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Individual Income and Tax Compliance Annual Update

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INDIVIDUAL INCOME AND TAX COMPLIANCE ANNUAL UPDATE

BY CHARLES BOREK, JD, MBA, CPA

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Use of materials

This course manual accompanies all formats in which the course is offered, including self-study text, self-study online, group study, in-firm, and other formats, as applicable. Specific instructions for users of the various formats are included in this section.

CPAs are required to participate in continuing professional education (CPE) to maintain their professional competence and provide quality professional services. CPAs are responsible for complying with all applicable CPE requirements, rules, and regulations of state licensing bodies, other governmental entities, membership associations, and other professional organizations or bodies.

Professional standards for CPE programs are issued jointly by the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA) to provide a framework for the development, presentation, measurement, and reporting of CPE programs. The Statement on Standards for CPE Programs (CPE standards) is available as part of AICPA *Professional Standards*, either in paperback or as an online subscription through the Association's Online Professional Library.

Review questions and exercises for self-study participants

The CPE standards require that self-study programs include review questions/exercises that provide feedback for both correct and incorrect responses. Note that these reviews are provided only as learning aids and do not constitute a final examination.

Requirements for claiming and receiving CPE credit

CPE standards place responsibility on both the individual participant and the program sponsor to maintain a record of attendance at a CPE program. CPAs who participate in only part of a CPE program, should claim CPE credit only for the portion that they attended or completed.

You must document your claims of CPE credit. Examples of acceptable evidence of completion include:

- For group and independent study programs, a certificate or other verification supplied by the CPE program sponsor
- For self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination

When you participate in group study and other live presentations, you will receive a completion certificate from the program sponsor. CPE program sponsors are required to keep documentation on programs for five years, including records of participation.

When you participate in self-study, you must complete the exam within one year of the date of course purchase to receive a certificate indicating satisfactory completion of the CPE program.

- The exam for self-study in print format is located in the "Examination" section at the end of the course manual.

- You can find the course code number for both the self-study exam and the self-study evaluation in the examination's introductory material. You will complete the self-study exam and evaluation online at https://cpegrading.aicpa.org. You must provide the unique serial number printed on the inside front cover of this publication and you must achieve a minimum passing grade of at least 70% to qualify for CPE credit.
    - Upon achieving a passing grade, you will receive a certificate displaying the number of CPE credits earned based on a 50-minute learning segment, in compliance with CPE standards. The grading system provides a completion certificate online, which you may print or save as a PDF. The grading system maintains a transcript of your completed courses.
    - If you do not achieve a passing grade, the online grading system notifies you of this and also provides instructions for retaking the exam. You have three attempts to pass the exam. If you do not pass the exam in three attempts, please contact the Global Engagement Center at 1.888.777.7077 to obtain additional attempts.

Program evaluations

The information accumulated from participant evaluation forms is important in our continual efforts to provide high quality continuing education for the profession. When you participate in group study and other live presentations, please return your evaluation forms prior to departing your program sessions. When you participate in self-study, please complete the course evaluation online. Your comments are very important to us.

Customer service

For help and support, including information on refund claims and complaint resolutions, please call the Global Engagement Center at 1.888.777.7077, or visit the online help page at https://www.aicpa.org/cpe-learning.

Table of Contents

Annual Tax Rates and Inflation Adjustments 1

Hobby Losses 31

Nonbusiness Income and Deductions 47

Charitable Contributions 69

Glossary 93

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Annual Tax Rates and Inflation Adjustments

Learning objectives

- Identify the correct 2022 rate tables applicable to filers.
- Calculate the maximum child tax credit for 2022.
- Indicate the limitations applicable to high deductible health plans for 2022.
- Recognize the 2022 COLA adjustments related to retirement plans.
- Calculate the correct standard mileage rate for different categories of mileage in 2022.

Rates and calculation of tax for 2022

Married individuals filing joint returns and surviving spouses

A return may be filed as "Married Filing Jointly" if any of the following apply: (1) the taxpayer was married at the end of the tax year, even if the taxpayer did not live with his or her spouse at the end of the year; (2) The taxpayer's spouse died during the year, and the taxpayer did not remarry during the year; or (3) the taxpayer was married at the end of the year, and the taxpayer's spouse died during the next year but before the taxpayer filed a return.

A taxpayer can also use the "Married Filing Jointly" rates (by filing as a "Qualifying Widow or Widower") if **all** of the following apply: (1) the taxpayer's spouse died in either of the two years preceding the tax year, and the taxpayer did not remarry before the end of the tax year; (2) the taxpayer has a child or stepchild (but not a foster child) whom the taxpayer can claim as a

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dependent or could claim as a dependent but for the child's income, the child having filed a joint return, or the taxpayer qualifying as someone else's dependent; (3) that child lived in the taxpayer's home for the entire tax year (except for temporary absences); (4) the taxpayer paid over half the cost of keeping up the taxpayer's home; **and** (5) the taxpayer could have filed a joint return for the year the taxpayer's spouse died, even if the taxpayer did not actually do so.

Generally, a married couple cannot file a joint return if either spouse is a nonresident alien at any time during the year. However, if the taxpayer was a nonresident alien or a dual-status alien and married to a U.S. citizen or resident alien at the end of the year, the taxpayer can elect to be treated as a resident alien and file a joint return.

Once you file a joint return, you cannot choose to file separate returns for that year after the due date of the return. For 2022, the rate table for married individuals filing joint returns and surviving spouses is as follows:

If taxable income is:	The tax is:
Not over $20,550	10% of the taxable income
Over $20,550 but not over $83,550	$2,055 plus 12% of the excess over $20,550
Over $83,550 but not over $178,150	$9,615 plus 22% of the excess over $83,550
Over $178,150 but not over $340,100	$30,427 plus 24% of the excess over $178,150
Over $340,100 but not over $431,900	$69,295 plus 32% of the excess over $340,100
Over $431,900 but not over $647,850	$98,671 plus 35% of the excess over $431,900
Over $647,850	$174,253.50 plus 37% of the excess over $647,850

Heads of households

A return may be filed as head of household if the taxpayer meets two criteria. The first is that the taxpayer must be unmarried or considered unmarried for this purpose. A taxpayer is "considered" unmarried for this purpose if **any** of the following apply: (1) the taxpayer is legally separated from their spouse under applicable state law; (2) the taxpayer lived apart from his or her spouse during the last six months of the year and paid at least half the cost of keeping up the taxpayer's home that was the main home of the taxpayer's dependent child, stepchild, or foster child for more than half of the year; **or** (3) the taxpayer is married to a nonresident alien at any time during the year and the election to treat the alien spouse as a resident alien is not made.

The second criteria is that the taxpayer must have paid over half the cost of keeping up a home that was either (1) the main home for the entire tax year of the taxpayer's dependent parent (even if the taxpayer cannot claim the parent as a dependent due to a multiple support agreement), regardless of whether or not the parent actually lived with the taxpayer or (2) a home in which the taxpayer lived and in which a qualifying child also lived for more than half of the year. For 2022, the rate table for married individuals filing as head of household is as follows:

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If taxable income is:	The tax is:
Not over $14,650	10% of the taxable income
Over $14,650 but not over $55,900	$1,465 plus 12% of the excess over $14,650
Over $55,900 but not over $89,050	$6,415 plus 22% of the excess over $55,900
Over $89,050 but not over $170,050	$13,708 plus 24% of the excess over $89,050
Over $170,050 but not over $215,950	$33,148 plus 32% of the excess over $170,050
Over $215,950 but not over $539,900	$47,836 plus 35% of the excess over $215,950
Over $539,900	$161,218.50 plus 37% of the excess over $539,900

Unmarried individuals (other than surviving spouses and heads of households)

An unmarried individual is an individual (1) who has never been married; or (2) who was divorced as of the last day of the tax year; or (3) whose spouse died during a previous tax year and the taxpayer has not remarried (although under some circumstances such a taxpayer may be a Qualifying Widow or Widower). For 2022, the rate table for unmarried individuals is as follows:

If taxable income is:	The tax is:
Not over $10,275	10% of the taxable income
Over $10,275 but not over $41,775	$1,027.50 plus 12% of the excess over $10,275
Over $41,775 but not over $89,075	$4,807.50 plus 22% of the excess over $41,775
Over $89,075 but not over $170,050	$15,213.50 plus 24% of the excess over $89,075
Over $170,050 but not over $215,950	$34,647.50 plus 32% of the excess over $170,050
Over $215,950 but not over $539,900	$49,335.50 plus 35% of the excess over $215,950
Over $539,900	$162,718 plus 37% of the excess over $539,900

Married individuals filing separate returns

Note that if a taxpayer files a return as Married Filing Separate the taxpayer cannot take (1) the student loan interest deduction; (2) the tuition and fees deduction; (3) the education credits; or (4) the earned income credit. The taxpayer is also prohibited from taking the standard deduction if the taxpayer's spouse itemizes deductions. For 2022, the rate table for married individuals filing separate returns is as follows:

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If taxable income is:	The tax is:
Not over $10,275	10% of the taxable income
Over $10,275 but not over $41,775	$1,027.50 plus 12% of the excess over $10,275
Over $41,775 but not over $89,075	$4,807.50 plus 22% of the excess over $41,775
Over $89,075 but not over $170,050	$15,213.50 plus 24% of the excess over $89,075
Over $170,050 but not over $215,950	$34,647.50 plus 32% of the excess over $170,050
Over $215,950 but not over $323,925	$49,335.50 plus 35% of the excess over $215,950
Over $323,925	$87,126.75 plus 37% of the excess over $323,925

There are several ways that the tax brackets described previously may be used in planning. For example, if a taxpayer will recognize income through the conversion of a traditional IRA to a Roth IRA, it may be wise to complete the conversion over two or more years, liquidating the traditional IRA in an amount that will not cause the income to be taxed in the next higher bracket. Because planning generally is focused on the tax liability of the next dollar of income or the tax value of the next dollar of deduction, an awareness of the brackets applicable to the taxpayer is crucial.

Example: Unmarried taxpayer

Sally is an unmarried taxpayer with a consistent taxable income of $100,000 per year. With this taxable income, she will have an income tax liability of $17,835.50 ($15,213.50 + [$100,000 - $89,075] × 24%) in 2022. However, she is considering converting her traditional IRA to a Roth, and this will cause her to recognize an additional $300,000 of taxable income upon conversion. If she converts the entire IRA in 2022, her taxable income will be $400,000, and her 2022 tax liability will be $115,274.50 ($87,126.75 + [$400,000 - $323,925] × 37%). In other words, the conversion will cost her $97,439 in additional federal income tax liability ($115,274.50 - $17,835.50).

If, instead, she converts only an amount of her IRA funds that will cause her to recognize $70,050 of additional taxable income in 2022 (keeping her within the 24% bracket), her 2022 tax liability will be $34,647.50 ($15,213.50 + [$170,050 - $89,075] × 24%), an additional tax liability of only $16,812 for 2022. If she continues to convert the IRA over five years in amounts that keep her in the 24% bracket, she will incur an aggregate total additional tax liability of $72,000 on $300,000 of taxable income from the IRA conversion ($300,000 × 24%), saving her $23,917.50 in federal income taxes as compared to a one-time conversion in 2022 ($95,917.50 - $72,000).

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Estates and trusts

If taxable income is:	The tax is:
Not over $2,750	10% of the taxable income
Over $2,750 but not over $9,850	$275 plus 24% of the excess over $2,750
Over $9,850 but not over $13,450	$1,979 plus 35% of the excess over $9,850
Over $13,450	$3,239 plus 37% of the excess over $13,450

Note that the estates and trusts tax brackets are both fewer in number and more compressed than those applicable to individuals. estates and trusts are so-called “conduit entities,” meaning that the taxable income of the estate or trust may be taxed either to the estate or trust itself or to the beneficiaries to whom such income is distributed, subject to the distributable net income rules. Given the structure of the brackets, favorable aggregate tax results are generally obtainable by distributing income from the estate or trust to individual beneficiaries. Bear in mind, however, that the trust document may restrict the trustee’s ability to make such distributions.

Standard deduction

For 2022, the standard deduction amounts are as follows:

Filing status	Standard deduction
MFJ Returns and Surviving Spouses	$25,900
Heads of Households	$19,400
Unmarried Individuals (other than Surviving Spouses and H of H)	$12,950
Married Individuals Filing Separate Returns	$12,950

The 2022 standard deduction for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of $1,150 or the sum of $400 plus the individual’s earned income.

For 2022, the additional standard deduction for the aged or the blind is $1,400. This additional standard deduction amount is increased to $1,750 if the individual is also unmarried and not a surviving spouse.

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Gross income limitation for a qualifying relative

Although the Tax Cuts and Jobs Act eliminated both the personal and dependency exemptions for tax years through 2025, the definition of a *dependent* is still relevant for many purposes — including the child tax credit, the credit for other dependents, the earned income credit, and head of household filing status. Dependents may be either qualifying children or qualifying relatives. The definition of qualifying relative dependent requires that the individual have income not exceeding the personal exemption amount. Because the personal exemption amount is zero through 2025, the IRS must specify this amount for purposes of the definition. For 2022, that amount is $4,400.

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Alternative minimum tax

For 2022, the alternative minimum tax (AMT) exemption amounts applicable to individuals and estates and trusts are:

Joint Returns or Surviving Spouses	$118,100
Unmarried Individuals (other than Surviving Spouses)	$75,900
Married Individuals Filing Separate Returns	$59,050
Estates and Trusts	$26,500

For a child to whom the kiddie tax applies in 2022, the exemption amount for purposes of the AMT may not exceed the sum of the child's earned income for the taxable year plus $8,200.

The AMT exemption amount is reduced by one dollar for every four dollars of alternative minimum taxable income (AMTI) above applicable threshold amounts based on filing status. For 2022, the AMT exemption phases out based on the following AMTI levels:

	Threshold phaseout amount	Complete phaseout amount
Joint Returns or Surviving Spouses	$1,079,800	$1,552,200
Unmarried Individuals (other than Surviving Spouses)	$539,900	$843,500
Married Individuals Filing Separate	$539,900	$776,100
Estates and Trusts	$88,300	$194,300

The AMT rate begins at 26% but raises to 28% when certain income thresholds are met. For 2022, the excess taxable income above which the 28% tax rate applies is $103,050 for married individuals filing separate returns and $206,100 for joint returns, unmarried individuals (other than surviving spouses), and estates and trusts.

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Maximum capital gains rate

For 2022, the maximum taxable income amounts to qualify for the 0% and 15% capital gains rates are as follows:

Filing status	0%	15%
Married Filing Joint	$83,350	$517,200
Married Filing Separate	$41,675	$258,600
Head of Household	$55,800	$488,500
Other Individuals	$41,675	$459,750
Estates and Trusts	$2,800	$13,700

Taxpayers with taxable incomes in excess of the applicable amounts shown in the 15% bracket for their filing status pay a capital gains rate of 20%.

Example: Capital gains

Sean and Pat file a joint return and have $600,000 in taxable income. They are considering liquidating an investment that is worth $50,000 and has a $20,000 basis, therefore generating $30,000 in capital gains resulting in a tax of $6,000 ($30,000 × 20%). They intend to gift the proceeds to Pat's parents, who also file a joint return but have only $50,000 in taxable income. If, rather than gifting the proceeds, Sean and Pat gift the investment to Pat's parents, and Pat's parents liquidate the investment, the entire $6,000 in capital gains tax will be saved (because Pat's parents are in the 0% capital gains bracket). In this example, gift tax consequences can be avoided with the use of gift splitting and the annual exclusion.

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Tax on insurance companies other than life insurance companies

Nonlife insurance companies are generally subject to tax at the corporate rate of 21%. However, nonlife insurance companies with net written premiums (or direct written premiums if greater) not in excess of an inflation-adjusted statutory amount may elect to be taxed only on taxable investment income instead of being taxed on both investment and underwriting income. For 2022, the amount of the limit on net written premiums or direct written premiums (whichever is greater) is $2,450,000 to elect the alternative to be taxed only on taxable investment income.

Limitation on use of cash method of accounting

Any taxpayer is allowed to use the accrual method of accounting for tax purposes, but the cash method is limited. With certain exceptions, such as with respect to inventory, any individual or S corporation is permitted to use the cash method of accounting. However, entities taxed under Subchapters C or K must use the accrual method of accounting if their average annual gross receipts exceed a specified amount. For 2022, a corporation or partnership must use the accrual method if the average annual gross receipts of such entity for the three-taxable-year period ending with the taxable year that precedes the 2022 tax year does not exceed $27,000,000.

Threshold for excess business loss

In the case of a taxpayer other than a corporation, any "excess business loss" is not allowed for tax years through 2025. *Excess business loss* means the excess of (1) the aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer (determined without regard to any deduction allowable under IRC sections 172 or 199A), over (2) the sum of (*a*) the aggregate gross income or gain of such taxpayer for the taxable year which is attributable to such trades or businesses, plus (*b*) an inflation-adjusted amount (200% of the inflation-adjusted amount in the case of a joint return). For 2022, the inflation-adjusted amount is $270,000 ($540,000 for joint returns).

Income

Unearned income of minor children (the kiddie tax)

For taxable years beginning in 2022, the amount that is used to reduce the net unearned income reported on the child's return that is subject to the kiddie tax is $1,150.

The same $1,150 amount is used to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the kiddie tax. For example, one of the requirements for the parental election is that a child's gross income is more than $1,150 but less than 10 times that amount, or $11,500.

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Income from U.S. savings bonds for taxpayers who pay qualified higher education expenses

For 2022, the exclusion regarding income from U.S. savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above $128,650 for joint returns and $85,800 for all other returns. The exclusion is completely phased out for modified adjusted gross income of $158,650 or more for joint returns and $100,800 or more for all other returns.

Qualified transportation fringe benefit

For 2022, the monthly limitation regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $280. The monthly limitation regarding the fringe benefit exclusion amount for qualified parking is $280.

Advance premium tax credit adjustments

If the advance payments of the premium tax credit to a taxpayer exceed the credit allowed, the tax imposed for the taxable year is increased by the amount of such excess. For taxable years beginning in 2022, in the case of a taxpayer whose household income is less than 400% of the poverty line for the size of the family involved for the taxable year, the amount of that increase shall in no event exceed the applicable dollar amount determined in accordance with the following table:

If the household income (expressed as a % of poverty line) is:	The limitation amount for unmarried individuals (other than surviving spouses and heads of households) is:	The limitation amount for all other taxpayers is:
Less than 200%	$325	$650
At least 200% but less than 300%	$825	$1,650
At least 300% but less than 400%	$1,400	$2,800

Periodic payments received under qualified long-term care insurance

Under IRC section 7702B, amounts (other than policyholder dividends or premium refunds) received under a qualified long-term care insurance contract are generally excludable as amounts received for personal injuries and sickness but are subject to a per diem limitation. If payments

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exceed the per diem limitation, the excess is excludible only to the extent of actual costs incurred for long-term care services. Amounts in excess of the dollar limitation, with respect to which no actual costs are incurred for long-term care services, are fully includible in income. For calendar year 2022, the stated dollar amount of the per diem limitation is $390 ($142,350 annually).

Qualified transportation fringe benefit

For 2022, the monthly limitation regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $280. The monthly limitation regarding the fringe benefit exclusion amount for qualified parking is $280.

Deductions

Certain expenses of elementary and secondary school teachers

For 2022, the amount of the deduction allowed for expenses paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom is $300.

Interest on education loans

For 2022, the $2,500 maximum deduction for interest paid on qualified education loans begins to phase out for taxpayers with modified adjusted gross income in excess of $70,000 ($145,000 for joint returns) and is completely phased out for taxpayers with modified adjusted gross income of $85,000 or more ($175,000 or more for joint returns).

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Eligible long-term care premiums

Certain long-term care premiums may be eligible for the medical expense deduction under IRC section 213. For 2022, the limitations regarding the amount of long-term care premiums allowable as a medical expense deduction are as follows:

Attained age before the close of the taxable year	Limitation on premiums
40 or less	$450
More than 40 but not more than 50	$850
More than 50 but not more than 60	$1,690
More than 60 but not more than 70	$4,510
More than 70	$5,640

Mileage deductions

The optional business standard mileage rate is used to compute the deductible costs of operating an automobile for business use in lieu of tracking actual costs. This rate is also used as a benchmark by the federal government and many businesses to reimburse their employees for mileage. Taxpayers always have the option of calculating the actual costs of using their vehicle rather than using the standard mileage rates. Due to increased gasoline prices, in June of 2022, the IRS announced that it was increasing the standard mileage rate for business and medical or moving mileage. Note that moving expenses (including mileage) are deductible only by members on active military duty in 2022. The 2022 mileage rates are indicated in the following chart:

Type of mileage	Rate 1/1–6/30/22	Rate 7/1–12/31/22
Business	58.5	62.5
Medical/Moving	18	22
Charitable	14	14

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IRC Section 179 deduction

For 2022, the aggregate cost of any IRC section 179 property that a taxpayer elects to treat as an expense cannot exceed $1,080,000, and the cost of any sport utility vehicle that may be taken into account under IRC section 179 cannot exceed $27,000.

The $1,080,000 limitation is reduced (but not below zero) by the amount by which the cost of IRC section 179 property placed in service during the 2022 taxable year exceeds $2,700,000.

Qualified business income deduction

For 2022, the threshold and phase-in range amounts for application of the limitations on the qualified business income deduction under IRC section 199A are as follows:

Filing status	Threshold amount	Phase-in range
Married Individuals Filing Joint Returns	$340,100	$340,100–$440,100
Married Individuals Filing Separate Returns	$170,050	$170,050–$220,050
All Other Returns	$170,050	$170,050–$220,050

Transportation mainline pipeline construction industry optional expense substantiation rules for payments to employees under accountable plans

Employers in the pipeline construction industry encounter several challenges to reimbursing under an accountable plan the costs relating to employee-provided welding rigs and mechanics rigs, particularly in determining the proper amount of the expense incurred. Rig welders and heavy equipment mechanics work for multiple companies for relatively short periods. Therefore, the proper allocation of fixed costs related to the equipment among employers is unclear. Moreover, although the rigs are mobile, the existing mileage-based expense substantiation provision does not accurately reflect rig-related costs because rigs are used primarily while stationary. Further, these employees incur substantial expenses as employees in providing these rigs as a condition of employment. Due to these unique features, reimbursing employees for rig-related expenses under the existing accountable plan requirements is unworkable for this industry. To enable this industry to reimburse rig-related expenses to employees under an accountable plan, Rev. Proc. 2002-42 provides an optional expense substantiation rule under which rig-related expenses may be treated as substantiated when reimbursing these expenses under an accountable plan. The amount of the per hour payments are adjusted annually for inflation.

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For 2022, an eligible employer may pay certain welders and heavy equipment mechanics an amount up to $19 per hour for rig-related expenses that are deemed substantiated under an accountable plan if paid in accordance with Rev. Proc. 2002-41. If the employer provides fuel or otherwise reimburses fuel expenses, an amount up to $12 per hour is deemed substantiated if paid under Rev. Proc. 2002- 41. If the employer provides fuel or otherwise reimburses fuel expenses, an amount up to $12 per hour is deemed substantiated if paid under Rev. Proc. 2002-41.

