Surgent cpe
EDUCATION FOR PROS

Surgent's S Corporation, Partnership, and LLC Tax Update

BCP4/22/V1

201 N. King of Prussia Road
Suite 370
Radnor, PA 19087
P : (610) 688 4477
F : (610) 688 3977
info@surgent.com
surgentcpe.com

Calling All **Exceptional** *INSTRUCTORS!*

Surgent is currently accepting nominations

of prospective new discussion leaders in the following areas:

- Tax
- Accounting and Audit
- Government and Not-for-Profit A&A
- Business and Industry (all topics)

If you are an **experienced CPA** with strong public speaking and teaching skills and an interest in sharing your knowledge with your peers by teaching live seminars, we would love to hear from you!

Learn More by Contacting:

Janet Benjamin
benjaminj@surgent.com

Surgent cpe EDUCATION FOR PROS

FIRM SOLUTIONS

Choose Surgent to be your firm's trusted resource for essential education.

Whether you need convenient online CPE programs or tailored in-house programs, we offer a full range of solutions to fit your needs.

ASK FOR A DEMO
of our Firm Portal!

Our **Versatile Educational Options** Include:

ON-SITE TRAINING

Utilize Surgent's renowned instructors and top-rated course materials. See for yourself why our Ethics, Tax Reform, A&A and Yellow Book courses have become the trusted source for CPE in the Accounting industry.

FLEXIBLE FIRM-WIDE ACCESS

Get 12 months of firm-wide access to any Surgent live webinar, self-study PDF, or on-demand webcast—with no need to buy seats or licenses. Available in increments starting with 100 CPE hours.

PRIVATE WEBINARS

Let us schedule private showings of our webinars on dates that are convenient for you. Choose from our extensive catalog of over 10,000 CPE Credits or from one of our 50+ brand new courses.

FIRM PORTAL

Surgent's Firm Portal is the latest CPE innovation, allowing you to track and manage continuing professional education for all users in your organization quickly and easily. Create a positive impact across your organization, knowing you have a solid handle on your firm's training and CPE compliance.

CONTENT LICENSING

Use Surgent's cutting-edge content and PowerPoint presentations with your own instructors.

Contact the **Firm Solutions Team** to Learn More:

Kris Moretti
morettik@surgent.com
610.994.9296

Joe Rastatter
rastatterj@surgent.com
610.994.9618

Surgent cpe
EDUCATION FOR PROS

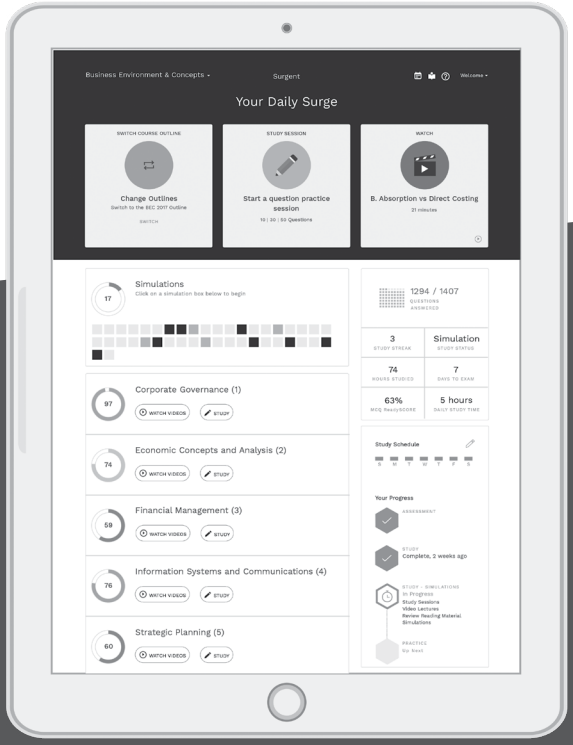
Industry-leading exam review courses

THAT HELP CANDIDATES ***PASS FASTER***

Surgent EXAMreview

Surgent's AI-powered software personalizes study plans for each student, targeting knowledge gaps and optimizing those plans in real-time.

This award-winning approach has been shown to save candidates **hundreds of hours** in study time.



How A.S.A.P. Technology™ Works:

ASSESSMENT

- ✔ Students complete a series of quizzes with content from all exam categories.
- ✔ A.S.A.P. Technology analyzes results alongside real exam scoring and calculates a baseline ReadySCORE™– a highly accurate estimate of what they'd score on their exam if they sat that day.
- ✔ Students receive a Diagnostic Report, detailing their starting strengths and weaknesses and estimates needed study hours.

STUDY

- ✔ Using assessment results, our course builds a personalized plan to close identified knowledge gaps.
- ✔ Real-time algorithms continue to optimize study plans based on progress.
- ✔ Students can see their ReadySCORE improve as they study.

REVIEW

- ✔ Unlimited practice exams – designed to match the actual exam—ensure they will be totally ready come exam day.
- ✔ Once students achieve a passing ReadySCORE, they know they're ready to pass.

A.S.A.P. TECHNOLOGY

helps you pass the

CPA Exam | CMA Exam

EA Exam | CIA Exam

CISA Exam

Benefits for Associates and Firms:

- ✔ A.S.A.P. Technology gets candidates CPA Exam-ready in just 58 hours, on average, and drives pass rates nearly 40 points higher than the national average.
- ✔ Staff can more easily balance full-time work and study, thanks to a study program that takes into account what they already know.
- ✔ Surgent's course content complements the adaptive model—and today's learners—with video lectures and clear answer explanations that teach specific concepts.

Questions? Contact our Firm Solutions Team at **877.721.3565** or **info@surgent.com**

Surgent.com/exam-prep

Table of Contents

Revised June 2022

NOTES

Schedules K-2 and K-3 Reporting Requirements

Schedules K-2 and K-3 Reporting Requirements

Learning objective

Upon reviewing this material, the reader will be able to discuss the new Schedules K-2 and K-3 and their reporting requirements.

I. Schedules K-2 and K-3 reporting

A. Introduction

The IRS introduced new Schedules K-2 and K-3 for the 2021 tax year. The new reporting requirements apply to partnerships, S corporations, and foreign partnerships. Trusts are not subject to the new reporting requirements.

Schedules K-2 and K-3 replace lines 16 and 20 on Schedules K and K-1 (Form 1065) and lines 14 and 17 of Schedule K and boxes 14 and 17 of Schedule K-1 (Form 1120-S). Schedules K-2 and K-3 likely require more detailed information than partnerships and S corporations previously reported.

Both Schedules K-2 and K-3 were created to standardize reporting of items of international tax significance to partners and shareholders. Prior to the 2021 tax year, Schedule K-1 only had a few boxes dedicated to foreign transactions and as a result, many taxpayers had to attach footnotes or additional statements to report the required information. Free-form footnotes were often inconsistent and could result in incorrect reporting by the partner or shareholder. Standardized Schedules K-2 and K-3 reporting provides greater clarity and consistency to partners and shareholders.

Schedule K-2 is an extension of Schedule K and is used to report items of international tax relevance from the operation of the S corporation or partnership. The partnership or S corporation only files one Schedule K-2. Schedule K-3 is an extension of Schedule K-1 and is used to report the partner or shareholder's share of items reported on Schedule K-2. The partnership or S corporation files a separate Schedule K-3 for each partner or shareholder. There are no general de minimis exceptions for filing the schedules.

Schedule K Changes:

Foreign Transactions

16a	Name of country or U.S. possession ▶	
b	Gross income from all sources	16b
c	Gross income sourced at partner level	16c
	Foreign gross income sourced at partnership level	
d	Reserved for future use ▶ e Foreign branch category ▶	16e
f	Passive category ▶ g General category ▶ h Other (attach statement) ▶	16h
	Deductions allocated and apportioned at partner level	
i	Interest expense ▶ j Other ▶	16j
	Deductions allocated and apportioned at partnership level to foreign source income	
k	Reserved for future use ▶ l Foreign branch category ▶	16l
m	Passive category ▶ n General category ▶ o Other (attach statement) ▶	16o
p	Total foreign taxes (check one): ▶ Paid ☐ Accrued ☐	16p
q	Reduction in taxes available for credit (attach statement)	16q
r	Other foreign tax information (attach statement)	

International Transactions

16	Attach Schedule K-2 (Form 1065), Partners' Distributive Share Items-International, and check this box to indicate that you are reporting items of international tax relevance ☐

Schedule K-1 Changes:

651119

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

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

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital		
4c	Total guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		

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

1	Ordinary business income (loss)	14	Self-employment earnings (loss)
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked ▶ ☐
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses
6c	Dividend equivalents		
7	Royalties		
8	Net short-term capital gain (loss)		
		19	Distributions
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)		
		20	Other information
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)		
11	Other income (loss)		
12	Section 179 deduction	21	Foreign taxes paid or accrued

New checkbox for Schedule K-3

New line 21 – Foreign Taxes Paid or Accrued

B. 2021 Form 1065 and 1120-S Instructions (pre-filing relief)

On January 18, 2022, the IRS released updated Form 1065 and 1120-S instructions, stating:
"A partnership/s corporation with no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued **may still need to report information on Schedules K-2 and K-3**. For example, if the partner/shareholder claims a credit for foreign taxes paid by the partner/shareholder, the partner/shareholder may need certain information from the partnership/s corporation to complete Form 1116. Also, a partnership/s corporation that has only domestic partners/shareholders may still be required to complete Part IX when the partnership/s corporation makes certain deductible payments to foreign related parties of its domestic partners/shareholders. The information reported in Part IX will assist any domestic corporate partner/shareholder in determining the amount of base erosion payments made through the partnership/s corporation, and in determining if the partners/shareholders are subject to the Base Erosion and Anti-Abuse Tax."

Many partnerships and S corporations were under the impression that they would be required to file Schedules K-2 and K-3 as a result of the updated January 18, 2022, instructions. Prior to the updated instructions, many practitioners assumed entities with neither international activities nor foreign partners would not be required to file Schedules K-2 and K-3.

C. 2021 Transitional filing relief – First round of FAQs[1]

Due to the challenges in meeting the new reporting requirements, the IRS issued transitional filing relief for 2021 in the form of FAQs on February 16, 2022. FAQ #15 states that certain domestic partnerships or S corporations are not required to file Schedules K-2 and K-3 for the 2021 tax year, provided the following requirements are met:

- In tax year 2021, the direct partners in the domestic partnership are not foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts.
- In tax year 2021, the domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated, or may reasonably be expected to generate foreign source income (see section 1.861-9(g)(3)).
- In tax year 2020, the domestic partnership or S corporation did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):
  - Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S); and
  - Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (line 17d for Form 1120-S).
- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.

Entities that met the requirements for the Schedules K-2 and K-3 filing exception were not required to file Schedules K-2 and K-3 with the IRS or with their partners/shareholders. However, if the partnership or S corporation was subsequently notified by a partner or shareholder that all or part of the information contained on Schedule K-3 was needed to complete their tax return, then the partnership or S corporation had to provide the information to the partner or shareholder. If a partner or shareholder notified the partnership or S corporation before the entity filed its return, the conditions for the exception were not met

[1] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120-S, and 8865).

and the partnership or S corporation must provide the Schedule K-3 to the partner or shareholder and file the Schedules K-2 and K-3 with the IRS.

Some entities may have begun following the January 18, 2022 form instructions prior to the transitional IRS guidance that was released on February 16, 2022. In the event an entity was notified that a partner/shareholder required certain information reported on Schedule K-3, the entity would not be eligible for transitional relief outlined in FAQ #15. The transitional relief applies to the entire Schedules K-2 and K-3 rather than specific parts, and the relief only applies to the 2021 tax year.

The Form 1065 Schedules K-2 and K-3 instructions also provide certain exceptions to completing Schedules K-2 and K-3:

- The partnership need not complete Schedules K-2 and K-3, Parts II and III if it knows that it has no direct or indirect partners eligible to claim a foreign tax credit.
- If a direct or indirect partner is eligible to claim a foreign tax credit, the partnership does not need to complete the Schedules K-2 and K-3, Parts II and III if the partnership knows that the direct and indirect partners are not completing Form 1116 or 1118.
- If the partnership has only U.S. source income and none of the partnership's income or deductions must be sourced or allocated and apportioned by the partner, and all partners are less-than-10% limited partners, the partnership is not required to complete Schedule K-2, Part II.
    - If the partnership has only U.S. source income and none of the partnership's income or deductions must be sourced or allocated and apportioned by the partner, Schedule K-3, Part II is not completed for its partners that are less-than-10% limited partners.
- If the partnership knows that all its partners are less-than-10% limited partners, the partnership does not need to complete Schedules K-2 or K-3, Part III, Section 2.
    - The partnership must only complete Schedule K-3, Part III, Section 2 with respect to its partners that are not less-than-10% limited partners.
- If any partner in the partnership holds a 10% or more interest or is a General Partner, Schedule K-2, Parts II and III must be completed.

Lastly, the Form 1120-S Schedules K-2 and K-3 instructions also provide certain exceptions to completing Schedules K-2 and K-3:

- The S corporation need not complete Schedules K-2 and K-3, Parts II and III if it knows that it has no shareholders who are eligible to claim a foreign tax credit.
- S corporations do not need to complete the Schedules K-2 and K-3, Parts II and III, if they know that the shareholder is not completing Form 1116 or 1118.

D. 2021 Transitional filing relief – Second round of FAQs[2]

The IRS added eight new FAQs regarding Schedules K-2 and K-3 on April 11, 2022. As discussed above, the IRS provided filing relief for partnerships and S corporations in FAQ #15. FAQ #19 references the Schedules K-2 and K-3 instructions and clarifies that partnerships and S corporations that failed to qualify for the exception in FAQ #15 are only required to complete the relevant portions of Schedules K-2 and K-3.

FAQ #20 addresses whether a filer otherwise required to file Forms 5471, 8865, and/or 8858 may qualify for an exception from filing those forms based on the Internal Revenue Code, IRS guidance, and/or instructions to those respective forms. If the filer qualifies for such exception, the filer is not required to complete and attach those forms. However, the filer must still attach to the Forms 1065, 1120-S, and the tax return of the U.S. person filing Form 8865, any required statements to qualify for the exception to filing the Forms 5471, 8865, and/or 8858. Additionally, if the filer qualifies for the Form 5471 multiple filer exception, the partnership or S corporation must provide on the Schedule K-3 to its partners or shareholders any information that the partnership or S corporation receives from the person required to file the Form 5471 and that is requested by the Instructions to the Schedules K-2 and K-3, such as Schedule Q (Form 5471) information, if applicable.

FAQ #21 clarifies that code "RIC" may be entered on certain lines of Parts II and III of Schedules K-2 and K-3 to report gross income and taxes by foreign country or U.S. possessions, including for regulated investment companies.

FAQ #22 discusses when a filer must complete Section 1 of Part III, Schedules K-2 and K-3. FAQ #22 clarifies that a filer is not required to complete Section 1 of Part III unless either the partnership or S corporation incurs research and experimental expense or the partner or shareholder is expected to license, sell, or transfer its intangible property to the partnership or S corporation. The FAQs note that this clarification will be added to the tax year 2022 instructions. However, the FAQs note that filers may choose to follow this clarification for tax year 2021.

FAQ #23 clarifies that if a foreign partnership has Passive Foreign Investment Companies (PFICs) for which a mark-to-market (MTM) election in Treas. Reg. §1.1291-1(c)(4) has been made, the filer of Form 1065 does not need to report information about the PFIC on Part VII of Schedules K-2 and K-3. The FAQ notes that the filer should report the partnership's MTM gain or loss on Schedule K (Form 1065) and report the partners' shares of such amounts on Part III of Schedule K-1 (Form 1065).

FAQ #24 explains that Part VIII (Form 1065) and Part VII (Form 1120-S) are not required to be completed with respect to dormant foreign corporations. The FAQs note that this clarification will be added to the tax year 2022 instructions. However, the FAQs stated that filers may follow this clarification for tax year 2021.

FAQ #25 addresses how a partnership should report its accrued Original Issue Discount (OID) and OID income taxable on a gross basis to a foreign partner on Section 1 of Part X of Schedules K-2 and K-3 of Form 1065. Typically, partnerships report OID on Schedules K and K-1 in the taxable year accrued. The Schedules K-2 and K-3 Form Instructions for Part X require the partnership to report OID only when it is taxable to foreign partners. To reconcile Schedules K-2 and K-3 reporting of OID with Schedules K and

[2] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120-S, and 8865).

K-1 reporting of OID and to provide foreign partners with the information necessary to complete their returns, the IRS recommends the following approach per FAQ #25 for reporting OID on Part X:

- ***Accrued OID Reported on Form 1065:*** *The amount of accrued OID reported on Schedules K (Form 1065) which is not taxable to foreign partners should be reported as interest income in column (f) (U.S. source (other)) of Part X, Schedule K-2. The IRS recommends that the partnership attach a statement to Form 1065 with respect to Part X clarifying that these amounts are not taxable to foreign partners and need not be reported on the foreign partner's tax return. The partnership should take a similar approach for reporting distributive share amounts to a foreign partner on Schedule K-3.*
- ***OID Payments or Gains Taxable on a Gross Basis to a Foreign Partner:*** *When the partnership receives payments on the OID instrument or gain on the sale or exchange of the OID instrument that are taxable on a gross basis to foreign partners, these amounts should be reported in column (e) (U.S. source (fixed, determinable, annual, or periodical - FDAP)) as interest income or gain, as appropriate. These amounts should also be entered as a negative adjustment in column (f) to ensure that the total OID reported on Part X reconciles with OID reported on Schedule K (Form 1065). Additionally, the IRS recommends attaching a statement explaining that the negative adjustment in column (f) is for reconciliation purposes only and is not relevant to the foreign partner's tax liability and therefore need not be reported on the foreign partner's tax return. The partnership should take a similar approach for reporting distributive share amounts to a foreign partner on Schedule K-3.*

FAQ #25 specifies that this approach is only recommended for tax year 2021, and the IRS recognizes that partnerships may have taken other approaches.

FAQ #26 clarifies the reporting on certain lines of Section 3 of Part X of Schedules K-2 and K-3 as follows:

- ***Line 2b:*** *Average worldwide assets. Report the partnership's basis in its average worldwide assets for purposes of Treasury Regulation section 1.882-5(b) using the average amount as defined in Treasury Regulation sections 1.882-5(b)(3) and 1.884-1(d)(3)(ii).*
- ***Line 3a.*** *Average U.S.-booked liabilities of the partnership. Enter the partnership's average U.S.-booked liabilities as defined in Treasury Regulation section 1.882-5(d)(2) using the average defined in Treasury Regulation section 1.882-5(d)(3).*
- ***Line 3b.*** *Directly allocated partnership indebtedness. Enter the portion of the principal amount of the partnership's indebtedness outstanding at year end that meets the requirements of Temporary Regulation section 1.861-10T(b) or (c), as limited by Temporary Regulation section 1.861-10T(d)(1), as described in Treasury Regulation section 1.882-5(a)(1)(ii)(B). See Treasury Regulation section 1.861-10T(d)(2).*

The IRS states that they will clarify this reporting in the tax year 2022 Schedules K-2 and K-3 instructions.

E. 2021 Reporting

Partnerships and S corporations are only required to complete relevant portions of Schedules K-2 and K-3. Partnerships are not required to obtain information from their direct or indirect partners to determine whether they need to file certain parts of Schedules K-2 and K-3. S corporations are not required to

obtain information from their shareholders to determine whether they need to file certain parts of Schedules K-2 and K-3.

Below are the main parts of Schedules K-2 and K-3:

- **Part I: Current Year International Information**
  - Used to report international tax items not reported elsewhere on Schedule K-2 or K-3.
- **Part II: Foreign Tax Credit Limitation**
  - Used to compute the partnership/S corporation income or loss by source/category and report the partner/shareholder's share of such income or loss. Partners and shareholders use information on Part II to claim a foreign tax credit on Form 1116 or 1118.
  - This section is not required to be completed if the partnership does not have a direct or indirect partner that is eligible to claim a foreign tax credit.
    - A partner that is eligible to claim a foreign tax credit includes, a U.S. citizen or resident, certain nonresident individuals, certain U.S. trusts and estates, a domestic corporation, and certain foreign corporations.
  - If the partnership knows that its only partners are less-than-10% limited partners that do not hold their interest in the ordinary course of the partner's active trade or business, the partnership's foreign source gross income and gross receipts should be reported as passive category income and its deductions allocated and apportioned to foreign source income should be reported as reducing passive category income.
- **Part III: Other Information for Preparation of Form 1116 or 1118**
  - Used to report information necessary for the partner/shareholder to determine the allocation and apportionment of R&E expense, interest expense, and the foreign-derived intangible income (FDII) deduction for the FTC limitation. Also, this section reports foreign taxes paid or accrued by the partnership/s corporation and the partner/shareholder's distributive share of such taxes. For partnerships, this section also reports income adjustments under §743(b) by source. Partners/shareholders use this information to compute the FTC on Form 1116 or 1118.
  - This section is not required to be completed if the partnership does not have a direct or indirect partner that is eligible to claim a Foreign Tax Credit.
- **Part IV:**
  - **Partnerships**: Used to report information necessary for the partner to determine its §250 deduction with respect to FDII. Partners use this information to claim and compute a §250 deduction with respect to FDII on Form 8993, *Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI).*
  - **S corporations**: Used to report information the shareholder needs to determine the amount of each distribution from a foreign corporation that is treated as a dividend or excluded from gross income because the distribution is attributable to Previously Taxed Earnings and Profits (PTEP) in the shareholder's annual PTEP accounts with respect to the foreign corporation, and the amount of foreign currency gain or loss on the PTEP that the shareholder is required to recognize under §986(c).

- **Part V:**
  - **Partnerships**: Used to report information the partner needs to determine the amount of each distribution from a foreign corporation that is treated as a dividend or excluded from gross income because the distribution is attributable to PTEP in the partner's annual PTEP accounts with respect to the foreign corporation, and the amount of foreign currency gain or loss on the PTEP that the partner is required to recognize under §986(c).
  - **S corporations:** Used to report information that the shareholder needs to determine any inclusions under §§951(a)(1) and 951A. Shareholders use this information to complete Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),* and Form 1040, with respect to subpart F income inclusions, §951(a)(1)(B) inclusions, and §951A inclusions.
- **Part VI:**
  - **Partnerships**: Used to report information required by the partner to determine any inclusions under §§951(a)(1) and 951A. Partners will use the information to complete Form 8992*, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, and Forms 1040 and 1120 with respect to subpart F income inclusions, §951(a)(1)(B) inclusions, and §951A inclusions.
  - **S corporations**: Used to report information required by shareholders to complete Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to provide shareholders with information necessary to determine income inclusions with respect to the passive foreign investment company (PFIC).
- **Part VII:**
  - **Partnerships**: Used to report information required by partners to complete Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to provide partners with information necessary to determine income inclusions with respect to the PFIC.
  - **S corporations**: Used to report the foreign corporation's net income in the income groups for purposes of the shareholder's deemed paid taxes computation with respect to inclusions under §§951A and 951(a)(1). Shareholders will use the information to figure and claim a deemed paid foreign tax credit on Form 1118.
- **Part VIII: Partnerships Only**
  - Used to provide the foreign corporation's net income in the income groups for purposes of the partner's deemed paid taxes computation with respect to inclusions under §§951A, 951(a)(1), and 1293(f). Partners use this information to compute and claim a deemed paid foreign tax credit on Form 1118.
- **Part IX: Partnerships Only**
  - Used to provide information for the partner to compute its Base Erosion and Anti-Abuse Tax (BEAT). Partners use this information to complete Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*.
- **Part X: Partnerships Only**
  - Used to provide information for the partner to determine its tax liability with respect to income effectively connected (ECI) with a U.S. trade or business, or with respect to fixed, determinable, annual, or periodical (FDAP) income. Partners utilize this information to compute and report any U.S. tax liability on Forms 1040-NR and 1120-F.

- **Part XI: Partnerships Only**
  - Used to provide certain information to U.S. and foreign partners with respect to §871(m) by a publicly traded partnership that satisfies certain other requirements. Certain partners use the information to determine their U.S. withholding tax obligations and to determine and report any U.S. tax liability on Forms 1042 and 1042-S.
- **Part XII: Partnerships Only**
  - Reserved for future use.
- **Part XIII: Partnerships Only**
  - Used to provide information for a foreign partner to determine its distributive share of deemed sale items on a transfer of the partnership interest. Partners use this information to complete Form 4797 and Form 8949.

F. Schedules K-2 and K-3 penalty relief

Noncompliance with the new Schedules K-2 and K-3 would typically result in certain penalties, including:

- **Failure to file complete tax return:** This inaction results in a penalty of $210 per partner per month (up to 12 months so maximum $2,520 per partner) for 2021 tax returns filed in 2022.
  - A complete return for a partnership reporting purpose includes Form 1065 and Schedules K-1, K-2, and K-3.
  - A complete return for an S corporation includes Form 1120-S and Schedules K-1, K-2, and K-3.
  - This penalty is not imposed if the failure is due to reasonable cause.
  - For 2022 returns filed in 2023, the penalty increases to $220 per partner per month.
- **Failure to file an information return on or before the required filing date, and failure to report all required information on Schedules K-1 and K-3:** This inaction results in the following penalties:
  - If the failure was non-intentional: $280 per partner (maximum $3,426,000) for 2021 forms filed in 2022.
  - For 2022 forms filed in 2023, the penalty increases to $290 per partner (maximum $3,532,500).
  - If the failure was the result of Intentional disregard: greater of:
    - $570 per partner for 2021 forms filed in 2022 or $580 per partner for 2022 forms filed in 2023; or
    - 10% of the aggregate amount of items required to be reported.

