189,000 | 147,000 | 105,000 | 63,000 | 21,000 | |

**Other Considerations:**

It is important to note that the changes to the recovery period of §174 R&E expenditures will not impact the §41 research credit. The §41 research credit will still be available for qualifying §174 costs, provided the four-part test (below) is met:

1. Qualified research is research with respect to which expenditures may be treated as expenses under §174 ("section 174" test);
2. Qualified research is research undertaken for the purpose of discovering information which is technological in nature (the "discovering technological information" test);
3. Qualified research is research in which the application is intended to be useful in the development of a new or improved business component of the taxpayer (the "business component" test); and
4. Substantially all of the activities of which constitute elements of a process of experimentation for a qualified purpose (also known as the "process of experimentation" test).

 

As discussed, the §174 changes require software development costs to be capitalized and amortized over five years (15 years for foreign research) for expenses incurred after December 31, 2021. Per §167(f)(1), purchased software may be amortized over 36 months, and it is eligible for bonus depreciation. Taxpayers should consider comparing the costs and pros/cons of developing software vs. acquiring it, especially in light of the recent §174 changes. Taxpayers should consider the effect of bonus depreciation phasing down starting in 2023.

Taxpayers with both U.S. and foreign operations should have a method in place to track §174 costs by location (domestic vs. foreign) to ensure the appropriate costs are matched with the correct amortization period. Similarly, taxpayers should have a practice in place to track §174 costs vs. non-§174 costs. Taxpayers with significant foreign operations should consider moving R&E expenditures to the U.S. to take advantage of the shorter recovery period.

### *2. Changes to Section 163(j)*

Section 163(j) generally limits the amount of business interest expense that can be deducted in the current taxable year. Under §163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of:

- The taxpayer's business interest income for the taxable year;
- 30 percent of the taxpayer's adjusted taxable income (ATI) for the taxable year (30 percent ATI limitation); and
- The taxpayer's floor plan financing interest expense for the taxable year.

Any disallowed business interest is carried forward and treated as business interest paid or accrued in the succeeding taxable year subject to §163(j).

The §163(j) limitation applies to all taxpayers other than certain exempt small businesses that meet the §448(c) gross receipts test and certain excepted trades or businesses. A business generally meets the gross receipts test of §448(c) when it is not a tax shelter and has average annual gross receipts of $25 million or less in the previous three years. In 2021, this amount was $26 million as indexed for inflation, and in 2022, this amount is $27 million as indexed for inflation.

The following businesses are excepted trades or businesses:

- The trade or business of providing services as an employee;
- Certain real property trades or businesses that elect to be excepted;
- Certain farming businesses that elect to be excepted; and
- Certain regulated utility trades or businesses.

Once made, the election to be an excepted trade or business is generally irrevocable and binding on the trade or business for all succeeding years. Exempt small businesses are not permitted to make an election to be an excepted trade or business because they are already not subject to the §163(j) limitation.

Business interest income is any interest income includible in the gross income of a taxpayer for the taxable year that is properly allocable to a non-excepted trade or business. Floor Plan Financing Interest is interest paid or accrued on "floor plan financing indebtedness." Floor Plan Financing Indebtedness is indebtedness that is used to finance the acquisition of motor vehicles held for sale or lease, and that is secured by the acquired inventory.

 

Adjusted Taxable Income (ATI) is the taxpayer's tentative taxable income with the following additions:

- Any business interest expense, other than disallowed business interest expense carryforwards;
- Any net operating loss deduction under §172;
- Any deduction under §199A;
- For taxable years beginning before January 1, 2022, any depreciation under §167 or §168;
- For taxable years beginning before January 1, 2022, any amortization of intangibles and other amortized expenditures;
- For taxable years beginning before January 1, 2022, any depletion under §611;
- Any deduction for a capital loss carryback or carryover; and
- Any deduction or loss that is not properly allocable to a non-excepted trade or business.

Additionally, the following subtractions are taken from the taxpayer's tentative taxable income to arrive at Adjusted Taxable Income:

- Any business interest income that was included in the computation of the taxpayer's tentative taxable income;
- Any floor plan financing interest expense for the taxable year that was included in the computation of the taxpayer's tentative taxable income;
- With respect to the sale or other disposition of property, the greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under §1016(a)(2), for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property;
- With respect to the sale or other disposition of stock of a member of a consolidated group by another member, the investment adjustments under §1.1502-32 with respect to such stock that are attributable to deductions;
- With respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in paragraph (b)(1)(ii)(C) of this section with respect to property held by the partnership at the time of such sale or other disposition to the extent such deductions were allowable under §704(d);
- Any income or gain that is not properly allocable to a non-excepted trade or business (for rules governing the allocation of items to an excepted trade or business, see §§1.163(j)-1(b)(44) and 1.163(j)-10)) and that was included in the computation of the taxpayer's tentative taxable income; and
- An amount equal to the sum of any specified deemed inclusions that were included in the computation of the taxpayer's tentative taxable income, reduced by the portion of the deduction allowed under §250(a) by reason of the specified deemed inclusions.

For taxable years beginning after 2021, deductions for depreciation, amortization, or depletion are not taken into account in calculating ATI. Businesses who previously did not have a §163(j) limitation may now be subject to the limitation starting in 2022.

### *3. Update to IRS FAQ process*

The Internal Revenue Bulletin is the authoritative instrument of the IRS to announce official rulings and procedures, and for publishing Treasury Decisions, Executive Orders, Tax Conventions, Court Decisions, Legislation, or any other important items.

 

- **Final and Temporary Treasury Regulations** may be relied on by taxpayers. Proposed regulations may be relied on if the regulations explicitly state that they may be relied on.
- **Revenue Rulings** provide the IRS's interpretation of the law to facts in the specific ruling. Taxpayers may rely on these rulings if their specific facts and circumstances are substantially the same as the revenue ruling. Revenue rulings have a lower level of authority than Treasury Regulations.
- **Revenue Procedures** are official statements of IRS procedure and administrative practices. Taxpayers may rely on this guidance if their specific facts and circumstances are substantially the same as the revenue procedure. Revenue procedures have a lower level of authority than Treasury Regulations.
- **Frequently Asked Questions (FAQs)** provide the IRS's responses to general inquiries rather than a specific set of facts and circumstances.

Over the past few years, the IRS released various FAQs regarding COVID-19 relief provisions to timely communicate information to taxpayers. However, practitioners were concerned as FAQs are not considered authoritative guidance.

In October 2021, the IRS announced that it updated its process for certain FAQs on newly enacted tax legislation. Significant FAQs on newly enacted tax legislation, as well as any later updates or revisions, will be announced in a news release and posted on the IRS.gov website in a separate fact sheet. Any prior versions of IRS Fact Sheets will be maintained on the IRS.gov website so that taxpayers will be able to determine which version of the FAQs they relied on, in the event they need to make this determination.

In the same news release, the IRS clarified that if a taxpayer relies on any FAQ (including FAQs released before the October 2021 news release) in good faith and that reliance is reasonable, the taxpayer will have a "reasonable cause" defense against any negligence penalty or other accuracy-related penalty if it turns out the FAQ is not a correct statement of the law as applied to the taxpayer's particular facts. The IRS also confirmed that FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return.

As part of the FAQ revision process, the IRS will add the following text to the Fact Sheet FAQs:
*"These FAQs are being issued to provide general information to taxpayers and tax professionals as expeditiously as possible. Accordingly, these FAQs may not address any particular taxpayer's specific facts and circumstances, and they may be updated or modified upon further review. Because these FAQs have not been published in the Internal Revenue Bulletin, they will not be relied on or used by the IRS to resolve a case. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Nonetheless, a taxpayer who reasonably and in good faith relies on these FAQs will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax. Any later updates or modifications to these FAQs will be dated to enable taxpayers to confirm the date on which any changes to the FAQs were made. Additionally, prior versions of these FAQs will be maintained on IRS.gov to ensure that taxpayers, who may have relied on a prior version, can locate that version if they later need to do so."*

 

# Investments, Retirement, and Miscellaneous

# Investments, Retirement, and Miscellaneous

## *Learning objectives*

Upon reviewing this material, the reader will be able to:

- Explain what constitutes a real estate professional in terms of participation and what constitutes a real property trade or business; and
- Discuss the challenges of self-employed (unincorporated) individuals with no common-law employees, who typically are looking to shelter some income but need the flexibility to make varying contributions each year.

## *I. Investments*

### A. Real estate

#### *1. The law*

A taxpayer qualifies as a real estate professional and is not engaged in a passive activity from rental activities if: (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates [750-hour service performance requirement]. In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse separately satisfies the requirements. Thus, if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not per se passive.

With respect to the evidence that a taxpayer may use to establish his or her hours of participation in a trade or business, the extent of participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of participation may be established by other reasonable means. Reasonable means may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. While the regulations allow taxpayers some latitude in establishing the extent of their participation in an activity, Tax Courts have consistently held that they do not allow a post-event "ballpark guesstimate."[1] With respect to the requirement that the hours a taxpayer spent on real property trades or businesses accounted for more than one-half of the total hours of personal services the taxpayer performed in all trades or businesses during the subject years, to qualify as a real estate professional, the taxpayer must aggregate all hours of personal services in trades or businesses.

For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.[2] The Court will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

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1 See *Goshorn v. Commissioner*, T.C. Memo. 1993-578; see also *Moss v. Commissioner*, 135 T.C. 365, 369 (2010); *Fowler v. Commissioner*, T.C. Memo. 2002-223.