Debt instruments arising out of sales or exchanges

In general, IRC sections 483 and 1274 determine the principal amount of a debt instrument given in consideration for the sale or exchange of nonpublicly traded property. In addition, any interest on a debt instrument subject to IRC section 1274 is taken into account under the original issue discount provisions of the IRC. However, Section 1274A modifies the rules under IRC sections 483 and 1274 for certain types of debt instruments.

Under IRC section 1274A, in the case of any qualified debt instrument, the discount rate used for purposes of IRC sections 483 and 1274 may not exceed 9%, compounded semiannually. The definition of a *qualified debt instrument* is dependent, in part, on its stated principal amount. For this purpose, a qualified debt instrument is distinguished from a cash method debt instrument. For 2022, a qualified debt instrument must have a stated principal amount that does not exceed $6,289,500, and a cash method debt instrument has stated principal that does not exceed $4,492,500.

Credits

Child tax credit

The child tax credit is generally a nonrefundable tax credit. However, under certain circumstances, the child tax credit may be treated as a partially refundable credit (commonly referred to as the “additional child tax credit”). Note that the child tax credit was fully refundable for most taxpayers for 2021.

The additional child tax credit is subject to a statutory limitation for which such amount is adjusted for inflation. For 2022, the maximum additional child tax credit is $1,500.

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Earned income credit

For 2022, the following amounts are used to determine the earned income credit.

	Number of qualifying children			
Item	One	Two	Three or more	None
Earned income amount[1]	$10,980	$15,410	$15,410	$7,320
Maximum amount of credit	$ 3,733	$ 6,164	$6,935	$560
Threshold phaseout amount[2] (single, surviving spouse, or head of household)	$20,130	$20,130	$20,130	$9,160
Completed phaseout amount[3] (single, surviving spouse, or head of household)	$43,492	$49,399	$53,057	$16,480
Threshold phaseout amount[2] (MFJ)	$26,260	$26,260	$26,260	$15,290
Completed phaseout amount[3] (MFJ)	$49,622	$55,529	$59,187	$22,610

[1] The "earned income amount" is the amount of earned income at or above which the maximum amount of the earned income credit is allowed.

[2] The "threshold phaseout amount" is the amount of adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out.

[3] The "completed phaseout amount" is the amount of adjusted gross income (or, if greater, earned income) at or above which no credit is allowed.

Note that for 2022, the earned income tax credit is not allowed if the aggregate amount of certain investment income exceeds $10,300.

Adoption credit

For 2022, the credit allowed for an adoption of a child with special needs is $14,890. The maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to $14,890. The available adoption credit begins to phase out for taxpayers with modified adjusted gross income in excess of $223,410 and is completely phased out for taxpayers with modified adjusted gross income of $263,410 or more.

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Benefits

Adoption assistance programs

For 2022, the amount that can be excluded from an employee's gross income for the adoption of a child with special needs is $14,890.

The maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for adoptions by the employee is $14,890. The amount excludable from an employee's gross income begins to phase out for taxpayers with modified adjusted gross income in excess of $223,410 and is completely phased out for taxpayers with modified adjusted gross income of $263,410 or more.

Cafeteria plans

For 2022, the dollar limitation on voluntary employee salary reductions for contributions to health flexible spending arrangements is $2,850. If the cafeteria plan permits the carryover of unused amounts, the maximum carryover amount is $570.

Qualified Small Employer Health Reimbursement Arrangement

Small employers with fewer than 50 employees that do not offer a group health plan can contribute to their employees' health care costs through a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA). A QSEHRA allows small employers to provide non-taxed reimbursement of costs such as health insurance premiums, coinsurance, and other out-of-pocket expenses to employees who maintain minimum essential coverage.

For taxable years beginning in 2022, to qualify as a QSEHRA the arrangement must provide that the total amount of payments and reimbursements for any year cannot exceed $5,450 ($11,050 for family coverage). For employees who become eligible for the QSEHRA midyear, the limits must be prorated to reflect the actual amount of time the employee is eligible.

Defined contribution plans

The 2022 limitations related to defined contribution plans are as follows:

Item	Limit

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Maximum employee elective deferral	$20,500
Employee catch-up contribution (applies if age 50 or older by year-end)	$6,500
Defined contribution maximum limit (combined employee and employer)	$61,000
Employee compensation limit for calculating contributions	$305,000
Key employee compensation threshold for top-heavy plan testing	$200,000
Highly compensated employee threshold for nondiscrimination testing	$135,000

Health savings accounts and high deductible health plans

The 2022 limits for health savings accounts (HSAs) and high deductible health plans (HDHPs) are indicated in the following table:

Item	Self-only	Family
HSA contribution limit (combined employer and employee)	$3,650	$7,300
HSA catch-up contributions (age 55 or older)	$1,000	$1,000
HDHP minimum deductibles	$1,400	$2,800
HDHP maximum out-of-pocket amounts	$7,050	$14,100

Healthcare flexible spending accounts

Note that the Consolidated Appropriations Act of 2021 gave employers that sponsor healthcare flexible spending accounts (FSAs) the option of letting participants carryover all unused amounts in these accounts from 2020 to 2021 and from 2021 to 2022, although the indexed carryover amount was $550 for both years. The applicable amounts for 2022 are as follows:

Item	Limit
Maximum salary deferral	$2,850
Maximum rollover amount	$570

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Dependent care FSAs

Deferral	Limit
Maximum salary deferral (single taxpayers and married couples filing jointly)	$ 5,000
Maximum salary deferral (married couples filing separately)	$ 2,500

Employee health insurance expense of small employers

An eligible small employer can claim a credit equal to 50% of its nonelective contributions for health insurance for its employees. To be eligible for the credit, an eligible small employer has to contribute at least 50% of the cost of the employee's insurance premiums under a contribution arrangement and offer the insurance through a small business health options program exchange. An employer can only claim the credit in two consecutive tax years. Due to the reductions of the credit under the phaseout rules, the full amount of the credit is available only to an eligible small employer with 10 or fewer full-time equivalent employees and whose employees have average annual full-time equivalent wages of less than a specified dollar amount, adjusted for inflation.

For 2022, the dollar amounts used for limiting the small employer health insurance credit and for determining who is an eligible small employer for purposes of the credit is $28,700.

Real estate

Low-income housing credit

For 2022, the amount used to calculate the state housing credit ceiling for the low-income housing credit is the greater of (1) $2.60 multiplied by the state population or (2) $2,975,000.

Rehabilitation expenditures treated as separate new building for low-income housing credit

Certain rehabilitation expenditures paid or incurred by the taxpayer with respect to any building are treated as a separate new building for purposes of the low-income housing credit under IRC section 42. Rehabilitation expenditures will be treated as a separate new building if the expenditures are allocable to one or more low-income units or substantially benefit such units and the amount of those expenditures during any 24-month period meets the greater of the following two tests: (1) the amount of the expenditures is at least 20% of the building's adjusted basis or (2) the "per low-income qualified basis amount" is at least $6,000 (adjusted for inflation). For calendar year 2022, the inflation-adjusted per low-income unit qualified basis amount is $7,400.

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The qualified basis is based upon the proportion of the property that will be used for affordable housing (the applicable fraction) and is equal to the eligible basis, multiplied by the applicable fraction. The eligible basis is the total amount of development costs that would be eligible for tax credits under IRC section 42 if all of the housing units were used for low-income housing.

Energy efficient commercial building deduction

IRC section 179D provides for a deduction in an amount equal to the cost of energy efficient commercial building property placed in service during the taxable year. For 2022, the deduction cannot exceed the excess of $1.88 (adjusted for inflation) multiplied by the square footage of the building over the aggregate amount of the deductions taken in prior years.

To qualify for the deduction, the property must generally be certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50% or more in comparison to a reference building which meets the minimum requirements of the most recent Standard 90.1 published by the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America.

If this requirement is not met, but there is a certification that the interior lighting systems; the heating, cooling, ventilation, and hot water systems; or the building envelope satisfy the energy-savings targets established by the IRS with respect to such systems, then the requirement will be treated as having been met with respect to such system, and the deduction will be allowed except that $0.63 (adjusted for inflation) is used instead of $1.88.

Employee health insurance expense of small employers

An eligible small employer can claim a credit equal to 50% of its nonelective contributions for health insurance for its employees. To be eligible for the credit, an eligible small employer has to contribute at least 50% of the cost of the employee's insurance premiums under a contribution arrangement and offer the insurance through a small business health options program (SHOP) exchange. An employer can only claim the credit in two consecutive tax years. Due to the reductions of the credit under the phaseout rules, the full amount of the credit is available only to an eligible small employer with 10 or fewer full-time equivalent employees and whose employees have average annual full-time equivalent wages of less than a specified dollar amount adjusted for inflation.

For 2022, the dollar amount used for limiting the small employer health insurance credit and for determining what an eligible small employer is for purposes of the credit is $28,700.

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Charitable contributions

Dues paid to agricultural or horticultural organizations

If an IRC section 501(c)(5) agricultural or horticultural organization requires annual dues to be paid to be a member of such organization, and the amount of such required annual dues does not exceed an inflation-adjusted amount, those dues amounts will not be treated as derived from an unrelated trade or business by reason of any benefits or privileges to which members of such organization are entitled. For 2022, the inflation-adjusted amount is $178.

Unrelated business income

Unrelated trade or business does not include activities relating to the distribution of low-cost articles incidental to soliciting charitable contributions. This applies to organizations described in IRC section 501 that are eligible to receive charitable income tax deductible contributions. For 2022, low-cost articles are deemed to be articles that cost $11.70 or less.

Insubstantial benefit limitations

Generally, a taxpayer must reduce the amount of the charitable contribution deduction by the value of any benefits received in connection with a payment to a charity in connection with a payment to a charity. However, such benefits can be ignored if they are considered to have insubstantial fair market value.

For 2022, benefits received in connection with a payment to a charity will be considered to have insubstantial fair market value if: (1) the payment occurs in the context of a fundraising campaign in which the charity informs patrons how much of their payment is a deductible contribution and (2) either (*a*) the fair market value of all of the benefits received in connection with the payment, is not more than 2% of the payment, or $117, whichever is less, or (*b*) the payment is $58.50 or more and the only benefits received in connection with the payment are token items (bookmarks, calendars, key chains, mugs, posters, tee shirts, etc.) bearing the organization's name or logo. The cost (as opposed to fair market value) of all of the benefits received by a donor must, in the aggregate, be within the limits established for "low-cost articles," which is $11.70 for 2022.

A qualifying fundraising campaign is one designed to raise tax-deductible contributions, in which the charity determines the fair market value of the benefits offered in return for contributions (using a reasonable estimate if an exact determination is not possible) and states in its solicitations (whether written, broadcast, telephoned, or in person)—as well as in tickets, receipts, or other documents issued in connection with contributions—how much is deductible and how much is not. If a charity is providing only insubstantial benefits in return for a payment, fundraising materials should include a statement to the effect that: "Under Internal Revenue Service guidelines the estimated value of [the benefits received] is not substantial; therefore, the full amount of your payment is a deductible contribution."

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When contributions are received in the form of pledges, the total face amount of a pledge payable in installments will be considered to be the amount of the payment. Benefits provided by charities in the form of cash, or its equivalent will never be considered insubstantial.

Reporting exception for certain exempt organizations with non-deductible lobbying expenditures

Generally, a tax exempt entity must report information setting forth the total expenditures of the organization related to lobbying, including the total amount of dues or other similar amounts paid to the organization to which lobbying expenditures are allocable. Furthermore, the organization must (at the time of assessment or payment of such dues or other similar amounts) provide notice to each person making such payment which contains a reasonable estimate of the portion of such dues or other similar amounts to which such expenditures are so allocable.

Social welfare organizations exempt under IRC section 501(c)(4) and agricultural and horticultural organizations exempt under IRC section 501(c)(5) are treated as satisfying the reporting requirements if more than 90% of all annual dues (or similar amounts) are received from persons, families, or entities who each pay annual dues (or similar amounts) less than an inflation-adjusted dollar amount (or if more than 90% is received from 501(c)(3) organizations and state and local governments). For 2022, the annual per person, family, or entity dues limitation to qualify for this reporting exception is $124 or less.

Foreign activities

Covered expatriate

A U.S. citizen who gives up U.S. citizenship or a long-term U.S. resident who gives up their residency status and who is a "covered expatriate" is subject to a mark-to-market rule under which the taxpayer's property is deemed to be sold on the day before the expatriation, and the taxpayer is taxed on the gain above a certain threshold. (See the following.) For 2022, an individual is a covered expatriate if the individual's average annual net income tax for the five taxable years ending before the expatriation date is more than $178,000.

Tax responsibilities of expatriation

Under IRC section 877A, all property of a covered expatriate is treated as sold on the day before the expatriation date for its fair market value. Generally, any gain or loss arising from such sale is taken into account for the taxable year of the sale. However, the amount which would otherwise be includible in the gross income of any individual is reduced (but not below zero) by an inflation-adjusted amount. For 2022, that is $767,000.

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Foreign earned income exclusion

Generally, under IRC section 911(d)(1), taxpayers qualify for the foreign earned income exclusion if their tax home is in a foreign country and they are either (1) U.S. citizens who can establish that they have been bona fide residents of one or more foreign countries for an uninterrupted period which includes the entire tax year or (2) U.S. citizens or residents who, during any period of 12 consecutive months, are present in one or more foreign countries during at least 330 full days. For 2022, the foreign earned income exclusion amount is $112,000.

Notice of large gifts received from foreign persons

For 2022, IRC section 6039F authorizes the Treasury Department and the Internal Revenue Service to require recipients of gifts from certain foreign persons to report these gifts if the aggregate value of gifts received in the taxable year exceeds $17,339.

Gifts, estates, and trusts

Annual exclusion for gifts

For calendar year 2022, the first $16,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts made during that year.

For calendar year 2022, the first $164,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts made during that year.

Applicable credit amount (unified credit)

Under IRC section 2010(c)(2), the applicable exclusion amount equals the decedent’s basic exclusion and, for a surviving spouse, the deceased spousal unused exclusion amount if a portability election was made. The basic exclusion amount is adjusted annually for inflation. For an estate of any decedent dying in calendar year 2022, the basic exclusion amount is $12,060,000.

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Valuation of qualified real property in decedent's gross estate

For an estate of a decedent dying in calendar year 2022, if the executor elects to use the special use valuation method for qualified real property, the aggregate decrease in the value of qualified real property resulting from the election cannot exceed $1,230,000.

Exemption amount for qualified disability trusts

A complex trust (a trust that may accumulate income, distribute corpus amounts in addition to income, and make deductible charitable contributions) is generally allowed an annual exemption amount of $100 (simple trusts get $300). However, if all of the beneficiaries of the trust as of the close of the tax year are determined by Social Security to have been disabled and certain other requirements are met, an election may be made to treat the complex trust as a qualified disability trust. Historically, the annual income deduction for qualified disability trusts was equal to the personal exemption amount. For 2022, the amount of the deduction for a qualified disability trust is $4,400.

Interest on a certain portion of the estate tax payable in installments

Under IRC section 6166, if the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds 35% of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in two or more (but not exceeding 10) equal installments.

If the executor so elects, then interest must be paid on the estate tax due. To calculate that interest the amount due is divided into a “2% portion” and the remaining portion. Interest on the 2% portion is paid at the rate of 2%, and interest on the remaining amount is paid at a rate equal to 45% of the normal annual rate.

The 2% portion is equal to the tax generated by the incremental estate tax on an inflation-adjusted amount above the unified credit applicable exclusion amount. For an estate of a decedent dying in calendar year 2022, the dollar amount used to determine the 2% portion is $1,640,000.

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IRS collection issues

Persons against whom a federal tax lien is not valid

For 2022, a federal tax lien is not valid against (1) certain purchasers who purchased personal property in a casual sale for less than $1,690 or (2) a mechanic's lien for a vendor who repaired or improved certain residential property if the contract price with the owner is not more than $8,440.

Property exempt from levy

For 2022, the value of property exempt from levy under IRC section 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) cannot exceed $10,090. The value of property exempt from levy under IRC section 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) cannot exceed $5,050.

Amount of wages, salary, or other income exempt from IRS levy

The IRS is subject to special provisions with respect to the garnishment of wages and is generally not subject to the stricter limitations placed on other creditors. For 2022, the amount of wages exempt from levy is (1) the number of the taxpayer's dependents multiplied by $4,400, plus (2) the taxpayer's standard deduction, (3) divided by 52. Therefore, for an unmarried taxpayer who is not a surviving spouse or head of household and who has two dependents the weekly amount of wages exempt from IRS garnishment in 2022 would be $418.27 [($8,800 + $12,950) ÷ 52].

Revocation or denial of passport

If the IRS certifies that an individual has a seriously delinquent tax debt, the Secretary of Treasury will transmit such certification to the Secretary of State for action with respect to denial, revocation, or limitation of a passport. An unpaid tax liability will not be considered a seriously delinquent tax debt unless (1) a Notice of Federal Tax Lien has been filed and the administrative rights with respect to such filing have been exhausted or have lapsed or (2) a levy is made. For calendar year 2022, the amount considered to be a serious delinquent tax debt is $55,000.

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Penalties

Minimum penalty for failure to file tax return

In the case of any return required to be filed in 2023, the amount of the addition to tax for failure to file within 60 days of the due date of such return (determined with regard to any extensions of time for filing) shall not be less than the lesser of $450 or 100% of the amount required to be shown as tax on such return.

Failure to file partnership or S corporation return

In addition to the penalties for willful failure to file return, supply information, or pay tax, if any partnership or S corporation fails to file a required return at the time prescribed therefore (determined with regard to any extension of time for filing), or files a return or a report which fails to show the information required, the partnership or S corporation is liable for a penalty determined for each month (or fraction thereof) during which such failure continues (but not to exceed 12 months), unless it is shown that such failure is due to reasonable cause. For 2022, the amount for any month is the product of $220 multiplied by the number of persons who were partners or S corporation shareholders during any part of the taxable year.

Preparer penalties

In the case of any failure relating to a return or claim for refund filed in 2023, the penalty amounts are as follows:

Scenario	Per return or claim for refund	Maximum penalty
Failure to furnish copy to taxpayer	$55	$28,000
Failure to sign return	$55	$28,000
Failure to furnish identifying number	$55	$28,000
Failure to retain copy or list	$55	$28,000
Failure to file correct information returns	$55 per return and item in return	$28,000
Negotiation of check	$560 per check	No limit

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Failure to be diligent in determining eligibility for head of household filing status, child tax credit, American Opportunity tax credit, and earned income credit (IRC section 6695(g))	$560 per failure	No limit

Failure to file correct information returns

For persons with average annual gross receipts for the most recent three taxable years of more than $5,000,000, for failure to file correct information returns:

Scenario	Penalty per return	Calendar year maximum
General rule	$290	$3,532,500
Corrected on or before 30 days after required filing date	$50	$588,500
Corrected after 30th day but on or before August 1, 2023	$110	$1,766,000

For persons with average annual gross receipts for the most recent three taxable years of $5,000,000 or less, for failure to file correct information returns:

Scenario	Penalty per return	Calendar year maximum
General rule	$290	$1,177,500
Corrected on or before 30 days after required filing date	$50	$206,000
Corrected after 30th day but on or before August 1, 2023	$110	$588,500

For failure to file correct information returns due to intentional disregard of the filing requirement (or the correct information reporting requirement):

Scenario	Penalty per return	Calendar year maximum
Return other than a return required to be filed under IRC sections 6045(a), 6041A(b), 6050H, 6050I, 6050J, 6050K, or 6050L	Greater of (i) $580, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Return required to be filed under IRC sections 6045(a), 6050K, or 6050L	Greater of (i) $580, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit

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Return required to be filed under IRC section 6050I(a)	Greater of (i) $29,440, or (ii) amount of cash received up to $117,500	No limit
Return required to be filed under IRC section 6050V	Greater of (i) $580, or (ii) 10% of the value of the benefit of any contract with respect to which information is required to be included on the return	No limit

Failure to furnish correct payee statements

For persons with average annual gross receipts for the most recent three taxable years of more than $5,000,000, for failure to furnish correct payee statements:

Scenario	Penalty per statement	Calendar year maximum
General rule	$290	$3,532,500
Corrected on or before 30 days after required furnishing date	$50	$588,500
Corrected after 30th day but on or before August 1, 2023	$110	$1,766,000

For persons with average annual gross receipts for the most recent three taxable years of $5,000,000 or less, for failure to furnish correct payee statements:

Scenario	Penalty per statement	Calendar year maximum
General rule	$290	$1,177,500
Corrected on or before 30 days after required furnishing date	$50	$206,000
Corrected after 30th day but on or before August 1, 2023	$110	$588,500

For failure to furnish correct payee statements due to intentional disregard of the requirement to furnish a payee statement (or the correct information reporting requirement):

Scenario	Penalty per statement	Calendar year maximum

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Payee statement other than a statement required under IRC sections 6045(b), 6041A(e) (in respect of a return required under IRC sections 6041A(b)), 6050H(d), 6050J(e), 6050K(b), or 6050L(c)	Greater of (i) $580, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Payee statement required under IRC sections 6045(b), 6050K(b), or 6050L(c)	Greater of (i) $580, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit

Inflation Reduction Act

The Inflation Reduction Act of 2022 (H.R. 5376) was signed into law on August 16, 2022, by President Joe Biden. The legislation includes large investments in making health care and prescription drugs more affordable, fighting climate change, and taxing wealthy corporations.

Significant tax savings included in the act include the following:

- Energy security and climate change investments that include providing significant incentives for individuals and business to become more energy efficient by extending, increasing, and expanding credits that will offset energy costs, investments in clean energy production, and tax credits that take aim at carbon emissions
- Doubling the amount of the research credit that can be applied against payroll taxes for qualified small businesses for post-2022 tax years
- Extending the current premium tax credit amounts through 2025 for taxpayers who purchase health insurance on state health care exchanges
  - These subsidies were previously scheduled to expire at the end of 2022.
- Limiting and capping various costs Medicare recipients will have to pay for prescription drugs and certain premiums and co-pays in addition to providing free vaccines
  - Medicare will now be able to negotiate the price of certain prescription drugs bringing down the price beneficiaries will pay for certain expensive drugs, starting in 2026.
  - Drugmakers will also be subject to inflation controls.
  - The maximum Part D out-of-pocket liability (prescription drug plan) will be $2,000, starting in 2025.
  - The bill also caps monthly costs for Medicare enrollees purchasing insulin at $35 per month starting in 2023.

These expanded programs would be paid for by doing the following:

- Increasing IRS funding for audits and compliance initiatives, investing $80 billion in the nation’s tax agency over the next 10 years
  - Treasury Secretary Janet Yellen issued a directive that the IRS should implement new programs that do not increase examinations of taxpayers making less than $400,000.

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- Extending the excess business loss limitation (Section 461(l)) for noncorporate taxpayers for an additional two years through the 2028 tax year
- Imposing a 1% excise on certain stock buybacks by corporations applicable to post 2022 stock repurchases
- Imposing a new 15% corporate minimum tax on corporations with average financial statement income (“book income”) over $1 billion per year, beginning with the 2023 tax year

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Hobby Losses

Learning objectives

- Identify restrictions of IRC Section 183.
- Recognize the manner in which profit motive is determined.
- Indicate the nine factors in the Treasury regulations used to determine if an activity is engaged in for profit.
- Identify why the Tax Court held that the taxpayer in Gallegos did not conduct the activity in a business-like manner.
- Recognize the holistic approach used by the Whatley court.