The IRS issued Notice 2021-39, providing penalty relief for taxpayers who make a good faith effort to comply with Schedules K-2 and K-3 for 2021. Specifically, a partnership required to file Form 1065, an S corporation required to file Form 1120-S, or a U.S. partner required to file Form 8865 will not be subject to penalties for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. If the taxpayer fails to establish a good faith effort, no penalty relief exists. This penalty relief is only in effect for the 2021 tax year.

For purposes of determining whether a good faith effort was made to complete Schedules K-2 and K-3, the following circumstances will be considered:

- The extent to which a Schedule K-2/K-3 filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3;
- The extent to which a Schedule K-2/K-3 filer has obtained information from partners, shareholders, or the CFP, or applied reasonable assumptions when information is not obtained; and
- The steps taken by the Schedule K-2/K-3 filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information with partners and shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3.

Recent Developments -- Pass-Throughs

Recent Developments -- Pass-Throughs

Learning objectives

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

- Discuss the effects and potential impact of recent and proposed legislation and IRS guidance;
- Understand the impact of the §461(l) business loss limitation on owners of pass-through entities;
- Navigate the provisions and elections of the centralized audit regime for partnerships; and
- Discuss the current standing of recharacterizing distributions from an S corporation as wages.

I. Recent legislation and IRS guidance

A. 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	

671121

☐ 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 ☐ Formal note ☐ Open account debt	Debt 2 ☐ Formal note ☐ Open account debt	Debt 3 ☐ Formal note ☐ 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					

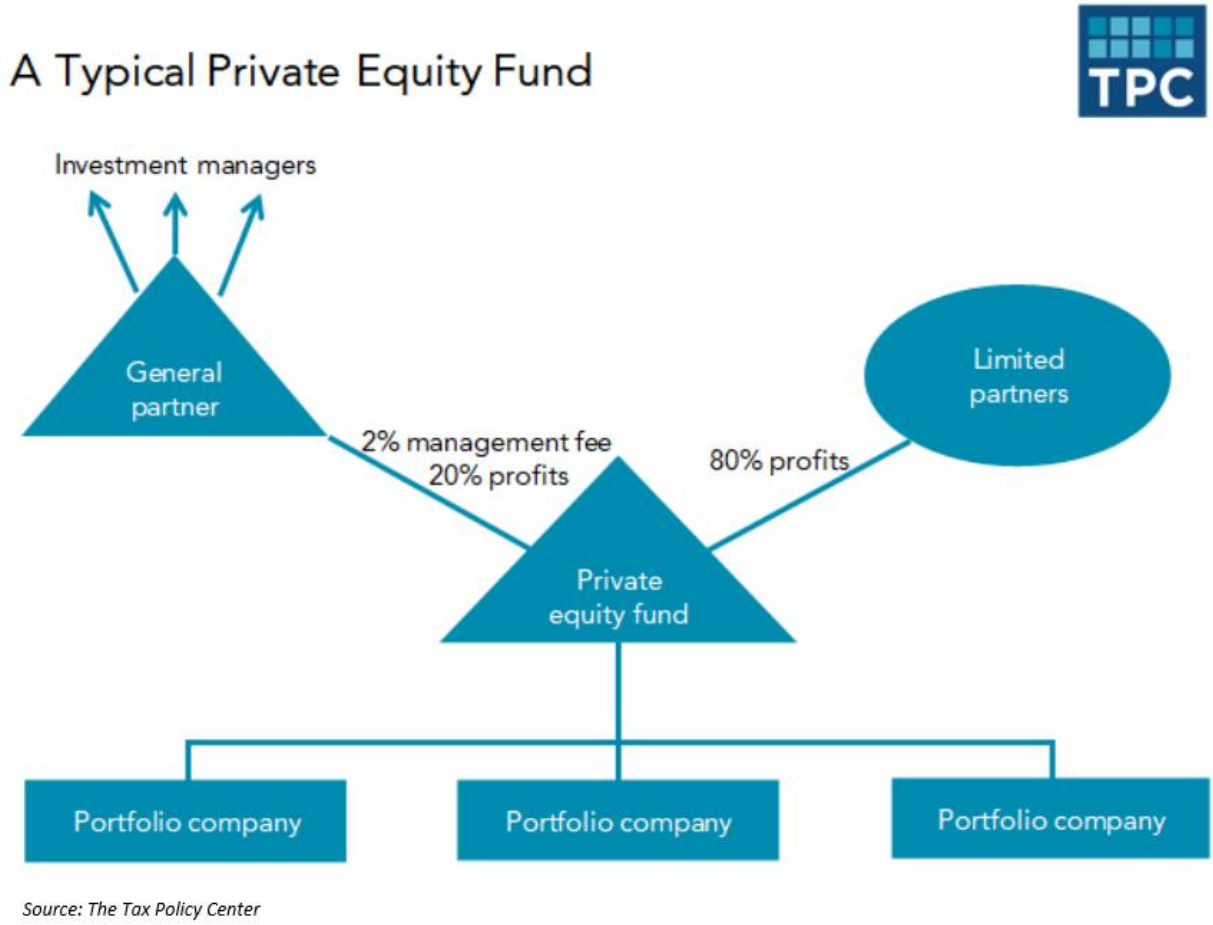
Corporate losses and deduction items are limited to the sum of the shareholder's stock and debt basis. If loss and deduction items exceed a shareholder's stock basis, the shareholder may deduct the excess up to the shareholder's debt basis. If a shareholder claims losses and deduction items in excess 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.

B. Three-year holding period for hedge fund managers

Hedge fund manager compensation has been a hot political topic for years. Hedge fund managers of private equity funds are often compensated with a profits-only interest in a partnership. Profits-only interests in partnerships are generally not considered to be taxable when received. Court case history for profits interests in partnerships favors the taxpayer. Even though compensating a partner (or non-partner) with property other than cash is technically a taxable event, there is no ascertainable value. Hedge fund companies have taken advantage of this for years by compensating managers with a profits-only interest and then allocating long-term capital gains to the managers. Eventually, the manager will sell the partnership interest back to the private equity fund. These positions are known as "carried interests." The only change that the TCJA makes to the carried interest rules is to change the holding period for long-term capital gains from assets in carried interest transactions from one year to three years.[1] If the three-year period is not met, gain will be treated as short-term gain taxed at ordinary rates.

[1] I.R.C. §1061. The TCJA redesignates old §1061 as §1062 and inserts new §1061.

Carried interest is basically a contractual right that entitles the general partner of a private investment fund (read Hedge Fund manager) to a share of the fund's profits. In a typical situation, the general partner contributes 1 to 5 percent of the fund's initial capitalization and is tasked with managing the fund. The general partner usually receives an annual fee of 2% of the fund's assets plus a "carried interest" of 20% of the profits that exceed a predetermined rate of return. Think of carried interest in essence as a performance fee.



In recent years, there has been debate regarding whether carried interest is considered an unfair loophole, since it is taxed at more favorable capital gains rates than at ordinary income rates. On January 7, 2021, the IRS released final regulations on carried interest, largely finalizing proposed regulations but also making a few significant changes to the following:[2]

- Capital Interest Exception;
- Lookthrough Rule for certain applicable partnership interest (API) dispositions;
- Funding a partnership interest with debt proceeds; and,
- Transfers to related parties.

As previously discussed, the three-year holding period does not apply to capital gain with respect to capital interests (i.e., a partnership interest provided in exchange for invested capital). The final regulations provide a revised and simplified rule that looks to whether allocations are *commensurate* with capital contributed. An allocation will be considered a Capital Interest Allocation if the allocation to the

[2] T.D. 9945.

applicable partnership interest holder with respect to its capital interest is determined and calculated in a *similar manner* to the allocations with respect to capital interests held by similarly situated unrelated limited partners who made significant aggregate capital contributions (determined as unrelated limited partners holding at least 5% of the aggregate capital balance of the partnership at the time the allocations are made).

The *similar manner* determination should take into account the amount and timing of capital contributed, the rate of return on capital contributed, the type and level of risk associated with the capital contributed, and the right to cash or property distributions during the partnership's operations and on liquidation. The *similar manner* determination may be applied on an investment-by-investment basis or on the basis of allocations made to a particular class of interests. The final regulations clarify that if API holders are not charged management fees on their capital or if their capital is not subject to allocations of API items, it will not prevent their capital interest from being eligible for the capital interest exception. Lastly, the final regs extend these concepts to allocations made through tiered structures.

Under proposed regs, the holding period for certain API dispositions was the owner's holding period in the asset sold, which would either be the partner's holding period in the underlying asset or the partner's holding period in the partnership interest. Additionally, the proposed regulations created a look-through rule that stated that if gain with respect to 80% or more (substantially all) of an entity's assets would be recharacterized as short term under §1061 if disposed of due to having a holding period of three years or less, the gain on the sale of this API would be recharacterized as short-term. Final regs modify the Lookthrough Rule to apply to two situations:

- **First Situation**: Where at the time of disposition of an API held for more than three years, the API would have a holding period of three years or less if the holding period of such API were determined by not including any period prior to the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates.
- **Second Situation**: Where a transaction or series of transactions has taken place with the principal purpose of avoiding gain recharacterization under §1061(a).

Final regulations provide that an allocation will be treated as a Capital Interest Allocation if the allocation is attributable to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance as described in the final regulations.

C. New look-through rule to determine effectively connected income from the sale of a partnership interest

A foreign person engaged in a trade or business in the United States is taxed on income that is "effectively connected" with a U.S. trade or business. The gain or loss from the sale of personal property is generally sourced to the taxpayer's country of residence. Since a partnership interest is intangible personal property, the general rule is that the gain from the sale of a partnership interest is sourced to the taxpayer's country of residence.

Gains and losses from the sale of U.S. real property interests are taxed by the U.S. Therefore, to the extent that the gain on the sale of a partnership interest can be attributed to underlying real estate, the

gain is considered to be from the sale or exchange of United States property. Also, the sale of a partnership interest can result in ordinary income treatment for the portion of the sale attributable to §751. This is treated as the sale of the underlying assets and can result in effectively connected income.

The IRS ruled in 1991 that a foreign partner in a partnership must treat any gain from the sale of a partnership interest as effectively connected income to the extent that the sale of the assets of the partnership would generate effectively connected income. However, in a 2017 decision, the U.S. Tax Court sided with the taxpayer against the IRS and determined that such income was not effectively connected. The new law is in response to the Tax Court decision.

The TCJA amends §864(c) to add the provisions of the 1991 Revenue Ruling to the Internal Revenue Code. The new provisions also required 10-percent withholding on effectively connected income from the sale of a partnership interest after December 31, 2017.[3]

D. Partner basis adjustments for charitable contributions and foreign taxes

Prior to the TCJA, partners were not required to reduce their basis in their partnership interests by the amount of charitable contributions or foreign taxes passed through to them from the partnership. The TCJA corrected this oversight in the former regulations. Partners must now reduce basis by charitable contributions and foreign taxes passed through by the partnership. Partners do not have to reduce basis by the full fair market value of some non-cash contributions. The TCJA applies the same rule to partnerships that S corporations have been subject to for several years. The rules are discussed later in this chapter.

E. Partner basis bonus depreciation application

As part of the TCJA, the bonus depreciation percentage increased from 50 percent to 100 percent for property acquired and placed in service after September 27, 2017, and before 2023. As a reminder, 2022 is the last year to take advantage of 100% bonus depreciation. The TCJA provides for a gradual decrease in the bonus depreciation percentage, allowing an 80-percent deduction for property placed in service in 2023, a 60-percent deduction for property placed in service in 2024, a 40-percent deduction for property placed in service in 2025, and a 20-percent deduction for property placed in service in 2026. The TCJA also changed the definition of property eligible for bonus depreciation (qualified property) by including used property.

In terms of partnerships, the IRS issued final regulations in September 2019, noting that a partner who purchases an interest in a partnership is generally able to take advantage of bonus depreciation on the portion of its basis step-up under §743(b) that is allocated to the partnership's qualified property.[4] The purchasing partner's stepped-up basis in the share of partnership property removes any difference in the inside and outside basis. Practitioners were under the impression that a partnership could elect out of bonus depreciation for §743(b) basis adjustments on a partner-by-partner and class-by-class basis. However, at a Federal Bar Association conference on March 5, 2019, IRS Office of Associate Chief Counsel, Jaime Park, confirmed that if a partnership elects out of bonus depreciation for one partner's §743(b) adjustment for one class of property, that election applies to other partners' §743(b) adjustments for that same class of property. This holds true even if unrelated partners purchase the partnership's property.

---

[3] I.R.C. §864(c) as amended by the Tax Cuts and Jobs Act of 2017.
[4] T.D. 9874 (September 2019).

F. State and local taxes

The TCJA provides that in the case of an individual, state, local, and foreign property taxes and state and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business, or an activity described in §212 (relating to expenses for the production of income). Thus, the TCJA allows only those deductions for state, local, and foreign property taxes, and sales taxes that were deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F on such individual's tax return. Thus, for instance, in the case of property taxes, an individual may deduct such items only if these taxes were imposed on business assets (such as residential rental property).

In the case of an individual, state and local income, war profits, and excess profits taxes are not allowable as a deduction. The provision contains an exception to the above-stated rule. A taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of:

(1) State and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in §212; and

(2) State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year.

Foreign real property taxes may not be deducted under this exception.

Per Notice 2019-12 (6/11/19), a safe harbor was created to treat state tax credit disallowed charitable contributions as SALT payments in the year of payment or preceding year, so there's a planning opportunity to amend the prior year's return. Excess disallowed charitable contributions are carried forward, but the safe harbor does not apply to the transfer of property.

The IRS included the safe harbor in Notice 2019-12 in proposed Reg. 107431-19 (12/13/19) but failed to address state SALT cap workarounds. As a result of the $10,000 SALT limitation, many states began to implement SALT cap workarounds in which states impose tax on pass-through entities at the entity level, in exchange for offsetting state tax credits for the entity's members.

The IRS issued final regs on August 7, 2020, largely adopting the proposed regs and the safe harbor in Notice 2019-12 and addressing SALT cap workarounds.[5] The final regs clarify that a taxpayer's payment to a §170(c) entity is considered an allowable deduction as a trade or business expense under §162, rather than a charitable contribution under §170. The final regs also stipulate that a taxpayer will be treated as receiving goods and services in consideration for a payment to a §170(c) entity, if at the time the taxpayer makes the transfer, the taxpayer either receives or expects to receive goods or services in return. This is often referred to as the "quid pro quo" principle, and it applies regardless of whether the party providing the quid pro quo is the donee or a third party. Lastly, the final regs clarify that the fair market value of goods and services includes the value of goods and services provided by parties other than the donee.

On November 9, 2020, the IRS issued Notice 2020-75, stating that the Treasury Department and IRS intend to issue proposed regulations clarifying SALT deduction limitations. Per the guidance, any "specified income tax payments" are deductible by partnerships and S corporations in computing their non-separately stated income or loss for the tax year of the payment. Specified income tax payments are

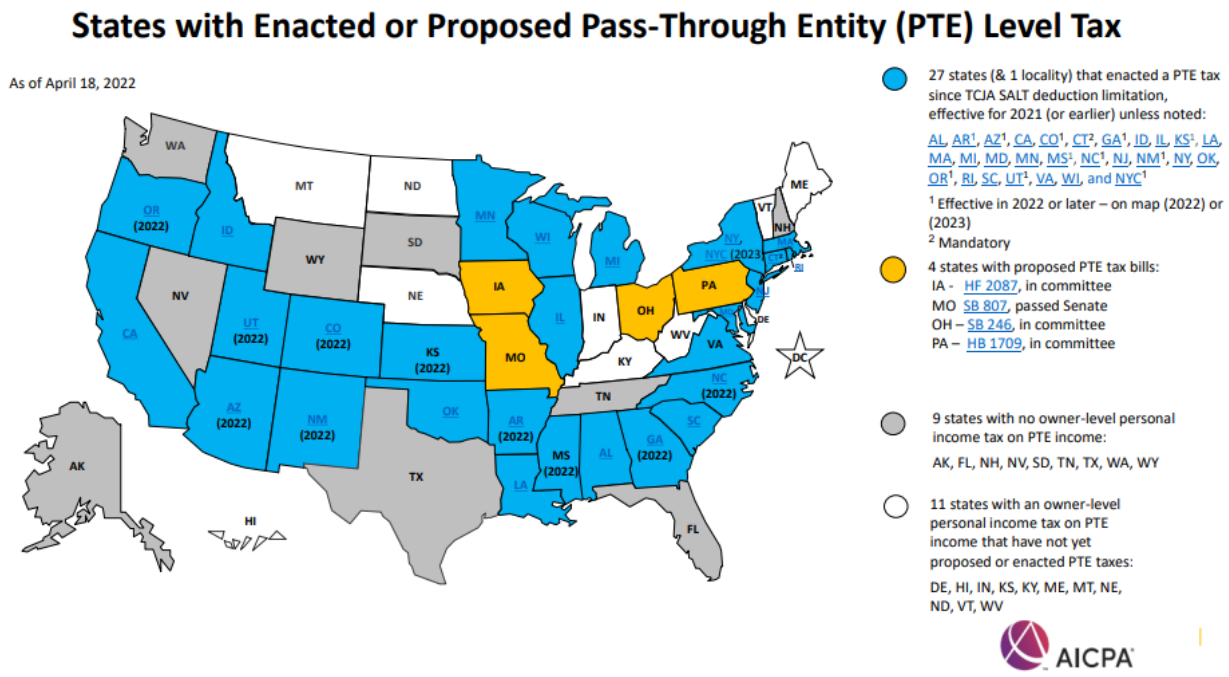
[5] Final Regs. T.D. 9907.

any amount imposed on and paid by a partnership or S corporation to a state to satisfy its income tax liability. As such, these payments are not subject to the SALT deduction limitation for partners and shareholders who itemize their deductions and are fully deductible. Notice 2020-75 states that the proposed regulations described in the notice apply to payments made on or after November 9, 2020. Additionally, Notice 2020-75 allows taxpayers to apply the rules to payments made in a taxable year of the partnership or S corporation ending after December 31, 2017 and before November 9, 2020. It is anticipated that as a result of this notice and the impending proposed regulations, more states will enact mandatory entity-level taxes and provide a corresponding owner-level deduction or credit.

Example 1: Partnership ABC has two equal partners, A and B. Partnership ABC pays State X income tax of $50,000. State X allows partners A and B to each claim a $25,000 credit against their own personal income tax liability owed to State X. Per Notice 2020-75, the $25,000 that each partner receives is **not** subject to the $10,000 SALT deduction limitation.

As demonstrated, the PTE-level tax largely resembles a corporate income tax on PTEs. Most regimes are currently elective and are not mandatory on PTEs. Currently, Connecticut is the only *mandatory* PTE tax state. The Connecticut PTE tax is assessed on the passthrough entity's taxable income or alternative tax base. In return, each individual shareholder, partner, or member is eligible for a refundable credit equal to their portion of the PTE tax, multiplied by 87.5%. Each passthrough entity reports the amount of the PTE tax credit allocated to each partner on Schedule CT K-1. Any credit in excess of the individual partner's tax liability is refundable.

A resident state credit may exist for taxes paid to other states, where states allow credits for resident individuals paying taxes to other states. In the distributive share/composite regime, many states allow credits and exclusions to mitigate double taxation. Some states provide a percentage limitation on available credits, while other states provide subtraction modifications for income subject to tax at the PTE-level.



6

SALT cap workarounds occur when states impose tax on pass-through entities (PTEs) at the entity level, in exchange for offsetting state tax credits or reductions for the entity's members. Certain states allow PTE members to take a credit to offset their taxable income, but the PTE member still reports such income on their tax return. Other states allow PTE members to reduce their AGI by their pro rata share of income from the PTE, provided the PTE elects to be taxed at the entity level. Some PTE elections are irrevocable, so it is important to weigh this consideration when determining whether to make a PTE election.

II. The Partnership Audit Rules of the Bipartisan Budget Act of 2015

The Bipartisan Budget Act of 2015 repeals the partnership audit procedures of Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and sets up a new centralized audit regime for partnerships. The new rules are effective for audits of tax years beginning after December 31, 2017. Final regulations giving guidance on the new audit regime were published in the Federal Register on February 27, 2019. The regulations are effective for taxable years beginning after December 31, 2017 and ending after August 12, 2018 and to partnerships electing to apply the centralized audit regime to years beginning after November 2, 2015 and before January 1, 2018. Final regulations on electing out of the centralized audit regime were published on January 2, 2018. Final regulations on the rules regarding the partnership representative were published in the Federal Register on August 9, 2018. At a November 2020 AICPA event, the IRS deputy commissioner of examination for small businesses announced plans to increase partnership audit activity by 50%. Additionally, in October 2021, the IRS Large Business & International Division released a legal memorandum (LB&I-04-1021-0017), describing the implementation of the Large Partnership Compliance (LPC) Pilot Program. This program will focus on ensuring compliance for large partnership tax returns through the use of identification criteria and data analytics tools. Specifically, the LPC Pilot Program will:

---

6 https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-pte-map.pdf

- Identify the largest partnership cases by focusing on the characteristics of the largest Form 1065 filers, typically those with more than $10 million in assets;
- Develop improved methods to identify and assist compliance risk of the largest Form 1065 filers;
- Consider examination tools that will provide a better audit of the largest Form 1065 filers; and
- Enhance the IRS's understanding of large partnership compliance issues by utilizing both technical and procedural feedback.

It is increasingly important to understand the Centralized Audit Regime considering these announcements.

A. The TEFRA rules

Partnerships with 10 or fewer partners were excluded, and partners and partnerships were audited separately. For a partnership with more than 10 partners, a single audit regime is performed at the partnership level. The IRS recalculates the tax liability of each partner for the audited year. These rules are repealed for audited tax years beginning after December 31, 2017.

B. The new rules

1. The general rule

The audit will be conducted at the partnership level. Any adjustments will be made at the partnership level and tax will be assessed to the partnership, using the top marginal tax rate applied to ordinary income for individuals effective at the time. Any payment made by the partnership is not tax deductible.

2. Election out of the general rule

Partnerships with 100 or fewer partners may elect out of the general rule.[7] Total number of K-1s is what is counted, so change of ownership can have an impact. The final regulations require that each K-1 issued by the partnership be issued to a partner who was an eligible partner for the partnership's entire taxable year.

a. **Partners must be eligible partners** -- The language of §301.6221(b)-1(b)(1)(ii) could mistakenly be interpreted to mean that an ownership change would exclude a partnership from electing out of the new audit rules. The wording contained in the regulation is: "Each statement the partnership is required to furnish under section 6031(b) for the partnership taxable year is furnished to a partner that was an eligible partner (as defined in paragraph (b)(3) of this section) for the partnership's entire taxable year." However, §6221(b) which contains the statutory language for the election does not exclude a partnership because of an ownership change. The correct interpretation is that all of the partners must be eligible partners for the entire time during the year that they are partners. Therefore, if an ineligible partner becomes eligible during the year, the partnership does not qualify to make the election. However, if an eligible partner sells an interest to another eligible partner, the partnership may make the election. Example 3 in §301.6221(b)-1(b)(2) illustrates how to count K-1s with ownership changes. The assumption in the example is that the partnership would be able to make the election.

---

[7] Final reg. §301.6221(b)-1(b)(1) and (2).

Example 1: **(*Section 301.6221(b)-1(b)(2), Example 3*)**
At the beginning of 2022, Partnership, which has a taxable year ending December 31, 2022, has three partners -- individuals A, B, and C. Each individual owns an interest in Partnership. On June 30, 2022, Individual A dies, and A's interest in Partnership becomes an asset of A's estate. A's estate owns an interest for the remainder of 2022. B sells his interest in Partnership to Individual D, who holds the interest for the remainder of the year. Under §6031(b), Partnership is required to furnish five statements for its 2022 taxable year -- one each to Individual A, the estate of Individual A, Individual B, Individual C, and Individual D. Therefore, for purposes of this paragraph (b)(2), Partnership has five partners during its 2022 taxable year.

Eligible partners are:[8]

- Individuals.
- C corporations.
- Eligible foreign entities.
- S corporations.
- The estate of a deceased partner.

A partnership that issues a K-1 to an ineligible partner may not elect out of the centralized audit rules. Ineligible partners are:[9]

- A partnership.
- A trust.
- A foreign entity that is not an eligible foreign entity.
- A disregarded entity.
- An estate of an individual other than a deceased partner.
- Any person that holds an interest in the partnership on behalf of another person.