2 I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

 

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual. Additionally, material participation can be met if historical material participation was met during any five of the ten immediately preceding tax years.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.[3]

### *2. Procedures to obtain extensions for single rental real estate activity treatment*

Effective June 13, 2011, the IRS issued guidance allowing some taxpayers to make late elections to treat all interests in rental real estate as a single rental real estate activity.[4] The guidance provides special procedures, in lieu of the letter ruling procedure under §9100, to obtain relief for late elections under Regs. §1.469-9(g). A taxpayer ineligible for relief under this guidance may request relief by applying for a letter ruling.

a. In general, §469(c)(7)(A) provides that a taxpayer's interests in rental real estate are treated as separate activities for determining whether the taxpayer materially participates in each rental real estate activity unless the taxpayer elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's **original income tax return** for the taxable year.

***The law:***

For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.[5] The Court will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

b. The Commissioner may under §9100 grant a reasonable extension of time to make a regulatory election, or a statutory election. Requests for relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer meets one of the requirements, which include that the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election.

c. The procedures in this revenue procedure are in lieu of the letter ruling procedure that is used to obtain relief for a late §1.469-9(g) election. Accordingly, user fees do not apply to corrective action under this revenue procedure. However, a taxpayer that is not eligible for relief under this revenue procedure may request relief by applying for a private letter

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[3] Treas. Regs. §1.469-9(e)(1).
[4] Rev. Proc. 2011-34; 2011-24 I.R.B. 875.
[5] I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

 

ruling, but the Service will not ordinarily issue a private letter ruling if the period of limitations on assessment has lapsed for any taxable year that would be affected by the requested late election. Any taxpayer receiving relief under the guidance is **treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity** as of the tax year for which the late election is requested.

d. A taxpayer is eligible for an extension of time to file an election if the taxpayer represents on a statement that satisfies the procedural requirements and under penalties of perjury that it meets all of the following requirements.

(i) The taxpayer failed to make an election **solely because the taxpayer failed to timely meet the requirements** in §1.469-9(g).

(ii) The taxpayer **filed consistently with having made an election** on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.

(iii) The taxpayer **timely filed each return** that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

(iv) The taxpayer has **reasonable cause for its failure to meet the requirements**.

***Note:***

The taxpayer must attach the statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file its current year tax return. The statement must contain the **declaration** required, must explain the **reason for the failure to file a timely election**, and must include the representations required in this revenue procedure. The statement must identify the taxable year for which it seeks to make the late election. Finally, the statement must state at the top of the document "FILED PURSUANT TO REV. PROC. 2011-34."

The declaration and representations required in this revenue procedure must be accompanied by a dated declaration, signed by the taxpayer which states: "Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election.

***Note:***

The granting of an extension of time to file an election and the issuance of a notification do not constitute an express or implied determination concerning whether the taxpayer satisfies the eligibility requirements of this revenue procedure, whether the taxpayer satisfies the real estate professional requirements, or whether the taxpayer materially participates in any activity.

 

***The law:***

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.[6]

***Planning point:***

The additional tax on unearned income also permits a taxpayer to make a grouping election if the taxpayer is first subject to the net investment income tax.

## B. Cases

### *1. The REDI Foundation Inc. v. Commissioner, T.C. Memo 2022-34*

***Facts:***

Richard M. Abraham was an experienced real estate developer who founded and incorporated The REDI Foundation Inc. ("REDI") on June 26, 1980. Abraham intended to offer seminars on real estate development through REDI, and REDI was granted §501(c)(3) status.

Abraham was the sole instructor for REDI and only offered two seminars in 1980 and 1990. In 2010, he developed an online course on real estate development. He had complete control over all aspects of course content and development, and he frequently worked over 60 hours per week on instruction and mentoring students. REDI's sole source of income during the period at issue was the tuition charged to students to enroll in the online course. Abraham himself testified that REDI was a "mere vehicle" to offer the online course and that REDI was "indistinguishable from himself." REDI allegedly compensated Abraham based on overall student enrollment in the online course.

REDI filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ending May 31, 2015, on June 9, 2015, reporting total revenue of $255,605 and salaries, other compensation, and employee benefits of $91,918. Abraham signed Form 990 as REDI's officer and treasurer. In 2014, REDI issued Form 1099-MISC to Abraham, reporting $91,918 in payments to Abraham. Abraham received a total of $120,000 from REDI during 2014. REDI did not file Form 941, *Employer's Quarterly Federal Tax Return,* for any of the periods at issue or during any period since its incorporation.

REDI's Form 990 was selected for employment tax examination. On May 1, 2018, REDI received Form 4564, *Information Document Request,* regarding REDI's treatment of Abraham as an independent contractor. The letter requested that REDI provide information on whether it met requirements for employment tax relief under Act §530. REDI responded by stating that Abraham was never an employee, and thus employment tax relief was not applicable.

In response, REDI received a notice of determination dated October 12, 2018, stating that Abraham was to be legally classified as an employee for purposes of federal employment taxes and that REDI was not

[6] Treas. Regs. §1.469-9(e)(1).

 

entitled to relief from that classification under Act §530 with respect to Abraham for the periods at issue. On November 30, 2018, REDI timely filed a petition disputing the determination of Abraham's classification of an employee and all related tax liabilities.

***Issues and Analysis:***

The Commissioner's determinations are presumed correct, and therefore, REDI bears the burden of providing that they are incorrect and that REDI is not liable for additions to tax under §6551(a)(1) and §6551(a)(2).

Per §3111, employers are required to pay FICA taxes based on wages paid to employees, with wages meaning all renumeration for employment. Under §3121(d)(1), an employee is defined for purposes of employment taxes to include any officer of a corporation. Per Treas. Reg. §31.3121(d)-1(b), an officer of a corporation is generally an employee of such corporation. However, an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation.

The IRS uses a 20-factor analysis for determining the existence of an employer-employee relationship (Rev. Rul. 87-41):

1. **Instructions**: Workers that are required to comply with the business's instructions on when, where, and how to work are generally considered employees.
2. **Training:** Workers that are trained by the business to complete tasks in specific ways are generally considered employees, whereas workers who complete tasks in their own way are generally considered independent contractors.
3. **Integration:** When the worker's services are integrated into the business operations, it demonstrates that the worker is subject to direction and control.
4. **Services Rendered Personally:** If services must be rendered personally, the business performed generally has an interest in the methods used to accomplish the work as well as in the results.
5. **Hiring, Supervising, and Paying Assistants:** If the business hires, supervises, and pays assistants, it generally means it has control over the workers on the job. If one worker hires, supervises, and pays other assistants, but a contract stipulates that the worker must provide materials and labor and the worker is fully responsible for attainment of a result, it typically indicates such worker is an independent contractor.
6. **Continuing Relationship:** A continuing relationship between the worker and business indicates that an employer-employee relationship exists.
7. **Set Hours of Work:** When a business sets the hours of work, it typically indicates control.
8. **Full Time Required:** If the worker must devote nearly full time to the business and is restricted from doing other gainful work, it typically indicates employee status. On the other hand, independent contractors generally work when and for whom they choose.
9. **Doing Work on the Employer's Premises:** If the work is performed on the business's premises, it generally indicates control over the worker and employee status, especially if the work could have been completed elsewhere.
10. **Order or Sequence Set:** If a worker must perform services in a sequence set by the business, it indicates control.
11. **Oral or Written Reports:** If the worker must submit regular or written reports, it indicates the business's control.

 

12. **Payment by Hour, Week, Month:** If a worker is paid hourly, weekly, or monthly, it indicates an employer-employee relationship. Commission typically indicates independent contractor status.
13. **Payment of Business and/or Traveling Expenses:** If the business typically pays the worker's business or traveling expenses, the worker is typically an employee.
14. **Furnishing Tools and Materials:** If the business furnishes significant tools, materials, or equipment to the worker, it generally indicates an employer-employee relationship.
15. **Significant Investment:** If the worker invests in the facilities they use to perform services, it typically indicates that the worker is an independent contractor.
16. **Realization of Profit or Loss:** Workers that realize profit or suffer a loss as a result of their services are often classified as independent contractors.
17. **Working for More than One Firm at a Time:** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, it generally indicates that the worker is an independent contractor.
18. **Making Services Available to General Public:** If the worker makes his or her services available to the general public on a regular and consistent basis, it generally indicates independent contractor status.
19. **Right to Discharge:** If a business has the right to discharge a worker, it generally indicates that such worker is an employee.
20. **Right to Terminate:** If the worker has the right to end his or her relationship with the business for whom they perform services, at any time without incurring liability, it generally indicates an employer-employee relationship.

***Conclusion:***

Since Abraham provided services to REDI that comprised REDI's entire source of income and Abraham received compensation for such services, it was established that Abraham's services were as an officer and statutory employee.

REDI countered Abraham's classification as statutory employee status as follows:

- REDI stated that Abraham provided services in dual capacities as both an independent contractor and officer-employee.
- REDI claimed that Abraham's officer duties were limited to administrative tasks for which he received no compensation.
- REDI asserted that Abraham could not be an employee because REDI exercised no control over him or the online course. REDI cited that under an employer-employee relationship, the employer must have the right to control the work performed by its employee. REDI claimed that since they had no control over Abraham's work, he could not be their employee.
- Lastly, REDI asserted that the payments made to Abraham constituted royalty payments for use of his real estate book in their online course.