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Hobby loss basics

IRC Section 162(a) permits deductions for "ordinary and necessary expenses paid or incurred … in carrying on any trade or business." IRC Sections 212(1) and (2) generally allow a taxpayer to deduct all the ordinary and necessary expenses paid or incurred "for the production or collection of income," and "for the management, conservation, or maintenance of property held for the production of income." Thus, even if there is no trade or business, a deduction for expenses relating to investment activities may be allowable. On the other hand, IRC Section 183(a) bars individual and S corporation taxpayers from claiming deductions for activities that are "not engaged in for profit." The only exceptions that allow a deduction with regard to activities not engaged in for profit are for amounts that would be deductible regardless of whether a business was being conducted (for example, state taxes or other itemized deductions allowed on Schedule A of Form 1040, *Individual Income Tax Return*) and deductions up to the amount of the gross income from that activity. However, the latter deductions can only be taken as miscellaneous itemized deductions and have been suspended through the 2025 tax year. Therefore, no deductions are currently allowed related to hobbies on Schedule A.

The main issue in determining whether an activity is engaged in for profit — and therefore treated as a business on Schedule C — or not engaged in for profit — and therefore subject to the hobby loss rules — is whether or not the taxpayer possesses a sufficient "profit motive." Thus, for example, deductions are not allowable for activities that are carried on primarily as a sport, hobby, or for recreation. The determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all the facts and circumstances of each case. A *reasonable* expectation of profit is not required. Consequently, it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. However, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the *objective* of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

The nine hobby loss factors

In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. The Treasury regulations list nine factors to aid in the determination of whether a profit motive exists.[1] No one factor is determinative in making this determination. In addition, it is not intended that only the nine factors described in the regulations are to be taken into account in making the determination.

Some courts rely exclusively on the nine factors, and the Tax Court's opinion in *Gallegos*, a case appealable to the Fifth Circuit, is an example of this. Judge Posner years ago promoted a more "holistic" approach rather than a slavish adherence to the factors. The Seventh and Eleventh Circuit Courts of

[1] Treas. Reg 1.183-2(b)

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Appeals take a more holistic approach to the issue, and in the *Whatley* case, the court alludes to such an approach (after it analyzes the nine factors).

Note that, even when the nine factors are applied, it is not intended that a determination is to be made on the basis that the number of factors indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. It is the weight of the factors, not their number, that is determinative.

The nine factors are as follows:

1. The manner in which the taxpayer carries on the activity. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, when an activity is carried on in a manner substantially similar to other activities of the same nature that are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

2. The expertise of the taxpayer or the taxpayer's advisers. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive when the taxpayer carries on the activity in accordance with such practices. When a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques that may result in profits from the activity.

3. The time and effort expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive when the taxpayer employs competent and qualified persons to carry on such activity.

4. Expectation that assets used in activity may appreciate in value. The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized because income from the activity together with the appreciation of land will exceed expenses of operation.

5. The success of the taxpayer in carrying on other similar or dissimilar activities. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

6. The taxpayer's history of income or losses with respect to the activity. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, when losses are sustained beyond the period that customarily is necessary to bring the operation to profitable status, such continued losses — if not explainable, as due to customary business risks or reverses — may indicate that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances that are beyond the control of the taxpayer — such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions — such losses would not be an indication that the activity is not engaged in for profit.

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A series of years in which net income was realized would be strong evidence that the activity is engaged in for profit.

7. The amount of occasional profits, if any, that are earned. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, when the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

8. The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved.

9. Elements of personal pleasure or recreation. The presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially when there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated when an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments that would yield a higher return, or that would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is engaged in for profit as evidenced by other factors.

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The regulations provide the following six examples[2]:

Example: Inherited farm 1

The taxpayer inherited a farm from her husband in an area that was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings that yield large income from dividends. The taxpayer lives on an area of the farm that is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.

Example: Lecturing

The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years, he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amount of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains), which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example: Recreational

The taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses. He began raising a particular breed of dog many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at "prestige" tracks, where he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property, on which the taxpayer also lives, that includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Because (i) the activity of raising dogs and horses and racing the horses is of a sporting and

[2] Treas. Reg 1.183-2(c)

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recreational nature; (ii) the taxpayer has substantial income from his business activities of retailing soft drinks; (iii) the horse and dog operations are not conducted in a businesslike manner; and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example: Farm 2

The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates the farm in the same manner that his parents operated it before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the state agricultural service from time to time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which area farms of similar size that grow similar crops are operated. Many of these other farms do not make a profit. The taxpayer himself does much of the farm's required labor, such as fixing fences, planting, crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example: Oil exploration

A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land that is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. Based on the experience of A and others who engaged in this activity, the chances are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil-bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example: Chemist

C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such

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development and has outfitted, at his own expense, a home workshop what he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis; incurs fees to secure consultation on his projects from time to time; and makes extensive efforts to “market” his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

Horsing around with the hobby loss deduction: *Gallegos v. Commissioner*, TC Memo 2021-25

Joseph Gallegos was making a very good living from his insurance business when he decided to devote a very large chunk of his time to team roping. This cost him tens of thousands of dollars, some of which he put on the same Schedule C, *Profit or Loss From Business*, as his insurance business.

Gallegos grew up on the largest ranch in Albuquerque, New Mexico, and he learned his way around horses at a very young age. It wasn't on horses that he rode to success, though. After graduating from high school in 1980, he began to sell health and life insurance. He didn't find it easy, and he and his wife relied on her job at a marketing research firm to make ends meet for their family. Then he had an excellent idea — he and his wife started up a field marketing organization, West Texas Brokers, Inc. Their field marketing organization specialized in what is called Medicare Advantage. At the time, Medicare Advantage was a relatively new area of the insurance industry, and Gallegos came up with a way to hire and train field agents to represent insurance companies and sell their policies in new markets. His agents earned commissions when they made sales and the Gallegoses' business would share in their success through override commissions.

The business was a galloping success. Gallegos proved exceptionally talented at spotting people with promise and, once he roped them into a training program and then let them loose in the market, he could share the commissions that they brought in. He was able to slow down his day-to-day operations, as much of the work could be delegated to his wife and other members of his family. And though the Gallegoses credibly testified that the insurance market could be extremely volatile, the business did well. It earned a net profit of just over $360,000 in 2009 and close to $500,000 in each of the two years that followed. With some extra time on his hands, and concerns about his continued success in the industry, Gallegos decided to focus his energy on team roping.

He started competing in team-roping competitions in 1989. He had been around competitions as a child but received a more formal introduction to the sport when he bought a horse from someone who bought

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and sold rope horses and staged team roping events. Gallegos at first intended to use the horse to cover more ground while deer hunting, but once he tried team roping, he was hooked.

With respect to team roping, Gallegos is a “header” whose job is to rope the head of the cow or the steer. Then there's the “heeler” who, after the header has roped the head, comes from behind to rope the two back feet. Both then wrap the rope around the horns of their saddles to pull the ropes taut and stop the steer. Once they face each other with the steer in the middle, a flag is dropped and time is called. The fastest team wins.

Team roping has gotten big enough to become its own event, completely separate from rodeo, and is done all over the world — though it remains most popular in the United States. Much of the sport's growing popularity is due to the founding of the United States Team Roping Championships (USTRC), the United States' primary roping association. The USTRC was founded in 1989 to provide a classification system that matches ropers in competitions based on their skill levels.

Under the classification system, ropers are rated on a scale of 1 to 10, with 10 being the most highly skilled. Roping is a team sport, and team ropers can enter competitions based on their combined rating Gallegos is rated a “5-5+”, and most of the 80,000 members of the USTRC are handicapped at a five or lower. This classification system allowed for more competition and a larger spread of winnings. The sport is pay-to-play and requires fairly hefty entry fees that have increased with the popularity of team roping. Additional costs include travel expenses, a trailer or truck for the horses, and the horses themselves. It is an expensive undertaking.

Gallegos had been team roping for years, but it wasn't until 2009 that he began reporting income and loss from it on the Schedules C of the joint returns he filed with his wife. Their position is that it was only then that Gallegos decided to make it his business and not just his pastime. According to them, they were worried that West Texas Brokers would not be as successful as it ultimately turned out to be. According to Mrs. Gallegos they began contemplating another business venture in 2008, and even considered buying a Subway franchise. But neither of the Gallegoses had restaurant experience, and team roping looked better.

Their business plan was simple: they would earn a profit by having Gallegos improve his skills at team roping, by winning team-roping competitions, and by selling (and possibly breeding) successful team-roping horses. He wanted to get better, put more effort into it, more time into it, and win. The values of horses were a main part of this plan, and the Gallegoses claim to have even bought a mare — in addition to their three other horses — for the sole purpose of breeding. But winning was key to making the horses more valuable. Improving also included having the proper equipment, such as a nice saddle and luxury horse trailer. The trailer came complete with living quarters, which Gallegos says ultimately saved him lodging and food expenses while away at roping competitions.

The Gallegoses did not make a profit during any of the years at issue. They also did not maintain a separate bank account or records for their team-roping activity and had no budget for it either. Nonetheless, the Gallegoses say that, starting in 2009, they only ever intended to make a profit. They say Mr. Gallegos was competing in a sport where he was likely to win and he had a business plan to improve and win some more.

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The Gallegoses say that they kept accurate books and records and carried on the team roping activity in a manner substantially similar to successful team ropers. To support this, they point to Mr. Gallegos's weight loss and his rigorous practice schedule, as these factors would improve his performance, and in turn, allow him to win more often. The court did find that Mr. Gallegos showed considerable discipline and commitment to the sport, but as the IRS points out, there are problems with this argument. First, the Gallegoses did not maintain complete and accurate books and records. They never created a budget for team roping, and they didn't keep track of the money flowing into and out of the activity. Specific proof of this is their largely inaccurate reporting of their 2009 team-roping expenses, and similar inaccuracies for 2010 and 2011. Without adequate recordkeeping, it would be quite difficult for the Gallegoses to evaluate economic performance and ways to improve profitability. The Gallegoses must have known how to keep good records, because they've kept and used adequate records for their insurance business, which is quite successful. Contrary to what they argued, the court didn't think the USTRC's tracking of its members' entry fees and winnings suffices inasmuch as entry fees are far from the only major expense a team roper incurs.

The court did not find their business plan to be credible. The sport's handicapping system means there is a greater financial benefit to keeping one's skills at somewhere in the lower-to-average range because there were more competitors and thus bigger pots at those levels. The Gallegoses' business plan — which focused on improved performance — was therefore at odds with improved profitability. If it worked, Gallegos would jump into a higher skill level with lower earnings. Given what the record shows, team roping is the unusual activity in which the route to profitability might more clearly lie in staying mediocre and attending as many competitions as possible.

Winning without more is not a very believable business plan, especially when the Gallegoses claim to have entered the team-roping business because of the insurance market's volatility. If they were looking for a safer investment, they haven't found it in winning a team-roping competition here and there. Many of the experts identified by the Gallegoses as individuals carrying on a similar activity do not (and cannot) rely on winnings to earn a profit; they have careers in horse training or selling team-roping equipment. The court characterized the objective of “winning” team-roping competitions as more of a hope than a real business plan, thus the manner in which the activity was conducted favors the IRS.

The Gallegoses characterize Mr. Gallegos as “an expert horseman.” They also pointed to the facts that he rated team ropers for the USTRC and consults with some of the best team ropers in the business. The court recognized that Gallegos had a good deal of experience with horses generally. However, the Gallegoses didn't show that they sufficiently considered the economics of team roping, even if Mr. Gallegos has great knowledge of its technical aspects. They made no financial projections with regard to team roping or horse breeding, and they did not estimate the return of capital invested in these activities.

They didn't even make a budget for themselves, and their purported business plan aimed to improve Mr. Gallegos's skill level at the expense of profitability. Consulting with some of the best team ropers is likewise insufficient when winning team-roping competitions isn't really even their business. Favoring technical knowledge over practical knowledge of an activity's economics reveals a skilled hobbyist and not a businessman. For these reasons the “expertise” factor favors the IRS.

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A taxpayer's choice to leave another job to spend most of his time on the activity may be very convincing evidence of his intention to turn a profit. The Tax Court was convinced that Gallegos devoted a significant amount of time to team roping. He traveled to three roping competitions a month and practiced several hours a day, twice a day at times. This was all on top of his daily chores, which included feeding, watering, and washing his horses, and mucking out their stalls. But the court also found that Gallegos's practices and competitions had substantial personal or recreational aspects, even given the work associated with it. There's no way, the court concluded, that team roping didn't have substantial personal and recreational aspects to Mr. Gallegos. He himself considered it a hobby from 1989 up until the years at issue and even gave up his beloved deer hunting for the sport. Although he did slow down his work with West Texas Brokers, it was not to the detriment of that business. Even so, the court felt that the time he put into team roping, though not insignificant, could be done around a normal work schedule and is in line with his lifetime enjoyment of horses. The time and effort factor, therefore, was neutral.

The Gallegoses stated that Mr. Gallegos was once offered $20,000 for a horse that he bought for $11,000, but highly skilled roper Wayne Baise says there's more money to be made than that. Wayne Baise says that he's sold a roping horse for $50,000. However, the court can infer a profit motive only if the Gallegoses expected that the horses' appreciation would exceed their team-roping operating expenses, such that the eventual gain on sale would allow them to recoup their losses. The Gallegoses have not demonstrated, or really even argued, that they ultimately expect horse sales to help offset their losses, which were over $150,000 for the three years at issue. The expectation of asset appreciation factor, therefore, favors the IRS.

The IRS pointed out that the Gallegoses did not apply to team roping many of the sound and customary business practices they applied to the insurance business, such as having a separate bank account and an effective recordkeeping system. Gallegos had shown a willingness to adapt with his insurance business, such as when he switched from selling life and health insurance to Medicare Advantage. However, the court did not see a similar willingness to move out of the money-losing activity of team roping. He had increased the time he spent on team roping over the years, but that's not the same. His increased effort has led him only to lose money at a gallop instead of a trot. The Gallegoses have therefore failed to show that their success in the insurance business has helped them to make Mr. Gallegos's team roping profitable. This factor favors the IRS.

The Gallegoses reported total losses from team roping of more than $150,000 for the years at issue. Gallegos had been team roping competitively since 1989 and never once earned a profit. The Gallegoses didn't address the 20 unprofitable years leading up to 2009 but say that the years at issue were the startup phase of their team-roping business. They contended that they need to have only 2 out of 7 profitable years, and so these were just their unprofitable years. Their argument seemed to be that they didn't make a profit in earlier years because Mr. Gallegos didn't have the right equipment (a trailer with living quarters, a new saddle, and new horses), but then blame their lack of profit during the years at issue on these very purchases. They then proceed to contradict themselves and blame their losses on entry fees, which are by far the most significant expense and unavoidable if they want to win big. The Tax Court didn't find any of these arguments to be persuasive — and if entry fees are here to stay, the court didn't see how they could support an argument that they are in any way peculiar to a startup phase. The court also found telling the absence of any claimed deductions for provender or boarding or veterinary expenses. Gallegos testified that he was doing all that himself, but the court noted that putting on

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blinders to such expenses doesn't make them disappear, and it doesn't make a money-losing activity lose any less money. The court found the IRS's argument — that Gallegos decided to spend more on team roping, and use its losses to offset other income only once his insurance business started blossoming — a more plausible one. Therefore, the history of income or loss factor favors the IRS.

The most Gallegos won at a roping competition during the years at issue was $3,890. Although his total winnings did go up in the years at issue, his associated expenses also went up, leaving his cumulative net loss at around $50,000. The court found that this was not a situation where there was a substantial profit to be made, nor that the investment or losses were comparatively small. Even if Gallegos happens to win big and make a substantial profit once in a great while, his investment in team roping is not comparatively small. The same is true for any potential sale of a horse. The amount of occasional profit factor favors the IRS.

A taxpayer's lack of substantial income or capital from sources other than the activity at issue may indicate that the activity is engaged in for profit. In other words, if profit from the activity is necessary to meet living expenses, that would be a good indication that the objective of the activity is profit. The Gallegoses admitted that their insurance business had been successful, but they worry about its continued success. They may be right, but the court could not ignore that they received substantial income from it of just under $400,000 in 2009 and around $500,000 in 2010 and 2011. This financial status factor, therefore, weighs heavily in favor of the IRS.

Mr. Gallegos admits that he enjoys team roping, but says Mrs. Gallegos does not. He also said that the horses were not ridden for pleasure, but rather are business assets that were for sale. He said that team roping was extremely hard work, time-consuming, physically demanding, and often gross. Many hobbies can take a lot of time and energy while still being mostly a source of personal recreation. Gallegos had been team roping as a hobby for nearly 20 years before the years at issue, and this led the court to find that he derived a significant amount of personal pleasure from it, even if he can also make some money doing it. He didn't participate in any substantial way in any other recreational activities, and he got a tremendous amount of satisfaction going to competitions, meeting top-ranked ropers, and winning a bit of his own fame. The personal recreation factor, the court concluded, favors the IRS.

For all these reasons the Tax Court found that the Gallegoses did not participate in team roping with the primary motivation to earn a profit. The IRS wins.

Greener acres: *Whatley v. Commissioner*, TC Memo 2021-11

Stephen Whatley, a proud Auburn alumnus, is a highly skilled entrepreneur who makes the tiger's share of his family's income from banking. In the early 2000s, he bought a property in rural Alabama near his hometown and alma mater. He then added two dozen more acres of land and formed an LLC to report his use of the property on his returns from 2004 to 2008. He recorded very large losses for what he described as a cattle farm. This cattle farm, however, was without cattle until at least 2008. He argued this cattle farm was also a tree farm. The Tax Court was left to decide whether this tree or cattle farm was a trade or business during those five tax years. If it was, Whatley could offset some of his large banking income with his substantial farming losses.

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The Whatley family has been in Lee County, Alabama, for 11 generations, an almost unbroken line of farmers and ranchers. Stephen Whatley was raised in Opelika, where his great-grandfather owned a 2,000-acre farm and raised dairy cattle, grew row crops, and grew and ginned cotton before downturns in the economy led to the property's falling out of the family's hands. Whatley's dad's cousin also had a dairy farm that Whatley often visited. By the age of six he was getting his hands dirty tending to the row crops and picking cotton.

When he was 27, Whatley started his first business, a timber-harvesting operation. He and his partner formed a company to buy standing timber and log some of it. It proved to be more of a learning experience than a living and closed after only two years. It turned out, however, that Whatley's real talent and vocation was banking. He'd been in banking for over 43 years. After graduating from Auburn, he started at Security Pacific Bank in Los Angeles. He then moved to Atlanta and worked at the Trust Company of Georgia. After several years there, he moved back home to Lee County and worked at Colonial Bank for 25 years. In May 2006, he retired from Colonial Bank.

He did not stay idle, but instead founded a bank of his own, Southern States Bank. His reputation was good enough that he easily raised $32 million in equity. By 2016, Southern States had between $650 and $700 million in assets with Alabama branches in Huntsville, Anniston, Auburn, Opelika, Birmingham, and Sylacauga, and more branches in Georgia.

Even before he started Southern States, Whatley wanted to find an oasis from banking where he could get back to his roots and work the land. He happened upon a 156-acre tract near Opelika, only a short drive from Auburn. The previous owner had used the land as a timber farm and at one point had used part of it as a cattle farm. The land was heavily forested, with 78 acres in pine and another 56 in mixed species. It was not an active operation, and, when Whatley bought it, the land was subject to the Conservation Reserve Program. Before closing, Whatley had a licensed forester come to take a look around. The forester gave Whatley some general advice on how to care for the timber and try to make a profit from it, and she also estimated the timber's value. Although Whatley definitely remembered being given a value for the timber, he couldn't remember what that value was. Whatley was convinced this was the property he wanted, and in 2003 he bought it for about $350,000.

After he bought the land, and on the advice of his longtime CPA, James Kemp, Whatley formed Sheepdog Farms, LLC. From 2004 to 2008, Whatley was a 97% owner of Sheepdog Farms, his wife was a 1% owner, and their children seem to have held the rest. But though he formed the LLC, he never transferred the land to it.

Sheepdog Farms was not to remain landless for long. In 2004, Whatley bought an additional 26 acres contiguous to the 156-acre tract. This second property came with some improvements — a 2,600-square-foot home built in 2000, a barn, and a smaller caretaker house. The main home is nicely done, with a primary bedroom, two additional bedrooms with a shared bath, a great room, and a small front room. The barn is 5,000 square feet, large enough to hold all the farming equipment if a rain storm rolls through. The caretaker house, however, is around 40 years old, in poor repair, and rarely occupied. Whatley transferred title to this smaller tract to Sheepdog Farms.

Whatley had no formal business plan for the now-combined property. He did spend about 700 hours a year there during the years at issue, which averages to a bit less than 14 hours a week. When he was at

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the farm, his day-to-day activities varied in some ways, but usually began in the morning with a ride through the woods with a hot cup of coffee. He'd make mental notes of any work that was needed and then tend to those chores.

The farm's timber operation focused on maintenance. This mostly meant that Whatley himself cleared the roads and fire lanes every year. Once every few years, Whatley thinned his property to allow additional sunlight to get down through the forest to speed the growth of the pine trees that remained. Because of the Conservation Reserve Program, there was no timber harvesting.

As to the farm's cattle operation, Whatley explained that he had wanted to introduce cattle from day one. He testified that he consulted two cattle experts for advice, but those men managed much larger herds — 600 and 1,500 head respectively — than what Whatley could reasonably expect to put on his property. Whatley, however, could not recall when this consultation took place or what advice he received. In any event, he didn't actually have cattle on his property until at least 2008, right after he learned that the IRS was going to audit him. He explained that many of the activities that he reported as related to cattle were really activities that he undertook in preparation for cattle that would arrive sometime in the future. These included the installation of some fencing and repairs to the barn.

The administrative side of Sheepdog Farms was run with striking informality. Although it kept minimal business records like yearly trial balances and tax-asset working papers, it's not clear when these documents were created. It kept no traditional accounting records — for example, ledgers, balance sheets, income statements, or cashflow statements. Whatley did try to introduce some records, but they weren't entirely accurate. For example, Sheepdog Farms failed to expense insurance that it had on the property. Sheepdog Farms didn't even have a separate bank account or any separate bank records during the years at issue.

Whatley kept only very limited business records for Sheepdog Farms. The court record has only annual trial balances and tax-asset sheets for each year. It is not clear when these records were created, or even whether there were any general ledger or other accounting records for Sheepdog Farms. Whatley had no separate bank account for Sheepdog Farms, so there weren't even bank records. Keeping so few records prevented Whatley from seeing how well — or how poorly — he was doing. He didn't know the value of his timber when he bought the property and did not keep track of its value over time. The absence of good records also prevented Whatley from reporting certain expenses for Sheepdog Farms, such as insurance. He could not track Sheepdog Farms' performance. This weighs against him.

Whatley had no business plan for Sheepdog Farms. It wasn't until July 24, 2008, that he finally got a forest-management plan. This was four years after he bought the property, but less than four months after he learned of the IRS audit. This factor also weighs against him.

