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

BCP4/24/V1

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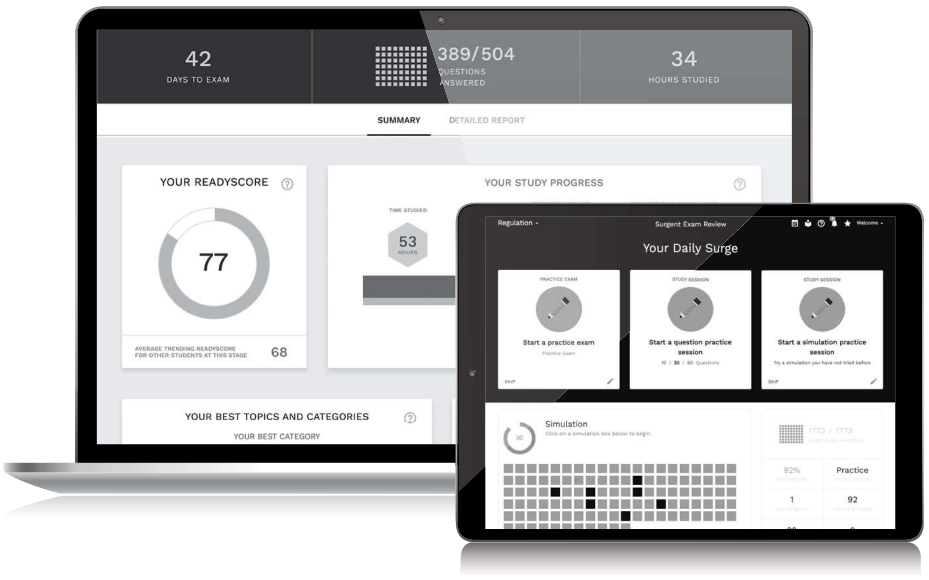

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Table of Contents

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NOTES

Principles and Considerations for Nonresident Withholding, Composite Payments, and Passthrough Entity Taxes

Principles and Considerations for Nonresident Withholding, Composite Payments, and Passthrough Entity Taxes

Learning objective

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

- Understand, discuss, and explain the differences in nonresident withholding, composite, and passthrough entity taxes and the possible advantages of a PTET election.

I. Background

For a number of reasons partnerships and S corporations, collectively referred to as passthrough entities, (PTEs), are the preferred vehicle for the majority of businesses here in the United States. To name a few benefits:

- PTE owners avoid double taxation through the “passthrough regime”.
- Depending on registration, owners receive liability protection.
- The §199A QBI deduction is accessible for managing tax liabilities.
- For S corporations, the opportunity to manage self-employment taxes arises.
- The formal entities and their agreements can provide ease of transferability and opportunities for succession planning.

In contrast to these benefits, the state implications of passthrough entities can serve as a significant source of difficulty as it relates to PTEs with activities in multiple states or an ownership pool that is a nonresident with respect to the primary state of a PTE’s activities.

While PTEs are often thought of as nontaxable entities, the passthrough nature remains consistent moving from the federal system to most state systems, and as states implement systems to ensure income taxes are collected for PTE economic activity within, regardless of the state of residency, the result is significant complexity for PTEs. Most states adopt one regime or a mix of regimes to ensure state taxes are collected on the allocable share of PTE income to owners. The regimes are usually thought of as withholding taxes, composite taxes, and passthrough entity taxes.

Note:

This chapter material does not, in any way, represent the full breadth and depth of any particular state for income/franchise tax purposes. The scenarios and examples of this chapter serve as tools to frame the various items of consideration and concern that should be addressed in working with multistate PTEs. Further, the items noted should not be considered all encompassing.

A. What drives tax reporting and obligations within a state?

1. Nexus and apportionment

Nexus in multistate taxation refers to the connection or presence that a business has in a particular state that subjects it to that state's tax laws and regulations. When a business has nexus in a state, it is typically required to register with the state's tax authorities and collect and remit various state taxes, such

as sales tax, income tax, or franchise tax. Nexus is a crucial concept in the realm of state taxation because it determines a business's tax obligations in multiple states.