The Court found that based on the evidence provided, Abraham provided extensive services to REDI and the payments he received were not royalty payments. The Court determined that REDI lacked sufficient evidence to demonstrate Abraham's classification as an independent contractor. Abraham was the sole person in charge of developing REDI's online real estate course and provided significant services to REDI. The Court found that REDI failed to establish that Abraham was engaged in dual rules as both an employee and independent contractor.

 

The Court further concluded that Abraham performed significantly more than “minor services” for REDI. Abraham developed the entire online real estate course for REDI, and it constituted all of REDI’s income for the periods at issue. Additionally, Abraham frequently worked in excess of 60 hours per week, and he was the sole instructor for the online real estate course, essentially providing all services necessary for REDI to operate as a business. Finally, the Court concluded that Abraham met the definition of a statutory employee under §3121(d)(1), and as such, REDI was not eligible for Act §530 relief.

The Court found REDI liable for addition to tax under §6651(a)(1) and §6651(a)(2) for the periods at issue.

***2. William Geiman v. Commissioner, T.C. Memo. 2021-80***

***Facts:***

William Geiman was a union electrician who worked in both Wyoming and Colorado in 2013. Geiman owned a trailer home in Clifton, Colorado as well as a rental property in Grand Junction, Colorado. Geiman lived in Clifton since at least 2007, but he registered his vehicles, received mail, spent time with friends, and participated in various hobbies in Grand Junction. Geiman belonged to the Local 969 of the International Brotherhood of Electrical Workers (IBEW) union in Grand Junction, and his member status gave him priority in jobs around the Grand Junction area.

Below is a timeline of the various work completed by Geiman:

- December 2012: Geiman worked for three weeks in Grand Junction.
  - After Geiman completed this job, work became scarce in the Grand Junction area, so he elected to travel for other jobs obtained through other IBEW unions.
- January 24, 2013 – February 1, 2013: Geiman worked on a job in Cheyenne, Wyoming.
  - The governing collective bargaining agreement did not provide for reimbursement of fuel, lodging, or meals.
- February 5, 2013 – May 15, 2013: Geiman worked on a job in Wheatland, Wyoming.
  - Geiman received subsistence of $30 per day.
  - Geiman stayed in the Wyoming Motel in Wheatland, Wyoming in February and March 2013.
- May 16, 2013 – August 15, 2013: Geiman was unemployed and spent time in the Grand Junction area as well as other states.
- August 16, 2013 – September 10, 2013: Geiman worked in Englewood, Colorado.
- September 11, 2013 – October 20, 2013: Geiman worked in Highlands Ranch, Colorado.
- October 21, 2013 – October 27, 2013: Geiman worked in Victor, Colorado.
  - Geiman received a one-time per diem of $500, consistent with Local 113’s collective bargaining agreement.
- October 28, 2013 – December 31, 2013: Geiman worked in Aurora, Colorado.

Geiman claimed the following items on his 2013 tax return:

- An unreimbursed employee business expense deduction of $39,392 for meals, lodging, and vehicle expenses. Per Form 2106-EZ, *Employee Business Expenses,* this amount was comprised of the following expenses:
  - Lodging - $15,120;
  - Meals - $3,480;
  - Vehicle Expenses (Using Mileage Rate) - $18,594; and

 

    - Union and Professional Dues - $2,198.
- Tax preparation fees of $125.
- An “other” expense deduction of $6,025. Per an attachment on Geiman’s 2013 return, this amount was comprised of the following expenses:
    - Laptop computer, tools, printer, and hard drive expenses (expensed under §179) - $1,502; and
    - Job-related expenses - $4,523.

During the 2013 tax year, miscellaneous itemized deductions were allowed only to the extent that the total of such deductions exceeded 2% of the taxpayer’s AGI. Geiman’s AGI for 2013 was $62,019, and as such, after applying the statutory limitation, the deductible amount of expenses was $44,302.

The IRS sent Geiman a timely notice of deficiency, disallowing such deductions for unreimbursed employee business expenses and other expenses.

***Issues and Analysis:***
Section 274(d) outlines substantiation requirements for deductions claimed, among others, for travel expenses (including meals and lodging while away from home) and listed property. No such deduction is allowed unless the taxpayer substantiates by adequate records, or by sufficient evidence corroborating his own statement, the amount, time, place, and business purpose for each expenditure. Taxpayers must maintain adequate records and produce such records as substantiation.

Per §162(a)(2), taxpayers may deduct reasonable and necessary travel expenses, including vehicle expenses, meal expenses, and lodging expenses incurred while away from home in pursuit of a trade or business. For purposes of this deduction, a taxpayer’s home is generally the taxpayer’s principal place of business rather than his or her personal residence. *Minick v. Commissioner* explains that “if a taxpayer cannot show that he had both a permanent and temporary abode for business purposes during the year at issue, he is not entitled to the deduction.”

***Conclusion:***
The Court noted that there are typically three factors considered in determining whether a taxpayer has a tax home:

- Whether the taxpayer incurs duplicate living expenses while traveling and maintaining the home;
- Whether the taxpayer has personal and historical connections to the home; and
- Whether the taxpayer has a business justification for maintaining the home.

Although the IRS argued that Geiman had no tax home, the Court determined otherwise and concluded that Geiman’s tax home for 2013 was Clifton, Colorado. Since Geiman worked various, temporary jobs throughout 2013, he did not have a principal place of business in 2013. The Court provided reasoning for determining Geiman’s tax home for 2013 as Clifton, Colorado:

- Geiman incurred substantial living expenses in Clifton, Colorado, including home mortgage payments and credit card statements.
- Geiman had significant personal and historical ties to Clifton, Colorado, claiming he was a resident since at least 2007.

 

- Geiman's membership in his local home union gave him an adequate business justification for making his home in Clifton, Colorado. Specifically, Clifton was Geiman's tax home away from temporary work assignments.
- Geiman noted how important it was to maintain membership in a local union.
- Geiman recently (December 2012) attained local work through his local union.

In summary, the Court determined that Geiman's trailer home was his tax home for purposes of §162 deductions. As a result, Geiman was permitted to deduct substantiated lodging costs, substantiated business mileage, and a per diem amount for business days away from Clifton. This case shines light on the importance of determining a tax home.

### *3. Clary Hood Inc. v. Commissioner, T.C. Memo. 2022-15*

***Facts*:**

Since his childhood, Clary Hood ("Mr. Hood") was heavily involved in the construction industry, specializing in both land grading and excavation. These skills came naturally to Mr. Hood, as his father was also in the construction profession and possessed the same specialties.

In 1980, Mr. Hood formed Clary Hood, Inc. with his wife. Clary Hood, Inc. was organized as a C corporation, with Mr. Hood and his wife serving as the sole shareholders and members of the board of directors. Mr. Hood held ultimate control over all of the business operations during the years in question. Over the years, Clary Hood, Inc. grew from a small operation of only a handful of employees, into a successful 150-person company with nearly $70 million in revenue by the end of its 2016 tax year.

Although Clary Hood, Inc. had substantial growth over the years, it was not without hardship along the way. From 2000 to 2010, Clary Hood, Inc. was impacted by the recession, and it sustained operating losses from 2009 to 2011. In 2012, Mr. Hood made a risky decision by ceasing work with one of his largest and most consistent clients, Walmart. Mr. Hood cited increased competition and dwindling profit margins as the main reason why he did not want to take on any more projects with Walmart.

Mr. Hood quickly landed a profitable project with a zinc recycling plant that brought in over $30 million in revenue and a gross profit margin of over 40% throughout the next few years. In 2011, Mr. Hood also landed a land grading project that brought in nearly $9.5 million in revenue over the next few years and had a profit margin of 41%. In 2014, Mr. Hood once again was able to land a profitable land grading project, bringing in over $23 million in revenue and $5.4 million in gross profit.

Although Mr. Hood held various titles during his time with the company, his duties remained fairly consistent and included the following:

- Oversight of Clary Hood, Inc.'s fleet of equipment (procurement, use, maintenance, and disposition);
- Hiring, training, and supervision of mechanics;
- Supervision and inspection of jobsites;
- Preparation, review, and approval of job estimates and budgets;
- Submission and negotiation of job bids;
- Setting of employee salaries and bonuses; and
- Acquisition of bonding for projects.

 

Mr. Hood rarely took vacations and routinely worked 60-70 hours per week, including weekends. From 2000 to 2011, Mr. Hood's son, Wesley, was president and CEO of Clary Hood, Inc., but he left the business in 2011 as it had taken too much of a toll on his personal life. Another individual in the business took on this role upon Wesley's departure.

There was no compensation arrangement between Mr. Hood and Clary Hood, Inc. during the period in question. Mr. Hood and his wife, acting in the capacity of Clary Hood, Inc.'s board of directors, set the amount of Mr. Hood's annual compensation and bonuses. Additionally, the Hoods agreed to guarantee any claim the bonding companies may have had against Clary Hood, Inc. during the period in question for amounts beyond Clary Hood, Inc.'s ability to pay. Further, Mr. Hood personally guaranteed some of Clary Hood, Inc.'s business loans, credit lines, and capital leases during the period in question.

In 2014, Mr. Phillips, Clary Hood, Inc.'s CFO and CPA, noted that he believed Mr. Hood was being undercompensated, and he sought advice from Clary Hood, Inc.'s accountants, Elliot Davis, LLC. In response, Elliot Davis, LLC sent Mr. Phillips a summary of salary surveys, which included data from a PAS, Inc. (PAS) survey and a 2010 Construction Financial Managers Association survey. Mr. Phillips used this information as a step in determining the amount that Mr. Hood was undercompensated during the period in question.