Many of the experts that Whatley consulted had either more than 125,000 acres of timberland or hundreds of head of cattle — that is, their operations were much larger than his. This suggests that Sheepdog Farms — with very limited acreage of timberland and no cattle until at least 2008 — was not operated like similar, profitable activities. The court acknowledged that the IRS didn't introduce any evidence as to what a small tree farm or cattle farm would look like or that a cattle or tree farm the size of Sheepdog Farms couldn't be profitable. However, the court did observe that a cattle farm without cattle is not likely to be profitable. It decided to call this factor neutral.

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During all the years at issue, Sheepdog Farms operated at a substantial loss. The facts painted no picture of rapid change to increase profitability, and Sheepdog Farms suffered greater losses as time went on. In 2004 — its first year of operation — it posted a loss of $90,000. In 9 out of the next 10 years, Sheepdog Farms reported even greater losses. Whatley took no significant steps during the years at issue to change what he was doing to cut these losses. This factor weighs heavily against him.

Whatley failed to transfer ownership of the 156-acre tract of land where most of the timber was growing to Sheepdog Farms. This is evidence that he did not run this operation in a businesslike manner. It also means that Sheepdog Farms claimed expenses related to land that it didn't own. Some of the specific expenses on Sheepdog's returns are of doubtful legitimacy. During the years at issue, for example, Sheepdog Farms claimed $67,735 in depreciation for two homes on the property. It is not clear why depreciation of Whatley's second home — which he stated was a personal residence — and of the rarely used caretaker home should be considered business expenses. On balance, the court found that Whatley did not conduct Sheepdog Farms in a businesslike manner. This factor weighs strongly against him.

Whatley cites his family's agrarian heritage, but he himself has no experience in running a cattle farm. His forebears' experience is not his own, and their expertise is not his.

Whatley also has no experience operating a timber farm like the one at Sheepdog Farms. His argument is that this foray into the business at the age of 27 should weigh in his favor. However, the court didn't think it should weigh very much, because it was over 35 years ago and this business was different. Sheepdog Farms is reportedly a timber farm. The business Whatley ran as a young man bought and logged timber that was ready to harvest. These businesses may be in the same general field, but timber harvesting and timber growing are not similar enough to find that Whatley had experience in the business. People who are trying to start up in a new field can also look to others to gain expertise, and Whatley also argues that he did this.

He first argues that he consulted with experienced individuals about the cattle operation. When these consultations took place is unclear. The record doesn't show whether they took place before Whatley started buying the land or when he finally got cattle on the land, which was after he came under the IRS's eye. Whatley also didn't introduce any evidence about what actual advice he received.

Whatley did consult some individuals on how to manage his timber before he bought the 156-acre tract. He also sought other foresters' advice while he owned the farm. Once he knew he was under audit, he did get a forest-management plan. The court did not believe, however, that these consultations were enough to tip this factor in Whatley's favor, even as to Sheepdog Farms' timber operations. It is again not clear what advice he received, and it's not even clear what type of advice he got. The advice to look for is advice on how to profit from doing the activity in question. The court found it more likely than not that the advice Whatley received was about how to care for the timber, not how to make a profit from it. This is an important distinction here, because these advisers had very large timber farms — they totaled more than 125,000 acres—and it is more likely than not that their advice would be less helpful in making a very small operation like Whatley's profitable. It is not clear when Whatley got this advice. Whatley testified it was after he bought the property. But the court was confused as to whether that meant the advice was received immediately after the purchase or after the tax years at issue. This factor weighs against Whatley.

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Whatley didn't leave his job as a banker to run Sheepdog Farms. He also made clear that during the years at issue he didn't hire anyone else to work on the farm. This leaves us to look at whether much of Whatley's personal time was devoted to Sheepdog Farms. Whatley didn't have a whole lot of free time. He worked full time as a banker for all the years at issue, traveling and working 70 hours a week. That left him with only about 700 hours a year — roughly 13.5 hours a week — to work at the farm. It is more likely than not that Whatley was simply spending his weekends at the farm and working on the land during the day. Whatley enjoyed working at the farm. This factor also weighs against Whatley.

The expectation of appreciation factor was not one that Whatley could cite in his favor on the cattle side of the farm. The trees were there when he bought the place, and Whatley testified that he expected them to grow in value. However, there is nothing in the record that establishes that Whatley knew the value of the timber when he bought the place.

A big part of Whatley's problem is that Sheepdog Farms was so spectacularly unprofitable. For the sake of argument, let's assume the value of the timber was $0 in 2004. And let's assume the projected value of this timber in 2022 would be $332,625 — the highest possible value in the record. At most, Whatley could project income of $332,625 from this timber in 2022, while his losses just from the years at issue — $512,222 — already exceeded that. So even if it were to be unreasonably assumed that Whatley had a zero basis in the timber and expected the timber to sell at the highest possible value that anyone estimated, it would still produce a total loss of at least $179,597. This doesn't even include the losses from years 2009–14, which would increase that total loss to $1,230,851. This also assumes that Sheepdog Farms wouldn't produce yet more losses from 2015 to 2022, which the court found to be not likely at all. This factor weighs against Whatley.

A track record of success in other business ventures may indicate that the taxpayer has the entrepreneurial skills and determination to succeed in subsequent endeavors. What is needed is some synergy between the prior business and the current activity. Whatley again pointed to his old timber-harvesting business. The court did not think that Whatley's starting a business in his twenties was an early sign of the entrepreneurial inclination that he has shown all his life. It can't be doubted that it taught him some very useful general lessons about how to run a business. However, the specifics of that business were too dissimilar and too long ago for the court to find that the skills learned in the former show by themselves that he intended to make a profit in the latter.

Sheepdog Farms is primarily a cattle farm. Whatley's old business had nothing to do with cattle at all. Growing timber is different from harvesting and logging it. Allowing for some recognition of those entrepreneurial skills, the court decided that this was a neutral factor.

Sheepdog Farms' losses were so sustained and so large that the court could not find them to be transitory or unexpected. There were losses every year from 2004 to 2014 — and the largest losses were from 2009 to 2014. Whatley did argue that the losses for the years at issue were caused by unforeseen circumstances — specifically a drought and a depressed market. He argued that the drought caused losses for his cattle operation and market conditions caused losses for his timber operation.

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The court, however, was unpersuaded that the drought caused losses for the cattle operation. The regulations say that the event must be unforeseen or fortuitous.[3] Whatley testified that there was a drought when he bought the land, which makes it neither unforeseeable nor fortuitous. The losses, moreover, were not sustained because of unforeseen or fortuitous circumstances as required by the regulation. The losses kept on rising even when Whatley finally bought cattle for the farm.

The court was also unpersuaded that depressed market conditions caused losses for the timber operation. This argument makes little sense, as market conditions had nothing to do with the losses Whatley sustained. Whatley didn't plan on selling timber until 2022 — and the court didn't see how market conditions in 2004–08 would affect the value of uncut timber in 2022. This factor weighs against Whatley.

Sheepdog Farms in its first 10 years showed no profit and only losses — and substantial ones at that. This factor weighs heavily against Whatley. Whatley had substantial income from banking. The losses from Sheepdog Farms would, if they were allowed, generate substantial tax benefits. Finally, Whatley found 182 acres of land near his hometown, and enjoyed going there as a retreat from his grueling and time-consuming banking business. Though many people do not find farming enjoyable, Whatley did. This factor also weighs against Whatley.

The factors discussed in Reg 1.183-2(b) — none of which favor Whatley and only two of which are neutral — led the court to find that Sheepdog Farms was not an activity engaged in for profit. The Seventh Circuit's "holistic" approach would get there much more quickly. Whatley was a banker working 70 hours a week. He found this property and bought it. This let him work outdoors — something that he did as a child and enjoyed — but the property was a cattle farm with no cattle during all but part of one year at issue. It had consistent and substantial losses that totaled over $1.5 million from 2004 to 2014. Even if he later cut and sold the timber, he had no chance of turning a profit; but Sheepdog Farms' expense, if allowed, would substantially offset his income from other sources. That deduction is just what IRC Section 183 prevents.

[3] Treas. Reg 1.183-2(b)(6)

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Nonbusiness Income and Deductions

Learning objectives

- Recognize how the Electric Vehicle Credit was modified by the Inflation Reduction Act of 2022.
- Identify three situations in which receipts from crowdfunding are not included in income.
- Indicate the three primary factors in determining worker status.
- Recognize the statutory requirement to elect to itemize deductions.
- Identify the five exclusions from cancellation of debt taxable income.

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Expanded Clean Vehicle Credit

Prior to the enactment of the Inflation Reduction Act of 2022 Internal Revenue Code (IRC) Section 30D provided a credit for qualified plug-in electric drive motor vehicles including passenger vehicles and light trucks. For vehicles acquired after December 31, 2009, the credit is equal to $2,500 plus $417 for a vehicle which draws propulsion energy from a battery with at least 5 kilowatt hours of capacity and an additional $417 for each kilowatt hour of battery capacity in excess of 5 kilowatt hours. The total amount of the credit allowed for a vehicle is limited to $7,500.

The credit begins to phase out for a manufacturer's vehicles when at least 200,000 qualifying vehicles have been sold for use in the United States (determined on a cumulative basis for sales after December 31, 2009). Notice 2009-89, which applies to vehicles acquired subsequent to December 31, 2009, sets forth a process that allows manufactures to certify to the IRS that a particular vehicle meets the requirements of Section 30D of the IRC. Taxpayers purchasing such vehicles can rely on the domestic manufacturer's (or, in the case of a foreign manufacturer, its domestic distributor's) certification that a particular make, model, and model year of vehicle qualifies as a plug-in electric drive motor vehicle under Section 30D, and certification of the amount of the credit allowable with respect to the vehicle.

IRC Section 30D originally was enacted in the Energy Improvement and Extension Act of 2008. The American Recovery and Reinvestment Act of 2009 amended Section 30D effective for vehicles acquired after December 31, 2009. Section 30D was also modified by the American Taxpayer Relief Act of 2013 for certain 2 or 3 wheeled vehicles acquired after December 31, 2011, and before January 1, 2014.

To qualify for the credit, the vehicles must be acquired for use or lease and not for resale. Additionally, the original use of the vehicle must commence with the taxpayer and the vehicle must be used predominantly in the United States. For purposes of the IRC Section 30D credit, a vehicle is not considered acquired prior to the time when title to the vehicle passes to the taxpayer under state law.

The Qualified Plug-in Electric Drive Motor Vehicle Credit phases out for a manufacturer's vehicles over the one-year period beginning with the second calendar quarter after the calendar quarter in which at least 200,000 qualifying vehicles manufactured by that manufacturer have been sold for use in the United States (determined on a cumulative basis for sales after December 31, 2009) ("phase-out period"). Qualifying vehicles manufactured by that manufacturer are eligible for 50% of the credit if acquired in the first two quarters of the phase-out period and 25% of the credit if acquired in the third or fourth quarter of the phase-out period. Vehicles manufactured by that manufacturer are not eligible for a credit if acquired after the phase-out period.

The Inflation Reduction Act of 2022 amends the Qualified Plug-in Electric Drive Motor Vehicle Credit contained in IRC Section 30D, now known as the Clean Vehicle Credit, and adds a new requirement for final assembly in North America that took effect on August 16, 2022. The Act removes the limitation on the number of vehicles eligible for the credit, so electric vehicles purchased from manufacturers that had previously reached their cap will now be eligible for the credit. Another change that has been added with the new Act includes price caps, so the credit is not allowed for cars with a manufacturer's suggested retail price over $55,000 or for vans, SUVs, or pickup trucks with a manufacturer's retail price over $80,000.

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The credit is allowed once per vehicle and requires that the vehicle identification number (VIN) is included on the return. Taxpayers with a modified adjusted income (MAGI) that exceeds certain thresholds ($300,000 on joint returns $225,000 for heads of household, and $150,000 for single taxpayers will not be allowed to take the credit. A new credit for used clean vehicles (new Sec 25E) has been created. Qualified buyers can claim a credit of up to $4,000. Their MAGI must be under $150,000 for joint filers, $112,500 for heads of household, and $75,000 for single taxpayers. The sales price of the vehicle must be $25,000 or less. The used Clean Vehicle Credit applies to vehicles acquired after December 31, 2022.

If the taxpayer purchased and took possession of a qualifying electric vehicle after August 16, 2022 and before January 1, 2023, aside from the final assembly requirement, the rules in effect before the enactment of the Inflation Reduction Act for the Electric Vehicle (EV) credit apply (including those involving the manufacturing caps on vehicles sold).

The North America final assembly requirement is key. Although The Department of Energy has provided a list of model year 2022 and early model year 2023 EVs that may meet the final assembly requirement, for some manufacturers, the build location may vary based on the specific vehicle, trim, or the date in the model year when it was produced because some models are produced in multiple locations. The build location of a particular vehicle should be confirmed by referring to its VIN using the VIN decoder supplied by the Department of Energy at https://afdc.energy.gov/laws/inflation-reduction-act. The same website contains a list of eligible vehicles; but, as noted, the specific vehicle should be checked to confirm it is eligible for the credit.

If a taxpayer entered into a written binding contract to purchase a new qualifying electric vehicle before August 16, 2022, but did not take possession of the vehicle until on or after August 16, 2022 (for example, because the vehicle has not been delivered), the EV credit may be claimed based on the rules that were in effect before August 16, 2022. The final assembly requirement does not apply before August 16, 2022.

In general, a written contract is binding if it is enforceable under state law and does not limit damages to a specified amount (for example, by use of a liquidated damages provision or the forfeiture of a deposit). Although the enforceability of a contract under state law is a facts-and-circumstances determination to be made under relevant state law, if a customer has made a significant non-refundable deposit or down payment, it is an indication of a binding contract. For tax purposes in general, a contract provision that limits damages to an amount equal to at least 5% of the total contract price is not treated as limiting damages to a specified amount. For example, if a customer has made a non-refundable deposit or down payment of 5% of the total contract price, it is an indication of a binding contract. A contract is binding even if subject to a condition, as long as the condition is not within the control of either party. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions.

Crowdfunding: IRS Tax Tip 2022-120

Crowdfunding is a method of raising money through websites by soliciting contributions from a large number of people. People use crowdfunding to fundraise for a business, for charity, or for gifts. Unfortunately, many taxpayers are not aware that money raised through crowdfunding may be taxable. It’s important to remember that, under the IRC, gross income includes all income from any source, unless

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it's specifically excluded from gross income by law. In most cases, gifts aren't included in the gross income of the person receiving the gift.

What is received by contributors to a crowdfunding project varies from project to project. Sometimes contributors are offered “rewards” of small or nominal value, such as cups with logo, tee shirts, or tickets to an event. In other cases, contributors may receive the right to have their contributions repaid with interest if the campaign is financially successful or may receive an equity interest in the project.

There are no definitive judicial rulings that directly address the taxability of proceeds received from a crowdfunding project. Under general tax principles, however, gross income includes all income from whatever source derived, except as otherwise provided in a specific provision of the IRC. In the *Glenshaw Glass* case, the U.S. Supreme Court ruled that income means all accretions of wealth clearly realized. The concept of gross income is construed broadly and extends to all accessions to wealth over which the taxpayer has complete control. As the Supreme Court explained, a gain is taxable income when its recipient has such control over it that, as a practical matter, the recipient derives readily realizable economic value from it.

One statutory exception to the definition of *gross income* is for money or other property transferred by gift. The value of property acquired by gift is generally excluded from the recipient's gross income. The U.S. Supreme Court in *Comm’r v. Duberstein, 363 U.S. 278 (1960)* defined a gift under IRC section 102 as “a transfer of property if it's made from detached and disinterested generosity, out of affection, respect, admiration, charity, or like impulses, and isn't made from a moral or legal duty, for anticipated economic benefit, or in return for services rendered.”

If a crowdfunding organizer is raising money on behalf of others, the money may not be included in the organizer's gross income as long as the organizer gives the money to the person for whom they organized the crowdfunding campaign. If people donate to a crowdfunding campaign out of generosity and without expecting anything in return, the donations are gifts. Therefore, they will not be included in the gross income of the person for whom the campaign was organized.

Although crowdfunding contributions made as a result of the contributors' detached and disinterested generosity, and without the contributor receiving or expecting to receive anything in return, may be gifts, taxpayers need to be cautious. For one thing, it needs to be appreciated that a gift is not the same as a charitable contribution. The transfer directly to an individual is not likely a charitable contribution because the individual isn't a qualified charitable organization. If the transfer is a gift, then the donor should be aware of the gift tax annual exclusion may be obligated to file a gift tax return.

However, not all contributions to crowdfunding campaigns are gifts and may be taxable. For example, any transfer from an employer to an employee is generally considered compensation and not a gift. Therefore, contributions to crowdfunding campaigns by an employer to or for the benefit of an employee are generally includible in the employee’s gross income.

The IRS has ruled that crowdfunding revenues generally are includible in income unless they are one of the following:

1. Loans that must be repaid

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2. Capital contributed to an entity in exchange for an equity interest in the entity
3. Gifts made out of detached generosity and without any quid pro quo

In addition, crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property.

The crowdfunding website or its payment processor must file Form 1099-K, *Payment Card and Third-Party Network Transactions*, with the IRS if the amount raised is more than $600 and/or Contributors to the crowdfunding campaign receive goods or services for their contributions. If a Form 1099-K is filed, the crowdfunding organizer or the beneficiary of the fundraiser will receive a copy, depending on who received the funding directly from the crowdfunding website. Note that prior to December 31, 2021, a Form 1099-K was required to be filed if the total amount of funds distributed to a person exceeded $20,000 in gross payments from 200 or more transactions or donations. After December 31, 2021, the threshold has been lowered to $600 regardless of the number of transactions or donations that took place during the campaign.

A person receiving a Form 1099-K for distributions of money raised through crowdfunding may not recognize the filer's name on the form, for example because the payment processor used by the crowdfunding website, rather than the crowdfunding website itself, issues it. If the recipient of a Form 1099-K doesn't recognize the filer's name or the amounts included on the Form 1099-K, they can use the filer's telephone number listed on the form to contact a person knowledgeable about the payments reported. Box 1 on the Form 1099-K will show the gross amount of the distributions made to a person during the calendar year.

Form 1099-K is an information return, not a tax return, so receiving a Form 1099-K doesn't automatically mean the amount shown is taxable. However, if the taxpayer doesn't include the distributions from the form on their tax return, the IRS may contact the recipient for more information. The recipient will need to explain why the crowdfunding distributions weren't reported. People who run crowdfunding campaigns or receive money from one should keep careful records about the campaign and the disposition of funds for at least three years.

Gig workers and self-employment: IRS Tax Tip 2022-97

Contrary to the belief held by some taxpayers, gig work, such as driving a car for booked rides (for example, Uber and Lyft), selling goods online, renting out property, or providing other on-demand work, is taxable and must be reported as income on the worker's tax return. Earnings from gig economy work is taxable, regardless of whether an individual receives information returns.

The reporting requirement for issuance of Form 1099-K changed for payments received in 2022 to totals exceeding $600, regardless of the total number of transactions. This means some gig workers will now receive an information return. This is true even if the work is full time or part time.

If they are self-employed, gig workers must pay all their Social Security and Medicare taxes on their income from the gig activity. The business or the platform must determine whether the individual providing the services is an employee or independent contractor. Gig economy workers who aren't

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considered employees have two ways to cover their income taxes — if they have another job where they are an employee, submit a new Form W-4 to their employer to have more income taxes withheld or make quarterly estimated tax payments to help pay their income taxes throughout the year, including self-employment tax.

To determine whether an individual is an employee or an independent contractor under the common-law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories — behavioral control, financial control, and the type of relationship of the parties.

Behavior control is demonstrated by facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of: Instructions that the business gives to the worker. An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work.

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Facts that show whether the business has a right to control the business aspects of the worker's job include the extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their employer.

Another fact demonstrating control is the extent of the worker's investment. An independent contractor often has a significant investment in the facilities or tools he or she uses in performing services for

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someone else. However, a significant investment isn't necessary for independent contractor status. Also, an independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is often paid a flat fee or on a time and materials basis for the job. However, it is common in some professions, such as accounting and law, to pay independent contractors hourly. Furthermore, an independent contractor can make a profit or loss.

Facts that show the parties' type of relationship include written contracts describing the relationship the parties intended to create. And whether or not the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay. If an employer engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.

The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of your regular business activity, it is more likely that you'll have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

Because the determination of whether a particular taxpayer is an employee or independent contractor is based on the facts and circumstances, examples are most helpful. The IRS offers a multitude of examples in Publication 15a. Those examples are categorized by industry and reproduced here.

Building and construction industry

Example: House remodeling

Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She didn't advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others that he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Jerry isn't free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. Jerry Jones and his assistants are employees of Wilma White.

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Example: Construction site

Milton Manning, an experienced tile setter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He doesn't have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example: Sawdust Co.

Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He isn't responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount that he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he isn't personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

Example: Elm Corporation

Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

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Example: Electrical work

Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at $16 per hour for 400 hours. She is to receive $1,280 every 2 weeks for the next 10 weeks. This isn't considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive $6,400. She also performs additional electrical installations under contracts with other companies that she obtained through advertisements. Vera is an independent contractor.

Example: Trucking industry

Rose Trucking contracts to deliver material for Forest, Inc., at $140 per ton. Rose Trucking isn't paid for any articles that aren't delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan, and she is responsible for all maintenance. None of the drivers are provided by Forest, Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.

Computer industry

Example: Computer Programmer

Steve Smith, a computer programmer, is laid off when Megabyte, Inc., downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It isn't clear how long it will take to complete the project, and Steve isn't guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract that provides that Steve is considered to be an independent contractor, is required to pay federal and state taxes, and receives no benefits from Megabyte. Megabyte will file Form 1099-NEC, *Nonemployee Compensation*, to report the amount paid to Steve. Steve works at home and isn't expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

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Automobile industry

Example: Auto dealer

Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works six days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She is required to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example: Auto repair

Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example: Furnished space

An auto sales agency furnishes space for Helen Bach to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all of the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is an independent contractor and the helpers are her employees.

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Example: Attorney

Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, online legal research linkup, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past two years, Donna has had only three clients, corporations with which there have been long-standing relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, online research time, fax charges, photocopies, postage, and travel costs for which the corporations have agreed to reimburse her. Donna is an independent contractor.

Example: Taxicab driver

Tom Spruce rents a cab from Taft Cab Co. for $150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares that he receives from customers. Although he receives the benefit of Taft's two-way radio communication equipment, dispatcher, and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.

Salesperson

To determine whether salespersons are employees under the usual common-law rules, you must evaluate each individual case. If a salesperson who works for you doesn't meet the tests for a common-law employee, the employer doesn’t have to withhold federal income tax from his or her pay. However, even if a salesperson isn't an employee under the usual common-law rules for income tax withholding, his or her pay may still be subject to social security, Medicare, and FUTA taxes as a statutory employee.

Under the IRS guidelines for meeting the requirements of a statutory employee, the employer is instructed to withhold FICA taxes on income. Because statutory employees’ FICA is withheld through an employer, the employees do not pay self-employment tax; however, they must still report their wages, income, and allowable expenses.

To determine whether a salesperson is an employee for social security, Medicare, and FUTA tax purposes, the salesperson must meet all eight elements of the statutory employee test. A salesperson is a statutory employee for Social Security, Medicare, and FUTA tax purposes if he or she

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1. works full time for one person or company except, possibly, for sideline sales activities on behalf of some other person;
2. sells on behalf of and turns his or her orders over to the person or company for which he or she works;
3. sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments;
4. sells merchandise for resale or supplies for use in the customer's business;
5. agrees to do substantially all of this work personally;
6. has no substantial investment in the facilities used to do the work, other than in facilities for transportation;
7. maintains a continuing relationship with the person or company for which he or she works; and
8. isn't an employee under common-law rules.