A foreign entity is an eligible foreign entity if the foreign entity would be treated as a C corporation if it were a domestic entity as a per se corporation under §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8), or is classified by default as an association taxable as a corporation under §301.7701-3(b)(2)(i)(B), or is classified as an association taxable as a corporation in accordance with an election under §301.7701-3(c).[10]

b. **Special rule for S corporations** -- For purposes of the 100 K-1 limitation, shareholders of an S corporation must be counted. S corporation shareholders do not have to be individuals or entities that would be eligible partners if they owned the partnership interest directly even though they are included in the count.[11]

Example 2: **(*Section 301.6221(b)-1(b)(2), Example 4*)**
During its 2022 taxable year, Partnership has 51 partners -- 50 partners who are individuals and S, an S corporation. S and Partnership are both calendar year taxpayers. S has 50 shareholders during the 2022 taxable year. Under §6031(b), Partnership is required to furnish 51 statements for the 2022 taxable year -- one to S and one to each of Partnership's 50 partners who are individuals. Under §6037(b), S is required to furnish a statement (that is, Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*) to each of its 50 shareholders. Under paragraph (b)(2)(ii) of this section, the number of

---

8 Final reg. §301.6221(b)-1(b)(3)(i).
9 Final reg. §301.6221(b)-1(b)(3)((ii).
10 Final reg. §301.6221(b)-1(b)(3)((iii).
11 Final regs. §301.6221(b)-1(b)(2(ii) and §301.6221(b)-1(b)(3)((i).

statements required to be furnished by S under §6037(b), which is 50, is taken into account to determine whether partnership has 100 or fewer partners. Accordingly, for purposes of this paragraph (b)(2), Partnership has a total of 101 partners (51 statements furnished by Partnership to its partners plus 50 statements furnished by S to its shareholders) and is therefore not an eligible partnership under paragraph (b)(1) of this section. Because Partnership is not an eligible partnership, it cannot make the election under paragraph (a) of this section.

c. **Procedure for making the election**[12] -- The election is made annually on a timely filed return, including extensions. Any changes in partners should be evaluated on an annual basis to determine whether an election may be made. The electing partnership must disclose each partner's name, taxpayer identification number (TIN), federal tax classification, and an affirmative statement that the partner is an eligible partner. If a partner is an S corporation, the statement must include the name, TIN, and entity classification of each shareholder of the S corporation. The partnership must notify each partner that the election has been made within 30 days of making the election.

The disclosure is made on Schedule B-2 (Form 1065). Also, line 29 on Form 1065 Schedule B should be answered "yes" and the total from Schedule B-2 should be entered in the space provided.

d. **Effect of electing out** -- If this election is made, the partnership and partners should be audited under the regime that currently exists for partnerships with 10 or fewer partners. The partnership and partners are audited under the individual audit procedures. Tax assessments will be issued to the partners who were partners during the audited tax year. Also, the statute of limitations will be determined at the partner level.

[12] Final reg. §301.6221(b)-1(c).

Schedule B-2 (Form 1065). The schedule also includes continuation sheets for each section.

SCHEDULE B-2 (Form 1065)
(December 2018)
Department of the Treasury
Internal Revenue Service

Election Out of the Centralized Partnership Audit Regime

▶ Attach to Form 1065 or Form 1066.
▶ Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123

Name of Partnership | Employer Identification Number (EIN)

Certain partnerships with 100 or fewer partners can elect out of the centralized partnership audit regime if each partner is an individual, a C corporation, a foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner. For purposes of determining whether the partnership has 100 or fewer partners, the partnership must include all shareholders of any S corporation that is a partner. By completing Part I, you are making an affirmative statement that all of the partners in the partnership are eligible partners under section 6221(b)(1)(C) and you have provided all of the information on this schedule. See the instructions, including the instructions for the treatment of real estate mortgage investment conduits (REMICs), for more details.

Part I **List of Eligible Partners**
Use the following codes under Type of Eligible Partner:
I – Individual C – Corporation E – Estate of Deceased Partner F – Eligible Foreign Entity S – S corporation

	Name of Partner	Taxpayer Identification Number (TIN)	Type of Eligible Partner (Code)
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			

Continued on Part IV

Part II **List of S Corporation Shareholders** (For each S corporation partner, complete a separate Part II and separate Part V, if needed.)
Use the following codes under Type of Person:
I – Individual E – Estate of Deceased Shareholder T – Trust O – Other

Name of S Corporation Partner ▶ | TIN of Partner ▶

	Name of Shareholder	Shareholder TIN	Type of Person (Code)
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			
11			
12			

Continued on Part V

Part III **Total Number of Schedules K-1 Required To Be Issued.** See instructions.

1	Total of Part I and all Parts IV Schedules K-1 required to be issued by the partnership	1	
2	Total of Part II and all Parts V Schedules K-1 required to be issued by any S corporation partners	2	
3	**Total. Add line 1 and line 2**	3	

Note: If line 3 is more than 100, the partnership cannot make the election under section 6221(b).

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. Cat. No. 69658K **Schedule B-2 (Form 1065) (12-2018)**

3. Mechanics of the centralized audit regime

If the partnership cannot or does not elect out of the new rules, additional income tax, penalties, and interest will be assessed to the partnership. The IRS will use the highest income tax rate in effect for the reviewed year under §1 or §11, depending on the entity type of each partner. The amount of the net adjustment that is attributable to partners who are individuals, trusts, or estates will be taxed at the highest rate for the relative entity types under §1 and the amount attributable to partners taxed under the corporate rates of §11 will be calculated using the corporate rate of 21%.[13] The partnership may either pay the tax, request a modification of the imputed amount and pay a recalculated amount, or request a modification of the imputed amount based on amended returns of the partners using actual amendments or the alternative procedure for amending the returns under §301.6225-2(d)(2).

4. Requesting a modification of the imputed underpayment

The request for modification is made on new Form 8980, *Partnership Request for Modification of Imputed Underpayments* by the partnership representative. Examples of modifications that may be requested on the form include:

- Modification of the imputed adjustment based on amended returns of one or more partners. The partners may amend the reviewed year returns or use the alternative procedure to filing amended returns included in the regulations.[14] This differs from the push out election in that this modification can be requested for amended returns filed by one or all of the partners. The total imputed underpayment will be reduced by the amount that the underpayment allocable to the partner or partners that filed the amended returns exceeds the amount calculated for their allocable portion of adjustments on the amended return.
- Modification for the portion of the adjustment allocated to tax-exempt partners.
- Modification where the actual highest tax rates of one or more partners is less than the rate used to calculate the adjustment.
- Modifications regarding passive loss carryforwards, etc. that would reduce the taxable income on the partners' returns.
- The request for modification must be made within 270 days of the date the Notice of Proposed Partnership Adjustments (NOPPA) is mailed. The deadline may be extended for another 270 days with IRS approval.[15]

5. The alternative procedure for amending returns for modification of the imputed underpayment on Form 8980

Instead of amending returns for the audited year, the partnership may use an alternative procedure. Under the alternative procedure, the partnership discloses to the IRS relevant information that would be provided to a relevant partner, the taxes computed on adjustments that would be allocated to the partner, plus penalties and interest. The partner agrees to include the adjustments on his tax return for the adjustment year and to adjust all related tax attributes for modification years. The adjustment year is the year that the IRS makes the adjustments, and the modification years are years affected by audit in subsequent years, such as reductions to basis, passive loss carryforwards, etc.

---

[13] Final reg. §301.6225-1(b).
[14] Final reg. §301.6225-2(d)(2).
[15] Final reg. §301.6225-2(c)(3).

6. The "push out" election of §301.6226-1

As an alternative to paying the imputed tax or requesting the modifications listed above, a partnership may elect under §301.6226-1 to issue information returns to all the partners for the reviewed year notifying them of the election and providing their allocable share of the adjustments. The reviewed-year partners then include the adjustments on their returns for the adjustment year. A partnership making a valid election under §301.6226-1 is not responsible for the tax.[16]

The "push out" election must be filed within 45 days of the date the final partnership adjustment (FPA) is mailed by the IRS.[17] The deadline cannot be extended. The election is made by the Partnership Representative. The election is made on Form 8988 and may be revoked using form 8989. The election must include:[18]

- The name, address, and TIN of the partnership;
- The taxable year to which the election relates;
- A copy of the FPA to which the election relates;
- In the case of an FPA that includes more than one imputed underpayment, the imputed underpayment to which it applies;
- The name and TIN of each reviewed-year partner;
- The current or last address of each reviewed-year partner that is known to the partnership; and
- Other information prescribed by the IRS in forms, instructions, and other guidance.

The partnership making an election under §301.6226-1 must provide statements to the partners providing the information that they need to include on their returns. The statements must be provided to the reviewed-year partners no later than 60 days after the date all of the partnership adjustments are finally determined. The final determination date is the later of:

- The expiration of the 90-day period of time to file a petition for judicial review under §6234; or
- If a petition under §6234 is filed, the date when the court's decision becomes final.

The statements to the partners must include:

- The name and TIN of the reviewed-year partner to whom the statement is being furnished;
- The current or last address of the reviewed-year partner that is known to the partnership;
- The reviewed-year partner's share of items as originally reported for the reviewed year to the partners;
- The reviewed-year partner's share of partnership adjustments;
- Modifications previously approved for the reviewed-year partners;
- Any penalties or additions to tax determined at the partnership level and the adjustments to which they relate;
- The date the statement is furnished to the reviewed-year partner;
- The partnership taxable year to which the adjustments relate; and
- Any other information that may be required by forms, instructions, or guidance issued by the IRS.

---

16 Final reg. §301.6226-1(b).
17 Final reg. §301.6226-1(c)(2).
18 Final reg. §301.6226-1(c)(3).

A copy of the statements to the partners must be submitted electronically to the IRS no later than 60 days after the final determination date.[19]

C. The partnership representative

In addition to the new rules regarding the audit of a partnership, the new centralized audit regime replaces the 'Tax Matters Partner' with a 'Partnership Representative'. The partnership representative does not have to be a partner of the partnership. The purpose of the new rule is to allow the partnership to designate the person it believes is most appropriate to represent the partnership. The partnership representative is designated by the partnership and is the only person that has the authority to represent the partnership before the IRS. The designated person will serve as the partnership representative until replaced by the partnership or removed by the IRS.[20]

1. Eligibility to serve as a partnership representative [21]

An individual, trust, estate, partnership, association, company or corporation may be appointed to be a partnership representative if they meet the following requirements. Also, the final regulations include disregarded entities. The final regs. clarify that a partnership may serve as its own representative.

a. The partnership representative must have a substantial presence in the United States. A person has a substantial presence in the United States if the person: (i) makes himself available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS; and (ii) the person has a United States TIN, a street address in the United States, and a telephone number with a U.S. area code.

b. If the person is not an individual (a trust, estate, partnership, association, company or corporation), an individual who would be eligible to serve as a partnership representative must be appointed by the partnership to be the sole individual through whom the partnership representative will act. This provision applies to disregarded entities that serve as partnership representatives as well.

2. Designation of the partnership representative

The partnership must designate a partnership representative for each tax year. The designation is only good for the taxable year for which it is made. The designation is made on the partnership return for the year for which the designation is intended. The designation of the partnership representative and the designation of the individual through whom the partnership representative will act (if the PR is not an individual) is entered on Page 3 of Form 1065. The appointment is effective on the date that the partnership return is filed.[22]

3. Resignation of the partnership representative[23]

A partnership representative may resign by sending a written notice of the resignation to the IRS. The resignation is effective upon the IRS receiving the written notice. The resignation may only be submitted after the IRS has issued a notice of administrative proceeding (NAP).

---

19 Final reg. §301.6226-2.
20 Final reg. §301.6223-1(a).
21 Final reg. §301.6223-1(b).
22 Final reg. §301.6223-1(c).
23 Final reg. §301.6223-1(d).

4. Revocation of the designation of a partnership representative [24]

A partnership may revoke the designation of a person as the partnership representative by sending a written notice to the IRS. The notice should include the designation of a new partnership representative. If the partnership representative is a person other than an individual, they must designate a new individual to be the spokesperson of the partnership representative. They make also revoke a designation of a designated individual and name a new individual to represent an existing non-individual partnership representative without changing the partnership representative. If the partnership representative was designated by the IRS, the partnership may only revoke the appointment with permission from the IRS.

5. Designation of a partnership representative by the IRS [25]

If the IRS determines that a designation of a partnership representative by the IRS is not in effect, the partnership must appoint a representative within 30 days. If they fail to do so, a partnership representative will be appointed by the IRS.

6. Partnerships who elect out of the centralized audit regime

Partnerships that elect out of the new audit regime are not required to appoint a partnership representative. Only partnerships that are subject to subchapter C of chapter 63 of the internal revenue code are required to appoint a partnership representative. Partnerships who elect out are electing out of subchapter C of chapter 63.[26]

7. The authority of the partnership representative[27]

The partnership representative has the sole authority to represent the partnership in tax matters with the IRS and to enter into binding agreements with the IRS. The partners are bound by the actions of the partnership representative. Partners that are not the partnership representative may only participate in administrative proceedings with permission from the IRS.

Questions to ponder

Electing out of the new centralized audit regime for partnerships means that the partnership is not subject to the new constricting partnership representative rules. It also means that the audit will be conducted for the partnership and the partners under standard audit procedures. What are the advantages of electing out? Not electing out?

D. Basis adjustments by the partners[28]

When the tax is paid by the partnership, the partnership must adjust certain tax attributes, capital accounts, and the outside basis of the partners must be adjusted also. The intent of these adjustments is to adjust the partners' basis and capital accounts to where they would have been if the audit adjustment items had been properly reported to the partners. The proposed regulations call for adjusting the tax basis and book value of partnership property offset by notional amounts of income, gain, loss, deduction, or credit based on the partnership adjustments that are allocated to the adjustment year partners' tax basis and capital accounts. Basis is not adjusted for a partner who is:

---

24 Final reg. §301.6223-1(e).
25 Final reg. §301.6223-1(f).
26 Final reg. §301.6223-1(a).
27 Final reg. §301.6223-2.
28 Prop. Reg. §301.6225-4.

- Not a tax-exempt entity and is a successor to a partner in the reviewed year who was a tax-exempt entity if the IRS approved a modification to the imputed underpayment because of the tax-exempt partner; or
- When the notional item would be allocated to a successor that is a related party within the meaning of §§267(b) or 707(b) and the successor received the interest from the reviewed party in a transaction in which not all of the gain was recognized during an administrative adjustment proceeding with respect for the reviewed year.

Note:

The second bullet above is an anti-abuse provision. It does not prevent an adjustment for all related party successors. It only prevents basis adjustments if the transfer is made during an audit in an attempt to shift the economic burden of the adjustment.

Example from the proposed regulation:

Example 1: (i) In 2022, A, B, and C are individuals that form Partnership. A contributes Whiteacre, which is unimproved land with an adjusted basis of $400 and a fair market value of $1000, and B and C each contribute $1000 in cash. The partnership agreement provides that all income, gain, loss, and deduction will be allocated in equal 1/3 shares among the partners. The partnership agreement also provides that the partners' capital accounts will be determined and maintained in accordance with §1.704-1(b)(2)(iv) of this chapter, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as provided in §1.704-1(b)(2)(ii)(b)(2) and (3) of this chapter).

(ii) Upon formation, Partnership has the following assets and capital accounts:

	Tax	Book	Value	Capital	Tax	Book	Value
Cash	$2,000	$2000	$2,000	A	$400	$1,000	$1,000
Whiteacre	400	1,000	1,000	B	1,000	1,000	1,000
Asset	0	0	120	C	1,000	1,000	1,000
Totals	2,400	3,000	3,120		2,400	3,000	3,000

(iii) In 2022, Partnership makes a $120 payment for Asset that it treats as a deductible expense on its partnership return.

	Tax	Book	Value	Capital	Tax	Book	Value
Cash	$1,880	$1,880	$1,880	A	$360	$960	$1,000
Whiteacre	400	1,000	1,000	B	960	960	1,000
Asset	0	0	120	C	960	960	1,000
Totals	2,280	2,280	3,000		2,280	2,880	3,000

(iv) Partnership does not file an AAR for 2023. The IRS determines in 2024 (the adjustment year) that Partnership's $120 expenditure was not allowed as a deduction in 2022 (the reviewed year), but rather was the acquisition of an asset for which cost recovery deductions are unavailable. Accordingly, the IRS makes a partnership adjustment that disallows the entire $120 deduction, which results in an imputed underpayment of $48 ($120 x 40 percent). Partnership does not request modification under §301.6225-2. Partnership pays the $48 imputed underpayment.

(v) Partnership first determines its tax attribute adjustments resulting from the partnership adjustment by applying paragraph (b) of this section. Pursuant to paragraph (b)(2)(i) of this section, Partnership must re-state the basis and book value of Asset to $120. Further, pursuant to paragraph (b)(3)(ii) of this section, a $120 notional item of income is created. The $120 item of notional income is allocated in equal shares ($40) to A, B, and C in 2024 under §1.704-1(b)(4)(xi) of this chapter. Accordingly, in 2024 Partnership increases the capital accounts of A, B, and C by $40 each, and increases A, B, and C's outside bases by $40 each under paragraph (b)(5)(ii) and (iii) of this section, respectively.

(vi) As described in paragraph (c) of this section, Partnership's payment of the $48 imputed underpayment is treated as an expenditure described in §705(a)(2)(B) under §301.6241-4. Under §1.704-1(b)(4)(xii) of this chapter, Partnership determines each partner's properly allocable share of this expenditure in 2024 by allocating the expenditure in proportion to the allocations of the notional item to which the expenditure relates. Accordingly, each of A, B, and C have a properly allocable share of $16 each, which is the same proportion (1/3 each) in which A, B, and C share the $120 item of notional income. Thus, A, B and C's capital accounts are each decreased by $16 in 2024 and A, B and C's outside bases are each decreased by $16 in 2024. The allocation of the expenditure under the partnership agreement has economic effect under §1.704-1(b)(2)(ii) of this chapter and, because the allocation of the expenditure is determined in accordance with §1.704-1(b)(2)(iii)(f) of this chapter, the economic effect of these allocations is deemed to be substantial.

(vii) The payment is also reflected by a $48 decrease in partnership cash for book purposes under §1.704-1(b)(4)(ii) of this chapter. Therefore, in 2024, A's basis in Partnership is $384 and his capital account is $984. B and C each have a basis and capital account of $984.

	Tax	Book	Value	Capital	Tax	Book	Value
Cash	$1,832	$1,832	$1,832	A	$384	$1,000	$1,000
Whiteacre	400	1,000	1,000	B	984	1,000	1,000
Asset	120	120	120	C	984	1,000	1,000
Totals	2,352	2,952	2,952		2,352	2,952	2,952

III. Proposed Partnership Audit Regs

A. Qualified Subchapter S subsidiary partners

In November 2020, the IRS issued proposed regulations regarding the centralized audit regime. [29] These proposed regulations state that if a partnership has a qualified subchapter S subsidiary (QSub) partner, the partnership cannot elect out of the centralized audit regime. Prior IRS guidance took a contrary position, stating that a QSub partner would be treated similar to S corporation partners and would be permitted to opt out of the centralized audit regime, provided certain conditions were met.[30] The IRS noted its concern that if they allowed partnerships with QSub partners to elect out of the centralized audit regime, it would result in partnerships with over 100 partners electing out of the centralized audit regime. The IRS further stated that the proposed regulations were necessary to address these concerns by making QSub partners ineligible partners for purposes of §6221. As a result, the exception allowing partnerships with QSub partners to elect out of the centralized audit regime was eliminated.

[29] REG-123652-18.
[30] Notice 2019-6.

Additionally, per prior final regulations released in 2018, partnerships with disregarded entities (defined in reg. §301.7701-2(c)(2)(i)) as partners could not opt out of the centralized audit regime. The new November 2020 proposed regs expand the definition of disregarded entities to include "*a wholly-owned entity disregarded as separate from its owner for federal income tax purposes*." Grantor trusts and qualified REIT subsidiaries fall under this new expanded definition. This provision is proposed to be effective for partnership tax years ending after November 20, 2020.

B. Partner-Level Audits

Typically, under the BBA partnership audit rules, adjustments for partnership-related items are determined at the partnership level. The proposed regulations outline "special enforcement considerations" that would allow the IRS to make an adjustment to a partnership-related item during the audit of a partner, if during the audit of the partner, it is determined that the partnership-related item is based on information provided by the partner. Per §6241(11), for partnership-related items involving special enforcement matters, the Secretary of the Treasury may prescribe regulations providing that the centralized partnership audit regime does not apply to such items. Rather, these special enforcement matters are subject to special rules that the Secretary of the Treasury determines to be necessary to effectively and efficiently enforce the Code. Special enforcement matters include:

- Failure to comply with the requirement for a partnership partner or S corporation partner to furnish statements or compute and pay an imputed underpayment;
- Assessments under §6851 relating to termination assessments of income tax, or under §6861 relating to jeopardy assessments of income, estate, gift, and certain excise taxes;
- Criminal investigations;
- Indirect methods of proof of income;
- Foreign partners or partnerships; and
- Other matters that the Secretary determines by regulation to be present special enforcement considerations.

Per the proposed regulations, the IRS anticipates making adjustments in cases in which the adjustments are relevant to a single partner or small group of partners, rather than items that are allocable to all partners.

The proposed regs state that the ability to adjust certain items at the partner level would be beneficial to partnerships, partners, and the IRS. If a partner-level audit was conducted, the special rule would prevent the need to open an examination of the entire partnership under the centralized audit regime.

C. Partner-Level Statute of Limitations

The proposed regulations also address the partner-level statute of limitations. Under prior TEFRA rules, partnership adjustments could be made if either the partner-level or partnership-level statute of limitations was open. Under the BBA, there was typically a three-year period for making partnership adjustments, which was generally the later of:

- The date the partnership return was filed;
- The due date of the return; or
- The date on which the partnership filed an AAR.

Under certain circumstances, this three-year period could be extended. The November 2020 proposed regulations would allow the IRS to make partnership adjustments after the partnership-level statute of limitations has expired, if the partner's statute of limitations is open and either:

- The partner has control over the partnership; or
- The partner has extended their statute of limitations under §6501 and the extension expressly states that the partner is extending the time to adjust and assess any tax attributable to partnership-related items for the taxable year.

The example below, outlined in the proposed regulations, details this proposed change.

Example 1: On June 1, 2018, A acquires an interest in Partnership by contributing Asset to Partnership in a section 721 contribution (Contribution). Partnership claims a basis in Asset of $50 under section 723 equal to A's purported adjusted basis in Asset as of June 1, 2018, based on information A provided to Partnership. There is no activity in Partnership that gives rise to any other partnership-related items between June 1, 2018 and June 2, 2019. On June 2, 2019, A sells A's interest in Partnership to B for $100 in cash and reports a gain of $50 based on A's purported adjusted basis in Partnership of $50 under section 722 (reflecting solely A's purported adjusted basis in Asset immediately prior to the Contribution). The IRS opens an examination of A and determines that A's adjusted basis in Asset immediately prior to the Contribution should have been $30 instead of the $50 claimed by A. As a result, A's basis in Asset immediately prior to the Contribution is reduced from $50 to $30 and A's adjusted basis in A's interest in Partnership under section 722 is reduced from $50 to $30. Because A's adjusted basis in A's interest in Partnership is reduced to $30, the total gain from the sale of A's interest in Partnership is increased to $70 ($50 as originally reported plus $20 as adjusted by the IRS). The amount of Partnership's adjusted basis in Asset, which is the property transferred by A in the Contribution, is based on information provided by A to Partnership; the adjustment to A's pre-Contribution adjusted basis in Asset, which is a non-partnership-related item, results in an adjustment to the adjusted basis of the property (that is, Asset) transferred to Partnership in the Contribution, which is a partnership-related item; and the Contribution underlies the adjustment to A's basis in A's interest Partnership, which is a non-partnership-related item. As a result, the IRS may determine that the rules of subchapter C of chapter 63 do not apply to the Contribution and may adjust, during an examination of A, the Contribution as it relates to the adjusted basis in Asset transferred in the Contribution.

IV. Cases and rulings

A. S corporation wages still a hot topic

The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

A recent tax court case, *Lateesa Ward v. Commissioner of Internal Revenue,* addresses the ongoing hot topic of S corporation wages and employment taxes.[31] Lateesa Ward (petitioner) opened a law firm, Ward & Ward Co., organized as an S corporation with herself as the sole shareholder. During the time period in question, Ward and one other attorney were the only two employees of Ward & Ward Co.

All S corporations file Form 941 to report compensation to officers and employees. Additionally, all S corporations file Form 1120S to report their annual activities. All shareholders of the S corporation report their share of income, expenses, and deductions on their own personal tax return, typically using Form 1120S as a source of information to report their flow through information. As such, Form 1120S and the individual shareholder's personal Form 1040 should typically match up.

In the case of *Lateesa Ward v. Commissioner of Internal Revenue,* there was a mismatch between the information reported on Ward & Ward Co.'s Form 1120S, Form 941, and Lateesa Ward's Form 1040. For tax year 2011:

- Ward & Ward Co.'s Form 1120S reported a loss of $1,373, officer compensation of $62,388, and wages of $33,925.
- Ward & Ward Co.'s Form 941 reported employee compensation of $41,483.78
- Lateesa Ward's Form 1040 reported *no wages or salaries received,* but correctly reported the $1,373 loss on Schedule E.

For tax year 2012:

- Ward & Ward Co.'s Form 1120S reported income of $5,309, officer compensation of $73,448, and wages of $47,141.
- Ward & Ward Co.'s Form 941 reported employee compensation of $52,198.60
- Lateesa Ward's Form 1040 reported *no wages or salaries received,* but instead reported the $73,448 a "other income." Only $2,654 of income was reported on Schedule E.