In 2015, the issue of Mr. Hood's compensation was once again discussed at a year-end meeting, with Mr. Phillips and a partner at Elliot Davis, LLC. All were in agreement that Mr. Hood was undercompensated during the period in question and that he deserved a bonus in the amount of $5 million, pending additional follow-up considerations. This amount was supported by an Excel workpaper, created by Mr. Phillips, that considered the following as part of Mr. Hood's calculated compensation:

- A base salary beginning with $200,000 for the tax year ending May 31, 2000, then increasing 5% annually;
- An annual bonus of 20% of profits before taxes;
- An annual fee of $100,000 for bonding guaranties;
- An annual debt guaranty fee equal to approximately 1% of the debt and capital leases personally guaranteed by Mr. Hood; and
- Data from Elliot Davis, LLC.'s salary surveys.

The tax partner at Elliot Davis, LLC. modified the worksheet to add a "Total Equity" figure and a "Return on Equity for the year" calculation for each year during the period in question. From this information, the model determined a $5 million bonus for Mr. Hood, which the board of directors approved in May 2015 as backpay compensation. Additionally, the board of directors justified this $5 million bonus in the board minutes as follows:

- Mr. Hood navigated Clary Hood, Inc. through the loss of a president and long-time vice president in 2011;
- Mr. Hood decided to change direction of the company away from 'big box' grading work to more industrial grading opportunities;
- Mr. Hood dealt with and reacted to the most severe recession faced by the company in 2009-2011;
- Mr. Hood personally guaranteed most or all of the company debt, capital leases, and credit lines since inception;
- Mr. Hood acted as the personal guarantor to the company's bonding company since inception;

 

- Mr. Hood provided a steadying influence to both customers, vendors, and, most importantly, employees;
- Mr. Hood led the company by being prudent in seeking job opportunities and the purchasing of equipment necessary to handle the company's emergent work opportunities;
- Mr. Hood personally oversaw that equipment used by Clary Hood, Inc. on job sites met or exceeded expectations in the performance of the job; and
- Mr. Hood managed and led the company over the most profitable four-year run in its existence.

Citing the same reasons as above, the board of directors approved a second $5 million bonus in 2016.

Following an audit of Clary Hood, Inc.'s federal income tax returns, the Commissioner timely issued a notice of deficiency to Clary Hood, Inc. for the years at issue. This notice determined that Mr. Hood's compensation for the years in question exceeded reasonable compensation, and as such, they disallowed the excess portions. Specifically, the Commissioner allowed $517,964 of the $5,711,105 total amount Clary Hood, Inc. reported as compensation for Mr. Hood for its 2015 tax year and $700,792 of the $5,874,585 total amount Clary Hood, Inc. reported for its 2016 tax year.

***Issues and Analysis:***
Corporations may deduct all ordinary and necessary business expenses incurred during the tax year, including a reasonable allowance for salaries and compensation. The reasonableness of the compensation paid is determined based on all facts and circumstances. Similarly, an employer may deduct compensation paid to an employee in one tax year, even if the employee performed related services in a prior year. In such cases, the employer must show that the employee was not sufficiently compensated in the prior year and that the current year's compensation was in fact to compensate for that underpayment.

Extra considerations must be taken when an employee is also a shareholder of the corporation, specifically when an officer-shareholder sets their own compensation for a closely held corporation in which they are in control. In such cases, it must be determined whether the compensation is not truly deductible compensation, but instead a nondeductible dividend. Per §1.162-7(b)(1), "any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock."

Multiple factors such as the employee's qualifications, the extent and scope of the employee's duties, the size and complexity of the business, a comparison of salaries paid with net income and gross income, comparison of salaries with distributions to stockholders, the company's salary policy, prevailing rates for comparable conditions, and overall economic conditions are often considered when determining whether compensation is reasonable. This analysis is often referred to as the "multifactor approach." Other courts use the "independent investor test" instead of the multifactor approach in order to determine the reasonableness of employee-shareholder compensation. Under the independent investor test, the court

 

asks ""whether an inactive, independent investor would be willing to compensate the employee as he was compensated."

***Conclusion***

The Court as well as the Court of Appeals for the Fourth Circuit historically utilized the multifactor approach rather than the independent investor test. As a result, the court utilized the multifactor approach to determine the reasonableness of Mr. Hood's compensation.

The Court noted that Mr. Hood was entitled to additional compensation, although they had to examine the extent to which that compensation could be deducted for federal income tax purposes on the basis of reasonableness. The Commissioner argued that Mr. Hood's substantial compensation in 2015 and 2016 (as compared to prior years) may have constituted a disguised dividend rather than deductible compensation.

The Court used the multifactor approach to analyze Mr. Hood's compensation as follows:

- **Background and Qualifications:** Mr. Hood was very experienced and had an excellent reputation within the construction industry.
- **Nature, Extent, and Scope of Mr. Hood's Work:** Mr. Hood was a key employee of Clary Hood, Inc., and his services were essential to its success. He built up the business, supervised all employees, and made strategic business decisions.
- **Size and Complexity of the Business:** During the period in question, Clary Hood, Inc. grew from 80 to 150 employees and $9 million to $68 million in revenue. Mr. Hood had technical specialties in earth excavation, site clearing and grading, storm drainage, installation of water systems, installation of curbs and gutters, landscaping, and irrigation services. These skills helped Clary Hood, Inc. succeed as a business.
- **Comparison of Mr. Hood's Compensation to Clary Hood, Inc.'s Income:** There is no exact ratio between compensation and gross or net taxable income to determine reasonableness of compensation. Clary Hood, Inc. paid approximately 42% and 26% of its pretax income to Mr. Hood as purported compensation in its 2015 and 2016 tax years. The Court stated that although significant, these amounts were not necessarily indicative of disguised dividends, especially since these amounts represented compensation for Mr. Hood's prior years of service.
- **Prevailing Economic Conditions:** Clary Hood, Inc.'s revenue increased to over $68 million during the period in question, an increase that cannot be attributed to economic conditions alone. The Court found that Mr. Hood's expertise contributed to Clary Hood, Inc.'s success outside of general economic conditions.
- **Comparison of Mr. Hood's Compensation With Distributions to Stockholders:** Typically, a complete absence of dividends to shareholders out of available profits may infer that some of the compensation paid to a shareholder-employee represents a distribution of profits. Clary Hood, Inc. was profitable during the years in question, but never declared or paid a cash dividend. Additionally, Clary Hood, Inc. decided to reward Mr. Hood for his years of service through a bonus rather than through a dividend.
- **Prevailing Rates of Compensation for Comparable Positions in Comparable Concerns:** To help determine whether or not compensation is reasonable, it is compared to that of persons holding comparable positions in comparable companies.
- **Mr. Hood's Salary Policy as to All Employees:** Courts have considered salaries paid to other employees of a business in deciding whether compensation is reasonable. There

 

was no structure as to how non-shareholder employee compensation was determined, rather Mr. Hood personally set the salary and bonus amounts of other employees and officers. Mr. Hood's salary and bonus in the years in question represented almost 90% of the total amount of compensation that Clary Hood, Inc. paid to its officers, despite the fact that non-shareholder officers worked nearly the same number of hours as Mr. Hood and shared in many similar responsibilities. As noted, Mr. Hood's compensation for the years in question was set by himself and his wife as the board of directors.

- **Mr. Hood's Prior Compensation:** The Court noted that although Mr. Hood's compensation increased over 300% in the 2015 tax year, Clary Hood, Inc.'s most profitable year to date, Mr. Hood did not experience an increase in duties or responsibilities that year. Although it was noted that this compensation was because Mr. Hood was undercompensated in prior years, it does not provide a blanket justification for Clary Hood, Inc. to deduct the entire backpay bonus amount.
- **Mr. Hood's Personal Guaranty of Petitioner's Debts and Bonding Obligations**: Clary Hood, Inc. cited Mr. Hood's guaranties during the period in question as justification for higher compensation. The Court noted that the record shows that it is customary for the owners of construction companies to guarantee debts and bonds, and that compensation for these guaranties is appropriate.

In conclusion, the Court found that Clary Hood, inc. did not adequately establish how the amounts paid to Mr. Hood in the years in question were both reasonable and paid solely as compensation for his services. The Court noted that the factors addressing comparable pay by comparable concerns, Clary Hood, Inc.'s shareholder distribution history, the setting of Mr. Hood's compensation in the years at issue, and Mr. Hood's involvement in the business were the most relevant and persuasive factors in reaching their conclusion. As a result, the Court found reasonable compensation of $3,681,269 for tax year 2015 and $1,362,831 for tax year 2016. Additionally, the Court found that Clary Hood, Inc. was liable for accuracy-related penalties due to substantial understatement for the years at issue.

Taxpayers should be mindful that the IRS will scrutinize whether reasonable compensation is too excessive and indicative of a disguised distribution.

 

### *4. James Lee Hicks, Jr. v. Commissioner, T.C. Memo 2022-10*

***Facts*:**

James Lee Hicks and Oddimissia N. Johnson had two children together. On June 15, 2006, the Summit County Court of Common Pleas Domestic Relations Division (state court) adopted a "Shared Parenting Plan" that was signed by Hicks and Johnson. The agreement provided that for tax purposes, Johnson would claim Child 1 every year, and Hicks would claim Child 2 every year, unless the parties reached another agreement in writing.

On October 28, 2009 the state court entered an order and judgment that adjusted Hicks and Johnson's child support obligations. The order stated that effective tax year 2009, Hicks would claim the dependency exemption for both minor children each year. This order was not signed by either Hicks or Johnson.