Failure to itemize: *Salter v. Commissioner*, TC Memo 2022-29

Deductions are a matter of legislative grace, and taxpayers bear the burden of proving their entitlement to any deduction claimed. A taxpayer must show that he or she has met all requirements for each deduction and keep books or records that substantiate the expenses underlying it. Failure to keep and present such records counts heavily against a taxpayer's attempted proof.

IRC Section 274(d)(4) sets forth heightened substantiation requirements with respect to “listed property.” Vehicles are listed property. No deduction is allowed for vehicle expenses unless the taxpayer substantiates, by adequate records or sufficient evidence corroborating his own statements, the amount, time and place, and business purpose for each expenditure.

Furthermore, IRC Section 63(e) provides that, “[u]nless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year.” That section, under the heading “Time and Manner of Election,” provides that “[a]ny election under this subsection shall be made on the taxpayer's return.” In certain circumstances, a taxpayer may make “a change of election with respect to itemized deductions” but only when a return was previously filed.

The statutory direction that an election to itemize deductions must be made on the taxpayer's return is mandatory. Therefore, if an individual fails to file a return, he or she has made no election to itemize his or her deductions. If no return is filed and, as a result, the IRS prepares a substitute return, then the individual has made no election and may not claim itemized deductions.

During the first half of 2013, Shawn Stephen Salter resided in Arizona and was employed by Home Depot as a district loss prevention manager. He supervised 10 stores, mostly in the Phoenix metropolitan area. His tasks included training employees in loss prevention techniques and policies, auditing inventory, and conducting investigations of shoplifting and other thefts.

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Salter worked from home but traveled regularly by car to the stores under his supervision. Home Depot offered reimbursement for his travel expenses at a mileage rate, but he declined to seek reimbursement because he believed that claiming such costs on his tax return (as an unreimbursed employee expense) would give him a bigger refund. He produced no evidence (such as logs or odometer readings) to substantiate his work-related travel.

Salter was laid off in mid-2013. To tide himself over during his period of unemployment, he requested from Northern Trust and received during 2013 a distribution of $37,647 from his retirement plan. He had not reached the age of 59½ by that time. Having received no return from Salter for 2013, the IRS prepared a substitute for return on the basis of third-party reporting.

Allowing the standard deduction and one personal exemption, the IRS determined taxable income of and computed a tax of $13,195. It also determined an additional tax of $3,765, calculated as 10% of the early distribution from his retirement plan. This produced total tax of $16,960, against which the IRS offset $10,851 of tax withheld by his payors, producing an outstanding liability of $6,109.

After receiving the notice of deficiency, Salter informed the IRS of his belief that he had filed a return for 2013 using H&R Block software. But IRS records showed that no return had been submitted, and Salter was unable to produce, from H&R Block or his own files, a copy of a return or evidence of its filing. He then prepared, in April 2021, a Form 1040, *U.S. Individual Income Tax Return*, for 2013, reporting all items of income as shown on the notice of deficiency, but claiming itemized deductions.

Salter insisted that he did timely file a return for 2013, but he offered no evidence of any kind to support that assertion. Although he allegedly used H&R Block software to prepare the return, he did not produce a copy of any return, from H&R Block or from his own files. He produced no evidence that a return was filed, either by mail or electronically. He asserted that the return he allegedly filed claimed a refund, but he produced no financial records to substantiate his receipt of a refund. The certified IRS transcript of his 2013 account shows that, in December 2014, the IRS made an "inquiry for non-filing of tax return"; that the IRS sent him in March 2020 a "final notice before tax is determined by IRS"; and that a "substitute tax return [was] prepared by IRS." On this basis, the Tax Court found that Salter did not file a return for 2013, that he made no election to itemize deductions as required IRC Section 63(e), and that he accordingly is not allowed any itemized deductions. He remains entitled to the standard deduction as calculated on the notice of deficiency.

Cancellation of debt income

Generally, if a debt for which the taxpayer is personally liable is forgiven or discharged for less than the full amount owed, the debt is considered canceled in whatever amount it remained unpaid. Generally, the taxpayer must include the canceled debt in his or her income.

A *debt* includes any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property. Debt for which the taxpayer is personally liable is *recourse debt*. All other debt is *nonrecourse debt*. If the taxpayer isn't personally liable for the debt, the taxpayer doesn't have ordinary income from the cancellation of debt unless the taxpayer retains the collateral; and either the lender offers a discount

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for the early payment of the debt, or the lender agrees to a loan modification that results in the reduction of the principal balance of the debt.

However, upon the disposition of the property securing a nonrecourse debt, the amount realized includes the entire unpaid amount of the debt, not just the fair market value (FMV) of the property. As a result, the taxpayer may realize a gain or loss if the outstanding debt immediately before the disposition is more or less than his or her adjusted basis in the property. There are several exceptions and exclusions that may result in part or all of a canceled debt being nontaxable.

The taxpayer must report any taxable canceled debt as ordinary income on

- Schedule 1 (Form 1040), line 8c, if the debt is a nonbusiness debt;
- Schedule C (Form 1040), line 6, if the debt is related to a nonfarm sole proprietorship;
- Schedule E (Form 1040), line 3, if the debt is related to nonfarm rental of real property;
- Form 4835, line 6, if the debt is related to a farm rental activity for which the taxpayer uses Form 4835 to report farm rental income based on crops or livestock produced by a tenant; or
- Schedule F (Form 1040), line 8, if the debt is farm debt and the taxpayer is a farmer.

If the taxpayer receives a Form 1099-C, *Cancellation of Debt*, that means an applicable entity has reported an identifiable event to the IRS regarding a debt the taxpayer owes. Unless the taxpayer meets one of the exceptions or exclusions, this canceled debt is ordinary income and must be reported on the appropriate form discussed previously. An applicable entity includes the following:

1. A financial institution
2. A credit union
3. Any of the following, its successor, or subunit of one of the following
    a. The Federal Deposit Insurance Corporation (FDIC)
    b. The Resolution Trust Corporation (RTC)
    c. The National Credit Union Administration (NCUA)
    d. Any other federal executive agency, including government corporations, any military department, the U.S. Postal Service, or the Postal Rate Commission
4. A corporate subsidiary of a financial institution or credit union (if the affiliation subjects the subsidiary to federal or state regulation)
5. A federal government agency, including a department, an agency, a court or court administrative office, or a judicial or legislative instrumentality
6. Any organization of which lending money is a significant trade or business

Box 6 of Form 1099-C should indicate the reason the creditor filed this form. Those codes are as follows:

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- Code A — Bankruptcy. Code A is used to identify cancellation of debt as a result of a Title 11 bankruptcy case.
- Code B — Other judicial debt relief. Code B is used to identify cancellation of debt as a result of a receivership, foreclosure, or similar federal or state court proceeding other than bankruptcy.
- Code C — Statute of limitations or expiration of deficiency period. Code C is used to identify cancellation of debt either when the statute of limitations for collecting the debt expires or when the statutory period for filing a claim or beginning a deficiency judgment proceeding expires. In the case of the expiration of a statute of limitations, an identifiable event occurs only if and when his or her affirmative defense of the statute of limitations is upheld in a final judgment or decision in a judicial proceeding, and the period for appealing the judgment or decision has expired.
- Code D — Foreclosure election. Code D is used to identify cancellation of debt when the creditor elects foreclosure remedies that statutorily end or bar the creditor's right to pursue collection of the debt. This event applies to a mortgage lender or holder who is barred from pursuing debt collection after a power of sale in the mortgage or deed of trust is exercised.
- Code E — Debt relief from probate or similar proceeding. Code E is used to identify cancellation of debt as a result of a probate court or similar legal proceeding.
- Code F — By agreement. Code F is used to identify cancellation of debt as a result of an agreement between the creditor and the debtor to cancel the debt at less than full consideration.
- Code G — Decision or policy to discontinue collection. Code G is used to identify cancellation of debt as a result of a decision or a defined policy of the creditor to discontinue collection activity and cancel the debt. For purposes of this identifiable event, a defined policy includes both a written policy and the creditor's established business practice.
- Code H — Other actual discharge before identifiable event. Code H is used to identify an actual cancellation of debt that occurs before any of the identifiable events described in codes A through G.

The amount in box 2 of Form 1099-C may represent some or all of the debt that has been canceled. The amount in box 2 will include principal and may include interest and other nonprincipal amounts (such as fees or penalties). Unless the taxpayer meets one of the exceptions or exclusions, the amount of the debt that has been canceled is ordinary income and must be reported on the appropriate form.

If any interest is included in the amount of canceled debt in box 2, it will be shown in box 3. Whether the interest portion of the canceled debt must be included in his or her income depends on whether the interest would be deductible if the taxpayer paid it.

If the taxpayer and another person were jointly and severally liable for a canceled debt, each of the taxpayers may get a Form 1099-C showing the entire amount of the canceled debt. However, the taxpayer may not have to report that entire amount as income. The amount, if any, the taxpayer must report depends on all the facts and circumstances, including

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- state law,
- the amount of debt proceeds each person received,
- how much of any interest deduction from the debt was claimed by each person,
- how much of the basis of any co-owned property bought with the debt proceeds was allocated to each co-owner, and
- whether the canceled debt qualifies for any of the exceptions or exclusions described in this publication.

If a lender discounts the principal balance of a loan because the taxpayer paid it off early or agrees to a loan modification (a "workout") that includes a reduction in the principal balance of a loan, the amount of the discount or the amount of principal reduction is canceled debt. However, if the debt is nonrecourse and the taxpayer didn't retain the collateral, the taxpayer doesn't have cancellation of debt income. The amount of the canceled debt must be included in income unless one of the exceptions or exclusions described later applies.

If the taxpayer owned property that was subject to a recourse debt in excess of the FMV of the property, the lender's foreclosure or repossession of the property is treated as a sale or disposition of the property by the taxpayer and may result in his or her realization of gain or loss. The gain or loss on the disposition of the property is measured by the difference between the FMV of the property at the time of the disposition and his or her adjusted basis (usually his or her cost) in the property. The character of the gain or loss (such as ordinary or capital) is determined by the character of the property. If the lender forgives all or part of the amount of the debt in excess of the FMV of the property, the cancellation of the excess debt may result in ordinary income. The ordinary income from the cancellation of debt (the excess of the canceled debt over the FMV of the property) must be included in his or her gross income reported on his or her tax return unless one of the exceptions or exclusions described later applies.

If the taxpayer owned property that was subject to a nonrecourse debt in excess of the FMV of the property, the lender's foreclosure on the property doesn't result in ordinary income from the cancellation of debt. The entire amount of the nonrecourse debt is treated as an amount realized on the disposition of the property. The gain or loss on the disposition of the property is measured by the difference between the total amount realized (the entire amount of the nonrecourse debt plus the amount of cash and the FMV of any property received) and his or her adjusted basis in the property. The character of the gain or loss is determined by the character of the property.

If the taxpayer abandoned property that secures a debt for which the taxpayer is personally liable (recourse debt) and the debt is canceled, the taxpayer will realize ordinary income equal to the canceled debt. The taxpayer must report this income on his or her tax return unless one of the exceptions or exclusions described later applies. For more details, see exceptions and exclusions, later. This income is separate from any amount realized from the abandonment of the property.

If the taxpayer abandoned property that secures a debt for which the taxpayer isn't personally liable (nonrecourse debt), the taxpayer may realize gain or loss but won't have cancellation of indebtedness income.

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If the taxpayer is a stockholder in a corporation and the corporation cancels or forgives his or her debt to it, the canceled debt is a constructive distribution.

The student loan exception

There are some exceptions to the requirement that the taxpayer include canceled debt in income. These exceptions apply before the exclusions discussed later and don't require the taxpayer to reduce his or her tax attributes. For example, in most cases, the taxpayer doesn't have income from canceled debt if the debt is canceled as a gift, bequest, devise, or inheritance. Another exception applies If a taxpayer uses the cash method of accounting and the payment of the debt would have been a deductible expense.

The most common and most complex exclusion, however, is for certain student loans. -

There are student loan exclusions for

- student loan cancellation due to meeting certain work requirements;
- cancellation of certain loans after December 31, 2020, and before January 1, 2026; and
- student loan repayment assistance programs.

If a taxpayer's student loan was canceled in part or in whole in 2021 due to meeting certain work requirements, the taxpayer may not have had to include the canceled debt in his or her income. To qualify for this work-related exclusion, his or her loan must have been made by a qualified lender to assist the taxpayer in attending an eligible educational organization. In addition, the cancellation must have been pursuant to a provision in the student loan that all or part of the debt will be canceled if the taxpayer work for a certain period of time, in certain professions, and for any of a broad class of employers.

The American Rescue Plan Act of 2021 modified the treatment of student loan forgiveness for discharges in 2021 through 2025. Generally, if the taxpayer is responsible for making loan payments, and the loan is canceled or repaid by someone else, the taxpayer must include the amount that was canceled or paid on his or her behalf in his or her gross income for tax purposes. However, in certain circumstances, the taxpayer may be able to exclude this amount from gross income if the loan was one of the following.

- A loan for postsecondary educational expenses
- A private education loan
- A loan from an educational organization described in section 170(b)(1)(A)(ii)
- A loan from an organization exempt from tax under section 501(a) to refinance a student loan

A loan for postsecondary educational expenses is any loan provided expressly for postsecondary education, regardless of whether provided through the educational organization or directly to the borrower, if such loan was made, insured, or guaranteed by one of the following:

1. The United States, or an instrumentality or agency thereof

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2. A state, territory, or possession of the United States; or the District of Columbia; or any political subdivision thereof

3. An eligible educational organization

An eligible educational organization is generally any accredited public, nonprofit, or proprietary (privately owned profit-making) college, university, vocational school, or other postsecondary educational organization. Also, the organization must be eligible to participate in a student aid program administered by the U.S. Department of Education.

A private education loan is a loan provided by a private educational lender that

- is not made, insured, or guaranteed under Title IV of the Higher Education Act of 1965; and
- is issued expressly for postsecondary educational expenses to a borrower, regardless of whether the loan is provided through the educational organization that the student attends or directly to the borrower from the private educational lender. A private education loan does not include an extension of credit under an open end consumer credit plan, a reverse mortgage transaction, a residential mortgage transaction, or any other loan that is secured by real property or a dwelling.

Private educational lender. A private educational lender is one of the following.

- A financial institution that solicits, makes, or extends private education loans
- A federal credit union that solicits, makes, or extends private education loans
- Any other person engaged in the business of soliciting, making, or extending private education loans

A loan from an educational organization is any loan made by the organization if the loan is made

- as part of an agreement with an entity described earlier under which the funds to make the loan were provided to the educational organization; or
- under a program of the educational organization that is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs where the services provided by the students (or former students) are for or under the direction of a governmental unit or a tax exempt Section 501(c)(3) organization.

An *educational organization* is an organization that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Note that care must be taken with regard to student loans that are “forgiven” in return for services performed for that organization or another organization that provided the funds for the loan. In these cases, the cancellation of a student loan must be included in gross income on his or her tax return.

Also, if the taxpayer refinanced a student loan with another loan from an eligible educational organization or a tax exempt organization, that loan may also be considered as made by a qualified lender. The

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refinanced loan is considered made by a qualified lender if it's made under a program of the refinancing organization that is designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs where the services required of the students are for or under the direction of a governmental unit or a tax exempt Section 501(c)(3) organization.

Finally, student loan repayments made to the taxpayer is tax free if the taxpayer received them for any of the following.

- the National Health Service Corps (NHSC) Loan Repayment Program;
- a state education loan repayment program eligible for funds under the Public Health Service Act; and
- any other state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health services in underserved or health professional shortage areas (as determined by such state).

Executive order providing cancellation of student loan debt

August 24, 2022, President Joe Biden announced an executive order providing student loan relief. Barring legal challenges, applications for cancellation are expected to open in October. Some borrowers whose income information is already listed with the Department of Education could see cancellation occur automatically.

Targeted debt relief is provided as the Department of Education will provide up to $20,000 in debt cancellation to Pell Grant recipients with loans held by the Department of Education, and up to $10,000 in debt cancellation to non-Pell Grant recipients. Borrowers are eligible for relief if their individual income is less than $125,000 ($250,000 for married couples).

The pause on federal student loan repayment will be extended one final time through December 31, 2022. Borrowers should resume payment in January 2023.

The American Rescue Plan, passed in 2021, had a provision that exempts all federal student loan forgiveness from taxation through the end of 2025. This would include the $10,000 and $20,000 in student loan forgiveness that the Biden executive order contained.

Exclusions of cancellation of debt income from taxable income

After the taxpayer has applied any exceptions to the general rule that a canceled debt is included in his or her income, there are several reasons why the taxpayer might still be able to exclude a canceled debt from his or her income. If a canceled debt is excluded from his or her income, it is nontaxable.

Bankruptcy

Debt canceled in a Title 11 bankruptcy case isn't included in his or her income. A Title 11 bankruptcy case is a case under Title 11 of the United States Code (including all chapters in Title 11 such as chapters 7, 11, and 13). The taxpayer must be a debtor under the jurisdiction of the court and the cancellation of the debt must be granted by the court or occur as a result of a plan approved by the court.

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The taxpayer doesn’t qualify for the bankruptcy exclusion by being an owner of (or a partner in a partnership that owns) a grantor trust or disregarded entity that is a debtor in a Title 11 bankruptcy case. The taxpayer must be a debtor in a Title 11 bankruptcy case to qualify for this exclusion.

Insolvency

There is also an insolvency exclusion. The taxpayer must be insolvent to qualify for this exclusion. Someone is insolvent immediately before the cancellation to the extent that the total of all of their liabilities was more than the FMV of all of their assets immediately before the cancellation. For purposes of determining insolvency, assets include the value of everything owned (including assets that serve as collateral for debt and exempt assets, which are beyond the reach of creditors under the law such as interest in a pension plan and the value of your retirement account). Liabilities include

- the entire amount of recourse debt;
- the amount of nonrecourse debt that isn't in excess of the FMV of the property that is security for the debt; and
- the amount of nonrecourse debt in excess of the FMV of the property subject to the nonrecourse debt, to the extent nonrecourse debt in excess of the FMV of the property subject to the debt is forgiven.

Farm debt

A taxpayer can exclude canceled farm debt from income if all of the following apply.

1. The debt was incurred directly in connection with the operation of the trade or business of farming.
2. 50% or more of the total gross receipts for the previous three years were from the trade or business of farming.
3. The cancellation was made by a qualified person.

A *qualified person* is an individual, organization, partnership, association, corporation, or other person who is actively and regularly engaged in the business of lending money. A qualified person also includes any federal, state, or local government or agency or instrumentality of one of those governments. For example, the U.S. Department of Agriculture is a qualified person. A qualified person can't be related to you, can't be the person from whom you acquired the property (or a person related to this person), and can't be a person who receives a fee due to your investment in the property (or a person related to this person).

Qualified real property business indebtedness

A taxpayer can elect to exclude canceled qualified real property business indebtedness from income. *Qualified real property business indebtedness* is debt (other than qualified farm debt) that meets all of the following conditions.

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1. It was incurred or assumed in connection with real property used in a trade or business. Real property used in a trade or business doesn't include real property developed and held primarily for sale to customers in the ordinary course of business.
2. It is secured by that real property. As long as certain other requirements are met, indebtedness that is secured by 100% of the ownership interest in a disregarded entity holding real property will be treated as indebtedness that is secured by real property.
3. It was incurred or assumed:
    - *a.* before 1993; or
    - *b.* after 1992, if the debt is either
        - i. qualified acquisition indebtedness or
        - ii. debt incurred to refinance qualified real property business debt incurred or assumed before 1993 (but only to the extent the amount of such debt doesn't exceed the amount of debt being refinanced).

Qualified acquisition indebtedness is either

- debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that is used in a trade or business and secures the debt; or
- debt resulting from the refinancing of qualified acquisition indebtedness to the extent the amount of the debt doesn't exceed the amount of debt being refinanced.

Qualified principal residence indebtedness

Qualified principal residence indebtedness is any mortgage taken out to buy, build, or substantially improve the taxpayer's principal residence. It must also be secured by that residence. Qualified principal residence indebtedness also includes any debt secured by the principal residence that the taxpayer used to refinance a mortgage taken out to buy, build, or substantially improve the principal residence but only up to the amount of the old mortgage principal just before the refinancing. The maximum amount that can be treated as qualified principal residence indebtedness is $750,000 ($375,000 if married filing separately).

Reduction of tax attributes

As noted, if a canceled debt is excluded from his or her income, it is nontaxable. In most cases, however, if the taxpayer excludes canceled debt from income under one of these provisions, the taxpayer must also reduce his or her tax attributes (certain credits, losses, and basis of assets).

Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, is used to reflect the reduction of tax attributes. The order in which the tax attributes are reduced depends on the reason the canceled debt was excluded from income. If the canceled debt is excluded by reason of the bankruptcy or insolvency exclusion, the excluded debt must be used to reduce

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the following tax attributes (but not below zero) in the order listed unless the taxpayer elects to reduce the basis of depreciable property first.

1. Net operating loss (NOL). Reduce any NOL in the order of the tax years from which the carryovers arose, starting with the earliest year. Reduce the NOL or carryover by one dollar for each dollar of excluded canceled debt.
2. General business credit carryover. Reduce the credit carryover in the order in which they are taken into account for the current year. Reduce the carryover by 33 ⅓ cents for each dollar of excluded canceled debt.
3. Minimum tax credit. Reduce the minimum tax credit available by 33 ⅓ cents for each dollar of excluded canceled debt.
4. Net capital loss and capital loss carryovers. Reduce the current year capital loss and then capital loss carryover in the order of the tax years from which the carryovers arose, starting with the earliest year. Reduce the net capital loss or carryover by one dollar for each dollar of excluded canceled debt.
5. Basis. Reduce the basis of the property in the following order (and, within each category, in proportion to adjusted basis):
    - *a.* Real property used in your trade or business or held for investment (other than real property held for sale to customers in the ordinary course of business) if it secured the canceled debt
    - *b.* Personal property used in your trade or business or held for investment (other than inventory and accounts and notes receivable) if it secured the canceled debt
    - *c.* Any other property used in your trade or business or held for investment (other than inventory, accounts receivable, notes receivable, and real property held for sale to customers in the ordinary course of business)
    - *d.* Inventory, accounts receivable, notes receivable, and real property held primarily for sale to customers in the ordinary course of business
    - *e.* Personal-use property (property not used in your trade or business nor held for investment)
6. Passive activity loss and credit carryovers. Reduce the current passive activity loss and credit carryovers by one dollar for each dollar of excluded canceled debt. Reduce the credit carryover by 33 ⅓ cents for each dollar of excluded canceled debt.
7. Foreign tax credit. Reduce the credit carryovers in the order in which they are taken into account. Reduce the carryover by 33 ⅓ cents for each dollar of excluded canceled debt.

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Charitable Contributions

Learning objectives

- Identify the basic requirements for a qualified conservation contribution.
- Recognize the restrictions contained in the extinguishment regulations.
- Indicate the subordination requirements for loans made on conservation easement property.
- Recognize how the anticipatory assignment of income doctrine affects charitable contributions of business interests.
- Identify the requirements for a contemporaneous written acknowledgment.