For tax year 2013:

- Ward & Ward Co.'s Form 1120S reported a loss of $17,402, no officer compensation, and wages of $108,469
- Ward & Ward Co.'s Form 941 reported employee compensation of $77,444.64
- Lateesa Ward's Form 1040 reported $24,105 of wages, $48,136 of other income, and the $17,402 loss on Schedule E.

Lateesa Ward admitted that during the time period in question, she was an officer of Ward & Ward. Co.

The Commissioner disagreed with Ward & Ward Co.'s failure to report and pay tax on the compensation paid to Lateesa Ward, and stated that Ward & Ward Co. failed to pay employment taxes on all of the wages that Lateesa Ward was paid for tax years 2011 through 2013. Ward & Ward Co. claimed that some compensation was considered wages, but the rest was considered a distribution. The Tax Court found that Ward & Ward Co. had no reasonable basis for treating Lateesa Ward as anything other than an employee, as she considered herself as an officer, and thus owed employment tax on such compensation.

---

[31] *Lateesa Ward v. Commissioner of Internal Revenue,* T.C. Memo 2021-32.

B. *Split-Dollar Arrangement Distributions*

1. Overview

Treasury Regulation §1.61-22 defines a split-dollar life insurance arrangement as any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria:

- Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;
- At least one of the parties to the arrangement paying premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and
- The arrangement is not part of a group-term life insurance plan described in §79 unless the group-term life insurance plan provides permanent benefits to employees.

Split-dollar life insurance arrangements may be between an employer and employee or a shareholder and a corporation. Essentially, split-dollar life insurance arrangements are contractual arrangements between two parties to split the costs, cash value, and benefits of an insurance policy.

Split-dollar arrangements can be used for a variety of purposes, including:

- To assist employees in purchasing life insurance for themselves and their families;
- To assist an estate in paying estate taxes; or
- To assist shareholders in paying premiums on life insurance policies used to fund shareholder agreements in the event of the death of a shareholder.

2. How are premiums split?

Premiums are generally split between the parties as follows:

- The employer or corporation may pay the entire premium.
- The employer or corporation may pay the premium up to the cash value of the policy, with the employee or shareholder paying the remaining amount*.
- The employee or shareholder may pay the premiums up to the current cost of life insurance coverage, with the employer or corporation paying the remaining amount.

*Note: If the S corporation provides the shareholder with a bonus equal to the shareholder's contribution to the premium, the shareholder is taxed on the value of the compensation under the split-dollar arrangement and on the bonus.

3. How are benefits split?

Benefits are generally split between the parties as follows:

- Upon maturity of the policy, the employer or corporation may receive a return of premiums paid, with the employee or shareholder receiving the balance of death benefits.
- The employer or corporation may receive the cash value of the policy, with the employee or shareholder receiving the balance of death benefits.
- The employer or corporation may receive the greater of the premiums paid or cash value of the policy, with the employee or shareholder receiving the balance of death benefits.

In equity split-dollar arrangements, an employer or corporation receives a return of premiums paid upon maturity of the policy, and the shareholder receives the balance of the benefits. The employee or shareholder receives the “equity” of the cash value accrued in the policy as well as any remaining death benefit in excess of the employer/corporation-paid premiums. Generally, the employee or shareholder’s benefits in the policy increase over time.

In non-equity split-dollar arrangements, the employer or corporation receives the cash value of the policy, while the employee or shareholder receives the proceeds net of the cash value. Generally, the employee or shareholder’s benefits in the policy decrease over time if the cash value increases while the death benefit remains fixed.

4. Compensatory vs. shareholder arrangements

Compensatory arrangements meet the following criteria:

- They are entered into in connection with the performance of services and not part of group-term life insurance;
- The employer or corporation pays, directly or indirectly, all or any portion of the premiums; and
- Either --
  - The beneficiary of all or any portion of the death benefit is designated by the employee or shareholder, or the beneficiary is any person whom the employee or shareholder would reasonably be expected to designate as the beneficiary; or
  - The employee or shareholder has any interest in the policy cash value of the life insurance contract.

Shareholder arrangements meet the following criteria:

- They are entered into between a corporation and a shareholder;
- The corporation pays, directly or indirectly, all or a portion of the premiums; and
- Either --
  - The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or
  - The shareholder has any interest in the policy cash value of the life insurance contract.

5. How are split-dollar arrangements set up?

Split dollar arrangements are typically set up using either the endorsement or collateral assignment method:

- **Endorsement Method**: The employer or corporation owns the insurance policy and receives its interest in the policy when the policy matures or is terminated. The rights of the employee/shareholder are outlined in the split-dollar arrangement.
  - Typically, the employer or corporation provides the employee or shareholder with the “right” to designate a beneficiary for the remaining benefit amount, and the employer or corporation endorses this portion of the death proceeds to the employee or shareholder’s beneficiary.
  - Split-dollar arrangements under the endorsement method are subject to the economic benefit regime.

- **Collateral Assignment Method**: The employee or shareholder owns the insurance policy, and the employer or corporation pays, directly or indirectly, all or a portion of the policy premiums. The employer is treated as lending premium payments to the employee. The employee or shareholder executes a collateral assignment of the policy benefits to the employer or corporation.
    - Split-dollar arrangements under the collateral assignment method are generally subject to the loan regime.

6. What is the economic benefit regime?

Split-dollar arrangements under the endorsement method are subject to the economic benefit regime. Under the economic benefit regime, the policy owner (employer or corporation) provides a benefit to the non-owner (employee or shareholder) by paying the policy premium. The non-owner (employee or shareholder) must take into account the full value of these benefits, which are classified as either compensation, a distribution, a capital contribution, a gift, or a transfer depending on the relationship between the owner and non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as provided from the owner to the non-owner. The value of the economic benefit that the non-owner (employee or shareholder) receives is calculated on an annual basis.

Under the economic benefit regime, the value of economic benefits provided to a non-owner (employee or shareholder) for a taxable year equals:

1. **The cost of current life insurance protection** provided to the non-owner.
    a. The amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account in computing the non-owner's economic benefit.
    b. Accumulated equity is deducted in computing the cost of coverage as to avoid double taxation when the non-owner is taxed on the equity.
    c. The cost of the insurance provided to the non-owner is equal to the amount of the current life insurance provided to the non-owner multiplied by the life insurance premium factor published in the Internal Revenue Bulletin.
2. The amount of policy cash value to which the non-owner has current access (to the extent that such amount was not actually taken into account for a prior taxable year).
    a. This includes any direct or indirect right under the arrangement allowing the non-owner to obtain, use, or realize potential economic value from the policy cash value. Examples include:[32]
        - If the non-owner can directly or indirectly make a withdrawal from the policy, borrow from the policy, or effect a total or partial surrender of the policy.
        - If the non-owner can anticipate, assign (either at law or in equity), alienate, pledge, or encumber the policy cash value.

[32] *68 FR 54336.*

- If the policy cash value is available to the non-owner's creditors by attachment, garnishment, levy, execution, or other legal or equitable process.

3. The value of any economic benefits not described that were provided to the non-owner (to the extent that such amount was not taken into account in a prior taxable year).

7. What is the loan regime?

Split-dollar arrangements under the collateral assignment method are generally subject to the loan regime. The economic regime applies to split-dollar arrangements under the collateral assignment method when the employee or shareholder has no interest in the cash value of the policy. Under the loan regime, the owner of the policy (the employee or shareholder) is treated as the borrower, and the non-owner (employer or corporation) is treated as the lender.

Per Treas. Regs. §1.7872-15(a)(2), a payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if:

- The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);
- The payment is a loan under general principles of federal tax law or, if it is not a loan under general principles of federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and
- The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

If a non-owner (employer or corporation) makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: one that is repayable and one that is not.

The loan regime applies when the interest on the loan is below market. A split-dollar demand loan is any split-dollar loan that is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand). A demand loan has below market interest when the interest rate is lower than the blended annual rate for the year, as published by the IRS in the Internal Revenue Bulletin. A split-dollar term loan is any split-dollar loan other than a split-dollar demand loan. A term loan has below market interest when the imputed loan amount is less than the amount loaned. The imputed loan amount is determined by calculating the present value of all loan payments using a discount rate based on the Applicable Federal Rate.

8. S corporation considerations: Ruben De Los Santos and Martha De Los Santos v. Commissioner

Classifying a split-dollar arrangement as either a compensatory or shareholder arrangement impacts whether the economic benefit received by the shareholder is classified as either compensation or a distribution. A recent tax court case, *Ruben De Los Santos and Martha De Los Santos v. Commissioner*, highlights that the benefits from a split-dollar life insurance arrangement received as an employee of an S corporation were taxable as ordinary income.

Ruben De Los Santos was a doctor who operated a medical practice organized as an S corporation. Dr. Ruben De Los Santos was the sole shareholder of the S corporation, and the S corporation employed Dr. Ruben De Los Santos, his wife (office manager), and four other employees.

In 2006, the S corp. adopted an employee welfare benefit plan to provide employees with life insurance benefits. In order to be eligible to receive benefits, the person was required to be an eligible employee who provided services to the S corporation. Under the life insurance policy provided by the S corporation, De Los Santos and his wife were entitled to a $12.5 million death benefit, while the remaining four employees were entitled to a $10,000 death benefit. To fund such benefits provided by the Legacy Employee Welfare Benefit Plan, the S corporation, as an employer, contributed to Legacy Employee Welfare Benefit Trust. Between 2006 and 2010, the S corp. paid $1,862,349 to the trust and treated such contributions as tax-deductible expenses of the S corp. Such premium payments led to an accumulation value of $744,460 at the end of 2012.

The De Los Santos filed federal tax returns for 2011 and 2012 but failed to report income related to participation in the Legacy Employee Welfare Benefit plan. On December 4, 2015, the IRS issued the De Los Santos a timely notice of deficiency, determining that the economic benefits they received under the Legacy Plan were taxable to them as ordinary income. The De Los Santos timely petitioned the Court upon receiving the notice of deficiency.

The Commissioner argued that the S Corp. had adopted a compensatory split-dollar arrangement because the Legacy Plan was “entered into in connection with the performance of services.”

As discussed, split-dollar life insurance arrangements are typically categorized into two categories: compensatory arrangements and shareholder arrangements. Under a compensatory arrangement, the arrangement is entered into in connection with the performance of services, whereas under a shareholder arrangement, the arrangement is entered into between a corporation and another person in that person’s capacity as a shareholder in the corporation. Under both arrangements, the owner of the life insurance contract pays the premiums, and the non-owner has a current interest in the policy.

Under any split-dollar arrangement, the economic benefits are treated as being provided to the non-owner of the life insurance contract, and this non-owner must take into account the full value of the economic benefits less any consideration paid. Typically, the economic benefits under a compensatory arrangement constitute payment of *compensation* to the service provider, whereas the economic benefits under a shareholder arrangement constitute a *distribution* to the shareholder.

The De Los Santos did not dispute that the life insurance arrangement was a compensatory arrangement but unsuccessfully argued that because Dr. De Los Santos was a shareholder of the corporation, the economic benefits received were taxable as a distribution. The De Los Santos cited the conclusion in *Machacek v. Commissioner,* which found that when an S corporation pays a shareholder with a split-dollar life insurance policy, it is characterized as a distribution.

The Tax Court disagreed with the opinion in *Machacek v. Commissioner* and found that the benefits were not characterized as a distribution. Section 301 provides that distributions must be made by the corporation to a shareholder regarding its stock and must be received in the individual’s capacity as a shareholder. The Tax Court found that since the De Los Santos received the benefits of the policy as employees, §301 does not apply. Additionally, the Tax Court cited that classifying the benefits as a

distribution would have allowed the S corporation to avoid employment taxes on the split-dollar arrangement.

The Tax Court ultimately ruled that the benefit plan constituted a compensatory split-dollar life insurance arrangement and that the economic benefits flowing to petitioners generated current taxable income. Lastly, the Tax Court determined that split-dollar life insurance benefits are considered fringe benefits, and §1372 applies. Under §1372(a), for the purposes of employee fringe benefits, the S corporation shall be treated as a partnership and any 2% shareholder (defined as a person who owns more than 2% of the outstanding stock of the corporation) of the S corporation shall be treated as a partner of such partnership. The Tax Court ruled that the De Los Santos S corporation should be treated as a partnership with respect to such employee fringe benefits. As such, the Tax Court ruled that the economic benefits are categorized as guaranteed payments under §707(c), and that Dr. De Los Santos must recognize the split-dollar life insurance as ordinary income.

9. Action on Decision

In May 2021, the IRS issued an Action on Decision (AOD) *on Machacek v. Commissioner*.[33] As noted when discussing the *De Los Santos* decision, the *Machacek* decision held that anytime an S corporation paid its shareholder with a split-dollar life insurance policy, it is considered a distribution of property under §301. *De Los Santos* rejected the *Machacek* decision.

The IRS issued a "nonacquiescence" decision, meaning they did not agree with the court and would not follow the decision in disposing of cases involving other taxpayers. Since *Machacek* was an opinion of the Sixth Circuit Court of Appeals, the IRS noted they will recognize the precedential impact of the opinion on cases arising within the circuit, but they would not follow the holding on a nationwide basis.

There is potential for S corporations to create a second class of stock if the split-dollar life insurance arrangement is treated as a distribution and only certain shareholders benefit from the arrangement, or the benefit is not proportionate to the shareholder's stock holding in the corporation. Creating a second class of stock could cause a termination of the S election. While split-dollar arrangements are valuable planning tools, it is important to consider all impacts that these arrangements can create on both the employer and employee.

C. Disguised payments for services

1. In general

Allocations under an arrangement between a partnership and a service provider to which §707(a) and §707(c) do not apply are treated as a distributive share under §704(b). The proposed regulations apply to a service provider who purports to be a partner even if applying the regulations causes the service provider to not be treated as a partner. The regulations may apply even if their application results in a determination that no partnership exists. Further, the regulations apply to a special allocation and distribution received in exchange for services by a service provider who receives other allocations and distributions in a partner capacity under §704(b). The regulations characterize the nature of an arrangement when the parties enter into or modify the arrangement. An arrangement that is treated as a disguised payment for services under these proposed regulations will be treated as a payment for services for all purposes of the Code. Thus, the partnership must treat the payments as payments to a

[33] AOD 2021-21.

non-partner in determining the remaining partners' shares of taxable income or loss. Where appropriate, the partnership must capitalize the payments or otherwise treat them in a manner consistent with the recharacterization.

a. Partnership allocations that are determined with regard to partnership income and that are made to a partner for services rendered by the partner in its capacity as a partner are generally treated as distributive shares of partnership income. In some cases, the right to a distributive share may qualify as a profits interest.

b. Section 707(c) provides that to the extent determined without regard to the income of the partnership, payment to a partner for services shall be considered as made to a person who is not a partner, but only for purposes of §61(a) and §162(a). A fixed salary, payable without regard to partnership income, to a partner who renders services to the partnership is a guaranteed payment. The amount of the payment shall be included in the partner's gross income, and shall not be considered a distributive share of income or gain. A partner who is guaranteed a minimum annual amount for its services shall be treated as receiving a fixed payment in that amount. But income reported by a Taxpayer financial consultant's solely owned S corporation should have been reported by Taxpayer individually where Taxpayer entered representative and broker agreements in his individual capacity.[34]

c. Section 707 (a) applies if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership: in such case, the transaction shall generally be considered as occurring between the partnership and one who is not a partner.

   (i) If a partner performs services for a partnership or transfers property to a partnership, there is a related direct or indirect allocation and distribution to such partner, and the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution are treated as a transaction between the partnership and a nonpartner.[35]

   (ii) If there is a direct or indirect transfer of money or other property by a partner to a partnership, there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and the transfers, when viewed together, are properly characterized as a sale or exchange of property, such transfers are treated either as a transaction between a partner and a nonpartner or as a transaction between two or more partners acting other than in their capacity as members of the partnership.[36]

---

34 *Fleischer v. Commissioner*, TC Memo 2016-238.
35 I.R.C. §707(a)(2)(A).
36 I.R.C. §707(a)(2)(B).

2. Scope

In general, these regulations apply to all arrangements entered into or modified after the date of publication of the Treasury decision adopting that section as final regulations in the Federal Register. To the extent that an arrangement permits a service provider to **waive all or a portion of its fee** for any period subsequent to the date the arrangement is created, then the arrangement is modified for purposes of this paragraph on the date or dates that the fee is waived.[37] In the case of any arrangement entered into or modified that occurs on or before final regulations are published in the Federal Register, the determination of whether the arrangement is a disguised fee for services is to be made on the basis of the statute and the guidance provided regarding that provision in the legislative history.[38] Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

3. Elements necessary to characterize arrangements as disguised payments for services

a. An arrangement will be treated as a disguised payment for services if --
   - (i) A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;[39]
   - (ii) There is a related direct or indirect allocation and distribution to such service provider;[40] and
   - (iii) The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.[41]

b. Whether an arrangement is properly characterized as a payment for services is determined at the time the arrangement is entered into or modified and without regard to whether the terms of the arrangement require the allocation and distribution to occur in the same taxable year. An arrangement that is treated as a payment for services is treated as a payment for services for all purposes of the Internal Revenue Code, including for example, §§61, 409A, and 457A (as applicable). The amount paid to a person in consideration for services under this section is treated as a payment for services provided to the partnership, and, when appropriate, the partnership must capitalize these amounts (or otherwise treat such amounts in a manner consistent with their recharacterization). The partnership must also treat the arrangement as a payment to a non-partner in determining the remaining partners' shares of taxable income or loss.[42]

Note:

The inclusion of income by the service provider and deduction (if applicable) by the partnership of amounts paid pursuant to an arrangement that is characterized as a payment for services is taken into account in the taxable year as required under applicable law by applying all relevant sections of the Internal Revenue Code, including for example, §§409A and 457A (as applicable),

---

37 Prop. Regs.§1.707-9(a)(1).
38 Prop. Regs.§1.707-9(a)(2).
39 Prop. Regs. §1.707-2(b)(1)(i).
40 Prop. Regs. §1.707-2(b)(1)(ii).
41 Prop. Regs. §1.707-2(b)(1)(i)ii.
42 Prop. Regs. §1.707-2(b)(2)(i).

to the allocation and distribution when they occur (or are deemed to occur under all other provisions of the Internal Revenue Code).[43]

c. If a person purports to provide services to a partnership in a capacity as a partner or in anticipation of becoming a partner, the rules here apply for purposes of determining whether the services were provided in exchange for a disguised payment, even if it is determined after applying the rules here that the service provider is not a partner. If after applying these rules, no partnership exists as a result of the service provider failing to become a partner under the arrangement, then the service provider is treated as having provided services directly to the other purported partner.[44]

d. Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. The below list in roman numerals provide a non-exclusive list of factors that may indicate that an arrangement constitutes in whole or in part a payment for services. The presence or absence of a factor is based on all of the facts and circumstances at the time the parties enter into the arrangement (or if the parties modify the arrangement, at the time of the modification). The most important factor is **significant entrepreneurial risk**. An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. For purposes of making these determinations, the weight to be given to any particular factor, other than entrepreneurial risk, depends on the particular case and the absence of a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services.[45]

(i) The arrangement lacks significant entrepreneurial risk. Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. The following bullets provide facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:[46]

- **Capped allocations of partnership income if the cap is reasonably expected to apply in most years**;
- An allocation for one or more years under which the service provider's **share of income is reasonably certain**;
- An **allocation of gross income**;
- An allocation (under a formula or otherwise) that is **predominantly fixed in amount, is reasonably determinable under all the facts and circumstances**, **or** is designed to assure **that sufficient net profits are highly likely to be available to make the allocation to the service provider** (e.g., if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); **or**

[43] Prop. Regs. §1.707-2(b)(2)(ii).
[44] Prop. Regs. §1.707-2(b)(3).
[45] Prop. Regs. §1.707-2(c).
[46] Prop. Regs. §1.707-2(c)(1).

- An arrangement in which a **service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms**.

(ii) The service provider holds, or is expected to hold, a **transitory partnership interest** or a partnership interest for only a **short duration**.[47]

(iii) The service provider **receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment**.[48]

(iv) The service provider **became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity**.[49]

(v) The **value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution**.[50]

(vi) The arrangement provides for **different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related** under §§707(b) or 267(b), **and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly**.[51]

Example 1: Partnership ABC constructed a building that is projected to generate $100,000 of gross income annually. A, an architect, performs services for partnership ABC for which A's normal fee would be $40,000 and contributes cash in an amount equal to the value of a 25-percent interest in the partnership. In exchange, A will receive a 25-percent distributive share for the life of the partnership and a special allocation of $20,000 of partnership gross income for the first two years of partnership's operations. The ABC partnership agreement satisfies the requirements for economic effect, including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Whether the arrangement is treated as a payment for services depends on the facts and circumstances. The special allocation to A is a capped amount and the cap is reasonably expected to apply. The special allocation is also made out of gross income. The capped allocations of income and gross income allocations described are presumed to lack significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Thus, the allocation lacks significant entrepreneurial risk. Accordingly, the arrangement provides for a disguised payment for services as of the date that A and ABC enter into the arrangement and should be included in income by A in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example 2: A, a stock broker, agrees to effect trades for Partnership ABC without the normal brokerage commission. A contributes 51 percent of partnership capital and in exchange, receives a 51-percent interest in residual partnership profits and losses. In addition, A receives a special allocation of gross income that is computed in a manner which approximates its foregone commissions. The special allocation to A is computed by means of a formula similar to a normal brokerage fee and varies with the value and amount of services rendered rather than with the income of the partnership. It is reasonably expected that

---

47 Prop. Regs. §1.707-2(c)(2).
48 Prop. Regs. §1.707-2(c)(3).
49 Prop. Regs. §1.707-2(c)(4).
50 Prop. Regs. §1.707-2(c)(5).
51 Prop. Regs. §1.707-2(c)(6).

Partnership ABC will have sufficient gross income to make this allocation. The ABC partnership agreement satisfies the requirements for economic effect, including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Whether the arrangement is treated as a payment for services depends on the facts and circumstances. Because the allocation is an allocation of gross income and is reasonably determinable under the facts and circumstances, it is presumed to lack significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Thus, the allocation lacks significant entrepreneurial risk. Accordingly, the arrangement provides for a disguised payment for services as of the date that A and ABC enter into the arrangement and should be included in income by A in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example 3: (i) M performs services for which a fee would normally be charged to new partnership ABC, an investment partnership that will acquire a portfolio of investment assets that are not readily tradable on an established securities market. M will also contribute $500,000 in exchange for a one-percent interest in ABC's capital and profits. In addition to M's one-percent interest, M is entitled to receive a priority allocation and distribution of net gain from the sale of any one or more assets during any 12-month accounting period in which the partnership has overall net gain in an amount intended to approximate the fee that would normally be charged for the services M performs. A, a company that controls M, is the general partner of ABC and directs all operations of the partnership consistent with the partnership agreement, including causing ABC to purchase or sell an asset during any accounting period. A also controls the timing of distributions to M including distributions arising from M's priority allocation. Given the nature of the assets in which ABC will invest and A's ability to control the timing of asset dispositions, the amount of partnership net income or gains that will be allocable to M under the ABC partnership agreement is highly likely to be available and reasonably determinable based on all facts and circumstances available upon formation of the partnership. A will be allocated 10 percent of any net profits or net losses of ABC earned over the life of the partnership. A undertakes an enforceable obligation to repay any amounts allocated and distributed pursuant to this interest (reduced by reasonable allowances for tax payments made on A's allocable shares of partnership income and gain) that exceed 10 percent of the overall net amount of partnership profits computed over the life of the partnership (a "clawback obligation"). It is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect, including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances.

(ii) Whether A's arrangement is treated as a payment for services in directing ABC's operations depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The arrangement with respect to A creates significant entrepreneurial risk because the allocation to A is of net profits earned over the life of the partnership, the allocation is subject to a clawback obligation and it is reasonable to anticipate that A could and would comply with this obligation, and the allocation is neither reasonably determinable nor highly likely to be available. Additionally, other relevant factors do not establish that the arrangement should be treated as a payment for services. The arrangement with respect to A does not constitute a payment for services.

(iii) Whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk.

The priority allocation to M is an allocation of net profit from any 12-month accounting period in which the partnership has net gain, and thus it does not depend on the overall success of the enterprise. Moreover, the sale of the assets by ABC, and hence the timing of recognition of gains and losses, is controlled by A, a company related to M. Taken in combination, the facts indicate that the allocation is reasonably determinable under all the facts and circumstances and that sufficient net profits are highly likely to be available to make the priority allocation to the service provider. As a result, the allocation presumptively lacks significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and should be included in income by M in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

(iv) Assume the facts are the same as paragraph: (i) of this example, except that the partnership can also fund M's priority allocation and distribution of net gain from the revaluation of any partnership assets. As the general partner of ABC, A controls the timing of events that permit revaluation of partnership assets and assigns values to those assets for purposes of the revaluation. Whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk. Under this arrangement, the valuation of the assets is controlled by A, a company related to M, and the assets of the company are difficult to value. This fact, taken in combination with the partnership's determination of M's profits by reference to a specified accounting period, causes the allocation to be reasonably determinable under all the facts and circumstances or to ensure that net profits are highly likely to be available to make the priority allocation to the service provider. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and should be included in income by M in time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Note:

The presence of certain facts, when coupled with a priority allocation to the service provider that is measured over any accounting period of the partnership of 12 months or less, may create opportunities that will lead to a higher likelihood that sufficient net profits will be available to make the allocation. One fact is that the value of partnership assets is not easily ascertainable and the partnership agreement allows the service provider or a related party in connection with a revaluation to control the determination of asset values, including by controlling events that may affect those values (such as timing of announcements that affect the value of the assets). By contrast, certain priority allocations that are intended to equalize a service provider's return with priority allocations already allocated to investing partners over the life of the partnership (commonly known as "catch-up allocations") typically will not fall within the types of allocations that will not lack significant entrepreneurial risk, although all of the facts and circumstances are considered in making that determination.