Another state order was entered into on August 26, 2010 and in effect for the 2014 taxable year. Under this arrangement, Hicks had physical custody of the children for less than half of 2014, while Johnson had physical custody of the children for more than half of 2014.

Both of the children were minors in 2014, and Hicks and Johnson lived separately throughout 2014. Johnson lived with her mother during 2014, and the children lived with them for more than half of the year. Hicks provided more than half of the children's support in 2014.

The August 2010 order did not modify the October 2009 order, which stated that Hicks would claim the dependency exemption for both minor children each year. Hicks filed his 2014 federal income tax return and claimed dependency exemption deductions and child tax credits for the two children. He did not attach Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent,* the written declaration or any waiver signed by Johnson, nor a pre-2008 court decree or separation agreement. However, he since provided the commissioner with a copy of the 2006 shared parenting agreement.

Johnson did not file a tax return for 2014, but her mother, Juanita, filed a 2014 tax return, claiming a dependency exemption deduction for Johnson and the two children.

The Commissioner issued a notice of deficiency to Hicks to deny the dependency exemption deductions and child tax credits. Hicks timely filed a petition for redetermination.

***Issues and Analysis:***

Prior to the TCJA, taxpayers could claim a dependency exemption deduction. Per §§151(a) and 151(c), a taxpayer may take a deduction for each individual who is a dependent of a taxpayer as defined in §152, meaning either a qualifying child or qualifying relative.

Per §152(c), in order for an individual to be considered the taxpayer's qualifying child, the individual must:

- Bear a specified relationship to the taxpayer, including being a child or grandchild;
- Have the same principal place of abode as the taxpayer for more than one-half of the taxable year;
- Meet certain age requirements;
- Have not provided more than one-half of his or her own support for the year; and

 

- If married, have not filed a joint return (other than only for a claim of refund) with his or her spouse.

As noted in the facts above, Hicks did not share the same principal place of abode with the children for more than half of the taxable year, and as a result, the children could not be considered his qualifying children for the 2014 tax year.

Per §152(d), in order for an individual to be considered the taxpayer's qualifying relative, the individual must:

- Bear a specified relationship to the taxpayer, including being a child or grandchild;
- Have gross income that is less than the exemption amount ($3,950 for 2014 tax year in question);
- Be provided with over one-half of his or her support by the taxpayer; and
- Not be a qualifying child of the taxpayer or of any other taxpayer.

Hicks' children met the relationship, gross income, and support tests noted above, but the main issue of this case was whether the children were considered qualifying children of any other taxpayer.

Under §152(c)(1), the children meet the criteria to be qualifying children of both Johnson and her mother, Juanita:

- The children are the children of Johnson and the grandchildren of Juanita;
- The children had the same principal place of abode as Johnson and Juanita for more than one-half of 2014;
- The children were minors during 2014;
- Each child did not provide more than one-half of their own support for 2014; and
- Neither child filed joint returns for 2014.

Section 152(c)(4)(A) outlines a **"tie-breaker"** rule in the event that an individual may be claimed as a qualifying child by two or more taxpayers. In the event that an individual may be claimed as a qualifying child by two or more taxpayers, the individual shall be treated as the qualifying child of the taxpayer who is the parent of the individual. If a parent does not qualify, the taxpayer with the highest adjusted gross income for the taxable year shall claim the individual. Additionally, §152(b)(1) provides that if an individual is a dependent of a taxpayer for any taxable year, that individual shall be treated as having no dependents for that year.

As noted in the facts above, Juanita claimed Johnson as a dependent in 2014, so per §152(b)(1), Johnson is treated as having no qualifying children for the 2014 tax year. As a result, the children cannot be claimed as qualifying children by Johnson for the 2014 tax year, and the tie-breaker rule does not apply. The children would have been treated as qualifying children of Juanita for 2014 had a special rule for separated parents not existed. Under §152(e), if certain criteria are satisfied, a child may be treated as the qualifying child of a parent with whom he or she did not share a principal place of abode for a sufficient portion of the year, regardless of the usual requirement of §152(c)(1)(B) or the tie-breaker rule of §152(c)(4).

Section 152(e)(1) is applicable to a child who is in the custody of one or both parents for more than one-half of a calendar year, receives over one-half of his or her support during the year from his or her parents, and whose parents are divorced, separated, or living apart throughout the last six months of the

 

year. When §152(e) applies, a child is generally treated as the qualifying child of the custodial parent, meaning the parent who has custody of the child for the greater portion of the year. On the other hand, the noncustodial parent is the parent who is not the custodial parent.

As noted, Hicks and Johnson lived apart during 2014, and the children lived with Johnson for more than half of 2014. By this reasoning, Johnson would be the custodial parent of both children in 2014. However, per §152(e)(2), a child is treated as the qualifying child of the noncustodial parent if the following two conditions are met:

1. The custodial parent signs a written declaration in such manner and form as the Secretary may by regulations prescribe, stating that he or she "will not claim such child as a dependent" for the year at issue; and
2. The noncustodial parent attaches the written declaration to his or her return for that year.

If the above conditions are met, the child is treated as the qualifying child of the noncustodial parent, and such noncustodial parent can claim the dependency exemption deduction for that child. The main issue of this case is whether as the noncustodial parent, Hicks satisfied the written declaration and attachment requirements.

**Conclusion**

A noncustodial parent can satisfy the written declaration requirement by either completing Form 8332 or attaching a statement conforming to the substance of Form 8332. Since Hicks did not provide a completed Form 8332 to Johnson, he could have satisfied the written declaration requirement only by means of some other document conforming to the substance of Form 8332. The only documents that could conform to the substance of Form 8332 are the 2006 and 2009 state orders. The 2006 state order stated that each parent was allowed to claim one of the two children for tax purposes. The 2009 state order indicated that Hicks was to claim the dependency exemption deduction for both of the children beginning with the 2009 taxable year.

Per §1.152-4(e)(5)), a written declaration executed in a taxable year beginning on or before July 2, 2008, that satisfies the requirements for the form of a written declaration in effect at the time the written declaration is executed, will be treated as satisfying the written declaration requirement. Agreements entered into after July 2, 2008 do not satisfy the written declaration requirement. As a result, only the 2006 state order may qualify for purposes of the written declaration requirement, provided it meets the requirements under §152(e) that were in effect when the agreement was signed in 2006. These requirements were as follows:

- The agreement must be signed by the custodial parent;
- The agreement must not place any conditions on the custodial parent's declaration that he or she will not claim a child as a dependent; and
- The agreement must otherwise meet the manner and form requirements the Secretary prescribed by regulation.

By definition, the 2006 Shared Parenting Plan agreement meets all of the requirements of §152(e) listed above. Johnson signed the document and it provided Hicks with unconditional right to claim one child every year for tax purposes unless the parties reach another agreement in writing. Although the agreement was subsequently modified in 2009, it merely expanded Hick's rights by allowing him to claim both children instead of only one child. Therefore, the 2006 agreement remains in effect for purposes of

 

the written declaration requirement. Lastly, the 2006 agreement contained substantially all of the same information required by Form 8332 as of 2006 (the year the agreement was entered into).

The Court found that the 2006 Shared Parenting Plan satisfied all requirements applicable to written declarations for purposes of §152(e) that were in effect when the state court entered it in 2006, and therefore, Hicks could rely on it for the 2014 taxable year with respect to the one child it allowed him to claim as a dependent.

Even though Hicks did not attach a copy of the agreement to his 2014 return, he presented it during examination, which conforms to Treasury Regulation §1.152-5(e)(2)(i). The Court ruled that Hicks was entitled to one dependency exemption deduction for that year under §151(c) for the 2014 tax year as well as the child tax credit for one child.

### *5. Lisa Milkovich et al. v. United States*

***Facts***:
In 2005, Lisa Milkovich and Dang Nguyen purchased a home in Renton, Washington for $748,425, and they used a mortgage to finance the transaction. One year later, they refinanced the home with CitiMortgage, and the principal amount of the loan was $744,993. They were unable to continue making payments as of February 2009, and they filed for bankruptcy in 2010, reporting the home value as $600,000. Milkovich and Nguyen's home was well beneath the amount of CitiMortgage's secured lien. The bankruptcy trustee examined Milkovich and Nguyen's finances and reported to the bankruptcy court that there was no property available for distribution from the estate over and above that exempted by law. The bankruptcy trustee stated that he was abandoning the assets of the estate with no distribution to creditors, and as a result, Milkovich and Nguyen retained legal title to their home. Per *Mason v. Commissioner,* upon abandonment, "any title that was vested in the trustee is extinguished, and the title reverts to the bankrupt."

In April 2010, Milkovich and Nguyen received a discharge from the bankruptcy court. The discharge changed their mortgage from "recourse" to "nonrecourse," meaning that CitiMortgage's ability to enforce the mortgage debt personally against Milkovich and Nguyen was eliminated, and instead CitiMortgage only had the ability to enforce the value of its lien. Although personal liability on their mortgage debt was relieved, the loan owed to CitiMortgage continued to be secured by the property and would stay with the property until foreclosure. CitiMortgage's right to foreclose on the mortgage survived through bankruptcy.

Instead of foreclosing on the property, CitiMortgage agreed to a short sale in July 2011. Short sales occur when the value of the property securing the mortgage is sold for less than the outstanding balance on the secured loan. The mortgage lender typically agrees to discount the loan balance due to the consumer's economic distress. The following information applies to the short sale of the home in July 2011:

- The sale price was approximately $555,005.92.
  - $522,015 was paid to CitiMortgage in satisfaction of the loan.
  - CitiMortgage credited $114,688 toward the accumulated unpaid interest on the secured loan.
  - The remaining amount was credited toward the loan principal.