Conservation easements

Property can be owned in any number of ways. When real property is owned by one person, it is commonly referred to as a "fee simple" interest. Simultaneous ownership among two or more persons can take the form of a tenancy-in-common interest, a joint interest, or, in some states, a tenancy-by-the-entireties interest. These are all examples of "undivided" interests, in the sense that the co-owners are deemed to own their respective portion of each molecule of the property rather than an identifiable physical part. Other interests in property may take the form of easements, licenses, and mineral rights. An easement or license is when the owner grants the right to use the property for a specific purpose. An easement or license can be of limited duration or may be perpetual.

The general rule is that a charitable contribution deduction of property is permitted only for the transfer of the entire interest in the property; deductions for partial interest donations are not allowed. However, there is a statutory exception found in IRC section 170(h). That section allows qualified conservation

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contributions. A *qualified conservation contribution* is a contribution of a qualified real property interest (typically an easement) to a qualified organization exclusively for conservation purposes. The main characteristics of a qualified conservation contribution is that the donee must be prohibited from making certain transfers, and the conservation purpose must be protected in perpetuity. In addition to conservation easements that preserve portions of real property to protect a natural habitat or maintain open space, there are also façade easements that preserve the historical character of a building's exterior.

The extinguishment regulations

In general, easements may be voluntarily extinguished in a variety of ways (such as through release, merger, or abandonment). Because a qualified conservation easement must meet the "in perpetuity" requirement, none of these methods of extinguishment is available to these types of easements. However, the regulations governing qualified conservation contributions contemplate that there may be circumstances when an easement created in perpetuity for conservation purposes may be involuntarily extinguished. For example, a subsequent unexpected change in the conditions surrounding the property could make the continued use of the property for conservation purposes impossible or impractical. In that case, there may be a court-ordered or "judicial" extinguishment.

Under Treasury Regulation section 170A-14(g)(6)(i), if a subsequent unexpected change in the conditions surrounding the property that is the subject to a qualified conservation easement makes the continued use of the property for conservation purposes impossible or impractical, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

The term *donee's proceeds* is defined in Treas. Reg. section 170A-14(g)(6)(ii). That section says that, for the taxpayer to be entitled to a deduction for a conservation easement:

> … at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time.

Furthermore, that proportionate value of the donee's property rights must remain constant. Accordingly, when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction, the donee organization — on a subsequent sale, exchange, or involuntary conversion of the subject property — must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

The question not directly addressed in these regulations is whether specific language in a deed is necessary to satisfy these requirements and whether the "proportionate value" due to the donee includes

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increases in value unilaterally created by the taxpayer (such as by virtue of improvements constructed on the property).

To address the first situation, the IRS provided sample deed language in June of 2021 via Chief Counsel Advice 2021300014. That sample language is as follows:

> Donor agrees that the donation of the perpetual conservation restriction described in this deed gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. For purposes of this paragraph, the proportionate value of the donee organization's property rights shall remain constant.
>
> On a subsequent sale, exchange, or involuntary conversion of the subject property, the donee organization will be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction.
>
> All of the donee organization's proceeds from a subsequent sale or exchange of the property must be used by the donee organization in a manner consistent with the conservation purposes of the original contribution.
>
> Note that this is suggested sample language only, it is not language mandated by law. The following recent cases explore these issues.

A win for the taxpayer: *Morgan Run Partners, LLC v. Commissioner*, TC Memo 2022-61

As noted previously, for the donation of an easement to be a “qualified conservation contribution,” the conservation purpose must be “protected in perpetuity.” Occasionally, an easement may be involuntarily extinguished (such as, through the condemnation of the property by the state). The regulations recognize that “a subsequent unexpected change in the conditions surrounding the [donated] property ... can make impossible or impractical the continued use of the property for conservation purposes.”

Despite that possibility, the conservation purpose can nonetheless be treated as “protected in perpetuity” if the restrictions are extinguished by a judicial proceeding (such as a condemnation procedure), and the easement deed ensures that the charitable grantee, following sale of the property, will receive a proportionate share of the proceeds and use those proceeds consistently with the conservation purposes underlying the original gift. In cases like this, the “protected perpetuity” requirement is deemed satisfied because the sale proceeds replace the easement as an asset deployed by the donee exclusively for conservation purposes. Therefore, a key issue involves the mandatory division of proceeds when the property is transferred for consideration following extinguishment of the easement.

Treas. Reg. section 1.170A-14(g)(6)(i) sets forth a formula for determining the proportionate share the grantee must receive upon any extinguishment of the easement. Under that formula, at the time of the

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gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. That proportionate value of the donee's property rights must remain constant. Therefore, when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction, the donee organization must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction.

In other words, the charity's proportionate share is to be determined by a fraction, the numerator of which is the fair market value of the conservation easement on the date of the gift, and the denominator of which is the fair market value of the property as a whole on the date of the gift.

Morgan Partners, LLC is an Alabama limited liability company. In November 2016, Greenwood Partners, LLC, acquired a 94% membership interest in Morgan by contributing to it roughly 232 acres of land in Jefferson County, Alabama. In December 2016, Morgan granted to the National Farmer's Trust a conservation easement over the property.

The easement deed stated that the fair market value of the trust's right and interest will be equal to the difference between: (*a*) the fair market value of the Conservation Area as if not burdened by the conservation easement and (*b*) the fair market value of the Conservation Area burdened by the conservation easement. Therefore, the deed defined the trust's property right as equal to the fair market value of the easement, but it did not specify the point in time at which this calculation is to be made.

The language of the deed expressed the parties' intention that "no change in conditions … will at any time or in any event result in the extinguishment of any of the covenants, restrictions, or easements" specified in the deed. However, it went on to acknowledge "that circumstances could arise which would justify the modification of certain of the restrictions" set forth in the deed. In that event, the trust and owner (i.e., Morgan) "shall mutually have the right, in their sole discretion, to agree to amendments to [the deed] which are not inconsistent with the Conservation Purposes." This procedure was subject to the proviso that the trust shall have no power to agree to any amendment "that would result in this Conservation Easement failing to qualify as a qualified contribution under Section 170(h) of the Internal Revenue Code."

The deed addressed the possibility that the easement restrictions might be abrogated "by exercise of eminent domain." In that event, the trust and owner "shall join in appropriate actions...to recover the full value of the taking and all incidental or direct damages." Upon such recovery, "[t]he Trust shall be entitled the Trust's Proportionate Share of the recovered proceeds," but the term *proportionate share* was not defined. In connection with any eminent domain action, "[a]ll expenses incurred by Owner and the Trust reasonable attorneys' fees...shall be paid out of the recovered proceeds."

The IRS contended that the deed violated the "judicial extinguishment" regulation. But this deed, unlike most easement deeds, did not explicitly address the subject of judicial extinguishment. Rather, it expressed the parties' intention that "no change in conditions ... will at any time or in any event result in the extinguishment" of the easement. Should circumstances arise that would justify modifying certain restrictions, the deed envisions that Morgan and the trust would agree to appropriate amendments, with

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the proviso that the trust would have no power to agree to any amendment that would violate IRC section 170(h). Given this text, Morgan had a reasonable argument that the deed violates neither the "judicial extinguishment" regulation nor the statutory requirement that the conservation purpose be "protected in perpetuity."

The deed did address the possibility that the restrictions might be abrogated "by exercise of eminent domain." The IRS urged that the trust would then be limited to receiving proceeds equal to the value of the easement when initially granted, with no protection against inflation. That outcome would be at odds with the "protected-in-perpetuity" requirement. But the deed says that in the event of eminent domain the Trust shall be entitled, not to a fixed historical value, but to "the Trust's Proportionate share of the recovered proceeds." Oddly, the term *proportionate share*, though seemingly intended as a term of art, is not defined in the deed. This creates an ambiguity that would need to be resolved under principles of Alabama law.

The IRS also faulted the deed for providing that, in the event of an eminent domain recovery, "[a]ll expenses incurred by Owner and the Trust reasonable attorneys' fees ... shall be paid out of the recovered proceeds." But it is not necessarily unreasonable for a deed to provide that prior claims or expenses may be paid from sale proceeds. What would be unreasonable (and violative of the regulation) would be a requirement that all claims and expenses of sale be paid out of the trust's share of the proceeds. Here, the deed provides that the proceeds will be reduced by both parties' expenses. It is not obvious that this violates the "judicial extinguishment" regulation or the statutory requirement that the conservation purpose be "protected in perpetuity." For that reason, the Tax Court denied the IRS's motion with respect to the "protected-in-perpetuity" requirement.

A win for the IRS: *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 2021)

In 2005, George R. Dixson purchased 2,602 acres of rural, undeveloped real estate in Van Buren County, Tennessee, for about $1.9 million. In 2008, Dixson transferred 652 acres that accounted for about $486,000 of the original purchase price to two limited liability companies that he wholly owned. In November 2013, that 652 acres was transferred to TOT Property Holdings, LLC, which, after the transfer, owned only the property and $100 cash.

On December 10, 2013, PES Fund VI, LLC purchased almost the entirety of the ownership interest in TOT Holdings. PES Fund paid $717,200 in cash and assumed the sellers' obligations to make $322,000 in capital contributions, a total consideration of $1,039,200.

On December 27, 2013, a few weeks after the PES Fund transaction, TOT Holdings executed a deed that donated to Foothills Land Conservancy a conservation easement encumbering nearly all its property. Section 9 of the deed governs extinguishment and condemnation of the easement. Section 9.1, the extinguishment section, states:

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> If circumstances arise in the future that render the purpose of this Easement impossible to accomplish, the Easement can only be terminated or extinguished, whether in whole or in part, by judicial proceedings in a court of competent jurisdiction. The amount of the proceeds to which Grantee shall be entitled from any sale, exchange, or involuntary conversion of all or any portion of the Property subsequent to such termination or extinguishment, shall be the stipulated fair market value of this Easement, or proportionate part thereof, as determined in accordance with Section 9.2 or 26 CFR Section 1.170A-14, if different.

Section 9.2 of the deed is entitled "Valuation." The easement is a real property interest immediately vested in Foothills. According to Sections 9.1 and 9.2, the stipulated fair market value of the easement at the time of such future extinguishment (which will determine the "amount of the proceeds to which Grantee shall be entitled") shall be determined by (as stated in Section 9.2):

> multiplying (a) the fair market value of the Property unencumbered by this Easement (minus any increase in value after the date of this grant attributable to improvements) by (b) a fraction, the numerator of which is the value of this Easement at the time of the grant and the denominator of which is the value of the Property without deduction of the value of this Easement at the time of this grant.

In other words, this Section 9.2 formula provides that, upon any such future extinguishment (for example, condemnation), the proceeds (for example, proceeds of the condemnation) shall be reduced by "any increase in value after the date of this grant attributable to improvements," and then the charitable donee's share would be determined by multiplying that reduced amount times the defined fraction. And the numerator and denominator of the fraction are the value, respectively, of the easement and unencumbered property at the time of the grant. Section 9.2 then concludes as follows: "It is intended that this Section 9.2 be interpreted to adhere to and be consistent with 26 CFR Section 1.170A-14(g)(6)(ii)."

This language at the end of Section 9.2 regarding intent to adhere to 26 CFR Section 1.170A-14(g)(6)(ii) and the language at the end of Section 9.1 — requiring proceeds be "determined in accordance with Section 9.2 or 26 CFR Section 1.170A-14, if different" — were together called the "Treasury Regulation Override" by the parties.

TOT Holdings timely filed a Form 1065 partnership tax return for the period beginning December 11, 2013, and ending December 31, 2013, on which it reported a charitable contribution of a qualified conservation easement of $6.9 million. An IRS revenue agent examined the tax return and determined that the easement did not qualify for the claimed deduction and that accuracy-related penalties were applicable.

The Tax Court held that the deed failed to protect the conservation purpose of the easement in perpetuity, a requirement for a deduction. This was because the formula for the distribution of extinguishment proceeds in Section 9.2 of the deed was inconsistent with the regulation that defined this

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protected-in-perpetuity requirement. The deed impermissibly provided that the donee's proportion of the proceeds would subtract out, and therefore not include, any increase in value (after the date of the charitable gift) attributable to improvements. Although TOT argued that the deed included the Treasury Regulation Override as an interpretive tool that required compliance with the regulation, the Tax Court concluded that the Override provisions were unenforceable as "condition subsequent savings clauses." Without the Override, the non-compliant Section 9.2 formula would impermissibly apply in extinguishment proceedings, and the IRS properly denied TOT's deduction. TOT timely appealed the Tax Court's decision to the U.S. Court of Appeals for the Eleventh Circuit.

On appeal TOT argued (*a*) that the easement deed complies with the regulatory formula requirement because the Treasury Regulation Override is an interpretive guide that requires compliance with the regulation; (*b*) that the value of the easement should have been based on the property's highest and best before use as a residential development; and (*c*) that an IRS supervisor did not approve the penalties in writing until after the initial determination.

The dispositive question for whether the taxpayer may claim a deduction in this case is whether the Treasury Regulation Override provisions in Section 9 of the easement deed are impermissible savings clauses that are triggered by a condition subsequent or valid interpretive provisions. If the former, the deed is not in compliance with the regulations and no deduction can be claimed. If the latter, it is at least arguable that the deed complies.

The statutes and regulations for conservation easements require a specific formula for the distribution of extinguishment proceeds, and the formula in the deed is different than the specific regulatory formula. Federal tax deductions are generally not allowed for anything less than a full donation of real property, but an exception is made for a "qualified conservation contribution." A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. The statute does not define this "protected-in-perpetuity" requirement.

To meet the protected-in-perpetuity requirement, the regulations require that the deed donating the property restriction (for example, an easement) must account for the possibility of unexpected changes to the property that would undermine the continued use of the property for conservation purposes. In the event of such changes, judicial extinguishment is required, and the donee of the restriction must receive a share of the proceeds determined by the regulatory formula.

TOT did not seriously dispute that the formula in Section 9.2 of the deed is different from this regulatory formula. Nor could they plausibly do so. Section 9.2 states that Foothills, as donee, is entitled to proceeds that are "determined by multiplying (*a*) the fair market value of the Property unencumbered by this Easement (minus any increase in value after the date of this grant attributable to improvements) by (*b*) a [defined] fraction." Unlike the formula in Section 9.2, the regulation does not allow for "any increase in value after the date of th[e] grant attributable to improvements" to be subtracted from the extinguishment (for example, condemnation) proceeds before the fraction is applied to the proceeds. No such "minus" language is included in the formula set out in the regulations. Therefore, the deed is different from and out of compliance with the formula set out in the regulation.

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TOT attempted to circumvent the problem of inconsistency of Section 9.2 with the requirements of the regulation, and the resulting disallowance of their deduction, by relying on the Treasury Regulation Override provisions of Sections 9.1 and 9.2. They argued that, pursuant to those provisions, the amount of the proceeds to which Foothills is entitled shall be "determined in accordance with Section 9.2 or 26 CFR Section 1.170A-14, if different," and "[i]t is intended that this Section 9.2 be interpreted to adhere to and be consistent with 26 CFR Section 1.170A-14(g)(6)(ii)." Their argument was that these provisions are interpretive tools that operate to require proceeds to be distributed in compliance with the regulations. Because the formula in Section 9.2 — the preferred alternative to applying CFR Section 1.170A-14, according to the deed — is, in fact, "different" from the regulatory formula and the deed requires the regulations to always control, TOT argued that we must interpret the deed to comply with the regulation.

TOT argued that the Tax Court erred in holding that the Treasury Regulation Override provisions were not interpretive and contained a "condition subsequent savings clause." Whether the donation of the conservation easement is deductible, therefore, turns on whether the Treasury Regulation Override provisions in the easement deed are unenforceable savings clauses, rather than valid interpretive provisions.

For federal tax purposes, courts and the IRS have refused to enforce a clause that purports to save an instrument from being out of compliance with the tax laws if the clause is operative by way of a condition subsequent. A condition subsequent rests on a future event, the occurrence of which terminates or discharges an otherwise absolute contractual duty. Such clauses that seek to recharacterize the nature of the transaction in the event of a future occurrence will be disregarded for federal tax purposes. On the other hand, when a clause has been recognized as an interpretive tool — and therefore valid — it is because it simply helps illustrate intent and is not dependent for its operation upon some subsequent adverse action by the IRS. Interpretive provisions are valid; conditions subsequent savings clauses will not be enforced.

To determine whether the Treasury Regulation Override provisions in the deed were interpretive provisions or condition subsequent savings clauses, the Eleventh Circuit relied on two cases from the Fourth Circuit, both of which held that clauses that purported to save a claimed tax deduction were unenforceable savings clauses.

First, in *Belk v. Commissioner* — a case affirming the disallowance of a deduction for the donation of a conservation easement, the clause at issue stated the donee "shall have no right or power to agree to any amendments ... that would result in this Conservation Easement failing to qualify ... as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations." The taxpayers, the Belks, argued that this clause was an interpretive clause that ensured regulatory compliance for deduction purposes, despite any facial noncompliance with the statutory requirements. The Fourth Circuit held that the clause was unenforceable because it rested on a future occurrence to save the deed and deduction and amounted to an "ask ... to 'void' the offending ... provision to rescue the[] tax benefit." There was also "no open interpretive question for the savings clause to 'help' clarify." Instead, the Belks hoped for the court to rewrite their easement deed to be compliant with the applicable regulations as if they had done so in the first place. "[T]o apply the savings clause as the Belks suggest[ed]" would be "sanctioning the very same 'trifling with the judicial process' [the court] condemned

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in” the second of our guiding Fourth Circuit cases (discussed next) and would lead to the “dramatic hamper[ing] [of] the Commissioner's enforcement power” and tax collection “grind[ing] to a halt.”

The second case was *Commissioner v. Procter*. In *Procter*, the taxpayer sought to avoid a gift tax by arguing that the following clause (in a trust indenture assigning to trustees’ interests in other trusts) avoided the possibility of a gift tax:

> [I]n the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.

In Proctor, the Tax Court had held in favor of the taxpayer, but the Fourth Circuit reversed because the only way a gift tax could be assessed was by way of collection and court proceedings, and the above-quoted clause, if valid, would operate to nullify any such proceedings. Such a condition subsequent was void as contrary to public policy. “It is manifest,” explained the court, “that a condition which involves this sort of trifling with the judicial process cannot be sustained.” Therefore, the clause impermissibly contained a condition subsequent that attempted to save the assignment from taxation and was unenforceable. The Fourth Circuit also held that the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case because the only possible controversy would be the validity of the clause’s operation between the donor and persons not before the court.

Three primary features of the Treasury Regulation Override provisions convinced the Eleventh Circuit that (like the clauses in Belk and Procter) they are unenforceable savings clauses not merely interpretive provisions. That is, the court held that TOT cannot use the Override to avoid taxation because the formula in Section 9.2 is unambiguous, the Override nullifies it, and it does so only in the event of some future occurrence.

First, the formula in Section 9.2 of the easement deed is unambiguous. It plainly and unambiguously provides that the required fraction or proportionate share shall be applied to the sales proceeds “minus any increase in value after the date of th[e] grant attributable to improvements.” Juxtaposed against the deed’s alternative formula — that in 26 CFR Section 1.170A-14(g)(6)(ii) — Section 9.2’s subtraction of the value of property improvements is stark. As in Belk, therefore, there is no open interpretive question for the savings clause to help clarify. Rather, Section 9.2 unambiguously provides that the value attributable to improvements will be subtracted from condemnation proceeds before the required fraction is applied.

Second, the operation of the Treasury Regulation Override provisions in this case means that the preferred formula — expressly described in the easement deed in Section 9.2 — is simply nullified. Again, Section 9.1 defines the fair market value of Foothills’s proceeds “as determined in accordance with Section 9.2 or 26 CFR Section 1.170A-14, if different.” Therefore, Section 9.1 clearly states that Section 9.2’s formula applies. It is first in the provision and has no condition attached to it. Then, the provision continues to contemplate the regulation’s application, but its application is conditional. That is, the

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application of the regulation is conditioned on whether it is “different” from the plain text of the express formula in the easement deed in Section 9.2. If it is “different,” the Override operates to simply rewrite the easement deed to eliminate the Section 9.2 formula, leaving operative only the regulatory formula. If enforced, the Override would then impermissibly countermand the plain text of the easement deed.

Third, for the Override to be triggered and for the regulation to apply as the proper formula over Section 9.2’s formula, a future event must occur (that is, a determination that the proper interpretation of the regulation is “different” from the formula set forth in Section 9.2). And, in this sense, Foothills’s property right to proceeds “equal to the [regulatory] proportionate value” is not “immediately vested” as the regulation requires because the defined right to proceeds — without improvements subtracted out — is conditioned on a subsequent IRS or court determination.

TOT made a few other arguments that the court rejected as without merit. They argued that the Treasury Regulation Override provisions are not conditioned on any adverse action by the IRS or a court; they argued that this meant the Override is an interpretive provision and not a condition subsequent savings clause. But whether Section 9.2 is “different” from CFR Section 1.170A-14(g) or whether Section 9.2’s formula can be interpreted as consistent with the regulation are questions that only the IRS or a court can determine. The clear necessity of an IRS or court determination makes TOT’s attempt to hide this necessity (while hidden by slightly more shrouded language than in Belk) unavailing. That is, although the Procter court examined language that expressly tied the savings clause’s effect to “an adverse IRS determination or court judgment” (and that was not present in this case), the court observed that it could think of no likely instance in which there might be an interpretation by anyone other than a court or the IRS that could lead to an operative interpretation of the Override that can be credited now for tax deduction purposes. TOT attempted to hedge its bets on both sides of the issue, hoping it could win no matter what. But as in Belk, the Treasury Regulation Override operates in precisely the same manner as that in Procter. Indeed, the court observed, the “if different” Override language is the same sort of problematic situation that leads to the trifling with the judicial process that case law has held to be unenforceable.

For the foregoing reasons, the Eleventh Circuit held that the Treasury Regulation Override provisions in this easement deed cannot operate to have the regulatory formula apply instead of Section 9.2’s formula. First, the unambiguous language of the formula set out in Section 9.2 is inconsistent with the formula required by the regulations. Second, case law that TOT did not challenge (for example, the Fourth Circuit Belk and Procter cases) holds that a condition subsequent savings clause is unenforceable for federal tax purposes. Third, the language of Sections 9.1 and 9.2 of the easement deed — especially the “if different” language — constituted an unenforceable condition subsequent savings clause and not merely interpretive guidance as the taxpayer urges. Accordingly, the formula set out in Section 9.2 controls over the “if different” savings clause in Section 9.1 such that the “protected-in-perpetuity” requirement of the statute and regulation is not satisfied, and the charitable gift of the easement deed does not qualify as an allowable deduction for federal tax purposes. Therefore, the Eleventh Circuit concluded that the Tax Court correctly upheld the IRS’s disallowance of TOT’s claimed deduction.