Example 4: (i) The facts are the same as in **Example 3,** except that ABC's investment assets are securities that are readily tradable on an established securities market, and ABC is in the trade or business of trading in securities and has validly elected to mark-to-market. In addition, M is entitled to receive a special allocation and distribution of partnership net gain attributable to a specified future 12-month taxable year. Although it is expected that one or more of the partnership's assets will be sold for a gain, it cannot reasonably be predicted if the partnership will have net profits with respect to its entire portfolio in that 12-month taxable year.

(ii) Whether the arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk. The special allocation to M is allocable out of net profits, the partnership assets have a readily ascertainable market value that is determined at the close of each taxable year, and it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio for the year to which the special allocation would relate. Accordingly, the special allocation is neither reasonably determinable nor highly likely to be available because the partnership assets have a readily ascertainable fair market value that is determined at the beginning of the year and at the end of the year. Thus, the arrangement does not lack significant entrepreneurial risk. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. The arrangement does not constitute a payment for services.

Note:

Several of the examples consider arrangements in which a partner agrees to forgo fees for services and also receives a share of future partnership income and gains. The examples consider the application of §707(a)(2)(A) based on the manner in which the service provider: (i) forgoes its right to receive fees; and (ii) is entitled to share in future partnership income and gains. In **Examples 5 and 6,** the service provider forgoes the right to receive fees in a manner that supports the existence of significant entrepreneurial risk by forgoing its right to receive fees before the period begins and by executing a waiver that is binding, irrevocable, and clearly communicated to the other partners. Similarly, the service provider's arrangement in these examples include the following facts and circumstances that taken together support the existence of significant entrepreneurial risk: the allocation to the service provider is determined out of net profits and is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the arrangement, and the service provider undertakes a clawback obligation and is reasonably expected to be able to comply with that obligation. The presence of each fact described in these examples is not necessarily required to determine that §707(a)(2)(A) does not apply to an arrangement. However, the absence of certain facts, such as a failure to measure future profits over at least a 12-month period, may suggest that an arrangement constitutes a fee for services.

Example 5: (i) A is a general partner in newly-formed partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. Funds that are comparable to ABC commonly require the general partner to contribute capital in an amount equal to one percent of the capital contributed by the limited partners, provide the general partner with an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and pay the fund manager annually an amount equal to two percent of capital committed by the partners.

(ii) Upon formation of ABC, the partners of ABC execute a partnership agreement with terms that differ from those commonly agreed upon by other comparable funds. The ABC partnership agreement provides that A will contribute nominal capital to ABC, that ABC will annually pay M an amount equal to one percent of capital committed by the partners, and that A will receive an interest in 20 percent of future partnership net income and gains as measured over the life of the fund. A will also receive an additional interest in future partnership net income and gains determined by a formula (the “Additional Interest”). The parties intend that the estimated present value of the Additional Interest approximately equals the present value of one percent of capital committed by the partners determined annually over the life of the fund. However, the amount of net profits that will be allocable to A under the Additional Interest is neither highly likely to be available

nor reasonably determinable based on all facts and circumstances available upon formation of the partnership. A undertakes a clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect, including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances.

(iii) Whether the arrangement relating to the Additional Interest is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The arrangement with respect to A creates significant entrepreneurial risk because the allocation to A is of net profits, the allocation is subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A could and would comply with this obligation, and the allocation is neither reasonably determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. The arrangement does not constitute a payment for services.

Example 6: (i) A is a general partner in limited partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. The ABC partnership agreement provides that A must contribute capital in an amount equal to one percent of the capital contributed by the limited partners, that A is entitled to an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and that M is entitled to receive an annual fee in an amount equal to two percent of capital committed by the partners. The amount of partnership net income or gains that will be allocable to A under the ABC partnership agreement is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available upon formation of the partnership. A also undertakes a clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.

(ii) ABC's partnership agreement also permits M (as A's appointed delegate) to waive all or a portion of its fee for any year if it provides written notice to the limited partners of ABC at least 60 days prior to the commencement of the partnership taxable year for which the fee is payable. If M elects to waive irrevocably its fee pursuant to this provision, the partnership will, immediately following the commencement of the partnership taxable year for which the fee would have been payable, issue to M an interest determined by a formula in subsequent partnership net income and gains (the "Additional Interest"). The parties intend that the estimated present value of the Additional Interest approximately equals the estimated present value of the fee that was waived. However, the amount of net income or gains that will be allocable to M is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the waiver of the partnership. The ABC partnership agreement satisfies the requirements for economic effect, including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. The partnership agreement also requires ABC to maintain capital accounts and to revalue partner capital accounts immediately prior to the issuance of the partnership interest to M. M undertakes a clawback obligation, and it is reasonable to anticipate that M could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.

(iii) Whether the arrangements relating to A's 20-percent interest in future partnership net income and gains and M's Additional Interest are treated as

payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The allocations to A and M do not presumptively lack significant entrepreneurial risk because the allocations are based on net profits, the allocations are subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A and M could and would comply with this obligation, and the allocations are neither reasonably determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. The arrangements do not constitute payment for services.

Note:

The Service ruled that a management fee of five percent of the gross rentals received by the partnership in return for management services provided to the partnership by the general partners of a real estate limited partnership that were reasonable in amount for the services rendered that the fees were guaranteed payments.[52] The partnership agreement specifies the taxpayers' shares of the profit and loss of the partnership. The general partners have a ten-percent interest in each item of partnership income, gain, loss, deduction, or credit. In addition, the partnership agreement provides that the general partners must contribute their time, managerial abilities and best efforts to the partnership and that in return for their managerial services each will receive a fee of five percent of the gross rentals received by the partnership. These amounts will be paid to the general partners in all events. In a case involving the payment of management fees based on a percentage of gross rentals both the United States Tax Court and the United States Court of Appeals for the Fifth Circuit held that the payments were not payments between a partnership and a partner not in the capacity of a partner.[53] The courts found that the terms of the partnership agreement and the actions of the parties indicated that the taxpayers were performing the management services in their capacities as general partners. The payments must then be either a guaranteed payment or a distributive share of partnership income. The Tax Court held that the management fees were not guaranteed payments because they were computed as a percentage of gross rental income received by the partnership. The court reasoned that the gross rental income was “income” of the partnerships and, thus, the statutory test for a guaranteed payment, that it be “determined without regard to the income of the partnership,” was not satisfied.

The Service believed that the management fees were guaranteed payments. Although a fixed amount is the most obvious form of guaranteed payment, there are situations in which compensation for services is determined by reference to an item of gross income. For example, it is not unusual to compensate a manager of real property by reference to the gross rental income that the property produces. Such compensation arrangements do not give the provider of the service a share in the profits of the enterprise, but are designed to accurately measure the value of the services that are provided. The term “guaranteed payment” should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits. Relevant facts would include the reasonableness of the payment for the services provided and whether the method used to determine the amount of the payment would have been used to compensate an unrelated party for the services.

---

52 Rev. Rul. 81-300, 1981-2 C.B. 143.

53 *Pratt v. Commissioner*, 64 T.C. 203 (1975), aff'd in part, rev'd in part, 550 F.2d 1023 (5th Cir. 1977)

As a guaranteed payment, a management fee would be ordinary income without regard to the composition of income, gain, loss, and deduction of the partnership. As a distributive share, the recipient would be entitled to a share of partnership income whose character is determined by reference to the composition of partnership items.

The Service notes that this ruling was revoked by the issuance of the proposed regulations on July 23, 2015.

e. The Service has previously ruled that if a partner's percentage of the partnership profits is less than his guaranteed minimum, the partner's share, computed on the percentage basis, of partnership income before deduction of the guaranteed payment is his distributive share of partnership income. The guaranteed payment is the difference between the partner's minimum guarantee and his distributive share of partnership income determined before deduction of the guaranteed payment.[54] At issue was a limited partnership that consisted of both general and limited partners. General partners received 75 percent of the net profits and the limited partners 25 percent of the net profits. The partnership losses were borne solely by the general partners. In addition, the Limited Partners shall be paid the sum of 4x dollars per annum for each 100 x dollars of contributed Contract Capital as minimum yearly profit participation, and if the profit participation calculated on the percentage basis above set forth shall be less than said minimum amount, or if there shall be losses, said minimum amount shall nevertheless be paid to the Limited Partners and said payment shall in all respects be treated as if it were an expense of the Limited Partnership. The Agreement provides that the minimum profit participation payments to limited partners shall be charged as a part of the expense of doing business in determining the partnership profits and losses, but only in the event that their respective profit participation in any one year would otherwise be less than said guaranteed payment. In the partnership taxable year in question the limited partners' profit participation calculated on the percentage basis was less than the minimum yearly profit participation as determined by using the formula in the Agreement.

(i) Under the regulations where a partner's percentage of profits is less than his guaranteed minimum, the partner's share, computed on the percentage basis, of partnership income before deduction of guaranteed payment is his distributive share of partnership income; and the guaranteed payment is the difference between the partner's minimum guarantee and his distributive share of partnership income before taking into account the guaranteed payment.[55]

(ii) The Service ruled that the fact that a partnership agreement provides that, in the event a minimum payment must be made to certain partners, the payment shall in all respects be treated as if it were an expense of the partnership, does not control as to whether the entire minimum amount will be considered an expense for Federal income tax purposes. Even if the partnership agreement required that the minimum profit participation payments be treated as an expense in all respects in the years the limited partners' guaranteed minimum is greater than their profit participation, when the guaranteed minimum is the greater, then only the difference between the limited partners' guaranteed minimum and their distributive share of the partnership income is a guaranteed payment for federal

[54] Rev. Rul. 66-95, 1966-1 C.B. 169.
[55] Treas. Regs. §1.707-1(c).

tax purposes. Only the amount of the guaranteed payment as thus determined should be considered as a business expense for federal income-tax purposes.

(iii) The proposed regulations change the result in the ruling by an example, the first in the current final regulations and the **second** in the proposed regulations when the regulations become final:

Example 2: Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Note:

Congress's emphasis on entrepreneurial risk requires changes to existing regulations for guaranteed payment. Specifically, **Example 2** provides that if a partner is entitled to an allocation of the greater of 30 percent of partnership income or a minimum guaranteed amount, and the income allocation exceeds the minimum guaranteed amount, then the entire income allocation is treated as a distributive share under §704(b). Example 2 also provides that if the income allocation is less than the guaranteed amount, then the partner is treated as receiving a distributive share to the extent of the income allocation and a guaranteed payment to the extent that the minimum guaranteed payment exceeds the income allocation.[56] The treatment of the arrangements in Example 2 is inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under §704(b). Accordingly, the proposed regulations modify Example 2 to provide that the entire minimum amount is treated as a guaranteed payment under §707(c) regardless of the amount of the income allocation.

Example 2 (as modified): Partner C in the CD partnership is to receive 30 percent of partnership income, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000). Of this amount, $10,000 is a guaranteed payment to C. The $10,000 guaranteed payment reduces the partnership's net income to $50,000 of which C receives $8,000 as C's distributive share.

f. The Service had also previously ruled on the proper method for computing, in accordance with the partnership agreement, the partners' distributive shares of the partnership's ordinary income and capital gains, where a partner also receives a guaranteed payment.[57]

Example: F and G are partners in FG, a two-man partnership. The partnership agreement provides that F is to receive 30 percent of the partnership income as determined before taking into account any guaranteed amount, but not less than 100x dollars. The agreement also provides that any guaranteed amount will be treated as an expense item of the partnership in any year in which F's percentage of profits is less than the guaranteed amount. The partnership agreement makes no provision for sharing capital gains. For the taxable year in question the partnership income before taking into account any guaranteed amount, is 200x dollars, and consists of 120 x dollars of ordinary income and 80x dollars of capital gains.

---

56 Treas. Regs. §1.707-1(c).

57 Rev. Rul. 69-180, 1969-1 C.B. 183.

A guaranteed payment is includable in gross income of the recipient as ordinary income, and is deductible by the partnership from its ordinary income as a business expense. For federal income-tax purposes, F's guaranteed payment is 40x dollars, 100x dollars (minimum guarantee) less 60x dollars distributive share (30 percent of partnership income of 200 x dollars).

After the guaranteed payment is taken into account, the partnership's ordinary income is 80x dollars (120x dollars of ordinary income less the 40x dollars guaranteed payment which is deductible by the partnership as a business expense. For federal income-tax purposes, the taxable income of the partnership amounts to 160x dollars (80x dollars of ordinary income and 80x dollars of capital gains).

Note:

If the partnership agreement does not specifically provide for the manner of sharing a particular item or class of items of income, gain, loss, deduction, or credit of the partnership, a partner's distributive share of any such item shall be determined in accordance with the manner provided in the partnership agreement for the division of the general profits or losses. In applying this rule, the manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss. Thus, F and G share the capital gains in the same ratio in which they share the general profits from business operations.

This ruling is also revoked upon the issuance of final regulations.

D. Partner's share of recourse liabilities

The IRS issued proposed regulations to apply to liabilities incurred or assumed by a partnership on or after the date these regulations are published as final regulations in the Federal Register. In response to an executive order by former President Trump, the service reviewed the regulations and partially withdrew them. Additional temporary regulations were issued that expired on October 4, 2019. However, the regulations gave insight into the IRS thinking, especially regarding the allocation of recourse liabilities caused by partner guarantees. The Service issued proposed regulations with respect to recourse and nonrecourse liabilities that are to apply on or after the date these regulations are published as final regulations in the Federal Register, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date.[58] Transition relief is provided in the final regs.

1. Recourse liabilities

a. For purposes of determining a partner's share of a recourse partnership liability, the amount of the partnership liability is taken into account only once. If the aggregate amount of the economic risk of loss that all partners are determined to bear with respect to a partnership liability (or portion thereof) (without regard to this) exceeds the amount of such liability (or portion thereof), then the economic risk of loss borne by each partner with respect to such liability shall equal the amount determined by multiplying: (i) the amount of such liability (or portion thereof) by (ii) the fraction obtained by dividing the amount of the economic risk of loss that such partner is determined to bear with respect to that liability (or portion thereof), by the sum of such amounts for all partners.

Example: (i) A and B are unrelated equal members of limited liability company, AB. AB is treated as a partnership for federal tax purposes. AB borrows $1,000 from Bank.

[58] Treas. Regs. §1.752-2(a).

A guarantees payment for the entire amount of AB's $1,000 liability and B guarantees payment for $500 of the liability. Both A and B waive their rights of contribution against each other.

(ii) Because the aggregate amount of A's and B's economic risk of loss ($1,500) exceeds the amount of AB's liability ($1,000), by the rule that the economic risk of loss borne by A and B each is determined by multiplying:(i) the amount of such liability (or portion thereof) by (ii) the fraction obtained by dividing the amount of the economic risk of loss that such partner is determined to bear with respect to that liability (or portion thereof) by the sum of such amounts for all partners. A's economic risk of loss equals $1,000 multiplied by $1,000/$1,500 or $667, and B's economic risk of loss equals $1,000 multiplied by $500/$1,500 or $333.

b. Except as otherwise provided, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment (the "payment") to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another person.[59]

(i) In general, the determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances at the time of the determination. Notwithstanding the prior sentence, a payment obligation will not be recognized if it fails to satisfy paragraphs (ii) and (iii) below. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section,[60] including:

- Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;[61]
- Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;[62] and
- Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.[63]

(ii) An obligation of a partner or related person to make a payment with respect to a partnership liability described in the first and second bullets under the preceding paragraph is not recognized unless all of the following requirements of this paragraph are satisfied. To the extent that an obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized, the rules are applied as if the obligation did not exist.[64]

- The partner or related person is:[65]
  - Required to maintain a commercially reasonable net worth throughout the term of the payment obligation;[66] or

59 Prop. Regs. §1.752-2(b)(1).
60 Prop. Regs. §1.752-2(b)(3)(i).
61 Prop. Regs. §1.752-2(b)(3)(i)(A).
62 Prop. Regs. §1.752-2(b)(3)(i)(B).
63 Prop. Regs. §1.752-2(b)(3)(i)(C).
64 Prop. Regs. §1.752-2(b)(3)(ii).
65 Prop. Regs. §1.752-2(b)(3)(ii)(A).
66 Prop. Regs. §1.752-2(b)(3)(ii)(A)(1).

- Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration (the "A" requirement).[67]

- The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition (the "B" requirement).[68]
- The term of the payment obligation does not end prior to the term of the partnership liability (the "C" requirement).[69]
- The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor (the "D" requirement).[70]
- The partner or related person received arm's-length consideration for assuming the payment obligation (the "E" requirement).[71]
- In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. For these purposes, the terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would be recognized. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable (the "F" requirement).[72]
- In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied. The indemnity, reimbursement agreement, or similar arrangement only satisfies this paragraph if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefitted party's payment obligation is recognized or would be recognized if such person were a partner or related person. For these purposes, the terms of an indemnity, reimbursement agreement, or similar arrangement will be treated as modified by any further right of indemnity, reimbursement, or similar arrangement regardless of whether that further arrangement would be recognized. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable (the "G" requirement).[73]

---

67 Prop. Regs. §1.752-2(b)(3)(ii)(A)(12).
68 Prop. Regs. §1.752-2(b)(3)(ii)(B).
69 Prop. Regs. §1.752-2(b)(3)(ii)(C).
70 Prop. Regs. §1.752-2(b)(3)(ii)(D).
71 Prop. Regs. §1.752-2(b)(3)(ii)(E).
72 Prop. Regs. §1.752-2(b)(3)(ii)(F).
73 Prop. Regs. §1.752-2(b)(3)(ii)(G).

(iii) In general, except as provided below, for purposes of determining the extent to which a partner or related person has a payment obligation or bears the economic risk of loss for a partnership liability, it is assumed that such partner or related person who has an obligation to make a payment actually performs its obligation, irrespective of its actual net value, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[74]

- In determining the extent to which a partner or related person other than an individual or a decedent's estate bears the economic risk of loss for a partnership liability other than a trade payable, a payment obligation is recognized only to the extent of the net value of the partner or related person as of the allocation date that is allocated to the partnership liability. A partner or related person's net value is determined under the rules of Treas. Regs. §1.752-2(k). This applies to a payment obligation of a partner or related person that is disregarded as an entity separate from its owner under §§856(i) (mutual fund) or 1361(b)(3) (S corporation) or §§301.7701-1 through 301.7701-3 or is a trust to which subpart E, part I, subchapter J, chapter 1 of the Code applies (a disregarded entity), even if the owner of the disregarded entity is an individual or a decedent's estate. A partner or related person that is not a disregarded entity is treated as a disregarded entity for purposes of determining net value of the partner or related person.[75]
- A partner that may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation [a §1.752-2(b)(1) payment obligation] of a person, including the partner, other than an individual or a decedent's estate, must provide information to the partnership as to that person's net value that is appropriately allocable to the partnership's liabilities on a timely basis.[76]

Example 1: E and F form a limited partnership. E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000 in cash to the partnership. E and F are both business entities [as defined in §301.7701-2(a)]. The partnership agreement allocates losses 20 percent to E and 80 percent to F until F's capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for $25,000 using its $10,000 cash and a $15,000 recourse loan from a bank. E's net value, at all times exceeds the $15,000 loan amount, but F guarantees payment of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership (including causing E to make any contributions required of a general partner under state law). In a constructive liquidation, the $15,000 liability becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	E	F
Initial contribution	$2,000	$8,000
Loss on hypothetical sale	-17,000	-8,000
	-$15,000	0

[74] Prop. Regs. §1.752-2(b)(3)(iii)(A).
[75] Prop. Regs. §1.752-2(b)(3)(iii)(B).
[76] Prop. Regs. §1.752-2(b)(3)(iii)(C).

E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of $15,000. E has net value to satisfy its payment obligation as of the allocation date. Because E has net value to the extent of its obligation, it is assumed that F would not have to satisfy F's guarantee. The $15,000 mortgage is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is $15,000, and F's share is zero.

Example 2: (i) A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other. A's and B's guarantees satisfy the A through E requirements.

(ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee satisfies the F requirement. Therefore, A's payment obligation is recognized. The amount of A's economic risk of loss is $300. However, because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee does not satisfy the F requirement and B's payment obligation is not recognized. Therefore, B bears no economic risk of loss for ABC's liability. As a result, $300 of the liability is allocated to A and the remaining $700 liability is allocated to A, B, and C under §1.752-3.

Example 3: (i) The facts are the same as in **Example 2**, except that, in addition, C agrees to indemnify A up to $50 that A pays with respect to its guarantee, and agrees to indemnify B fully with respect to its guarantee. C's indemnity satisfies the A through E requirements and paragraph (iii) above.

(ii) The determination of whether C's indemnity satisfies the G requirement is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee satisfies the G requirement. The amount of C's economic risk of loss for its indemnity of A's guarantee is $50.

(iii) Because C's indemnity of A's guarantee satisfies the G requirement, it is treated as modifying A's guarantee such that A is treated as liable for $250 only to the extent any amount beyond $50 of the partnership liability is not satisfied. Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and, as a result, A's guarantee is not recognized because it fails the F requirement. Therefore, A bears no economic risk of loss for ABC's liability.

(iv) Because B's obligation is not recognized, C's indemnity of B's guarantee does not satisfy the G requirement, and C's payment obligation to B is not recognized. Therefore, C bears no economic risk of loss for its indemnity of B's guarantee. As a result, $50 of the liability is allocated to C and the remaining $950 liability is allocated to A, B, and C under §1.752-3.

Example 4: (i) A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of 25 percent of each dollar of the $1,000 liability that is not recovered by Bank. A's guarantee satisfies the A through E requirements and paragraph (iii) above.

(ii) If $250 of the $1,000 partnership liability is not recovered by Bank, A is only obligated to pay $62.50 ($250 x .25) pursuant to the terms of the guarantee. Because

A is not obligated to pay up to the full amount of its payment obligation ($250) to the extent that $250 is not recovered by Bank, A's guarantee does not satisfy the requirement, and A's payment obligation is not recognized. As a result, the ABC liability is allocated to A, B, and C under §1.752-3.

Final regs. were issued regarding §1.752-2 in October 2019, adopting the temporary regs. with some changes primarily affecting deficit restoration orders and assumption of liability.[77]

Bottom-dollar payment obligations are not recognized as payment obligations in deciding whether debt is recourse to a partner. Bottom-dollar payment obligations exist when a partner guarantees to repay a portion of the partnership's debt in the event that a creditor is unable to recover the full portion of the debt from the partnership. The guarantor / partner is only required to repay the guaranteed amount in the event that the creditor collects ***less*** than the guaranteed minimum amount.

In the past, this has been a tax-planning technique to increase a partner's basis in the partnership and defer gain recognition. Final regs. require a partnership to disclose bottom-dollar payment obligations with respect to partnership liabilities on Form 8275, *Disclosure Statement* in the year the bottom-dollar payment obligation is undertaken or modified. Final regs. apply to liabilities and payment obligations occurring on or after October 5, 2016, unless such liabilities or payment obligations were pursuant to a written binding contract effective before that date.

Example: ***Bottom-Dollar Guarantee***

Bill and Jessica are partners in ABC partnership. Out of the partnership's $100,000 of debt, Jessica guarantees $20,000. Assume the partnership pays $10,000 and defaults on the remaining $90,000 balance. Since Jessica made a bottom-dollar guarantee, she is obligated to pay $10,000, the difference between the bottom-dollar guarantee of $20,000 and the $10,000 recovered from the partnership.

Using the same facts as above, assume the partnership pays $25,000 and defaults on the remaining $75,000 balance. Since the bottom-dollar amount of $20,000 was collected, Jessica is not required to pay *any* of the remaining debt; however, her basis in her partnership interest increases by $20,000 as she bears the economic risk of loss for this amount.

As previously mentioned, final regs. provide that a "bottom dollar payment obligation" is disregarded when determining whether a partner bears the economic risk of loss.

An alternative to the bottom-dollar guarantee is the vertical-slice guarantee. A partner can increase his or her basis in the partnership without guaranteeing the entire partnership liability.

Example: ***Vertical-Slice Guarantee***

Bill and Jessica are partners in ABC partnership. Out of the partnership's $100,000 of debt, Jessica guarantees 10% in a vertical-slice guarantee. Assume the partnership pays $10,000 and defaults on the remaining $90,000 balance. Since Jessica made a vertical slice guarantee, she is obligated to pay $9,000, 10% of the remaining $90,000 balance in default.

It is important to note that vertical-slice agreements should not violate anti-abuse rules in §752. The final regulations prohibit:

---

[77] Treas. Regs. §1.752-2.

- A payment obligation that does not represent a real economic risk of loss (bottom-dollar guarantee); and
- An agreement that purposefully creates the appearance of a bottom-dollar payment obligation, even if that taxpayer **actually bears** the economic risk of loss.