CitiMortgage issued a Form 1098, *Mortgage Interest Statement* for 2011, indicating that it had received $114,688 in interest payments from Milkovich and Nguyen, so they claimed a $114,688 mortgage interest deduction that year.

 

In October 2014, the IRS issued a notice of deficiency, stating that they intended to disallow the $114,688 interest deduction on the ground that Milkovich and Nguyen did not establish that the amount was either an interest expense, or paid. Unfortunately for Milkovich and Nguyen, the Notice was mailed to the sold property, so they never received or responded to it. As a result, the IRS disallowed the interest deduction and assessed additional tax due.

When Milkovich and Nguyen finally learned about the IRS Notice, they pursued various remedies, but were denied requests for relief by the IRS Appeals Office in May 2018. The IRS noted that Milkovich and Nguyen had realized income from cancellation of debt of $222,977.95 from the short sale, but that they were not required to recognize that income because it was non-recourse debt. Further, the IRS noted that due to the fact that Milkovich and Nguyen had unrecognized income from forgiveness of debt in excess of the accrued interest, they had no loss of income from that interest, and therefore the interest deduction was disallowed.

Specifically, §265(a)(1) provides that “any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.” The IRS argued that this limitation on deductions applied because the cancellation-of-debt income that occurred at the short sale was exempt from income taxes due to being non-recourse.

Milkovich and Nguyen paid the assessed tax and filed a claim for refund. The IRS did not respond in six months, so Milkovich and Nguyen filed civil action seeking a refund, but the district court granted the IRS's motion to dismiss Plaintiffs' complaint pursuant to Federal Rule of Civil Procedure 12(b)(6). The district court provided reasoning, citing *Estate of Franklin v. Commissioner,* and stating that “the nonrecourse liability (mortgage) exceeds a reasonable estimate of the fair market value of the indebted property.” Since the mortgage balance was far in excess of the fair market value of Milkovich and Nguyen’s property, the district court stated that the transaction lacked economic substance, and as a result, they were unable to take an interest deduction relating to that transaction. Milkovich and Nguyen timely appealed the district court’s judgment.

***Issues and Analysis:***

In *Estate of Franklin v. Commissioner,* the court determined that interest deductions were not allowed if they were claimed in connection with debt-financed transactions that lacked economic substance. When a transaction lacks economic substance, it cannot support interest deductions.

Generally, taxpayers who itemize deductions are permitted to deduct home mortgage interest, provided they meet all necessary requirements. In order to deduct home mortgage interest, it must be a secured debt.

The main issues in this case are whether Milkovich and Nguyen entered into a transaction that lacked economic substance, and whether they were entitled to deduct the interest reported on Form 1098.

 

***Conclusion:***
The Court found that Milkovich and Nguyen's home purchase was a valid sale, and neither the initial purchase nor refinance lacked economic substance. The Court noted that although Milkovich and Nguyen's mortgage became nonrecourse, it did not "deprive the debt of its character as a bona fide debt obligation able to support an interest deduction." As a result, the Court concluded that the district court erred in applying the facts in *Estate of Franklin v. Commissioner* to the fact pattern presented by Milkovich and Nguyen.

Additionally, the Court rejected the IRS's argument that Milkovich and Nguyen were unable to claim the mortgage interest deduction due to §265(a)(1). The Court elaborated that since the short sale involved nonrecourse debt, it did not result in cancellation-of-debt income that would trigger §265(a)(1). Further, the conversion of the mortgage from a recourse to nonrecourse debt did not have an effect on the tax treatment of the short sale.

Per *Tufts*, "when a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, he or she must include among the assets realized the outstanding amount of the obligation." This holds true even if the unpaid amount of the mortgage is greater than the value of the property transferred. As a result, per *Tufts*, a cancellation of a nonrecourse loan in a short sale or foreclosure is not classified as income from discharge of indebtedness, but rather income derived from dealings in property.

When a debtor has recourse debt, he or she remains liable for the unpaid balance even after a foreclosure or short sale. Per §1.1001-2(a)(2), the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under §61(a)(12).

Since Milkovich and Nguyen's short sale was for nonrecourse debt, the Court determined that it did not generate cancellation-of-indebtedness income. Additionally, the Court determined that according to the rules that govern short sales concerning nonrecourse debt, Milkovich and Nguyen were entitled to deduct the mortgage interest that CitiMortgage received at the short sale, as they paid the interest in question and the interest payment is deductible. Lastly, the IRS argued that the 2010 bankruptcy discharge's conversion of Milkovich and Nguyen's mortgage from recourse to nonrecourse made any interest payment from the 2011 short sale disallowed under §265(a)(1). The IRS further explained their reasoning by stating that Milkovich and Nguyen received "income" when the bankruptcy discharge converted their recourse debt to nonrecourse debt, and this "income" was exempt from taxation under §108(a)(1)(A). The Court rejected the IRS's argument that the conversion of debt led to "income" exempt from taxation under §108(a)(1)(A). The Court confirmed that the loan conversion through bankruptcy discharge did not preclude Milkovich and Nguyen from taking a mortgage interest deduction for the interest paid and received from the short sale.

 

## C. Section 401(k) limitations

### *1. Maximum elective deferral*

The maximum amount of deferral in a §401(k) plan in 2022 is $20,500 (increased from $19,500 in 2021).

A qualified plan may now allow up to a $6,500 (2022, unchanged from 2021) additional elective deferral to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions. The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

***Planning point:***

Elective deferrals remain an annual addition; however, the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee, but also up to 25 percent of the total participant compensation for the year for other contributions.

### *2. Roth contribution programs*

A §401(k) plan may permit an employee who makes elective contributions under a qualified cash or deferred arrangement to designate some or all of those contributions as **designated Roth contributions**. Although designated Roth contributions are elective contributions under a qualified cash or deferred arrangement, unlike pre-tax elective contributions, they are currently includible in gross income. However, a **qualified distribution of designated Roth contributions is excludable from gross income**.

## D. Self-employed persons

Self-employed (unincorporated) individuals with no common-law employees provide a specific challenge. This group typically is looking to shelter some income but needs the flexibility to make varying contributions each year.

### *1. Simplified Employee Pension (SEP)*

The SEP works quite well for most self-employed persons. The individual can contribute 20 percent of self-employment income (after reducing income by the deduction for 1/2 of the Social Security taxes paid). Contributions are **flexible**, the plan can be established with a simple document, and no annual reporting is required. The maximum contribution in 2022 is $61,000. As noted below, this has advantages over a profit-sharing plan in all instances where the self-employed has no other employees. But the allocation of contributions is not flexible and is pro rata with compensation levels (and no more than $305,000 in 2022 may be taken into account).[7]

[7] Notice 2021-61.

 

***Note:***

A SEP is another excellent choice for the employer looking for a plan that provides for discretionary contributions. The rules are as flexible as the profit-sharing plan. However, the employer also wanting to skew contributions toward the business owner will choose the cross-tested profit-sharing plan over the SEP.

### *2. SIMPLE*

For self-employed persons with relatively small income, the SIMPLE can result in a larger contribution than a SEP. In 2022, an individual can defer up to $14,000 to the SIMPLE, and the employer is then **required** to make a matching contribution of 3 percent of compensation of a participating employee or an additional contribution (2-percent of compensation of all eligible employees). Eligibility is narrower than a SEP, using employees who make a certain amount in compensation over the immediate three years. The maximum total contribution to a SIMPLE is $28,000.[8]

***Note:***

In contrast to a §401(k) plan, the SIMPLE is an easy way to give employees the opportunity to participate in a pre-tax salary-reduction plan, although there are required contributions by the employee. The IRS has provided model documents, participant election forms, and instructions. And, for most part, these documents even satisfy participant notification requirements. Other than determining the required contribution and monitoring the $14,000 deferral limit, the employer has little other responsibility. Unlike qualified plans, the service providers are required to prepare the summary plan description and provide benefit statements. No annual reporting is required and there are few rules to violate.

a. Employers with 100 or fewer employees that already sponsor §401(k) plans may not want to switch to SIMPLEs due to the tremendous flexibility that the §401(k) plan provides. The maximum salary deferrals are higher ($20,500 a year in 2022) and the employer can sponsor other plans in addition to the §401(k) plan. With a §401(k) plan, the eligibility, vesting, and contributions requirements are more flexible. The employer matching contribution can take various forms and be subject to a vesting schedule. Employer profit-sharing contributions are discretionary and allocations can be skewed to the highly compensated through Social Security integration or cross-testing. Another important §401(k) feature is the ability to allow participant loans, giving participants access to their savings without income tax consequences.

b. If a business owner is looking for a plan that allows contributions for the owner in excess of $28,000,[9] the SIMPLE is generally not the right plan. With other defined-contribution type plans -- or combination of plans -- the business owner can often have total contributions of $61,000[10] for the year in 2022. However, the higher contribution amount will have a cost -- both in terms of contributions for employees and the cost of administering the more complicated plans. If the owner's spouse is providing services to the company, the owner could leave the spouse off the payroll, because of the additional income increased taxable income and increased payroll taxes. However, with a SIMPLE, adding the spouse to the payroll is a way to get more money into the SIMPLE, for the cost of only payroll taxes.

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8 Notice 2021-61.

9 Maximum is less for the individual earning less than $450,000.

10 I.R.C. §415 provides that contributions to all qualified plans that are defined-contribution plans, as well as contributions to SEPs, cannot exceed the lesser of $61,000 (inflation adjusted) or 25 percent of compensation for the year.