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Uncertainty Regarding the Validity of Extinguishment Regs: *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021) and *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022)

David and Tammy Hewitt appealed a decision of the Tax Court that they were not entitled to carryover a charitable contribution deduction for the donation of a conservation easement. The Tax Court concluded that the easement did not satisfy the "protected-in-perpetuity" requirement because it violated the judicial extinguishment proceeds formula set forth in Treas. Reg. section 1.170A-14(g)(6)(ii). Specifically, in the event of judicial extinguishment, the easement deed subtracts the value of post-donation improvements to the property before determining the donee's share of the proceeds, which the IRS asserted was in violation of the protected-in-perpetuity requirement. On appeal, the Hewitts contended that the IRS's interpretation of the regulation was incorrect because subtraction of the value of post-donation improvements from the proceeds allocated to the donee is the "better reading" of the regulation. In a previous case from 2018, the Eleventh Circuit determined that Treas. Reg. section 1.170A-14(g)(6)(ii) "does not indicate that any amount, including that attributable to improvements, may be subtracted out."

But the Circuit Court in that case did not address whether Treas. Reg. section 1.170A-14(g)(6)(ii) was procedurally valid under the Administrative Procedures Act or substantively valid under the Supreme Court's framework articulated in *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984). Here, however, the Hewitts challenged the regulation's validity on appeal. Specifically, the Hewitts argued that the IRS's interpretation of CFR Section 1.170A-14(g)(6)(ii) — prohibiting the subtraction of the value of post-donation improvements to the property on which a conservation easement exists from the proceeds in the event of judicial extinguishment — is arbitrary and capricious for violating the procedural requirements of the Administrative Procedure Act (APA) because the Treasury Department failed to respond to significant comments as to the improvements issue in promulgating the regulation. The Hewitts further argued that the regulation is substantively invalid under Chevron as an unreasonable interpretation of the statute.

The taxpayers' argument focused on how the Treasury Department handled (or failed to handle) comments to the regulation when it was initially proposed. In response to the Notice of Proposed Rulemaking containing the regulation in its proposed form, the New York Landmarks Conservancy ("NYLC") urged the Treasury to delete the proposed "proceeds" regulation because it contained problems of practical application. NYLC stated that although Congress enacted the statute to encourage the protection of the environment through the donation of conservation restrictions, the proposed regulation would thwart the purpose of the statute by deterring prospective donors because those donors would be discouraged from making a donation which could tie them to share proceeds of a sale or exchange with the donee under circumstances which cannot possibly be foreseen. NYLC believed that, if a split of proceeds under unknown circumstances would be required, it would discourage such donations of conservation easements. Furthermore, because the possibility of extinguishment is relatively remote, NYLC felt it was unnecessary for the Treasury to provide for allocation of proceeds after extinguishment.

NYLC also specifically commented on the issue of whether the value of post-donation improvements to the easement property should be included or excluded from the extinguishment proceeds formula

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contained in the regulation. NYLC asserted that the formula in the regulations failed to take into account that improvements may be made thereafter by the owner which should properly alter the ratio. In support of its concern, NYLC presented a mathematical example that was based on a fact pattern in the proposed regulations to show that requiring the prospective donor to turn over extinguishment proceeds attributable to post-donation improvements to the donee would obviously be undesirable to the prospective donor and would constitute a windfall to the donee organization. Therefore, in light of the potential inequities, NYLC recommended that the proposed proceeds formula be revised if the provision was not deleted in its entirety.

After a public hearing, the Treasury adopted the proposed regulations with some revisions. In the preamble to the final rulemaking, the Treasury stated that it had "consider[ed] ... all comments regarding the proposed amendments." However, in the "Summary of Comments" section, the Treasury did not discuss or respond to the comments made by NYLC or the other six commenters who made comments concerning the extinguishment proceeds regulation.

The Hewitts asserted that these seven comments (in particular, NYLC's comment) were sufficiently significant to warrant a response from the Treasury in promulgating the final extinguishment proceeds regulation. In response, the IRS asserted that none of the comments were not so significant so as to require a response from the Treasury because they did not raise any point casting doubt on the regulation's reasonableness. Therefore, the issue before the Eleventh Circuit was whether the Treasury's failure to respond to NYLC's and the other commenters' concerns about the extinguishment proceeds regulation was in violation of the procedural requirements of the APA.

Because the Treasury did not provide a response to NYLC's comments, its actions failed to provide an explanation sufficient for its path to be reasonably discerned or to provide any insight on what major issues of policy were assessed and why the agency reacted to them as it did. Courts are not required to take the agency's word that it considered all relevant matters. The court said a relevant and significant comment requires a response regardless of whether the point is made by many, a few, or even a single commenter.

For these reasons, the Eleventh Circuit concluded that the IRS's interpretation was, in fact, arbitrary and capricious and violated the APA's procedural requirements. Because the court found the IRS's interpretation to be invalid under the APA, the easement deed's subtraction of the value of post-donation improvements from the extinguishment proceeds allocated to the donee did not violate the protected-in-perpetuity requirement. Accordingly, they reversed the Tax Court's order disallowing the Hewitts' carryover deduction for the conservation easement.

The Sixth Circuit disagreed with this analysis and took a contrary position in *Oakbrook Land Holdings, LLC v. Commissioner*. In that case, the court also analyzed NYLC's comment in addition to comments from others who raised concerns about the perpetuity requirement and the judicial extinguishment proceeds formula. However, the Sixth Circuit concluded, in agreement with the IRS, that these comments were not significant enough to require a response from the Treasury pursuant to the APA.

The status of conservation easement deeds that do not allocate a pro rata portion of the fair market value of post-donation improvements is, for the moment, uncertain except for taxpayers in the Eleventh

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and Sixth circuits. A split among the circuits like this sometimes ends with a resolution in the U.S. Supreme Court, but it is impossible to predict whether a relevant case will come before the high court. Unless and until it does, taxpayers will have to use caution when taking a position contrary to the IRS with regard to extinguishment proceeds involving post-donation improvements.

No Negligence Penalty for Disallowed Easement Deductions: *Plateau Holdings LLC, et al. v. Commissioner*, TC Memo 2021-133

The Internal Revenue Code imposes a penalty for which any portion of an underpayment of tax is attributable to negligence or disregard of rules or regulations or to a substantial understatement of income tax. An understatement of income tax is "substantial" if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return. In the case of a partnership, a penalty applies when the partnership takes a return position that is negligent or that might create a substantial understatement of tax at the partner level.

The determination of an underpayment cannot be made at the partnership level because partnerships do not pay tax. However, the IRS can determine at the partnership level the applicability of the penalty for negligence or substantial understatement of income tax.

On its 2012 federal income tax return. Plateau Holdings, LLC claimed a deduction of $25,449,000 for the donation of certain conservation easements. The Tax Court disallowed the deduction in full because the judicial extinguishment clauses of the easement deeds did not protect the conservation purpose in perpetuity.

The Tax Court determined that the correct value of the easements was $2,691,200 and that a 40% penalty applied to the portion of the underpayment that resulted from Plateau's gross overvaluation of the easements. The overvaluation was $22,757,800 (that is, the difference between the value Plateau improperly claimed ($25,449,000) and the correct value of the easements ($2,691,200)).

The IRS also sought a 20% penalty for negligence or a substantial understatement of tax. This penalty would apply to what might be called the "lower tranche" of the underpayment (that is, the portion of the underpayment that was not attributable to a valuation misstatement). In other words, the 20% penalty would apply to the portion of the underpayment resulting from the Tax Court's conclusion that Plateau was not entitled to a charitable contribution deduction of $2,691,200, corresponding to the correct value of the easements.

Plateau contended that the 20% penalty should not apply because it had reasonable cause and acted in good faith when claiming a charitable contribution deduction. "Reasonable cause" is determined on a case-by-case basis, taking into account all pertinent facts and circumstances. One circumstance that may indicate reasonable cause is an honest misunderstanding of fact or law that is reasonable in the light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer.

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The Tax Court held that Plateau was ineligible for a charitable contribution deduction because the conservation purpose underlying the easements was not protected in perpetuity. That was chiefly because the deeds provided, in the event of a future judicial extinguishment of the easements, that the donee's proportionate share of the sale proceeds would be reduced by an impermissible carve-out for donor improvements.

The easement deeds were prepared by Mark Jendrek, an attorney for the donee, Foothills Land Conservancy. Both Mr. Jendrek and the Conservancy had considerable experience in drafting easement deeds, and the deeds in this case were modeled after others shared through an alliance of land trusts. Although Mr. Jendrek was not Plateau's lawyer, Plateau could reasonably have believed that he drafted the easements in a manner that was intended to comply with the regulations and to protect the Conservancy's interests.

When Plateau filed its 2012 return, the validity of such judicial extinguishment clauses had not been tested in litigation. All of the judicial opinions that have found such clauses wanting were issued well after Plateau executed the deeds. The information available to Mr. Jendrek and Plateau in December 2012 arguably supported the acceptability of judicial extinguishment clauses resembling those here.

For these reasons, the 20% penalty should not apply because Plateau had reasonable cause and acted in good faith when claiming a charitable contribution deduction, at least with respect to its claim of a deduction corresponding to the correct value of the easements.

Failure to Subordinate Destroys Deduction: *Broadway Limited v. Commissioner*, (2021) TC Memo 2021-132

901 South Broadway Limited Partnership transferred to the Los Angeles Conservancy of a façade easement on a building at 901 South Broadway Avenue, Los Angeles, California. When the partnership granted the easement to the Conservancy, the underlying property was subject to five deeds of trust securing loans made to the partnership. Those loans had been made by three different lenders: MAC Commercial Mortgage Corp. ("GMAC"), the City of Los Angeles ("City"), and the City's Community Redevelopment Agency ("Agency").

Those lenders were beneficiaries of deeds of trust on the building with secured loans made to the partnership. In some circumstances, the deeds of trust required the lenders to allow insurance proceeds arising from damage to building or the proceeds from its condemnation to be used to repair or restore building. In other circumstances, the lenders could apply those proceeds to satisfy the indebtedness secured by the deeds of trust. The easement deed provided that, in the event of casualty or condemnation, the partnership and the Conservancy were entitled to share any net proceeds remaining after the satisfaction of "prior claims."

The Tax Court noted that the partnership significantly overstated the case in claiming that the deeds of trust require the lenders, in all circumstances, to use insurance or condemnation proceeds to repair or restore the building. For example, the partnership asserted that "[t]he City Deeds of Trust unambiguously

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require the beneficiary to use proceeds of a casualty or condemnation to repair or rebuild the property." That assertion, the court noted, was accurate only in regard to insurance proceeds. The City Deeds of Trust required the lender to use condemnation proceeds to repair or preserve the building only to the extent "reasonable and necessary."

Each GMAC deed of trust gives GMAC the option of allowing insurance or condemnation proceeds to be used for the repair or restoration of the building. The court accepted that the covenant of good faith and fair dealing implied in the GMAC deeds of trust would prevent GMAC from using insurance or condemnation proceeds to satisfy the indebtedness secured by its mortgage on the building unless GMAC could demonstrate an impairment of its security.

Nonetheless, the partnership again overstated the case when it claimed that "[t]he GMAC Deeds of Trust, as applied in accordance with applicable California law and applicable … regulations [issued by HUD], … require the beneficiary thereunder to use proceeds of a casualty or condemnation to repair or rebuild the property." The implied duty of good faith and fair dealing, as interpreted by California law, would allow GMAC to exercise its right to use insurance or condemnation proceeds to satisfy the indebtedness secured by its mortgages to the extent that it could demonstrate that the casualty or condemnation impaired the security for that indebtedness. The partnership asserted that HUD regulations "require, in cases where a HUD loan is not delinquent, that any insurance proceeds be used to repair the property." Even if the court accepted this assertion as accurate, it does not follow that HUD would not, in any circumstance, approve the use of condemnation proceeds to repay the indebtedness secured by the deeds of trust in GMAC's favor.

The partnership noted that "further factual development would be appropriate" were we to "believe[] that there is any question remaining regarding the proper interpretation of the GMAC Deeds of Trust," but it identified no such question. Nor did the court see any material question remaining regarding the interpretation of the GMAC deeds of trust. Those deeds contemplate circumstances in which GMAC would be able to use condemnation or insurance proceeds to satisfy the indebtedness secured by GMAC's mortgages. Again, the partnership's claim that GMAC would be required, in all possible circumstances, to allow those proceeds to be used for repair or rebuilding contravenes the plain terms of the deeds of trust and the subordination agreements.

The circumstances in which a lender would be required to allow insurance or condemnation proceeds to be used for repair or rebuilding are not exhaustive. At least in some circumstances, the lender could exercise its right to apply those proceeds to satisfy the debt secured by its mortgage on the building.

Moreover, the circumstances enumerated by the partnership in which the proceeds of insurance or condemnation would be required to be used for repair or rebuilding are beside the point. In those circumstances, the lenders would not have a priority right over the Conservancy. Instead, the proceeds would be used for the benefit of all who hold interests in the property. A right never granted need not be subordinated. In determining whether the partnership's gift of the easement satisfies the mortgage subordination requirement of the regulations, the focus must be on those rights of the lenders that, in the absence of an agreement to the contrary, would impinge on the Conservancy's rights to enforce the gift's conservation purposes. If under any circumstances that have at least a material chance of occurrence

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the lenders would have a priority right over the Conservancy to insurance or condemnation proceeds that the lenders did not agree to subordinate to the Conservancy, it would violate the requirement of Treas. Regs. section 1.170A-14(g)(2) that states:

> In the case of conservation contributions made after February 13, 1986, no deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity.

The number of circumstances in which the lenders would not have a priority right in this case, the court noted, would be of no consequence.

The partnership contended that, "[t]o the extent there may be any scenario where proceeds derived from a casualty or condemnation might not be applied to complete repairs, it would be remote as defined in Treasury Regulations Section 1.170A-14(g)(3)." That section states that: "A deduction shall not be disallowed . . . merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible." However, paragraph (g)(3) of section 1.170A-14 is not an alternative provision on which taxpayers may rely if they otherwise fail to satisfy the express requirements of paragraph (g)(2).

Section 1.170A-14(g)(2) of the regulations requires a mortgagee to subordinate "its rights in the property" — not merely those rights sufficiently likely to arise. Therefore, read in accordance with its plain terms, the requirement in the regulations would be violated if the lenders were able, in any circumstance, to apply insurance or condemnation proceeds to satisfy the partnership's indebtedness before any amounts would be paid to the Conservancy. The likelihood of any such circumstances arising would be irrelevant.

The deeds of trust contemplate circumstances in which the lenders would be able to apply insurance or condemnation proceeds against the partnership's debt rather than allowing those proceeds to be used to fund repair or rebuilding. GMAC could use insurance or condemnation proceeds to satisfy the partnership's indebtedness, at least with HUD's approval, if it demonstrates that the event that led to the proceeds had impaired its security. And the City or the Agency could use condemnation proceeds to satisfy the partnership's debt when repair or preservation of the building would not be "reasonable and necessary." Clause (i) of section 1 of the subordination agreements expressly retains those priority rights granted in the deeds of trust. The proviso's cross-reference does not defeat those rights. Were the parties to have disregarded those circumstances in which the lenders would not be required to allow insurance or condemnation proceeds to fund repair or rebuilding, much of the language in the relevant documents would have been unnecessary.

For the foregoing reasons, the Tax Court held as follows:

> Treasury Regulations section 1.170A-14(g)(2) requires the subordination of any priority right of a lender to use insurance or condemnation proceeds to satisfy the secured indebtedness in circumstances that have a material chance of arising. The circumstances in which the lenders can

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use insurance or condemnation proceeds to apply to the partnership's indebtedness, which are specifically addressed in the relevant documents, had a material chance of arising. The priority rights to insurance or condemnation proceeds granted to the lenders in the deeds of trust were "prior claims" within the meaning of the relevant provisions of the easement deed; consequently, the lenders' rights in building were not subordinated to the Conservancy's rights, as required by Treasury Regulations section 1.170A-14(g)(2).

Anticipatory assignment of income doctrine: Keefer v. United States, 130 AFTR 2d 2022-5002 (DC TX)

The assignment of income doctrine holds that one who earns income cannot escape tax upon the income by assigning it to another. Instead, if one, entitled to receive income at a future date makes a grant of it by anticipatory assignment, he or she realizes taxable income as if he had collected it and then paid it over. Ultimately, the question is whether the taxpayer himself or herself ever earned income, or whether it was earned instead by the assignee.

Kevin and Patricia Keefer sought a refund of tax paid in 2015. The alleged overpayment resulted when the IRS disallowed the Keefers' charitable deduction for a donation of a 4% interest in Burbank HHG Hotel, LP, limited partnership, to the Pi Foundation, a nonprofit corporation.

Burbank was a limited partnership existing for the purpose of owning and operating a single hotel property Kevin was a limited partner in Burbank. On April 23, 2015, Burbank and Apple Hospitality REIT exchanged a nonbinding letter of intent (LOI) for a deal that included Apple's purchase of the hotel. Burbank did not sign the LOI but continued negotiating for the hotel's sale. Burbank was also considering other offers for the hotel. On June 18, 2015, Kevin assigned a 4% limited partner interest in Burbank to Pi for the purpose of establishing a donor advised fund at Pi. As of that date, Burbank had tentatively agreed on the sale of the hotel to Apple for $54 million, but the contract for sale had not been signed, and Apple had not conducted its review of the property and records. On July 2, 2015, Burbank and Apple signed a contract for Apple to purchase the hotel for $54 million. The contract provided for a 30-day review period for Apple to evaluate the property. The sale closed on August 11, 2015.

To substantiate the donation, the Keefers' tax advisor commissioned an appraisal of the donated partnership interest as of June 18, 2015. The appraisal was performed by Katzen, Marshall & Associates, Inc. (KM) and was prepared and signed by David Marshall, a principal of that firm. It included an appraiser's certification and a description of Marshall's qualifications but did not include either Marshall's or KM's tax identification numbers. Additionally, the appraisal included a section titled "Partnership Agreement," setting out "[c]ertain provisions of the [Burbank Partnership] Agreement[,]" including that agreement's definition of *available cash flow* and the schedule for "Distribution of Available Cash Flow."

The appraisal indicated that its "purpose [was] estimating the fair market value of a 4.000% limited partnership interest, subject to an oral agreement, ... in Burbank ..., owned by Kevin." Attached to the appraisal was a "STATEMENT OF LIMITING CONDITIONS" describing the referenced oral agreement as follows:

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> [KM] ha[s] been informed that the Donor and Donee have an agreement that the Donee will only share in the next proceeds from the Seller's Closing Statement. The Donee will not share in Other Assets of the Partnership not covered in the sale.

After describing its method for calculating the donated asset's value, the appraisal concluded that $1,257,000 "reasonably represent[ed] the fair market value, excluding Other Assets of the Partnership, of a 4.000% Limited Partnership Interest in Burbank...as of June 18, 2015," with "[a]ll estimates of value ... subject to the attached Statement of Limiting Conditions and Appraisers' Certification." The appraisal indicated that "[Kevin] stated that at the Valuation Date, he was not aware of any material fact or condition that would...derail the sale...[and that] the Partnership had a second bidder at essentially the same price." Id. at 55. The appraisal estimated a "5% probability of no sale."

On June 5, 2015, Pi sent Kevin a 12-page packet of materials provided by Pi related to establishment of the "Keefer Donor Advised Fund" ("the DAF Packet"). Kevin signed the DAF Packet on June 8, 2015. The DAF Packet stated that "Kevin ... hereby transfers as an irrevocable gift to [Pi] ... the property described in Schedule A attached here to and incorporated as part of this Document." Schedule A described the property as "4.00% of Interest in [Burbank]." Schedules B, C, and E, also included in the DAF Packet, provided additional details including the following provisions that the Keefers claim acknowledge Pi's exclusive legal control over the donated interest:

Schedule B ... "THE PI FUND PROCEDURES FOR OPERATION OF DONOR ADVISED FUNDS"

1.1 Authorization. The Board of Directors of [Pi] has authorized the adoption of these procedures for the establishment and administration of DAF. These procedures may be amended from time to time, when deemed necessary or desirable by the Board of Directors.

1.2 Establishment of Funds. DAF are and shall be administered as part of the endowment funds of [Pi].

1.3 Nature and Terms of Funds. Each DAF shall be held by [Pi]. The Distribution Committee of [Pi] or the Board of Directors of [Pi]...shall have the ultimate authority and control of all assets in the DAF, and the income derived therefrom, for the charitable purposes of [Pi].

2.1 Authorization. A donor may not impose any material restriction or condition that prevents [Pi] from freely and effectively employing the contributed assets, or the income derived therefrom, in furtherance of a charitable purpose of [Pi].

3.1 In General. The Distribution Committee has the right to direct all distributions of income or principal of DAFs. The donor of a DAF account...may...recommend to [Pi] the making of distributions from the fund which are consistent with the charitable objectives of [Pi]...but such recommendations will be solely advisory and [Pi] is not bound by such recommendations.

3.5.2 Staff Investigation. With respect to each recommendation by a donor, [Pi] will make an investigation to determine whether the recommendation is consistent with the charitable mission of [Pi]. If [Pi] determines that the recommendation is not consistent with the charitable mission of [Pi], the donor shall be advised that the recommendation does not meet the standards for distributions.

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3.5.3 Distribution Committee Action. The Distribution Committee shall act upon all recommendations by donors and shall allocate funds from DAFs in accordance with regular Distribution Committee grantmaking procedures.

Schedule C ... "HOW TO OPERATE YOUR [DAF]"

OWNERSHIP AND CONTROL

Donor advised funds will be the exclusive property of the Pi Fund. They will be administered under and subject to the bylaws and procedures of the Pi Fund including any amendments. All donor advised funds are subject to variance power which gives the Pi Fund the ability to redirect funds should the cause for which they were established become obsolete.

GRANTMAKING

Donors have the privilege of making nonbinding recommendations as to the timing, amount, and charitable recipient of distributions. The Pi Fund retains the legal right to direct grants. The Pi Fund, as required by law, retains authority over the use and distributions of the fund ....

Approval process: [R]ecommendation[s] will be evaluated and presented to the Board ... . Should the Board not approve the grant, the donor will be notified immediately.

Management of the Pi Fund retains control of investments, including control of the retention or sale of any assets contributed ... .

Schedule E "FEE SCHEDULE"

The Foundation may elect, in its sole discretion, whether and how to invest the proceeds of a donor's account. The Foundation retains the exclusive right to manage and invest the assets in any account as the Board determines from time to time.

When the court applied the assignment of income doctrine to this case, it noted the crucial question is whether the asset itself or merely the income from it has been transferred. If the taxpayer gives away the entire asset with accrued earnings, the assignment of income doctrine does not apply. But it does apply if the taxpayer carves income or a partial interest out of the granted asset and retains something for himself or herself.

In 1964, the Tax Court established a two-prong test with respect to the donation of business interests. In *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964), the court said it will respect the form of a donation of appreciated stock shares if the donor (*a*) gives the property away absolutely and parts with title thereto and (*b*) does so before the property gives rise to income by way of a sale.

The Keefers argued that the assignment here satisfied both prongs on the Humacid test because there was some uncertainty that the hotel's sale to Apple would occur and because Kevin assigned to Pi a 4% partnership interest including "all rights and interests pertaining" to that interest. The IRS urged the court to find that the anticipatory assignment doctrine applies because the hotel sale was "practically certain"

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by the time Kevin assigned the partnership interest to Pi, and the Keefers carved out and retained a portion of the partnership asset by oral agreement.