2. Miscellaneous

An obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized if the facts and circumstances indicate that the partnership liability is part of a plan or arrangement involving the use of tiered partnerships, intermediaries, or similar arrangements to convert a single liability into more than one liability with a principal purpose of circumventing the rules of F and G requirements.[78]

a. In determining the extent to which a partner bears the economic risk of loss for a partnership liability other than a trade payable, an obligation to make a payment [§1.752-2(b)(1) payment obligation] of a business entity that is disregarded as an entity separate from its owner under §§856(i) or 1361(b)(3) or §§301.7701-1 through §§301.7701-3 or a trust to which subpart E, part I, subchapter J, chapter 1 of the Code applies (disregarded entity) is taken into account only to the extent of the net value of the disregarded entity as of the allocation date that is allocated to the partnership liability as determined under the rules of this paragraph.[79]

b. The fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law (including the disregarded entity's enforceable rights to contributions from its owner, and the fair market value of an interest in any partnership, but excluding the disregarded entity's direct or indirect interest in the partnership for which the net value is being determined and the net fair market value of property pledged to secure a liability of the partnership);[80] less all obligations of the disregarded entity that do not constitute §1.752-2(b)(1) payment obligations of the disregarded entity.

3. Partner's share of nonrecourse liabilities

The regulations under §1.752-3 with respect to nonrecourse liabilities are proposed to apply to **liabilities incurred or assumed** by a partnership on or after the date these regulations are published as final regulations in the Federal Register. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are in accordance with the partners' liquidation value percentages. A partner's liquidation value percentage, which is determined upon the formation of a partnership and redetermined upon any event described in §1.704-1(b)(2)(iv)(f)(5), irrespective of whether the capital accounts of the partners are adjusted under §1.704-1(b)(2)(iv)(f), is the **ratio** (expressed as a percentage) **of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership**. Any change in the partners' shares of partnership liabilities as a result of an event described in §1.704-1(b)(2)(iv)(f)(5)[81] is taken into account in determining the tax

---

78 Prop. Regs. §1.752-2(j)(4).

79 Prop. Regs. §1.752-2(k)(1).

80 Prop. Regs. §1.752-2(k)(2)(i)(A).

81 The adjustments to capital account are made principally for a substantial non-tax business purpose—(i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or (ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or (iii) In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner

consequences of the event that gave rise to such change. The liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after the formation of the partnership or the occurrence of an event described in §1.704-1(b)(2)(iv)(f)(5), as the case may be, the partnership sold all of its assets for cash equal to the fair market value of such assets [taking into account §7701(g)], satisfied all of its liabilities (other than those assumed by the partnership), paid an unrelated third party to assume all of its liabilities assumed in a fully taxable transaction, and then liquidated.[82]

Example: (i) X and Y each contribute $100 to a limited liability company classified as a partnership for U.S. tax purposes (XY) in exchange for equal interests in XY. XY's organizing agreement provides that it will maintain members' capital accounts in accordance with §704 and the regulations thereunder and will make liquidating distributions in accordance with positive capital account balances. XY has a calendar year taxable year. On the same day, XY borrows $50 from a person unrelated to either X or Y. The liability is a nonrecourse liability. XY purchases Land A for $50 and Land B for $200. The partners agree to allocate excess nonrecourse liabilities in accordance with the partners' liquidation value percentages as defined above.

(ii) The liquidation value percentage for each of partners X and Y is 50 percent [(each partner's liquidation value immediately after the formation of $100) divided by (XY's aggregate liquidation value immediately after the formation of $200)]. Therefore, X and Y each has a $25 share of the $50 liability and each is treated as contributing $25 to XY.

(iii) On September 1, 2022, XY owns the following assets: (1) Land A with a fair market value of $40 and an adjusted tax basis of $50; (2) Land B with a fair market value of $800 and an adjusted tax basis of $200; and (3) Land C with a fair market value of $400 and an adjusted tax basis of $390. The outstanding principal on the partnership liability is $40. Thus, X and Y each own an interest in XY with a fair market value of $600 and an adjusted tax basis of $320. The partners continue to agree to allocate excess nonrecourse liabilities in accordance with the partners' liquidation value percentages as defined above. On September 1, 2022, XY distributes Land C to X. Assume XY has no items of income, gain, loss, deduction, or credit in its taxable year ending December 31, 2022.

(iv) The distribution of Land C to X is an event described in §1.704-1(b)(2)(iv)(f)(5) and, thus, X's liquidation value percentage must be redetermined as of September 1, 2022, irrespective of whether the capital accounts of the partners of XY are adjusted under §1.704-1(b)(2)(iv)(f). X's liquidation value percentage is 25 percent [(X's liquidation value immediately after the distribution of $200) divided by (XY's aggregate liquidation value immediately after the distribution of $800)]. Accordingly, X's share of the $40 liability is reduced from $20 to $10 on September 1, 2022, while Y's share of the liability is increased from $20 to $30. Thus, X is treated as receiving a distribution of $10 from XY, and Y is treated as contributing $10 to XY. Because the distribution of $10 to X does not exceed X's $320 adjusted basis in its interest in XY, X recognizes no gain. X's basis in Land C is $310.

---

capacity or in anticipation of being a partner, or (iv) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or (v) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

82 Prop. Regs. §1.752-3(a)(3).

E. Determining a general partner's self-employment tax

The IRS issued Chief Counsel Advice on February 28, 2020, describing the procedure to determine a general partner's self-employment tax. Specifically, the Chief Counsel Advice addresses whether the basis loss limitation under §704(d) and the at-risk loss limitation under §465 apply to determining a general partner's net earnings from self-employment ("NESE").[83] NESE is the gross income derived by an individual from any trade or business carried on by the individual, less allowable deductions attributable to such trade or business, plus the individual's distributive share of income or loss under §701(a)(8) from any trade or business carried on by a partnership of which the individual is a member, subject to certain rules under §1402. Losses that partners incur from partnership activities are limited for general income tax purposes. First, basis loss limitation under §704(d) applies. Next, the at-risk loss limitation under §465 applies. Last, the passive loss activity limitation applies under §469.

In the provided example, disregarded LLC elects to be treated as a partnership for federal tax purposes. The LLC has three members, Member A, Member B, and Member C, who are all general partners. During tax year 2022, the LLC had a current year NOL, and all three members received guaranteed payments:

- Member A reduced his guaranteed payment by his individual share of the partnership's losses without applying the basis loss limitation under §704(d).
- Member B reduced his guaranteed payment by his individual share of the partnership's losses without applying the at-risk loss limitation under §465.
- Member C had sufficient basis and at-risk amounts to apply his share of the partnership loss against his guaranteed payment. Member C materially participated in the LLC and was not limited by any loss limitation.

The Chief Counsel Advice specifically states that any loss limitation rule that applies for determining a partner's general tax liability also applies in determining a partner's self-employment tax liability, unless a Code regulation provides otherwise. If any individual's share of loss from a partnership is disallowed under a basis loss limitation rule, such as §704(d) or §465, the loss should not be taken into account when determining the individual's NESE, and subsequently the individual's self-employment tax liability.

Applying this reasoning, Member A's share of LLC's losses are disallowed for both calculation of self-employment tax and general income tax liability, because Member A did not have sufficient basis under §704(d). Likewise, Member B's share of LLC's losses are disallowed for both calculation of self-employment tax and general income tax liability, because Member B did not attain a sufficient at-risk amount under §465. Member C had sufficient basis and at-risk amounts and was not limited by any loss limitation.

F. Special basis adjustments

In the event that a partner acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner, he or she may be able to choose a special basis adjustment for property distributed by the partnership under §732(d). This code section applies to situations in which a partnership does not have a §754 election in effect and a partner who would have a positive §743(b) adjustment if the partnership had a §754 election in effect receives a current or liquidating distribution of property from the partnership. In this case, the adjusted partnership basis of the property distributed to the transferee partner is treated as the adjusted partnership basis the property would have if the adjustment in §743(b) were in effect.

---

[83] Chief Counsel Advice 202009024 (February 28, 2020).

To make a §732(d) special adjustment, both of the following conditions must apply:

- The partner must have received the distribution within two years after acquiring the partnership interest; and
- The partnership must not have chosen the §754 optional adjustment to basis when the partner acquired the partnership interest.

If a partner chooses the §732(d) special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the §754 optional adjustment to basis. The basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the §754 optional adjustment.

To make the §732(d) election, the partner must include it with his or her tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice does not have to be made for the distribution year, it must be made with the tax return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax. The partner making the §732(d) special basis adjustment must attach a statement to his or her tax return to adjust the basis of property received in a distribution. The statement must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated.

Example: Tim purchased a 25% interest in Partnership A for $20,000 cash.

At the time of the purchase, Partnership A owned inventory having a basis to the partnership of $12,000 and a fair market value of $16,000.

$4,000 of the $20,000 that Tim paid is attributable to his share of inventory, with a basis to the partnership of $3,000. This is due to the fact that 25% of the $16,000 FMV is $4,000, and 25% of the basis of $12,000 is $3,000.

Within 2 years after acquiring interest in Partnership A, Tim withdrew from the partnership and for his entire interest received cash of $1,500, inventory with a basis to the partnership of $3,000, and other property with a basis of $6,000.

The value of the inventory received was 25% of the value of all partnership inventory. It does not matter whether the inventory Tim received was on hand when he acquired his interest in the partnership.

Since Partnership A did not make the §754 election or the §743(b) optional adjustment to basis, Tim elected to adjust the basis of the inventory he received under §732(d).

Tim’s share of Partnership A’s basis for the inventory is increased by $1,000 (25% of the $4,000 difference between the $16,000 FMV of the inventory and its $12,000 basis to the partnership at the time Tim acquired his interest).

This §732(d) adjustment applies only for purposes of determining Tim’s new basis in the inventory and not for purposes of partnership gain or loss on disposition.

The total to be allocated among the properties Tim received in the distribution is $18,500 ($20,000 basis of Tim’s interest - $1,500 cash Tim received).

Tim's basis in the inventory items is $4,000 ($3,000 partnership basis + $1,000 §732(d) adjustment).

The remaining $14,500 is allocated to Tim's new basis for the other property he received.

Sometimes, it is mandatory for a partner to make a §732(d) adjustment. The §732(d) special adjustment to basis must be made for a distribution of property (whether or not within 2 years after the partnership interest was acquired) if all the following conditions existed when the partner received the partnership interest:

- The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership;
- If there had been a liquidation of the partner's interest immediately after it was acquired, an allocation of the basis of that interest under the general rules would have decreased the basis of property that could not be depreciated, depleted, or amortized and increased the basis of property that could be: and
- The optional §743(b) basis adjustment, if §754 had been elected by the partnership, would have changed the partner's basis for the property actually distributed.

Section 732(d) applies to situations in which a partnership does not have a §754 election in effect and a partner who would have had a positive §743(b) adjustment if the partnership had a §754 election in effect receives a current or liquidating distribution of property from the partnership. When §732(d) applies, the adjusted partnership basis of the property distributed to the transferee partner is treated as the adjusted partnership basis the property would have if the adjustment in §743(b) were in effect following a §754 election. Generally, if a partner chooses to make a §732(d) special basis adjustment and notifies the partnership or if the partnership makes a distribution for which the §732(d) special basis adjustment is mandatory, the partnership must provide a statement to the partner that provides information necessary for the partner to calculate the special basis adjustment.

Recent Developments -- Business

Recent Developments -- Business

Learning objectives

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

- Better understand the business provisions of TCJA;
- Understand select state tax issues;
- Describe recent developments concerning trust fund penalties; and
- Describe the recent developments affecting passive activities.

I. Recent court cases of interest

A. *CIC Services vs. IRS*

1. Background

The IRS requires that both taxpayers and material advisors provide information regarding reportable transactions, which are transactions that have a potential for tax avoidance or evasion.

In November 2016, the IRS issued Notice 2016-66, classifying micro-captive transactions as “transactions of interest” due to the fact that they have potential for tax avoidance or evasion. Micro-captive transactions are generally insurance agreements between a parent company (“Insured”) and an insurer under its control (“Captive”).

In Notice 2016-66, the IRS noted what was considered a micro-captive transaction of interest. There were different types of micro-captive scenarios described in Notice 2016-66, including:

- Captive Enters into Contract with Insured; and
- Insured and Captive Use an Intermediary Company.

When the Captive enters into a contract with the Insured, the Captive and the Insured treat the contract as an insurance contract for federal income tax purposes, with the Captive providing coverage for the Insured. Pursuant to the contract, the Insured makes payments to the Captive and treats them as insurance premiums that it deducts as an ordinary and necessary business expense under §162. Similarly, the Captive treats the payments received as premiums for insurance coverage. The micro-captive transaction is structured so that the Captive has no more than $2,200,000 ($1,200,000 for taxable years beginning before January 1, 2017) in net premiums written (or, if greater, direct premiums written) for each taxable year in which the transaction is in effect.

When the Insured and Captive use an Intermediary Company, the Captive may indirectly enter into a micro-captive contract with the Insured by reinsuring the risks that the Insured initially insured with an intermediary, and the parties treat this as an insurance contract. Then, the intermediary enters into a reinsurance contract with the Captive to reinsure risks under the contract between the Insured and the intermediary. The Insured, Captive, and intermediary treat the micro-captive contract as an insurance contract for federal income tax purposes, with the Insured claiming a deduction for the insurance premiums paid under §162. The Captive excludes the premium income from its taxable income by electing under §831(b) to be taxed only on its investment income. The Captive uses the premium for

purposes other than administering and paying claims under the contract, and these purposes usually provide some kind of benefit to the Insured.

Essentially, when the Insured deducts premium payments as a business expense and the Captive excludes up to $2.2 million in premiums from taxable income, the monetary amounts escape taxation. The IRS believes that some micro-captive transactions are shams in which the Insured and Captive entered into the contract merely to escape tax liability. Notice 2016-66 stated that certain micro-captive agreements are reportable transactions and required taxpayers and material advisors associated with the agreement to describe the micro-captive transaction in sufficient detail in order for the IRS to gain understanding regarding its tax structure. If a taxpayer or material advisor did not comply with Notice 2016-66, they could face both significant monetary penalties as well as criminal penalties under §7203, including up to one year of prison time.

2. CIC Services vs. IRS – Facts, issues, and analysis

CIC Services ("CIC"), the petitioner, is a material advisor to taxpayers participating in micro-captive transactions. CIC challenged the IRS regarding the lawfulness of Notice 2016-66 prior to receiving any reporting violation.

CIC argued that the IRS violated the Administrative Procedure Act ("APA"), because it issued Notice 2016-66 without the standard notice-and-comment procedures. The APA generally requires U.S. agencies to file notice regarding a proposed regulation in the Federal Register and solicit comments and feedback. CIC argued that Notice 2016-66 was "arbitrary and capricious" under the APA because it imposed new reporting requirements without proven need. CIC urged the court to enjoin enforcement of Notice 2016-66 and declare it unlawful.

The IRS originally asked the court to dismiss the case based on the Anti-Injunction Act, as it would interfere with the IRS's ability to assess tax penalties against material advisors who failed to comply with the requirements outlined in Notice 2016-66. The Anti-Injunction Act provides that "No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person." (26 U. S. C. §7421(a)). The IRS argued that CIC never received an assessment or penalty, and therefore, the suit was prohibited. Per the Anti-Injunction Act, taxpayers generally may challenge a federal tax only after he or she pays it by suing for a refund. Both the U.S. District Court for the Eastern District of Tennessee and the U.S. Court of Appeals for the Sixth Circuit sided with the IRS and held that CIC could not bring suit against the IRS due to the Anti-Injunction Act. After, the case was heard by the Supreme Court.

3. CIC Services vs. IRS – Conclusion

The Supreme Court Justices unanimously found that CIC's suit challenging Notice 2016-66 was not barred by the Anti-Injunction Act. The Justices concluded that CIC brought suit against the IRS to ask the court to invalidate Notice 2016-66, not the tax penalty that could arise from failure to comply with such notice.

The Supreme Court Justices provided three key conclusions to support their reasoning:

- Notice 2016-66 imposed affirmative reporting obligations which would result in costs separate from the statutory tax penalty;
- The reporting requirements and the statutory tax penalty of Notice 2016-66 were several steps removed from each other; and
- Violation of the Notice is punishable not only by a tax, but by separate criminal penalties.

The Supreme Court Justices unanimously agreed to reverse the judgement reached in both the U.S. District Court for the Eastern District of Tennessee and the U.S. Court of Appeals for the Sixth Circuit. However, the case was remanded back to the United States District Court for the Eastern District of Tennessee for a decision on the merits.

Justice Sotomayor issued a concurring opinion but noted that the conclusion reached by the court may have been different had CIC been a taxpayer rather than a tax advisor. Justice Kavanaugh also wrote a concurring opinion, citing what remains and does not remain of *Alexander v. "Americans United" Inc*. and *Bob Jones Univ. v. Simon*. In both of these cases, the court adopted a "bright-line rule" to determine whether a pre-enforcement suit is barred by the Anti-Injunction Act. Under this rule, if the pre-enforcement suit would "necessarily preclude" the assessment or collection of a tax, that suit would be barred by the Anti-Injunction Act, and the taxpayer would have to bring a refund suit after paying the tax. The Supreme Court effectively created a new exception to *Americans United* and *Bob Jones*, specifically for pre-enforcement suits that challenge regulations backed by tax penalties.

On March 21, 2022, the U.S. District Court for the Eastern District of Tennessee found Notice 2016-66 unlawful, ruling that Notice 2016-66 should have been given the proper notice-and-comment procedure and that the IRS acted arbitrarily and capriciously in issuing Notice 2016-66. It is important to note that this decision only applies to taxpayers in the Sixth Circuit Court (Tennessee, Kentucky, Ohio, and Michigan), and that other federal courts may come to different conclusions. Additionally, the Court required the IRS to return all information and documents it collected pursuant to Notice 2016-66 for all taxpayers and material advisors, not just CIC. It is possible that the IRS could publish a new notice regarding micro-captive transactions after the proper notice-and-comment procedure. Despite this ruling, the IRS will likely continue to pursue micro-captive arrangements, as it has had much past success in doing so.

II. Legislative updates

The Tax Cuts and Jobs Act of 2017 was signed into law by former President Trump on December 22, 2017. In this chapter, we will cover the provisions of TCJA that apply to pass-through entities as well other types of business entities. Although the focus of this course is taxation of pass-through entities, business owners and tax practitioners need to understand the changes to the corporate tax structure and decide whether or not a business's current entity form is still the best option. Although the TCJA provisions have been in effect for a few tax seasons, it is important for all tax practitioners to remain aware of key provisions and updated guidance.

A. Reduction in the corporate tax rate

1. Corporations have a flat tax of 21 percent

The corporate tax rate is set at a flat 21 percent for years after 2017. An important observation is that the lawmakers did not lower the top bracket to 21 percent, but instead replaced the entire corporate tax rate structure with a flat corporate income tax rate of 21 percent. They did this by replacing the old I.R.C. §§11(b)(1) and (2) with a very simply worded new I.R.C. §11(b). Old §11(b)(1) contained the corporate tax brackets, while old §11(b)(2) contained the provisions for taxing personal service corporations at the highest corporate tax rate.

a. The purpose of lowering the income tax rate for corporations is to make American companies more competitive in the global market. Our companies have been paying a

higher tax rate than most of their competitors have been paying in their jurisdictions. The lower rate combined with changes in the international tax scheme should help our companies to compete, and hopefully create expansion and jobs in the U.S.

b. Note that the 15-percent bracket disappears after 2017. This means that C corporations with low taxable income will have a *tax increase*.

Example 1: Small Corporation is a C Corporation owned by Doug Small. Doug has significant income from other sources and takes a generous salary from Small Corporation. However, Doug leaves some income in Small Corporation and takes out the amount as a dividend.

Prior to the TCJA, Small Corporation has taxable income of $50,000. Under the old rates, tax would be $7,500. With the new 21-percent rate, the tax is $10,500, a $3,000 increase.

In 2021, Small Corporation has taxable income of $75,000. Under the old rates, tax would be $13,750 ((50,000 x .15) + (25,000 x .25)). With the new 21-percent rate, the tax is $15,750, a $2000 increase.

The break-even point rounds to $90,385. At that income level, under the old rates, tax would have been (50,000 x .15) + (25,000 x .25) + (15,385 x .34) = $18,981. Under the new rate, the tax will be $90,385 x .21 = $18,981.

c. The elimination of the 15-percent bracket also makes the income-splitting strategy of leaving $50,000 income in a small C corporation to take advantage of the lower bracket and taking the after-tax amount as a qualified dividend less advantageous.

Example 2: Same as **Example 1**, with taxable income of $50,000. You are helping Doug to decide whether or not to leave the $50,000 in or bonus it out. We are disregarding state income tax. We are assuming that Doug is in the new 37-percent tax bracket and pays 23.8 percent on qualified dividends.

	Tax Rate	***Without Bonus***	***Tax Rate***	***With Bonus***
Income before bonus and tax		***$50,000***		***$50,000***
Bonus		***0***		***(49,285)***
Employer Medicare			***1.45%***	***(715)***
Taxable Income		***$50,000***		***$0***
Corporate tax	***21%***	***$10,500***		***$0***
Dividend		***$39,500***		***$0***
Wages (net of employer Medicare)				***$49,285***
Individual tax	***23.8%***	***$ 9,401***	***37%***	***$18,232***
Employee Medicare			***2.35%***	***$ 1,158***
Total Tax (corporate and individual		***$19,901***		***$20,115***
Cash in owner's pocket		***$30,099***		***$29,855***

Doug will benefit by only $214 using this strategy with the new tax rate structure.

Questions to ponder:

1. Are smaller C corporation clients aware of the elimination of the 15-percent tax bracket?
2. Should small C corporations consider an entity change?
3. What factors should be considered in deciding between the C corporation, S corporation, partnership, or sole proprietorship entity structure for a small business?
4. How have the factors changed with the passage of TCJA?

2. No special treatment of personal service corporations

As stated in the previous paragraph, TCJA repeals §11(b)(2), and thus eliminates the requirement for personal service corporations to pay tax at the highest corporate rate. Professionals operating in C corporations will be taxed at 21 percent, putting all domestic C corporations on equal footing.

Practice Note:

As discussed earlier, proposed legislation would likely replace the current flat 21% corporate income tax rate with a graduated rate structure and reintroduce special rules for personal service corporations.

B. Modifications to the dividends received deduction

The dividends received deduction percentages are modified by TCJA for tax years after 2017. Congress decided that the tax advantage given to corporations through the dividends received deduction was adequate under old law. TCJA reduces the exclusion amounts for dividends received so that the corporate taxpayers still have approximately the same tax break for the dividends under TCJA as they did pre-TCJA. The dividends received deduction amounts under TCJA are:[1]

Ownership Type and %	Exclusion % pre-TCJA	Exclusion % TCJA
Affiliated group*	100%	100%
Domestic, ≥20% ownership*	80%	65%
Domestic, <20% ownership	70%	50%
Foreign, ≥10% ownership**	0%	100%

* The affiliated group rules can be complex. The general rule is that ownership of 80 percent or more will qualify, especially if the company qualifies to file a consolidated return. The 100-percent exclusion is available for "qualifying dividends."[2] The 65-percent exclusion is generally thought of as applying for ownership greater than or equal to 20 percent but less than 80 percent; however, you can have an ownership over 80 percent that does not qualify for the 100-percent exclusion but may still qualify for the 65-percent exclusion.

** The exclusion rules for foreign dividends are also very complex. The general rule under old law is the foreign source dividends do not qualify. However, certain U.S. sourced income of foreign subsidiaries could qualify. Also, there were rules based on the U.S. taxation of the subsidiary that allowed some foreign dividends to be treated as domestic dividends and minimize double taxation. The new rule allows a 100-percent exclusion for a 10-percent-or-greater owned foreign subsidiary.[3] The intent of the new rule is to allow corporations to bring money into the United States with no tax burden to encourage

[1] I.R.C. §243(a)(1), §243(c)(1).
[2] I.R.C. §243(a)(3), §243(b).
[3] I.R.C. §245A.

domestic investment. The new provision goes hand-in-hand with the new territorial tax scheme.

C. Alternative minimum tax (AMT)

1. Repeal of the corporate alternative minimum tax

The corporate alternative minimum tax is repealed for tax years beginning after December 31, 2017. Unfortunately, the individual AMT remains with us with increased limits and phaseouts. The exemptions and phaseouts are indexed for inflation after 2018. The individual AMT exemption is increased to $109,400 for 2018, $111,700 for 2019, $113,400 for 2020, $114,600 for 2021, and $118,100 for 2022 for married-filing-joint status and surviving spouses. The exemption for unmarried individuals other than surviving spouses is $70,300 for 2018, $71,700 for 2019, $72,900 for 2020, $73,600 for 2021, and $75,900 for 2022. The exemption for married-filing-separately status is $54,700 for 2018, $55,850 for 2019, $56,700 for 2020, $57,300 for 2021, and $59,050. The phaseout of the exemption for 2018 starts at $1,000,000 for married-filing-joint and surviving spouse and $500,000 for single, head-of-household, and married-filing-separately. The phaseout thresholds for 2019 are, $1,020,600 for married-filing-joint and surviving spouse and $510,300 for single, head-of-household, and married-filing-separately. The phase-out thresholds for 2020 are, $1,036,800 for married-filing-joint and surviving spouse and $518,400 for single, head-of-household, and married-filing-separately. The phaseout thresholds for 2021 are, $1,047,200 for married-filing-joint and surviving spouse and $523,600 for single, head-of-household, and married-filing-separately. The phaseout thresholds for 2022 are, $1,079,800 for married-filing-joint and surviving spouse and $539,900 for single, head-of-household, and married-filing-separately.[4] Although these amounts are for individuals and not C corporations, the numbers are relative to business tax planning for pass-through entities.