 

c. Since the SIMPLE salary deferral and matching contribution are not subject to either the 25-percent deduction limits or the §415 allocation limits that apply to other plans, an individual with low earnings can actually make larger deductible contributions to the SIMPLE than other plans. This might be helpful to a second wage-earner in a family that can afford to contribute significant amounts to a retirement plan. It can also be helpful for an individual that has self-employment income in addition to employment income. However, for this second type of individual, there are several possible traps. First, income earned from personal services could be aggregated with the individual's employer under the controlled group or affiliated service group rules. Second, remember that if an individual sponsoring the SIMPLE is also a participant in a §401(k) plan, §403(b) plan, SARSEP or SIMPLE of another employer, total salary deferrals for a calendar year cannot exceed $20,500 in 2022.[11]

### *3. Profit-sharing*

The profit-sharing plan is the most common form of defined-contribution plan. The other types of defined-contribution plans are simply a variation of a profit-sharing plan combined with features of a pension plan. A profit-sharing plan is a type of defined-contribution plan. A defined-contribution plan is one in which individual accounts for each participant are maintained. The account balance at any time measures the participant's accrued benefit. At any time, the participant is entitled to the product of the participant's account balance and vested percentage.

a. The profit-sharing plan is another alternative that provides the same contribution opportunity. The profit-sharing plan for the sole proprietor is generally not very complicated, since the plan's service provider may supply a prototype document at no or little cost. Also, a plan that only covers an owner (and the owner's spouse) that has less than $250,000 in assets is not required to file IRS Form 5500. In most cases; however, the SEP seems more appropriate, since no reports are ever required, and IRA assets can be withdrawn or rolled over more easily. The profit-sharing plan does allow investments in life insurance, and if the sole proprietor expects to have employees in the near future, the sole proprietor may prefer the qualified plan eligibility and vesting provisions. The maximum annual addition to an individual's account balance is $61,000 in 2022.

b. The profit-sharing plan is incredibly versatile. Contributions are completely discretionary (unless the plan is drafted to require employer contributions), and, if contributions are made, can be allocated in ways favorable to the business owner (see discussion of cross-tested allocations). There are several limitations to the discretionary contribution rule.

   (i) If there is a "complete discontinuance" of contributions, the plan is deemed to be terminated and participants become 100-percent vested in their benefits. As a rule of thumb, if an employer makes no contributions for more than two years, the plan could be considered terminated.

   (ii) Except for "complete discontinuance" issues, profit-sharing plans (even top-heavy plans) can skip contributions entirely for a year. Remember that under the top-heavy minimum-contribution requirement, no contributions have to be made for non-key employees if no employer contributions are made on behalf of key employees.

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[11] As a result of the amendment to I.R.C. §457(c) by the Economic Growth and Tax Relief Reconciliation Act of 2001, an employee is able to exceed such an elective deferral limitation if a §457 plan is combined with another plan that permits elective deferrals, such as a §401(k) plan.

 

### *4. Section 401(k) plans*

***Note:***

Employees have often wanted to be able to add to their retirement by making contributions to qualified retirement plans. In the past, this was done through thrift plans by which the employee made contributions to an employer-sponsored plan. The disadvantage of such arrangements was that the contributions from the employee were after-tax. In other words, the employee had federal income and employment taxes withheld from their salary in respect of such contributions. While the employees enjoyed tax-deferred accumulation of earnings in the thrift plan, they did not enjoy the tax leverage on their contributions as the employer did on its deductible contributions.

Section 401(k) permits contributions to come not only from bonuses and other additions to normal salary, but also from the normal salary itself by the affirmative election by the employee to reduce that salary by the amount the employee wanted contributed to the plan on the employee's behalf. This suits employers quite well, as in many cases it eliminates the need for the employer to come up with additional funds above the normal salary levels.

In order to reduce salary without the employee being in constructive receipt, it is necessary for the employee to sign a salary-reduction agreement, in advance of earning that salary, by which the employee's normal salary is reduced in the payroll system to reflect the amounts that are put in the plan. The employee has a choice between current cash and deferred payments, and this system is referred to as a cash or deferred arrangement (CODA).

While the qualified salary reduction agreement is sufficient to eliminate the amount from wages for income-tax purposes -- it is not reported as such on the employee's W-2 -- the amounts remain wages for employment-tax purposes and are reported as such on the employee's W-2. This is an exception to the rules discussed earlier for profit-sharing and other qualified plans. However, such reductions to a self-employed person's draw are **not reflected in earnings from self-employment** and thus do not escape employment tax.

Because of the inclusion of elective deferrals in wages for Social Security tax purposes, it would appear that one cannot avoid the .9 percent tax on excess earnings in 2022 and later years by salary reduction.

Only a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan can include a cash or deferred arrangement (§401(k) arrangement) and be a qualified plan. A cash or deferred arrangement is part of a plan for these purposes if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.[12]

A cash or deferred election can only be made with respect to an amount that is **not currently available** to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.[13]

In general, elective contributions under a qualified cash or deferred arrangement (including designated Roth contributions) are treated as employer contributions. Thus, for example, elective contributions under such an arrangement are treated as employer contributions for purposes of §401(a) (qualification requirements), §401(k) (special requirements), §402 (contributions), §404 (deductions), §411 (minimum

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12 Treas. Regs. §1.401(k)-1(a)(1).
13 Treas. Regs. §1.401(k)-1(a)(3)(iii)(A).

 

vesting), §415 (limitations on contributions and benefits), §416 (top-heavy rules), and §417 (minimum survivor benefits).[14]

***Note:***

> Such a characterization would suggest that the elective contributions made to the plan would be treated as employer contributions to a defined contribution retirement plan that would be subject to the limitation on tax benefits, if enacted.

Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

In the most common type of CODA, **a salary-reduction arrangement**, the participant is given the option of having wages reduced in return for having an employer contribution made to the plan.[15]

Elective deferrals increase to the applicable amount.

In the case of taxable years beginning after December 31, 2006, the $15,000 applicable dollar amount is indexed for inflation based on July 1, 2005 indexes, rounded to the next lower multiple of $500 (currently $20,500 in 2022).

A qualified plan may now allow additional elective deferrals to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are not taken into account under the ADP or other limitations on such contributions. The applicable dollar amount increases in the cost-of-living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500. It is currently $6,500.

The limitation on the total contributions to a §401(k) account for an individual is at $61,000 in 2022, so employer contributions can be used to enhance the contribution above the limitation on elective deferrals noted above. However, such employer contributions are subject to different nondiscrimination rules; there is no ADP test to give leeway from a compensation proportionate contribution standard.

***Note:***

> The problem areas in §401(k) plans are two-fold. First, a cash or deferred arrangement satisfies the coverage and nondiscrimination requirement for a plan year only if: (i) the group of eligible employees under the cash or deferred arrangement satisfies the requirements of §410(b) (including the average benefit percentage test, if applicable);[16] and (ii) the cash or deferred

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14 Treas. Regs. §1.401(k)-1(a)(4)(ii).
15 Treas. Regs. §1.401(k)-1(a)(3)(i).
16 Treas. Regs. §1.401(k)-1(b)(1)(i).

 

arrangement satisfies either the ADP test, the ADP safe harbor, or the SIMPLE §401(k) provision.[17] These provisions deal with (i) coverage and (ii) nondiscrimination in funding. Coverage simply means that an adequate number of employees, regardless of the level of contributions made, are participants -- i.e., contributing something -- to the plan. The nondiscrimination in funding requirement compares the level of elective contributions as a percentage of compensation by the class of non-highly compensated employees with that of the highly-compensated to make sure that the latter does not vary greatly from the former. Strict equality is not required, but this is certainly an area where employers have had trouble because (a) employees have not participated, or (b) their participation is at such low levels that higher-compensated individuals have an elective deferral limitation that is less, often much less, than what they may have wanted. Alternatives include (a) automatically entering employees into the plan at a specified level of salary reduction unless the employee affirmatively opts out, and (b) sweetening the pot with employer matching contributions, which may defeat the employer's purpose of limiting cash outlays (other than those that otherwise would have paid any way in salary).

### *5. Solo §401(k) plans*

Because §401(k) plans are generally profit-sharing plans, the same objections raised against the profit-sharing plan in favor of a SEP generally apply. However, in the case of a true sole proprietor (or one whose only employee is a spouse), the low-cost, flexible SEP may have to give way in favor of a **solo §401(k) plan** at certain levels of Schedule C income.

***Note:***

A §401(k) plan can be designed primarily to allow for employee pre-tax salary deferrals. The plan can then allow for discretionary profit-sharing contributions or even discretionary employer-matching contributions. A discretionary match may not encourage employee salary deferrals, which is the normal reason to have the match. One caution, however: an employer will be required to contribute 3 percent of compensation for non-key employees if the plan is top-heavy and any key employee makes a 3-percent-of-compensation salary deferral.

a. One advantage of the SEP was generally the low installation costs and nondiscrimination rules that are minimal in cases where there are several employees. But in a solo operation, nondiscrimination is not an issue, as there are no other employees against which to measure disparities of treatment.

b. The proprietor with other employees in a §401(k) plan must bridle any instinct to make the maximum elective deferral of $20,500 in 2022, since ADP testing might preclude this and limit the amount of the elective deferral in accordance with the rules discussed. Again, this is not a concern in a case where there is a single participant in the plan.

c. Yet, for one major reason solo §401(k) plans have gained traction in the last couple of years, the availability of elective deferrals in such plans, a feature not now generally available in a SEP, and only available in a SIMPLE to a much lesser extent. This presents an opportunity for the proprietor who wants to maximize his contributions advantageously for some Schedule C proprietors.