Generally, analysis of the second Humacid prong focuses on whether a legal right to income from redemption of the appreciated stock vested before the donor transferred ownership and control of the asset. In a few cases, courts have extended this doctrine to situations in which the stock's redemption was so imminent and certain that the shareholder's corresponding right to income had already crystallized at the time of the gift. These courts have generally drawn the line where the corporation's shareholders or directors have already voted to redeem shares, creating a binding obligation of redemption. But the Ninth Circuit has extended this principle to situations in which — considering the facts and circumstances of a particular deal — redemption is "practically certain to proceed" without a binding obligation.

The IRS urged the court to follow the Ninth Circuit's more expansive approach in applying Humacid to this limited partnership interest. However, the court declined to extend the Ninth Circuit's analysis to the real estate transaction at issue here. The uncontroverted evidence showed that the Keefers executed the agreement to assign the partnership interest to Pi on June 18, 2015. The partnership executed the contract for sale of the hotel on July 2, 2015. So, at the time of the assignment on June 18, 2015, the hotel was not even under contract. Although Apple had sent an LOI to Burbank before that date, the LOI was nonbinding and was never signed by Burbank. Moreover, even after the contract with Apple was signed, it provided Apple a 30-day review period. Until that review period elapsed, Apple had no binding obligation to close and the deal was not "practically certain" to go through.

Under these circumstances, the partnership's right to the income from the hotel sale had not yet vested when the Keefers assigned the interest to Pi. Therefore, the pending sale — even if very likely to occur considering the presence of backup offers and as reflected in the appraiser's estimate that the risk of no sale was only 5% — does not render this donation an anticipatory assignment of income.

However, the court still had to consider the first Humacid prong: whether by assigning the 4% interest subject to an oral agreement the Keefers carved a partial interest out of the assigned asset. If so, then they retained that partial interest in the asset after the assignment and the anticipatory assignment of income doctrine would apply, as the whole asset was not transferred before the hotel sale closed on August 11, 2015.

The Keefers explained that "before Kevin...transferred the 4% partnership interest to Pi, the partnership owed money to the pre-existing partners for pre-donation earnings that had not been distributed to those pre-existing partners ... because the partnership, as the owner of the hotel, was required ... to maintain a certain amount of cash reserves...to comply with...loan and franchise obligations." Kevin testified that the "oral agreement" referenced in the appraisal was an agreement between the pre-assignment partners:

> [T]he general partner had made the decision that [the reserve accounts] — since those were amounts withheld from earnings prior to the date of the gift~~, that~~ the general partner was going to distribute ~~that~~ to the partners in their percentage of ownership prior to that date of the gift. It was his opinion and responsibility to pay those reserves i~~n~~ to the partners from the reserve accounts — where the earnings had been held back prior to June 18th. The General Partner stated — what I told

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> the Pi Foundation is we were going to distribute those reserves to a number of partners–— effectively a distribution — a liability at the time of the transfer to the partners. And they had — they acknowledged what we were doing and how we were gonna treat it, and so we were sure that the [appraisal] valuation was done that way. So that's what — I consider it an oral agreement in how we were treating that. We treated it as a liability at the time of the transaction, so all those reserves were distribution to the partners prior to June 135 [sic], that we had a liability to pay them, and that's why they weren't included in the valuation.

The cash reserves in question, Kevin testified, were reflected on the partnership's balance sheet as "equipment reserves" and "working capital reserves." The reason for keeping these reserves, which had been "reserved from the distributions that [the partnership had] been making from the partners," was so "if the hotel sale didn't go through [the partnership] would have the money to [make future renovations to the hotel as required by the franchise agreement] because the Pi Foundation could not obviously contribute capital for the renovation," he testified. So, if the hotel sale occurred and the renovations would not be required "those reserves [would be released as] accrued distributions to those partners prior to the Pi Foundation being admitted." However, Kevin testified that the franchise agreement did not require such cash reserves; they were reserved at the discretion of the general partner. In sum, the Keefers argue that "[t]he partnership's payment of pre-existing liability to its pre-existing partners is not a 'carving out' from the 4% partnership interest to Pi any more than the partnership paying a liability for a pre-existing light bill is a 'carving out' from some partnership interest.

The court did not agree with the Keefers that the reservation of cash reserve accounts for distribution, post-sale, to pre-June 18 partners did not carve out a portion of the interest Pi received. According to Kevin's testimony, the "reserve accounts" were funds that the general partner chose to maintain for compliance with "loan and franchise agreements" and that had been withheld from partner distributions at the discretion of the general partner. Per his testimony, said the court, they were not liabilities like a pre-existing light bill. Instead, they were a reserve of cash held back to address future potential liabilities.

Therefore, as described by Kevin, the cash reserves fall within the Partnership Agreement's definition of *available cash flow*, which is set forth in the appraisal. Per the appraisal's recitation of the Partnership Agreement's provisions, "*Available Cash Flow*, if any, in each calendar quarter of a partnership year shall be allocated to and distributed among the Partners pro rata...at such time as the general partner determines, but in no event later than thirty (30) days after the close of such calendar quarter of the Partnership year." As Marshall noted: "The Agreement provides that available cash flow shall be distributed to the Partners."

By contrast, the appraisal indicates that, pursuant to the "oral agreement," the interest donated to Pi would not be subject to the Partnership Agreement's Available Cash Flow provisions but to an alternative arrangement:

On June 18, 2015, the donor transferred a 4% limited partnership interest in the Partnership to the Pi Foundation. By oral agreement, the Foundation and donor agreed that the Foundation would only share in the proceeds from Seller's Closing Statement; the Foundation would not receive its pro rata share in other net assets of the Partnership.

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Regarding this oral agreement, Kevin testified that upon the hotel's sale, the partnership intended to take the sale proceeds, deduct the reserve funds from the proceeds, and pay them out in shares to the pre-June 18 partners but not to Pi, and then disburse to Pi its 4% share of the remaining net proceeds. He also testified that the donated interest as described in the appraisal "is what [Pi] received."

Therefore, based on this evidence, the court found that no genuine issue of material fact exists as to whether the Keefers carved out a portion of the 4% partnership interest before donating it to Pi. The court concluded that they did. After the assignment, Pi did not have the right that other partners had to share in a Distribution of Available Cash Flow as described in the Partnership Agreement but only had a right to share in the net proceeds of the hotel sale. Or, in the unlikely event the hotel sale had not been completed as planned, Pi would not have shared equally with the other limited partners in the duty to contribute funds for renovation, should additional funds be required to fulfill the partnership's obligations under the loan or franchise agreements. Reflecting this carve-out, the appraisal calculated a lower value for the donated interest than for a full 4% interest in all of the partnership's assets. Accordingly, the Keefers did not donate their full 4% partnership interest on June 18, 2015, but donated only a portion thereof. The anticipatory assignment of income doctrine therefore applies to this transaction.

Contemporaneous written acknowledgment: *Keefer* (cont.) and *Izen v. Commissioner*, 129 AFTR 2d 2022-755 (5th Cir.)

In addition to the issue discussed previously, the court in Keefer also found that the IRS correctly disallowed the Keefers' charitable contribution because they did not obtain a contemporaneous written acknowledgment (CWA) satisfying the requirements of IRC section 170(f)(8) and (18). That IRC section provides that a charitable deduction "for any contribution of $250 or more" shall not be allowed "unless the taxpayer substantiates the contribution by a [CWA] of the contribution by the donee organization that meets the requirements of subparagraph (B)." Subparagraph B requires in relevant part that a CWA state: (1) "The amount of cash and a description (but not value) of any property other than cash contributed"; and (2) "Whether the donee organization provided any goods or services in consideration, in whole or in part, for [the donated property.]"

A donation to a donor advised fund must also comply with IRC section 170(f)(18), which requires:

> A deduction ... for any contribution to a donor advised fund ... shall only be allowed if ... the taxpayer obtains a [CWA] … from the sponsoring organization ... of such donor advised fund that such organization has exclusive legal control over the assets contributed.

Importantly, the doctrine of substantial compliance does not apply to excuse compliance with the substantiation requirements of IRC section 170(f)(8)(B); strict compliance is required.

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On or around September 9, 2015, Kevin received a letter from Pi acknowledging the donation. The body of this letter read in full:

> Thank you for your donation to the Pi Foundation, Inc. of a 4.00% interest in Burbank HHG Hotel, LP. The Pi Foundation, Inc., is a 501(c)(3) nonprofit organization. Your contribution is tax-deductible to the extent allowed by law. No goods or services were provided in exchange for your generous financial donation. Please keep this page for your records.

The IRS asserted that multiple documents cannot be combined to constitute a CWA unless the documents contain a merger clause. But even if they could be, the IRS argued that neither the DAF Packet nor the Acknowledgment Letter contains a statement that Pi had "exclusive legal control." The court found that the Keefers did not obtain a statutorily compliant CWA and that their charitable donation deduction was properly denied on that basis. Based on the plain text and the contemporaneous common meaning of "acknowledgment," the intended function of this IRS substantiation requirement, and the text of the Code, the court held that a CWA acknowledges a completed contribution or one that is legally obligated to occur. Here, the evidence shows, as a matter of law, that the DAF Packet did not complete the donation or legally obligate Kevin to donate the interest to Pi. Although the DAF Packet stated that "Kevin...hereby transfers as an irrevocable gift to [Pi]...the [4.00 percent partnership interest]," the actual assignment did not occur when Kevin signed the DAF Packet documents on June 8, but 10 days later.

Next, the court explained why the September 9, 2015, Acknowledgment Letter cannot be supplemented by the DAF Packet. The court carefully examined each of the cases cited by the parties and found that none of them supported the Keefers' assertion that the DAF Packet may supplement the Acknowledgment Letter to constitute a proper CWA. Finding that the DAF Packet cannot supplement the Acknowledgment Letter, the court did not consider whether the DAF Packet establishes that Pi had "exclusive legal control" over the donated property. Instead, because the Acknowledgment Letter alone contains nothing to prove "exclusive legal control," the court found that IRC section 170(f)(18) was not satisfied.

The Fifth Circuit addressed a similar issue in *Izen*. That case involved an airplane, and there are special substantiation rules related to vehicles. For a contribution of a qualified vehicle, including airplanes, whose value exceeds $500, the taxpayer must provide CWA from the donee organization of the contribution, including the name and taxpayer identification number of the donor. An acknowledgment is contemporaneous if it is provided by the donee organization within 30 days of the contribution. Further, the donee organization must provide the IRS with the information contained in the acknowledgment. Finally, where the contribution's value exceeds $5,000, the taxpayer must also provide a qualified appraisal.

On his 2010 federal income tax return Joe Alfred Izen, Jr. claimed a deduction of $338,080 for the charitable donation of his 50% interest in an airplane to the Houston Aeronautical Heritage Society. The deduction was initially denied for failure to provide adequate substantiation. Izen attempted to remedy this by attaching additional materials to an amended return. The problem was that Izen failed to provide a CWA from the donee organization that satisfied the requirements of the IRC.

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Izen included a letter dated December 30, 2010, from the Society discussing the donation of the airplane, but the letter was addressed to Philippe Tanguy, not Izen. The letter does not mention Izen and does not provide his taxpayer identification number. Therefore, the letter did not provide a proper CWA for the contribution of the airplane. Izen also included a copy of the donation agreement between him, Tanguy, and the Society, but the agreement did not satisfy the CWA requirements because it lacked Izen's taxpayer identification number. Finally, Izen attached a Form 8283 to his Form 1040X, but the Form 8283 did not include his taxpayer number.

Izen argued that he substantially complied with the requirements and that the documents he provided should be read together with the return to substantiate his claimed deduction. The doctrine of substantial compliance may support a taxpayer's claim where he or she acted in good faith and exercised due diligence but nevertheless failed to meet a regulatory requirement. But, as noted previously, substantial compliance is inapplicable to a CWA. Congress specifically required the CWA include the taxpayer identification number, but that was lacking here, and so the deduction was denied.

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Tax Glossary

401(k) plan. A qualified retirement plan to which contributions from salary are made from pre-tax dollars.

accelerated depreciation. Computation of depreciation to provide greater deductions in earlier years of equipment and other business or investment property.

accounting method. Rules applied in determining when and how to report income and expenses on tax returns.

accrual method. Method of accounting that reports income when it is earned, disregarding when it may be received, and expense when incurred, disregarding when it is actually paid.

acquisition debt. Mortgage taken to buy, hold, or substantially improve main or second home that serves as security.

active participation. Rental real estate activity involving property management at a level that permits deduction of losses.

adjusted basis. Basis in property increased by some expenses (for example, by capital improvements) or decreased by some tax benefit (for example, by depreciation).

adjusted gross income (AGI). Gross income minus above-the-line deductions (such as deductions other than itemized deductions, the standard deduction, and personal and dependency exemptions).

alimony. Payments for the support or maintenance of one's spouse pursuant to a judicial decree or written agreement related to divorce or separation.

alternative minimum tax (AMT). System comparing the tax results with and without the benefit of tax preference items for the purpose of preventing tax avoidance.

amortization. Write-off of an intangible asset's cost over a number of years.

applicable federal rate (AFR). An interest rate determined by reference to the average market yield on U.S. government obligations. Used in Sec. 7872 to determine the treatment of loans with below-market interest rates.

at-risk rules. Limits on tax losses to business activities in which an individual taxpayer has an economic stake.

backup withholding. Withholding for federal taxes on certain types of income (such as interest or dividend payments) by a payor that has not received required taxpayer identification number (TIN) information.

bad debt. Uncollectible debt deductible as an ordinary loss if associated with a business and otherwise deductible as short-term capital loss.

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basis. Amount determined by a taxpayer's investment in property for purposes of determining gain or loss on the sale of property or in computing depreciation.

cafeteria plan. Written plan allowing employees to choose among two or more benefits (consisting of cash and qualified benefits) and to pay for the benefits with pretax dollars. Must conform to Sec. 125 requirements.

capital asset. Investments (such as stocks, bonds, and mutual funds) and personal property (such as home).

capital gain/loss. Profit (net of losses) on the sale or exchange of a capital asset or Sec. 1231 property, subject to favorable tax rates, and loss on such sales or exchanges (net of gains) deductible against $3,000 of ordinary income.

capitalization. Addition of cost or expense to the basis of property.

carryovers (carryforwards) and carrybacks. Tax deductions and credits not fully used in one year are chargeable against prior or future tax years to reduce taxable income or taxes payable.

Conservation Reserve Program (CRP). A voluntary program for soil, water, and wildlife conservation, wetland establishment and restoration and reforestation, administered by the U.S. Department of Agriculture.

credit. Amount subtracted from income tax liability.

deduction. Expense subtracted in computing adjusted gross income.

defined benefit plan. Qualified retirement plan basing annual contributions on targeted benefit amounts.

defined contribution plan. Qualified retirement plan with annual contributions based on a percentage of compensation.

depletion. Deduction for the extent a natural resource is used.

depreciation. Proportionate deduction based on the cost of business or investment property with a useful life (or recovery period) greater than one year.

earned income. Wages, bonuses, vacation pay, and other remuneration, including self-employment income, for services rendered.

earned income credit. Refundable credit available to low-income individuals.

employee stock ownership plan (ESOP). Defined contribution plan that is a stock bonus plan or a combined stock bonus and money purchase plan designed to invest primarily in qualifying employer securities.

estimated tax. Quarterly payments of income tax liability by individuals, corporations, trusts, and estates.

exemption. A deduction against net income based on taxpayer status (such as single, head of household, married filing jointly or separately, trusts, and estates).

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fair market value. The price that would be agreed upon by a willing seller and willing buyer, established by markets for publicly-traded stocks, or determined by appraisal.

fiscal year. A 12-month taxable period ending on any date other than December 31.

foreign tax. Income tax paid to a foreign country and deductible or creditable, at the taxpayer's election, against U.S. income tax.

gift. Transfer of money or property without expectation of anything in return, and excludable from income by the recipient. A gift may still be affected by the unified estate and gift transfer tax applicable to the gift's maker.

goodwill. A business asset, intangible in nature, adding a value beyond the business's tangible assets.

gross income. Income from any and all sources, after any exclusions and before any deductions are taken into consideration.

half-year convention. A depreciation rule assuming property other than real estate is placed in service in the middle of the tax year.

head-of-household. An unmarried individual who provides and maintains a household for a qualifying dependent and therefore is subject to distinct tax rates.

health savings account (HSA). A trust operated exclusively for purposes of paying qualified medical expenses of the account beneficiary and thus providing for deductible contributions, tax-deferred earnings, and exclusion of tax on any monies withdrawn for medical purposes.

holding period. The period of time a taxpayer holds onto property, therefore affecting tax treatment on its disposition.

imputed interest. Income deemed attributable to deferred-payment transfers, such as below-market loans, for which no interest or unrealistically low interest is charged.

incentive stock option (ISO). An option to purchase stock in connection with an individual's employment, which defers tax liability until all of the stock acquired by means of the option is sold or exchanged.

income in respect of a decedent (IRD). Income earned by a person, but not paid until after his or her death.

independent contractor. A self-employed individual whose work method or time is not controlled by an employer.

indexing. Adjustments in deductions, credits, exemptions and exclusions, plan contributions, AGI limits, and so on, to reflect annual inflation figures.

individual retirement account (IRA). Tax-exempt trust created or organized in the U.S. for the exclusive benefit of an individual or the individual's beneficiaries.

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information returns. Statements of income and other items recognizable for tax purposes provided to the IRS and the taxpayer. Form W-2 and forms in the 1099 series, as well as Schedules K-1, are the prominent examples.

installment method. Tax accounting method for reporting gain on a sale over the period of tax years during which payments are made, such as, over the payment period specified in an installment sale agreement.

intangible property. Items such as patents, copyrights, and goodwill.

inventory. Goods held for sale to customers, including materials used in the production of those goods.

involuntary conversion. A forced disposition (for example, casualty, theft, condemnation) for which deferral of gain may be available.

jeopardy. For tax purposes, a determination that payment of a tax deficiency may be assessed immediately as the most viable means of ensuring its payment.

Keogh plan. A qualified retirement plan available to self-employed persons.

key employee. Officers, employees, and officers defined by the Internal Revenue Code for purposes of determining whether a plan is “top heavy.”

Kiddie tax. Application of parents’ maximum tax rate to unearned income of their child under age 19. Full-time students under 24 are also subject to the kiddie tax.

lien. A charge upon property after a tax assessment has been made and until tax liability is satisfied.

like-kind exchange. Tax-free exchange of business or investment property for property that is similar or related in service or use.

listed property. Items subject to special restrictions on depreciation (for example, cars, computers, cell phones).

lump-sum distribution. Distribution of an individual’s entire interest in a qualified retirement plan within one tax year.

marginal tax rate. The highest tax bracket applicable to an individual’s income.

material participation. The measurement of an individual’s involvement in business operations for purposes of the passive activity loss rules.

mid-month convention. Assumption, for purposes of computing depreciation, that all real property is placed in service in the middle of the month.

mid-quarter convention. Assumption, for purposes of computing depreciation, that all property other than real property is placed in service in the middle of the quarter, when the basis of property placed in service in the final quarter exceeds a statutory percentage of the basis of all property placed in service during the year.

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minimum distribution. A retirement plan distribution, based on life expectancies, that an individual must take after age 70½ in order to avoid tax penalties.

minimum funding requirements. Associated with defined benefit plans and certain other plans, such as money purchase plans, assuring the plan has enough assets to satisfy its current and anticipated liabilities.

miscellaneous itemized deduction. Deductions for certain expenses (for example, unreimbursed employee expenses) limited to only the amount by which they exceed 2 percent of adjusted gross income.

money purchase plan. Defined contribution plan in which the contributions by the employer are mandatory and established other than by reference to the employer's profits.

net operating loss (NOL). A business or casualty loss for which amounts exceeding the allowable deduction in the current tax year may be carried back two years to reduce previous tax liability and forward 20 years to cover any remaining unused loss deduction.

nonresident alien. An individual who is neither a citizen nor a resident of the United States. Nonresidents are taxed on U.S. source income.

original issue discount (OID). The excess of face value over issue price set by a purchase agreement.

passive activity loss (PAL). Losses allowable only to the extent of income derived each year (such as by means of carryover) from rental property or business activities in which the taxpayer does not materially participate.

passive foreign investment company (PFIC). A foreign based corporation subject to strict tax rules which covers the treatment of investments in Sections 1291 through 1297.

pass-through entities. Partnerships, LLCs, LLPs, S corporations, and trusts and estates whose income or loss is reported by the partner, member, shareholder, or beneficiary.

personal holding company (PHC). A corporation, usually closely-held, that exists to hold investments such as stocks, bonds, or personal service contracts and to time distributions of income in a manner that limits the owner(s) tax liability.

qualified subchapter S trust (QSST). A trust that qualifies specific requirements for eligibility as an S corporation shareholder.

real estate investment trust (REIT). A form of investment in which a trust holds real estate or mortgages and distributes income, in whole or in part, to the beneficiaries (such as investors).

real estate mortgage investment conduit (REMIC). Treated as a partnership, investors purchase interests in this entity which holds a fixed pool of mortgages.

realized gain or loss. The difference between property's basis and the amount received upon its sale or exchange.

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recapture. The amount of a prior deduction or credit recognized as income or affecting its characterization (capital gain vs. ordinary income) when the property giving rise to the deduction or credit is disposed of.

recognized gain or loss. The amount of realized gain or loss that must be included in taxable income.

regulated investment company (RIC). A corporation serving as a mutual fund that acts as investment agents for shareholders and customarily dealing in government and corporate securities.

reorganization. Restructuring of corporations under specific Internal Revenue Code rules so as to result in nonrecognition of gain.

resident alien. An individual who is a permanent resident, has substantial presence, or, under specific election rules is taxed as a U.S. citizen.

Roth IRA. Form of individual retirement account that produces, subject to holding period requirements, nontaxable earnings.

S corporation. A corporation that, upon satisfying requirements concerning its ownership, may elect to act as a pass-through entity.

Saver's credit. Term commonly used to describe Sec. 25B credit for qualified contributions to a retirement plan or via elective deferrals.

Sec. 1231 property. Depreciable business property eligible for capital gains treatment.

Sec. 1244 stock. Closely held stock whose sale may produce an ordinary, rather than capital, loss (subject to caps).

split-dollar life insurance. Arrangement between an employer and employee under which the life insurance policy benefits are contractually split, and the costs (premiums) are also split.

statutory employee. An insurance agent or other specified worker who is subject to social security taxes on wages but eligible to claim deductions available to the self-employed.

stock bonus plan. A plan established and maintained to provide benefits similar to those of a profit-sharing plan, except the benefits must be distributable in stock of the employer company.

tax preference items. Tax benefits deemed includable for purposes of the alternative minimum tax.

tax shelter. A tax-favored investment, typically in the form of a partnership or joint venture, that is subject to scrutiny as tax-avoidance device.

tentative tax. Income tax liability before taking into account certain credits, and AMT liability over the regular tax liability.

transportation expense. The cost of transportation from one point to another.

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travel expense. Transportation, meals, and lodging costs incurred away from home and for trade or business purposes.

unearned income. Income from investments (such as interest, dividends, and capital gains).

uniform capitalization rules (UNICAP). Rules requiring capitalization of property used in a business or income-producing activity (such as items used in producing inventory) and to certain property acquired for resale.

unrelated business income (UBIT). Exempt organization income produced by activities beyond the organization's exempt purposes and therefore taxable.

wash sale. Sale of securities preceded or followed within 30 days by a purchase of substantially identical securities. Recognition of any loss on the sale is disallowed.

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