2. Corporate AMT credits from prior years

The TCJA repealed the corporate alternative minimum tax effective for taxable years beginning after December 31, 2017 and allows the AMT credit to offset the regular tax liability for any taxable year. The AMT credit was made refundable for any taxable year beginning after 2017 and before 2021 in an amount equal to 50 percent of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. For tax years beginning in 2021, the AMT credit was made refundable in an amount equal to 100% of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. As such, any AMT credit was set to be refunded to the taxpayer by 2021.

The CARES Act accelerated the ability of companies to recover such AMT credits established by the TCJA.[5] Taxpayers could have elected to receive a 50% AMT credit for 2018 and a 100% credit for 2019 or could have claimed the entire AMT credit for 2018. Luckily, the CARES Act recognizes the need for taxpayers to swiftly take advantage of the refundable AMT credits and allows the taxpayer to file for a tentative refund for the refundable AMT credit for the 2018 tax year. The taxpayer did not need to file an amended return if the tentative refund application was filed by December 31, 2020. The IRS will review such application within 90 days.

---

4 Rev. Proc. 2018-57, Rev. Proc. 2019-44, Rev. Proc. 2020-45, Rev. Proc. 2021-45.

5 CARES Act §2305.

If the taxpayer wished to forgo filing a 2018 amended return (or filing for a refund relating to 2018), it could have claimed its outstanding AMT credits on its 2019 return. Any AMT credits not claimed in either 2018 or 2019 were forfeited.

Planning point:

Tax practitioners should review each C corporation client to reevaluate their entity choice. Due to changes in the C corporation tax structure, notably the elimination of the 15-percent tax bracket, many smaller C corporations should make the election to be taxed under Subchapter S to avoid double taxation and take advantage of the new §199A pass-through deduction.

D. Depreciation changes

1. Bonus depreciation

The TCJA enlarged several components of depreciation that can substantially increase a taxpayer's depreciation expense. Since there is no dollar limit to bonus depreciation, a tax loss could potentially be created. Bonus depreciation percentage increased from 50 percent to 100 percent for property acquired and placed in service after September 27, 2017, and before 2023. The TCJA also provides for a gradual decrease in the bonus depreciation percentage, allowing an 80-percent deduction for property placed in service in 2023, a 60-percent deduction for property placed in service in 2024, a 40-percent deduction for property placed in service in 2025, and a 20-percent deduction for property placed in service in 2026. As a reminder, 2022 is the last year for 100% bonus depreciation.

The TCJA also changed the definition of property eligible for bonus depreciation (qualified property) by including used property and removed the requirement that the original use of qualified property must commence with the taxpayer. Thus, the TCJA allows bonus depreciation for new and used property.

2. Qualified improvement property (QIP)

Perhaps as the result of a drafting mistake, the TCJA statutory language did not reflect the intended 15-year recovery period for qualified improvement property (QIP). This meant that QIP was not eligible for bonus depreciation because it was not 15-year property.

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

The CARES Act reclassifies QIP as 15-year property (20-year ADS life) and allows businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life. The CARES Act QIP fix is effective for property placed in service after December 31, 2017. [6]

Most types of personal property also qualify for bonus depreciation (machinery and equipment, computer software/hardware, and furniture and fixtures). The 100% write-off is permitted without proration even if qualifying assets are acquired and in service only for one day in 2021.

3. Guidance on bonus depreciation elections

Rev. Proc. 2019-33 (July 30, 2019) enables taxpayers to make or revoke bonus depreciation elections under §168(k)(5) – plants, (7) – election not to deduct additional first-year depreciation, or (10) – election

[6] CARES Act §2307.

to deduct 50%, not 100% additional first-year depreciation; for property acquired after 9/27/17 and placed in service during a tax year including 9/28/17.

Since proposed regs for 168(k) were issued in August 2018, some taxpayers had already filed returns for the tax year including 9/28/17. Similarly, taxpayers with extended due dates in September and October of 2018 for a tax year including 9/28/17 had little time to digest the proposed regs. Relief including late elections therefore seemed fair. The late elections or revoked elections will be treated as a change in accounting method with a §481(a) adjustment.

On September 13, 2019, the IRS and Department of Treasury issued final and proposed regulations regarding the first-year bonus depreciation deduction under §168(k).[7] The September 2019 final regulations adopted the August 2018 proposed regulations with few modifications. Neither the final nor proposed regulations fixed the "retail glitch" for Qualified Improvement Property (QIP) in the TCJA.

On September 21, 2020, the IRS and Department of Treasury released the second round of final regulations, making further clarifications to §168(k) bonus depreciation under the TCJA.[8] In addition, the final regulations address the CARES Act QIP fix. The CARES Act reclassified QIP as 15-year property (20-year ADS life) and allowed businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life but stated that the improvement must be "made by the taxpayer." The final regulations clarify that an improvement is made by a taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself, or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract. On the other hand, the final regulations state that if a taxpayer acquired nonresidential property in a taxable transaction and such property had an existing improvement placed in service by the seller of such property, the existing improvement is not considered to have been made by the taxpayer. Property with preexisting QIP transferred in a nonrecognition event does not qualify for bonus depreciation, since the basis of the QIP is dependent upon the transferor's basis.

The September 2019 proposed regulations outlined a Partnership Lookthrough rule to determine the extent to which a partner is deemed to have a depreciable interest in property held by a partnership. The Partnership Lookthrough Rule provides that a person is treated as having a depreciable interest in a portion of property prior to the person's acquisition of the property if the person was a partner in a partnership at any time the partnership owned the property. The September 2020 final regulations withdrew the Partnership Lookthrough Rule outlined in the September 2019 proposed regulations, stating that it would place a significant administrative burden on both taxpayers and the IRS. The IRS further clarified that a partner will not be treated as having a depreciable interest in partnership property solely by virtue of being a partner in the partnership.

Lastly, the final regulations provide additional guidance regarding the five-year lookback period for determining whether property was previously owned by the taxpayer. The September 2019 proposed regulations created a safe harbor that required taxpayers to look back five years to determine whether property was eligible as used property. Without a safe harbor, taxpayers would have had to trace an asset's history back to when it was first placed in service by any taxpayer to determine prior ownership interests. The September 2020 final regulations confirm that only the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property are taken into account when utilizing

---

[7] T.D. 9874, REG-106808-19.
[8] T.D. 9916.

the five-year safe harbor. The “placed-in-service year” is the current calendar year in which the property is placed in service by the taxpayer. The September 2020 final regulations clarify that the five calendar years immediately prior to the current calendar year in which the property is placed in service by the taxpayer, as well as the portion of that calendar year up to the placed-in-service date of the property, should be considered in determining whether the taxpayer previously had a depreciable interest.

The September 2020 final regulations allow taxpayers to choose between applying the proposed regs or the final regs for property acquired between September 27, 2017, and the effective date for the final rule.

In November 2020, the IRS released Rev Proc. 2020-50, providing transition relief for taxpayers with property placed in service after September 27, 2017, and before January 1, 2021. Rev Proc. 2020-50 allows taxpayers who filed tax returns and relied on prior bonus depreciation guidance to change to either the 2020 final regulations, 2019 final regulations, or both the 2019 final and proposed regulations. Taxpayers could choose to apply the 2020 final regulations, 2019 final regulations, or both the 2019 final and proposed regulations by either:

- Filing an amended return or AAR by December 31, 2021, but no later than the applicable time period of limitations on assessment; or,
- Attaching a Form 3115 to an originally filed return for the first or second taxable year succeeding the taxable year in which the affected assets were placed in service (or, if later, on a tax return that is timely filed on or after Nov. 6, 2020, and on or after Dec. 31, 2021)
    - The change constitutes an impermissible to permissible method change (DCN 246) if it is the first time that the taxpayer makes the change with respect to an asset. This change is made with a §481(a) adjustment.
    - The change constitutes a permissible to permissible method change (DCN 247) if it is the second time that the taxpayer makes the change with respect to an asset. This change is made on a cut-off basis, so no §481(a) adjustment is required.

Taxpayers who chose to apply the 2020 final regulations must apply the rules to all subsequent tax years.

Due to the CARES Act QIP modification, the IRS issued Rev. Proc. 2020-25 on April 17, 2020 addressing the process for taxpayers to change the depreciation method of QIP placed in service in the 2018, 2019, or 2020 tax year. Taxpayers could have either filed an amended return, Form 3115 or an AAR to change the depreciation method of QIP placed in service in the 2018, 2019, or 2020 tax year, unless:

- Such QIP property was placed in service after December 31, 2017 and such taxpayer made a late election, or withdrew an election, under §163(j)(7). Changes to depreciation for such QIP should be made in accordance with Rev. Proc. 2020-22 (see above).
- Such taxpayer deducted cost or other basis of such QIP as an expense.

Form 3115 is to be filed in the subsequent year the property is placed in service, meaning the §481(a) adjustment will be taken in the subsequent year. The guidance modifies Rev. Proc. 2019-43 to add two new automatic method changes. DCN 244 is an automatic method change to change the depreciation method of QIP placed in service after December 31, 2017. DCN 245 is an automatic method change to make a late election out of bonus depreciation or to revoke an election out of bonus depreciation.

Rev. Proc. 2020-25 also permitted taxpayers to either make or revoke a §168 election for property placed in service by the taxpayer in its 2018, 2019, or 2020 taxable year by either filing an amended federal return or Form 1065 for the property placed in service on or before October 15, 2021 (but no later than the period of limitations on assessment) or filing Form 3115 with the taxpayer's original timely filed federal return or Form 1065 for the taxpayer's first or second tax year succeeding the tax year in which the property was placed in service.

4. Passenger vehicles and SUVs

The TCJA changed the depreciation limitations for passenger vehicles placed in service after December 31, 2017. If the taxpayer doesn't claim bonus depreciation, the greatest allowable depreciation deduction in 2022 is:

- $11,200 for the first year;
- $18,000 for the second year;
- $10,800 for the third year; and
- $6,460 for each later taxable year in the recovery period.[9]

An additional $8,000 is available in Year 1 when the taxpayer claims 100% bonus depreciation. Thus, $19,200 is the maximum first-year depreciation on a passenger auto.

But an SUV or truck weighing more than 6,000 pounds is not subject to these limits. Only §179 limits the first-year depreciation of an SUV to $27,000 in tax year 2022. The bonus depreciation is the applicable §168 percentage of 100%. As such, an $80,000 Escalade can be fully deducted in the year it's placed in service, yet the vehicle under 6,000 pounds is limited to first-year depreciation of $19,200.

5. Section 179 expense

a. Increased amounts: The Act increases the annual limitation to $1,000,000, with the phaseout starting at $2,500,000 for tax years beginning after December 31, 2017.[10] The amounts are indexed for inflation for years after 2018.[11] For 2022 the amounts are indexed to $1,080,000 for the annual limit and $2,700,000 for the phaseout threshold.

b. The Act expands qualified property to include the following improvements to nonresidential real property referred to as qualified real property:[12]
   - Roofs;
   - Heating, ventilation, and air conditioning systems;
   - Fire protection and alarm systems;
   - Security systems; and
   - Any other building improvements that aren't elevators or escalators, don't enlarge the building, and are not attributable to internal structural framework (QIP).

   Qualified real property is not included as §179 property unless the taxpayer elects to do so. The election is made by listing the property on the Form 4562. For a more detailed treatment of bonus depreciation and §179 expensing rules, please consider our webinar, *New Depreciation Rules for Bonus and Section 179 Expensing* (DRBE) at surgentcpe.com.

---

9 Rev. Proc. 2022-17.
10 I.R.C. §179(b).
11 I.R.C. §179(b)(6).
12 I.R.C. §179(f).

c. SUV limitation: The $25,000 SUV limitation and the overall §179 amounts will be adjusted for inflation using the C-CPI-U for years after 2018. The $25,000 SUV limit was not adjusted for inflation in prior years. The amount for 2022 indexed for inflation is $27,000.

d. Section 179 for rental activities: Section 179 expensing is available for qualified property used to furnish lodging or in connection with furnishing lodging for tax years after December 31, 2017.[13]

e. One hundred percent bonus depreciation is a tremendous benefaction for lots of taxpayers. It looks great on paper, but after *TCJA* it could create large, limited NOLs that will not offset future income. As such, §179 is not dead. With §179, excess deductions over income can be carried over on Form 4562, thus avoiding the new NOL limits.

E. Accounting method reform

The Act contains provisions that greatly expand the applicability of the cash method of accounting. The combination of the following changes results in a surprising, sweeping change to accounting methods that most taxpayers and practitioners did not see coming. The changes are effective for tax years after December 31, 2017.

1. The C corporation gross receipts limit for cash method is increased

Under old law, a C corporation was required to use the accrual method of accounting unless its average annual gross receipts for the prior three years did not exceed $5,000,000. As a result of the TCJA, the $5,000,000 is raised to $25,000,000.[14] The threshold has been indexed for inflation for 2022 to $27,000,000.[15] The threshold amount is found in §448(c).

2. The inventory requirement is modified

Prior to the TCJA, all businesses had to use the accrual method if they had inventory, unless their average annual gross receipts for the prior three years did not exceed $1,000,000. Exceptions existed for taxpayers who were not C corporations with certain industry codes. Under the new law, businesses with average annual gross receipts that do not exceed §448(c) threshold amount of $27 million can account for inventory in one of two ways:[16]

a. Account for inventory as nonincidental materials and supplies. Under this method, inventory cannot be expensed until the later of when it is used, consumed, or (if a cash method taxpayer) paid for.

b. A taxpayer may elect to account for inventory using the same method used to account for inventory on the company's financial statement, or absent an applicable financial statement for the tax year, the books and records that are prepared in accordance with its accounting procedures. This is an election, not a requirement.

3. Unicap rules of §263A are modified

A company with gross receipts that do not exceed the §448(c) threshold is exempt from the Unicap rules of §263A.[17] This is more than an inventory adjustment for mixed services. Section 263A(i) excludes taxpayers meeting the exception from ALL provisions of 263A.

---

13 I.R.C. §179(d)(1).
14 I.R.C. §448(c)(1).
15 Rev. Proc. 2021-45.
16 I.R.C. §471(c)(1).
17 I.R.C. §263A(i).

Most people are discussing this in terms of the 263A adjustment. The 263A adjustment to include mixed service expenses in inventory is a small part of 263A. Section 263A is the code section that requires a manufacturing firm to capitalize direct and indirect costs in WIP and finished goods. Without 263A, we are left with very broad instructions under IRC 263 and the related regulations.

Section 263A(f)(1) is the reason we capitalize construction period interest. Capitalization shouldn't be required for a small business under the new law.

Section 263(a) requires the capitalization of all costs to acquire an asset or improve an asset. Section 263(a) applies to real and tangible property. Reg. §1.263(a)-2 pertains to amounts paid to acquire or produce tangible property. Produce is defined as "construct, build, install, manufacture, develop, create, raise, or grow". This definition is intended to have the same meaning as the definition used for purposes of §263A(g)(1) and §1.263A-2(a)(1)(i), except that improvements are excluded from the definition in paragraph (b)(4) and are separately defined and addressed in §1.263(a)-3.

The code and regs. under 263(a) define costs as the materials and the work performed prior to the building being placed in service. An example in the regs, Example 4: "Acquisition or production cost. D purchases and produces jigs, dies, molds, and patterns for use in the manufacture of D's products. Assume that each of these items is a unit of property as determined under §1.263(a)-3(e) and is not a material and supply under §1.162-3(c)(1). D is required to capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the jigs, dies, molds, and patterns." They define cost to acquire or produce in 1.263(a)-2(d) as "Amounts paid to acquire or produce a unit of real or personal property including the invoice price, transaction costs as determined under paragraph (f) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under §168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale."

Another interesting example in 1.263(a)-2(d) is Example 8: "Production of building; coordination with §263A. J constructs a building. J must capitalize under paragraph (d)(1) of this section the amount paid to construct the building. See section 263A for the costs required to be capitalized to the real property produced by J." In this example they defer to 263A. For a small business 263A does not apply.

It appears that the IRS can interpret 263(a) as requiring the capitalization of direct costs. However, 263A governs indirect costs. With this interpretation, a manufacturer would capitalize direct costs, but not indirect costs, such as manufacturing overhead, indirect labor, etc.

4. Long-term contracts

The $10,000,000 gross receipts test for small contractors to be exempt from the requirement to use the percentage-of-completion method to account for contracts is raised to $25,000,000 for 2018 for contracts entered into after December 31, 2017. The threshold, as with the thresholds under §§263A and 471, is tied to §448(c). Therefore, the threshold for taxable years beginning in 2022 is $27,000,000. The exception applies if the contracts are for the construction or improvement of real property if the contract: (1) is expected to be completed within two years of commencement of the contract; and (2) is performed by a taxpayer that meets the $27,000,000 gross receipts test.[18] A contractor with contracts qualifying for the exception may use the completed contract method for those contracts.

---

[18] I.R.C. §460(e)(1)(B).

5. Rev. Proc. 2018-40

A taxpayer who switched from cash to accrual previously and was required to take the §481(a) adjustment over four years may continue to take into account any remaining adjustment over the relevant number of years even with the switch to the cash method in current year.

A transition rule is provided for taxpayers who filed a Form 3115 for a non-automatic change, pending on August 3, 2018. The taxpayer may choose to make the change under the automatic change procedures if otherwise eligible.

6. Rev. Procs. 2018-60 and 2019-37

Rev. Proc. 2018-60, issued November 29, 2018, waives the requirement to file Form 3115 for certain taxpayers if there is no §481(a) adjustment or the $27M gross receipts test is met. However, filing Form 3115 affords audit protection for the change in method. Rev. Proc. 2019-37 (September 6, 2019) allows automatic consent by IRS to a change in the method of accounting to comply with rules on advance payments, the all events test, and the related inclusion under §451(b) with an applicable financial statement.

7. Small Business Accounting Regs

On July 29, 2020, the IRS issued proposed regulations, implementing the TCJA changes to small business tax accounting and removing references to pre-TCJA gross receipts tests.[19]

The TCJA allows taxpayers meeting the gross receipts test to use simplified inventory methods by either treating inventory as non-incidental materials and supplies or conforming to the inventory method used in the entity's applicable financial statements. The proposed regulations allow taxpayers to determine the amount of materials and supplies using the specific identification method, FIFO method, or average cost method. The proposed regulations specifically exclude the LIFO and lower-of-cost-or-market (LCM) methods. Materials and supplies may be deducted at the later of: (i) when the taxpayer pays or incurs the cost; or (ii) when the taxpayer provides goods to customers, also referred to as "used and consumed."

The proposed rules state that noncorporate taxpayers must aggregate their gross receipts from all trades and businesses, excluding personal receipts such as wages, Social Security benefits, disability benefits, and personal injury awards and settlements. Personal receipts do not include guaranteed payments. Additionally, the proposed regs state that the cash method of accounting may not apply to a tax shelter, including any "syndicate," narrowly defined as a partnership or other entity (other than a C corporation) with more than 35 percent of the losses during the taxable year allocated to limited partners or limited entrepreneurs. Taxpayers may elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate for purposes of §448(d)(3) for the current taxable year. Such election applies to all subsequent tax years and for all purposes for which status as a tax shelter under §448(d)(3) is relevant. Under the proposed regs, taxpayers meeting the syndicate definition will be required to use the accrual method of accounting.

On January 5, 2021, the IRS issued final regulations permitting a taxpayer to make an annual election to use allocations made in the immediately preceding tax year instead of the current tax year to determine whether a taxpayer is a syndicate for the current tax year.[20] This election must be made on a timely filed original return (including extensions) for the tax year for which it is made. Unlike prior proposed

---

[19] REG-132766-18.
[20] TD 9942.

regulations that required taxpayers to make a permanent election to apply to all subsequent tax years, the election under the final regs is valid only for the tax year for which it is made and cannot be revoked. [21]

Additionally, in the final regulations, the IRS eliminated the proposed regulation's five-year restriction on automatic method changes. Under the proposed regs, a taxpayer would need to obtain written consent from the Commissioner before changing to the cash method of accounting if such taxpayer had previously changed its method of accounting from the cash method during any of the five tax years ending with the current tax year. The IRS eliminated these proposed regulations in the final regulations, citing that the restriction could have been burdensome for small business taxpayers who were required to change from the cash method as a result of not meeting the gross receipts test in a taxable year but becoming eligible to use the cash method of accounting in the subsequent taxable year.

8. Six-year §481(a) adjustment and S corporation distributions

An eligible terminated S corporation that needs to change from the overall cash method to an overall accrual method of accounting for its first year as a C corporation (due to revocation of S corporation election) must use a six-year adjustment period per §481(a).

An eligible terminated S corporation ("ETSC") is any C corporation that:

- Is an S corporation the day before the enactment of the TCJA;
- During the two-year period beginning on the date of such enactment revokes its S corporation election under §1362(a); and
- All of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.

On November 4, 2019, proposed regs (REG-131071-18) were issued that provided rules relating to the definition of an eligible terminated S corporation and distributions after the post-termination transition period (PTTP).

Special rules apply to distributions made to distributions made by an ETSC following its conversion to a C corporation. After the S corporation election terminates, there is a resulting "post-termination transition period," beginning on the day of the corporation's last tax year as an S corporation and generally ending on the later of either one year after the date of termination or the due date for filing the return for the last year as an S corporation (including extensions). During the PTTP, if the C corporation distributes cash, it is treated as coming from AAA. This is usually more favorable to shareholders, as distributions from C corporations are generally treated as taxable dividends coming from E&P, whereas distributions from AAA are tax-free to the extent of the shareholder's basis. Section 1371(f), newly enacted as part of the TCJA, provides that if an ETSC makes a qualified distribution after the PTTP period ends, such distribution is attributed to the AAA and accumulated E&P in the same ratio as the amount of the corporation's AAA bears to the amount of the corporation's E&P. This extended period is known as the ETSC period.

On September 15, 2020, the Department of Treasury and IRS issued final regulations (TD 9914), largely adopting the proposed regulations and providing additional clarification. The final regulations address compliance with the revocation requirement and shareholder-identity requirement. If a revocation was made before the 16th day of the third month of an S corporation's tax year, it is generally effective

---

[21] Proposed Regs. (REG-132766-18), Final Regs. TD 9942.

retroactively on the first day of the tax year. If the revocation was made after the 15th day of the third month of the corporation's tax year, it is generally effective on the first day of the corporation's next tax year. Lastly, in the case that the revocation had a retroactive effective date, the revocation is treated as having been on the effective date of the revocation. The final regs. clarify that §7503 applies to the requirement to make the revocation within two years, meaning that if a revocation was made on December 23, 2019, it will be treated as made during the two-year period.

The final regs apply to tax years beginning after October 20, 2020 (the date the final regs were published in the Federal Register).

Questions to ponder:

Think about your clients. Many of them are now eligible to switch to the cash method of accounting and to account for inventory as nonincidental materials and supplies. But should they? What factors should be considered?

F. Limitation on the deduction of business interest

Per TCJA rules, a taxpayer's deduction for net business interest is limited by §163(j) to the sum of business interest income, 30% of adjusted taxable income, and floor plan financing interest. 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 CARES Act temporarily amended the TCJA §163(j) limitation by retroactively increasing the limitation on the deductibility of interest expense from 30% to 50% for tax years beginning after December 31, 2018 and before January 1, 2021.[22] In the event that the business did not have taxable income in 2020, such business could have elected to use its 2019 adjusted taxable income in computing its 2020 limitation.

The CARES Act provided a special carve out rule for partnerships so that a partnership could not use the increased limitation in 2019, thereby deferring any potential benefits from the 50% threshold to 2020. Any interest disallowed at the partner level is treated under current applicable law. The 50% suspended interest will free up in 2020 and become fully deductible. The remaining 50% will be suspended until the partnership allocates interest income or excess taxable income to the partner. Partnerships can elect, at the partnership level, to use 2019 adjusted taxable income in computing their 2020 limitation. Partnerships can also elect out of §163(j) at the partnership level.

Businesses with average gross receipts over the previous three-year period of $27M or less are exempt (annual determination which may change year to year), but this exception does not apply to tax shelters.

Tax shelters for these purposes are defined much more broadly than you'd expect and counter to their conventional meaning. Among the entities qualifying as a tax shelter is a partnership or S-corp if it allocates more than 35% of its losses for the year to limited partners or limited entrepreneurs.

As such, the relevant tax shelter definition really revolves around operating losses allocated to partners/shareholders not active in the business. Therefore, many entities not conventionally thought of as a tax shelter will be unable to utilize the $27M exception.

[22] CARES Act §2306(a).

In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level. Intercompany obligations are disregarded. For taxpayers other than corporations or partnerships, §163(j)(3) provides that the gross receipts test is determined for purposes of §163(j) as if the taxpayer were a corporation or partnership.

Switching gears, taxpayers engaged in a real property business may elect to not have the business interest limitation apply. The election is irrevocable. There are additional costs.