   (i) In either case, the maximum annual addition to the participant's account in the plan is $61,000 in 2022. But how the owner gets there is very different.

   (ii) The SEP is a straight profit-sharing plan that limits employer contributions to 25 percent of the proprietor's earned income (20 percent of self-employment income before taking into account the contribution itself).

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[17] Treas. Regs. §1.401(k)-1(b)(1)(ii).

 

(iii) By contrast, the proprietor in a §401(k) plan may first make an "employee" contribution by an elective deferral of up to $20,500 in 2022. At low levels of self-employment income this could generate a high ADP. But because there are no other employees, this will not be a problem. Thus, the proprietor now only has to fund $41,000 by an employer contribution, and it is only the employer contribution that is limited by the 25 percent of earned income rule applicable to defined contribution plans.

(iv) At some point, the additional cost of having a document prepared for a §401(k) plan and making annual reports may overweigh the additional available contribution.

d. The solo §401(k) also works well when the proprietor has the spouse as the sole common-law employee. The spouse is treated as a highly-compensated employee regardless of the level of compensation actually paid by reason of the relationship to the proprietor as a highly compensated employee.

***Note:***

The economics tilt toward the solo §401(k) because of the availability of an up-front contribution that is largely independent of self-employment income or compensation paid.[18] This gives the plan a head start on contributions compared to the simpler and less expensive SEP.

### *6. Money-purchase pension plan*

A money-purchase pension plan must specify a fixed annual contribution by the employer. The contribution must be definitely determinable and cannot be ambiguous in any way.[19] Any contribution formula must meet the nondiscrimination rules. These rules provide design safe harbors and several general tests, whereby the plan can demonstrate nondiscrimination by performing an annual mathematical test. Note that compensation must be capped, for purposes of determining the applicable contribution, to $305,000 (as indexed in 2022). The most common contribution formula is a level percentage (up to 25 percent) of compensation for all participants. This formula satisfies a design safe harbor (meaning that no nondiscrimination testing must be performed) if: (i) the plan has a single uniform formula for all participants; and (ii) the plan has a uniform normal retirement age and vesting schedule applicable to all employees.[20]

For the sole proprietor, the money-purchase plan had been used as a supplement; because today's annual additions and deduction limitations are the same, its major use is not a tax one; the required contributions to the money-purchase plan may provide greater certainty to employees than a profit-sharing plan. The maximum contribution is $61,000. For the self-employed individual with no employees, it produces the same bottom line result as a profit-sharing plan, but because of the obligation to make a fixed level of contribution, lacks the degree of flexibility of a profit-sharing plan.

### *7. Defined-benefit plan*

In a defined-benefit plan, the employer promises to provide a benefit, which is generally expressed as an amount payable as a **single life annuity** beginning at a stated **normal retirement age**. In order to fulfill this obligation, the employer must not only make sufficient contributions to fully fund all obligations under the plan, as determined by an actuary, but also make payments in the future. The actuary will adjust the

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18 The elective deferral cannot exceed the self-employment income or compensation.
19 Rev. Rul. 73-379, 1973-3 C.B. 124.
20 Treas. Regs. §1.401(a)(4)-2.

 

contribution levels in accordance with the mix of life expectancies and remaining time to retirement with respect to each obligation as well as the actual investment experience of the fund. **Each year**, the actuary must take a new plan census and determine the projected benefit at retirement for each participant based on the participant's current and projected salary, and the time left to complete funding, i.e., at the projected retirement. In determining the amount the employer must contribute each year, the actuary takes into account the actual investment and mortality experience of the fund in light of its obligations.

***Note:***

> The employer's annual contribution to the plan is the amount that is actuarially estimated to be required to fund expected plan benefit liabilities. ERISA generally requires that a defined benefit plan's assets be valued at least annually, and that at that time, there be a new determination of the plan's experience gains and losses and, hence, of the plan's total liability. This illustrates the greatest impediment to these plans: significant overhead in plan administration and the necessity of a trained professional actuary to determine the status of the plan's funding each year.

In a defined-benefit plan, the promise to make contributions is not to any one participant's account (there are none), but to actuarially create a separate fund that will be sufficient to pay fixed benefits at retirement of each participant. This requires an actuary to determine, based on mortality and presumed investment assumptions, the amount required to be set aside to meet the particular benefits of the plan's particular participants.

The employer is liable for the payment of the promised benefit without regard to the investment experience of the fund. This has two corollaries:

a. If the fund has investment experience less favorable than the initial assumptions, the amount of future contributions will have to be increased over any original projected contribution scales; and
b. If the fund has investment experience more favorable than the initial assumptions, the amount of future contributions will have to be decreased over any original projected contribution scales.

***Planning point:***

> The contribution level may fluctuate each year based on the performance of the plan's assets, a factor that is somewhat outside of the control of the plan sponsor. Since the sponsor is required to make contributions to satisfy the minimum-funding requirements, only the most stable plan sponsors will be able to sponsor defined-benefit plans. Cash flow is not predictable because it depends on investment performance as well as mortality of the employee group, both of which can vary wildly from the actuarial assumptions used in the plan.

Defined-benefit plans have been disappearing over the past 15 years from most small businesses because of the high overhead in maintaining them and the difficulty in communicating its features to employees. Costs cannot be projected and controlled without the aid of the arcane ways of the actuary. This may be particularly important to employers with cash-flow concerns.

a. Another difficulty lies in the mandatory nature of pension contributions because the contributions cannot be easily determined and can change rapidly depending on changes in current market rates. Employers with **steady, dependable cash flow** are the only ones who should venture into this area. Contributions to a defined-benefit plan must be made, without regard to the employer's financial condition, subject to obtaining a funding waiver from the government.

 

b. In a defined-benefit plan, the employee benefits from the certainty of a specified benefit. The employer is responsible to make contributions necessary to fund promised benefits. If the plan's investment experience exceeds the actuarial assumptions, the employer's required contributions will be lowered. Similarly, if investment experience is inferior, contributions will increase.

***Planning point:***

Assuming the small business has at least two employees, a defined-benefit plan can generally maximize income for older owner-employees and provide maximum tax shelter for the employer as discussed below in connection with the deduction available. They are unique in being able to take into consideration service that predates the adoption of the plan.

A defined-benefit plan could turn into a tax shelter if limitations are not placed on the amount of benefit that can be defined at retirement. This limit applies to the annual benefit payable beginning at the Social Security retirement age. A defined-benefit plan may not provide an annual benefit greater than the lesser of 100 percent of the average of the employee's compensation in the employee's three highest-paid years (the "percentage limit") or $245,000 in 2022 (the "dollar limit").

a. The highest three years is the period specified in the plan of consecutive calendar years (not in excess of three) during which the employee was both a participant and had the greatest aggregate compensation.[21]

b. The dollar limit must be actuarially increased for participants who work beyond the normal retirement age, since benefits continue to accrue.[22]

***Planning point:***

Funding levels to the extent attributable to individual participants are functions of age/mortality, years to normal retirement age, and interest (return) rate assumptions. In all cases, an older person at a given salary level will require more annual funding than a younger employee at the same compensation. An individual at a given age with high compensation will require more funding than another employee at the same age, but with a lower salary. Together, an older employee with a high wage will require considerably more funding than a younger employee with a lower compensation base. Thus, in many defined benefit plans, the cost for other employees may be very small compared to that of the principal of the company, and certainly the percentage of annual contributions to the plan for a lower-salaried employee would be far less than that based on compensation.

For maximum reduction in income (given a tax rate rise), reduction in AGI (given the 3.8 percent tax), reduction in wages subject to Social Security (given the .9 percent tax on excess earnings), and its apparent favored status as a deduction (given the potential application of tax savings limitations on certain deductions and some exclusions), the defined benefit plan is hard to beat. However, taxpayers could also consider the **cross-tested profit-sharing** plan discussed above which also can create a disproportionality of contribution level (but apparently without the benefit of not being subject to the limitation on tax benefits).

There is no rule prohibiting a self-employed person from establishing a defined-benefit plan. In some ways, the self-employed person is a good candidate because there will be no benefit costs for other employees. However, due to the additional administrative expense, few self-employed persons have been interested in a defined-benefit plan.

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21 I.R.C. §415(e)(3).

22 I.R.C. §415(b)(2)(D).

 

***Note:***

> The greatest impediment to the defined benefit plan is the loss of flexibility with respect to contributions and its counter-intuitive requirement that as the performance of the investments in the plan declines, the level of required contributions goes up. At a time when the lower investment prices may show a problem in the economy -- when a business might want to be most protective of its flexibility with respect to cash -- the mandatory contribution rules may prove a major problem.

The reasons to consider a defined-benefit plan is if the self-employed person is either looking for a deductible contribution in excess of $61,000 or a contribution in excess of 25 percent of compensation. A consultation with an actuary is needed to determine if it is possible to meet one of these objectives. It is more likely that this goal can be met for an individual over age 45. Given the additional tax that applies either to excess earnings or investment income when AGI exceeds $250,000, the most dramatic way of reducing AGI -- assuming it does not conflict with the client's economic needs and lifestyle -- is to shift income from current earnings to deferred compensation. Given the current interest rate environment, the discount factors will be so small that substantial contributions will be actuarially required annually in order to fully fund a maximum benefit of an individual in his or her 50s; advisors need to determine from an actuary these current levels.

 