Electing real property businesses must use the Alternative Depreciation System (ADS) for nonresidential real property, and residential rental property.

Nonresidential real property will have a depreciable life of 40 years, instead of the regular 39 with the interest limitation.

Residential rental property will have a depreciable life of 30 years, instead of the regular 27.5.

Qualified Improvement Property will have a depreciable life of 20 years, instead of the regular 15 years.

The ADS cost of the election is not a huge consideration, particularly for just a one-year differential with nonresidential real estate, but...

> Is it true that assets would not be eligible for bonus depreciation? Yes; however, it is important to note that Rev. Proc. 2020-22, issued pursuant to the CARES Act, allows electing real property trades or businesses or farming businesses to withdraw an election made under §163(j)(7) for the 2018 and 2019 tax years. Such businesses previously were required to use the ADS to calculate depreciation for QIP. Businesses who withdraw their §163(j)(7) election become retroactively eligible for bonus depreciation for QIP in 2018 or 2019 tax years and must consider such changes when preparing their amended return.

Circling back to definitions, interest is any amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement or that is treated as interest under the Internal Revenue Code or the regulations thereunder. Interest also includes certain amounts that are closely related to interest such as substitute interest payments, debt issuance costs, loan commitment fees, and certain amounts that affect the economic cost of funds or yield of a borrowing or an interest-generating asset. Under an anti-abuse rule, certain amounts predominantly associated with the time value of money also may be treated as interest expense for purposes of §163(j). The proposed regulations (106089-18) provide additional information on what constitutes interest under §163(j).

Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of §163(d).

Adjusted taxable income means the taxable income of the taxpayer computed without regard to:

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- Any business interest or business interest expense;
- The amount of any net operating loss deduction;

- The deduction under §199A; or
- For tax years 2018 through 2021, deductions allowable for depreciation, amortization, or depletion.

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.

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable years. Interest deductions may be carried forward indefinitely, subject to certain restrictions applicable to pass-through entities, C corps, and consolidated groups.

But what happens with a carried forward amount if the entity later elects out? This determination could be a tremendous planning point for your clients.

G. Miscellaneous Provisions

1. Net operating loss carryforwards

Per the TCJA, generally, NOLs arising in tax years ending after December 31, 2017 could no longer be carried back to prior years and could be carried forward indefinitely.[23] Carryforwards of NOLs arising in tax years beginning after December 31, 2017 were limited to 80 percent of taxable income.[24] Carryforwards were applied on a first-in-first-out basis.

The CARES Act amended the TCJA and provided that NOLs arising in a tax year beginning after December 31, 2017 and before January 1, 2021 could be carried back to each of the five tax years preceding the tax year of such loss. It also temporarily suspended the taxable income limitation in the TCJA to allow an NOL to fully offset income. For taxable years beginning before 2021, taxpayers are eligible for an NOL deduction equal to 100% of taxable income. For taxable years beginning after 2021, the taxpayer will be eligible for a 100% deduction of NOLs arising in tax years prior to 2018 and will be eligible for a deduction limited to 80% of modified taxable income for NOLs arising in tax years after 2017.

---

[23] I.R.C. §172(b).
[24] I.R.C. §172(a).

2. Fringe benefits

TCJA makes the following changes to fringe benefits:

a. The deduction and exclusion for moving expenses are repealed except for members of the Armed Forces, their spouses, and their dependents on active duty that move pursuant to a military order and incident to a permanent change of station. The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026. However, Notice 2018-75 makes it clear that 2018 employer-provided reimbursements to an employee for qualified moving expenses incurred in a prior year are not subject to income or employment taxes. Also tax-free is the situation where employer pays a moving company in 2018 for services provided to the employee prior to 2018.

b. The deduction and exclusion for the reimbursement of bicycle commuting expense is suspended for tax years beginning after December 31, 2017, and before January 1, 2026.

c. TCJA makes changes to the exclusion from income of employee achievement awards. Subject to value limitations, an employee achievement award of tangible personal property is excluded from the employee's income. TCJA provides that tangible personal property shall not include:
   - Cash or cash equivalents;
   - Gift cards, gift coupons, or gift certificates except for rights to receive tangible personal property from a limited array;
   - Fire protection systems;
   - Vacations, meals, lodging, or theater or sporting events tickets; and
   - Stocks, bonds, securities, or similar items.

3. Other repealed business provisions

The following provisions are repealed for tax years beginning after December 31, 2017.

a. The deduction for lobbying expenses for local governments is repealed.

b. The domestic productions activity deduction (§199) is repealed.

c. The rollover of publicly traded securities gains into specialized small business stock (§1044) is repealed.

d. The deduction for expenses for providing qualified transportation fringe benefits is repealed, but the amounts are still excluded from the employee's income.

e. The deduction for entertainment expenses is repealed.

4. Limits on entertainment, etc., expenses

As stated above, TCJA repeals deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer's trade or business and provides that no deduction is allowed for:

- An activity considered entertainment, amusement, or recreation;
- Membership dues for any club organized for business, pleasure, recreation, or other social purposes; or
- A facility or portion of a facility used in connection with any of the above.

Notice 2018-76, issued October 3, 2018, clarifies taxpayers generally may continue to deduct 50% of the food and beverage expenses associated with operating their trade or business.

a. The Notice provides that taxpayers may deduct 50% of an otherwise allowable business meal expense if:

(i) The expense is an ordinary and necessary expense under §162(a) paid or incurred during the taxable year in carrying on any trade or business;
(ii) The expense is not lavish or extravagant under the circumstances;
(iii) The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
(iv) The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
(v) In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

The IRS and Treasury issued proposed regulations (REG-100814-19) on February 21, 2020, largely substantiating previous guidance in Notice 2018-76. Proposed regs §1.274-12(b)(2) define food or beverage expenses as the cost of the food or beverages, including any delivery fees, tips, and sales tax.

In the proposed regulations, a potential business contact follows the definition of a "business associate" in §1.274-2(b)(2)(iii), as a "person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective." Since employees are considered "business associates," it applies to events where an employer provides meals to both employees and non-employee business associates.

As mentioned above, the law allows food and beverages purchased or consumed during entertainment events as a 50% expense if the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The proposed regs clarify in §1.274-11(b)(1)(ii) that unless expenses for food or beverages provided at or during an entertainment comply with the aforementioned rule, the taxpayer may not allocate the expenses; the entire amount is a nondeductible entertainment expenditure.

Additionally, Prop Reg §1.274-11(b)(1)(iii) outlines an "objective test" to determine whether an activity is of a type generally considered to be entertainment. The regs specifically mention that a taxpayer's trade or business will be considered in applying the test. For example, attending a theatrical performance is generally considered "entertainment;" however, if a professional theatre critic attended a theatrical performance in a professional capacity, it would not be considered entertainment.

On October 2, 2020 the IRS published final regulations (T.D. 9925) regarding meals and entertainment expenses, confirming proposed regs issued in February 2020 with minor modifications. The final regulations clarify that for purposes of §274(a), the term "entertainment" does not include food or beverages unless they're provided at or during an entertainment activity and the costs are not separately stated.

Example 1: Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B.

The baseball game is entertainment as defined in Reg. §1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the Code §274(a)(1) disallowance.

Therefore, A may deduct 50% of the expenses associated with the hot dogs and drinks purchased at the game.

Example 2: Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages.

The basketball game is entertainment as defined in Reg. §1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the Code §274(a)(1) disallowance.

Therefore, C may not deduct any of the expenses associated with the basketball game.

Example 3: Assume the same facts as in *Example 2*, except that the invoice for the basketball game tickets separately states the cost of the food and beverages.

As in *Example 2*, the basketball game is entertainment as defined in Reg. §1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the Code §274(a)(1) disallowance.

Therefore, C may deduct 50% of the expenses associated with the food and beverages provided at the game.

Note: As discussed previously, the CAA 2021 temporarily increases the 50% limit on the business meals deduction to 100%. 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.

A Re-Cap of the Post-TCJA allowable Meals Deduction is as follows:

	Pre-TCJA	Post-TCJA
Meals with clients, customers…business is discussed during, directly before, or after, the meal	50% Deduction	50% Deduction
Meals with clients, customers, without business being discussed	No Deduction	No Deduction
Meal Reimbursements for Employees travelling for business purpose	50% Deduction	50% Deduction
Meals with clients, customers…business is discussed during, directly before, or after, the meal, while attending a sporting event or associated with entertainment	50% Deduction	50% Deduction *
Meals provided to employees included in their compensation	Deductible via Wages	Deductible via Wages
Meals to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer	100% Deduction	50% Deduction
Traditionally paid recreational expenses for employees (Christmas parties, etc.)	100% Deduction	100% Deduction

***** In the case of food and beverages provided during or at an entertainment activity, where the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

H. Like-kind exchanges -- Review and updates

1. Introduction

With the real estate market continuing to have increased activity, many taxpayers are seeking assistance from tax professionals on how to manage tax liabilities amidst the buying and selling. As a result, like-kind exchanges under §1031 have increasingly become topics of conversation and are being seen with greater frequency among taxpayers newer to real estate investing. Like-kind exchanges represent the most common type of nontaxable exchange, the exchange of property for the same kind of property. These exchanges allow taxpayers to effectively defer taxes on gain realized with the sale of a property under the right conditions. To be qualified as a like-kind exchange, the property traded and the property received must be both qualifying property and like-kind property. Like-kind exchange treatment applies only to exchanges of real property held for use in a trade or business or for investment, rather than real property held primarily for sale. Note: Under the TCJA, beginning after December 31, 2017, Section 1031 now applies only to exchanges of real property and no longer to exchanges of personal or intangible property.)

The following types of owners of investment and business property are eligible for the IRC §1031 deferral:

- Individuals;
- General partnerships;.
- Limited partnerships;
- Limited liability companies;
- C corporations;

- S corporations;
- Trusts; and
- Any other taxpaying entity.

"Partially Nontaxable Exchanges" occur when the taxpayer receives money or non-like-kind property or the buyer assumes a liability in a like-kind exchange. These transactions may result in the recognition of some of the realized gain.

Multiple-party transactions – The like-kind exchange rules also apply to property exchanges that involve more than two parties. If a multiple-party transaction meets all the requirements described in this section, any part of these transactions can qualify as a like-kind exchange.

Receipt of title from third party – In a multiple-party transaction, if party A receives property in a like-kind exchange and party B who transfers the property to party A does not give party A the title, but party C does, party A can still treat this transaction as a like-kind exchange if it meets all other requirements.

Basis of property received – For the property acquired in a like-kind exchange, the basis of that property is generally the same as the basis of the property transferred.

Example: Abby exchanges real estate held for investment with an adjusted basis of $37,500 for another real estate held for investment. The FMV of both properties is $75,000. The basis of her new property is the same as the basis of the old one, which was $37,500.

Money paid – If, in addition to giving up like-kind property, the taxpayer pays money in a like-kind exchange, there is no recognized gain or loss. The basis of the property received is the basis of the property traded plus the money paid.

Example: John exchanges real estate held for investment with an adjusted basis of $45,000 for another real estate held for investment, plus $10,000 cash. The basis in the new property is the $45,000 from the original property, plus the $10,000 of additional cash paid, for a $55,000 basis in the new property.

Reporting the exchange – Like-kind exchanges are reported on IRS Form 8824, *Like-Kind Exchanges*. Taxpayers who engage in like-kind exchanges are required to file this form in order to report each exchange. The following is a summary of the rules and other attributes concerning this form:

- IRC §1031 requires the filing of this form, even when no gain is recognized.
- The form must be filed in the year that the taxpayer transferred property to another party that qualifies as a like-kind exchange.
- If the like-kind exchange involves a related party, this form is required to be filed for the two years following the year of the related party exchange.
- Any recognized gain or loss reported on this form would then flow to Form 1040, Schedule D, for investment property or Form 4797 for property held in a trade or business.

Exchange expenses – Revenue Ruling 72-456 provides limited guidance regarding allowable exchange expenses, the payment of which does not create boot (i.e., potential recognized income). The following is

a list that tax professionals have generally accepted as allowable exchange expenses paid out of closing costs for the purpose of reducing both realized gain and recognized gain. In other words, these expenses are not considered boot:

- Commissions and broker fees;
- Exchange or accommodator fees;
- Escrow, processing, and statement fees;
- Appraisal fees (for the benefit of the party making the exchange, not the lender);
- Finder fees;
- Tax service fees;
- Inspection and testing fees;
- Notary and recording fees;
- Title insurance premiums (for the benefit of the party making the exchange, not the lender);
- Transfer taxes; and
- Legal, accounting, and other professional fees related to the transaction.

However, the following is a list of closing costs that are not considered by tax professionals to be allowable exchange expenses and may be treated as boot:

- Rent prorations;
- Security deposits;
- Utilities;
- Property taxes;
- Property insurance;
- Association dues;
- Repairs and maintenance;
- Termite certification;
- Credits to buyers for nonrecurring closing costs or repairs; and
- Loan acquisition fees (including points, mortgage insurance, application fees, lender's life insurance, assumption fees, appraisal fees, and hazardous waste removal and property inspections required by the lender).

2. Qualifying property

In a like-kind exchange, both the property received, and the property traded must be only real property held for investment or productive use in a trade or business. Exceptions apply if property is disposed of prior to January 1, 2018, or to property received in an exchange before January 1, 2018. Examples of qualifying property include buildings, land, and rental property.

For exchanges of the following property, the like-kind exchange rules **do not** apply:

- Real property used for personal purposes, such as a person's home;
- Real property held primarily for sale to customers; and
- Any personal or intangible property.

However, a taxpayer may have a nontaxable exchange under other rules.

An exchange of a business's assets for a similar business's assets cannot be treated as an exchange of one property for another property. An analysis of each asset involved in the exchange is necessary.

Practice note:

> As previously noted, a personal residence is not eligible for like-kind treatment. However, if a portion of the house was used in a trade or business or for investment, that portion would be eligible for like-kind exchange treatment under IRC §1031.

3. Like-kind property

Like-kind properties have the same character or nature, even if they differ in grade or quality, and include the exchange of real estate for real estate. For instance, the exchange of land improved with a store building for land improved with an apartment house, improved real property for unimproved real property, or rural real property for city real property all are considered a like-kind exchange.

Conversely, an exchange of real property for personal property does not qualify as a like-kind exchange. For example, an exchange of a store building for a piece of machinery does not qualify.

An exchange of farm property for city property, or unimproved property for improved property, is a like-kind exchange.

The exchange of real estate that is owned for a real estate lease on property that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify for like-kind exchange. The exchange of a life estate (this gives the holder the power to retain ownership until death) expected to last less than 30 years for a remainder interest, which gives the holder the right to take ownership when the life estate has ended, is not a like-kind exchange.

However, if the nature or character of the two property interests is the same, an exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange.

Foreign real property exchanges – Real property not located in a state or the District of Columbia is foreign real property. Under the like-kind exchange rules, real property located within the United States and real property located outside the United States are not considered like-kind properties. If a taxpayer exchanges foreign real property for real property located in the United States, a gain or loss on the transaction is recognized.

For the replacement of condemned real property, the foreign real property exchange rule does not apply. Under the rules for replacing condemned property to postpone reporting gain on the condemnation, foreign and U.S. real property can still be considered like-kind property.

4. Partially nontaxable exchanges

If a taxpayer receives money or non-like-kind property in an exchange of like-kind property on which they realize a gain, they may have a partially nontaxable exchange. They are taxed on the gain realized, but only to the extent of the money and the FMV of the non-like-kind property they received. If the taxpayer realizes a loss on the exchange, it is not recognized.

To determine the taxable gain, the taxpayer must first determine the FMV of any non-like-kind property received and add it to any money they may have received. Then they reduce that total by any exchange expenses (closing costs) that they paid. This is the maximum gain that can be taxed. Next, they calculate the gain on the whole exchange as discussed earlier. The taxpayer's recognized (taxable) gain is the lesser of these two amounts. Figure the recognized gain and the realized gain as follows:

(1) Gain realized = Amount realized – Adjusted basis of the property given up

(2) Maximum taxable gain = Money received + FMV of non-like-kind property received – Exchange expenses

(3) Amount realized = FMV of like-kind property received + Cash received + FMV of non-like-kind property received – Exchange expenses

Example: Robert exchanges real estate held for investment with an adjusted basis of $12,000 for other real estate he wants to hold for investment. The FMV of the real estate he receives is $15,000. He also receives $1,500 in cash and pays $750 in exchange expenses.

FMV of like-kind property received	$ 15,000
Cash received	1,500
Total received	$ 16,500
Minus: Exchange expenses	(750)
Amount realized	$ 15,750
Minus: Adjusted basis of prop. Robert trans.	(12,000)
Realized gain	**$ 3,750**

Cash received	1,500
Minus: Exchange expenses	(750)
Recognized gain	**$ 750**

Although the total gain realized on the transaction is $3,750, the recognized (taxable) gain is only $750.

If the other party to a nontaxable exchange assumes any liabilities, the taxpayer is to treat the assumption of liabilities as if cash was received in the amount of the liability (§357(d); Reg. §1031(d)-2).

Maximum taxable gain = Money received + Liability relieved + FMV of non-like-kind property received – Exchange expenses

Example: Robert exchanges real estate held for investment with an adjusted basis of $12,000 for other real estate he wants to hold for investment. The FMV of the real estate he receives is $15,000. He also receives $1,500 in cash and pays $750 in exchange expenses. The property that Robert gave up is subject to a $4,500 mortgage for which he was personally liable. The other party in the trade has agreed to pay off the mortgage. Figure the gain realized as follows.

FMV of like-kind property received	$ 15,000
Cash received	1,500
Mortgage assumed by other party	4,500
Total received	$ 21,000
Minus: Exchange expenses	(750)
Amount realized	$ 20,250
Minus: Adjusted basis of prop. Robert trans.	(12,000)
Realized gain	$ 8,250

The recognized gain is: $1,500 + $4,500 – $750 = $5,250. The realized gain is taxed only up to $5,250.

If in addition to like-kind property, a property owner gives up non-like-kind property, they must recognize gain or loss on the non-like-kind property given up. Gain or loss is the difference between the FMV of the non-like-kind property and its adjusted basis.

Gain or loss on non-like-kind property = FMV of the non-like-kind property – Adjusted basis of the non-like-kind property

Example: Andy exchanges stock and real estate held for investment for real estate he also intends to hold for investment. The stock he transfers has a FMV of $2,000 and an adjusted basis of $4,500. The real estate he exchanges has a FMV of $19,000 and an adjusted basis of $15,000. The real estate received has a FMV of $20,000. Andy does not recognize gain on the exchange of the real estate because it qualifies as a nontaxable exchange. However, he must recognize (report on his return) a $2,500 loss on the stock because it is non-like-kind property.

Basis of property received – In a partially nontaxable exchange, the total basis for all properties (other than money) received is the total adjusted basis of the properties given up, with some necessary adjustments. Illustration below:

Total adjusted basis of the properties given up
+ Additional costs paid
+ Gain recognized on the exchange
– Money received
– Loss recognized on the exchange
= Total basis for all properties received (other than money)

Allocate this basis to the non-like-kind property first, other than money, up to its FMV on the date of the exchange. The remaining amount is the basis of the like-kind property.

The TCJA has restricted like-kind exchanges to real property only. There will not be like-kind exchanges allowed for any other property.

Practitioner Note – Realized Losses:

It should be noted that the receipt of boot does not result in a recognized loss if there is in fact a realized loss, but it does reduce the substituted basis of the property received in the exchange.

5. Time restrictions

There are two major restrictions regarding like-kind exchanges as outlined below:

1. The taxpayer has 45 days from the date they sell the relinquished property (midnight on the 45th day) to identify potential replacement property. This identification must be in writing, signed by the taxpayer, and delivered either to a person involved with the exchange (i.e., the seller of the replacement property) or to a qualified intermediary. As part of identifying the property, the taxpayer is required to describe it. This description typically consists of the property's exact address or an unambiguous description.
2. The replacement property must be received, and the exchange completed, no later than 180 days after the sale of the exchange property or the due date (including extensions) of the income tax return for the tax year in which the relinquished property was sold,

whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit detailed in "1." above.

A few notes concerning these time restrictions:

- If both of the above time limits are not met, then the entire gain will be taxable (i.e., the transaction does not qualify for like-kind exchange treatment).
- These limits cannot be extended for any circumstances or hardship, with the exception of presidentially declared disasters.
- If the seller takes control of cash or other proceeds before the exchange is complete, in most instances this will disqualify the entire transaction from like-kind treatment and make the entire gain immediately taxable.

If the taxpayer desires to identify and acquire multiple properties, the following guidelines must be followed:

- The taxpayer may identify up to three properties of any value with the intent of purchasing at least one;
- The taxpayer may identify more than three properties with an aggregate value that does not exceed 200% of the market value of the relinquished property; or
- The taxpayer may identify more than three properties with an aggregate value exceeding 200% of the relinquished property, knowing that 95% of the market value of all properties identified must be acquired.

6. Qualified intermediaries

A qualified intermediary is an unrelated company that is in the full-time business of facilitating IRC §1031 tax-deferred exchanges. Qualified intermediaries are generally required parties for successful and compliant like-kind exchanges. Qualified intermediaries enter into a contract with the taxpayer whereby the qualified intermediary transfers the relinquished property to the buyer and transfers the replacement property to the taxpayer (seller) pursuant to the exchange agreement. The qualified intermediary holds the proceeds from the sale of the relinquished property in a trust or escrow account to ensure that the taxpayer never has actual or constructive receipt of the sale proceeds (which would invalidate the IRC §1031 transaction). Any person who is related to the taxpayer, or who has had a financial relationship with the taxpayer (with the exception of routine financial services) within the two years prior to the close of escrow, cannot act as a qualified intermediary. Based on this definition, the following persons associated with the taxpayer generally would NOT satisfy the qualified intermediary requirement:

- The taxpayer themself;
- Attorney;
- CPA;
- Real estate agent;
- Investment banker;
- Employee; or
- Any similar type of person.

It should be noted that there have been some recent incidents of a qualified intermediary receiving taxpayer funds and subsequently declaring bankruptcy, resulting in a loss to the taxpayer of all amounts deposited with this entity. Accordingly, taxpayers (working in conjunction with their outside attorney and/or CPA) should be careful in their selection of the qualified intermediary.

III. General business tax issues

A. Form 1099-K Expansion

ARPA amended the de minimis threshold for Form 1099-K, *Payment Card and Third Party Network Transactions,* reporting. Currently, a two-step de minimis standard exists, in which Third Party Settlement Organizations are required to report third party network transactions of a participating payee on Form 1099-K if:

- The amount that would otherwise be reported exceeds $20,000; and
- There were over 200 transactions.

ARPA amends the two-step de minimis standard and instead creates a single standard with a single $600 reporting threshold beginning in 2022. In other words, beginning on January 1, 2022, Third Party Settlement Organizations will be required to file a Form 1099-K for participating payees receiving over $600. This new change mirrors the Form 1099-MISC and Form 1099-NEC reporting requirements for payments of compensation of $600 or more.

For purposes of this change, a reportable payment transaction is any payment card transaction and any third-party network transaction. Transactions meeting the $600 aggregate payment de minimis standard must be reported to all payees who accept payment from a third-party settlement organization. Examples of third-party settlement organizations include PayPal, Square, Venmo, and Stripe.

As a result of the ARPA change, numerous gig workers will receive Form 1099-Ks in 2023. This includes gig workers such as casual Uber or Lyft drivers, Airbnb hosts, sellers on eBay, Etsy, or Poshmark, and other freelancers. Generally, such individuals were always required to report such earnings, but it has now become much more visible, as the IRS also receives a copy of Form 1099-K.

B. DOL – Independent Contractor / Employee Rules

With the expansion of the gig economy, it has become increasingly important for all small businesses to understand and correctly apply the rules related to classifying workers as either employees or independent contractors. Notably, employers are required to withhold income taxes and pay Social Security, Medicare, and unemployment tax on wages paid to employees. Employers are not required to withhold taxes or pay Social Security, Medicare, and unemployment tax on independent contractors.

1. 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.[25]

[25] 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.

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.

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.[26]

In addition, on April 29, 2019[27] 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. 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.[28]

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**

---

26 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.

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

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

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

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. Localities jumping into the game? Practitioners beware

Unlocking a potential slippery slope, three of the largest cities in Texas (Austin, San Antonio and Dallas[29]) 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.

---

[29] 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.

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.

C. Employee vs. independent contractor – Recent 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.

Dynamex established 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 stated the intent of the Legislature to codify the decision in the Dynamex case and clarify its application. The bill provided 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 exempted specified occupations from the application of *Dynamex* and would instead provide that these occupations are governed by *Borello*.[30]
- These exempt occupations included, 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 redefined 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 specified conditions, including that the individual performs work that is outside the usual course of the hiring entity's business.

---

[30] *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.

Because this bill increased 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 stated that specified Labor Code provisions of the bill applied retroactively to existing claims and actions to the maximum extent permitted by law while other provisions applied to work performed on or after January 1, 2020.

The bill provided that its provisions would 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 employee for purposes of these provisions, the bill expanded 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 was 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."**

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. [31] The California Trucking Association currently has a petition for writ of certiorari pending before the U.S. Supreme Court.

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. [32] 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

---

[31] *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.*

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

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 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.[33] 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.

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

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 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." [34]

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.

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.

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