Nexus can be established in various ways, and the specific criteria may vary from state to state. Some common factors that can create nexus include:

- **Physical Presence:** A physical presence in a state, such as a storefront, office, warehouse, or manufacturing facility, can create nexus.
- **Sales Activity:** Conducting sales within a state, either through in-person sales representatives, e-commerce, or other means, can establish nexus.
- **Employee Activity:** Having employees working within a state can create nexus. This can include remote workers or sales representatives.
- **Property Ownership:** Owning or leasing property in a state may trigger nexus.
- **Economic Thresholds:** Some states have economic nexus thresholds, where a business may establish nexus if it reaches a certain level of sales or transactions within the state, even without a physical presence.
- **Affiliate or Related Entity Relationships:** Nexus can be established if a business has related entities or affiliates that operate within a state.

It's important to understand the nexus rules of each state in which a business operates to ensure compliance with state tax laws. Non-compliance with nexus requirements can result in penalties, fines, and legal consequences. Additionally, the United States Supreme Court's decision in the *South Dakota v. Wayfair* case in 2018 has led to changes in the rules for collecting sales tax in different states, making it even more important for businesses to stay informed about nexus issues.

Allocation and apportionment are additional essential concepts in multistate taxation, especially for businesses that operate in multiple states. These concepts help determine how a business's income, sales, or other factors are divided among different states for tax purposes. This is important because each state may have its own rules and methods for taxing businesses that have nexus within their jurisdiction.

- **Allocation:** Allocation refers to the process of assigning a specific portion of a business's income, expenses, or other tax-related factors to a particular state. This is typically necessary when certain income or expenses are directly attributable to a specific state. For example, if a business has a manufacturing facility in one state and a sales office in another, it may need to allocate a portion of its income and expenses to each state based on where those activities occur.

  Allocation is straightforward when it's clear-cut and can be directly traced to a single state. However, not all income and expenses can be easily allocated in this manner, which is where apportionment comes into play.
- **Apportionment:** Apportionment is the process of dividing a business's income, expenses, or other relevant factors among multiple states when they cannot be directly allocated. It's a method for fairly distributing these factors among states based on specific formulas or ratios.

  The most common factor used in apportionment is typically the sales factor. States often use a formula that considers the ratio of a business's sales in a particular state to its total

sales across all states in which it operates. However, states may also consider factors like payroll, property, or a combination of these factors in their apportionment formulas. For example, if a business's total sales are $1,000,000, and $200,000 of those sales occur in state A while $800,000 occur in state B, the sales factor for state A would be 20%, and for state B, it would be 80%. The business would then allocate a portion of its income and expenses to each state based on these percentages.

Apportionment formulas and rules can vary significantly from state to state, which can make multistate tax compliance complex for businesses.

The goal of allocation and apportionment is to prevent double taxation and ensure that each state taxes a fair share of a business's income based on its economic activity within that state. But these nexus, allocation, and apportionment determinations are made at the PTE level.

At the individual level, it is important to remember the PTE owner's resident state will take a similar approach as the federal tax system does for US citizens and residents: all income is taxable to the resident taxpayer no matter which state the income is derived in. To mitigate double taxation, much like the federal system, the resident state may offer a "credit for taxes paid to other states."

2. What do these taxpayer scenarios look like: Setting the stage

In framing this material, consider the following scenario:

Scenario: AB Partnership, a 60/40 partnership, is a 60/40 partnership formed by Brian and Bob. Brian is a resident of North Dakota, and Bob is a resident of Indiana. AB drop ships tangible personal property across the US utilizing Amazon fulfillment from North Dakota and California. These are the only states where there is property, rent, or employees, and as such PL 86-272 protects the sales apportionment of the goods to the states where there is physical presence nexus ties, and in this case, California and North Dakota are the states with nexus ties.

Issues to Consider:

California

With respect to California, what are the tax consequences to AB Partnership?
How does California treat the allocable share of apportioned income to nonresident partners Brian and Bob?
Are there any specific elections available to AB, Brian, and/or Bob?

North Dakota

With respect to North Dakota, what are the tax consequences to AB Partnership?
How does North Dakota treat the allocable share of apportioned income to resident partner Brian?
How does North Dakota treat the allocable share of apportioned income to nonresident partner Bob?
Are there any specific elections available to AB, Brian, and/or Bob?

Indiana

What implications are there for AB Partnership with respect to Indiana?
What are the taxes and/or reporting requirements, if any, for the nonresident Indiana partner Brian?
What are the taxes and/or reporting requirements, if any, for the resident Indiana partner Bob?

II. Nonresident withholding taxes

Nonresident withholding taxes are state-level taxes imposed on income earned within a state by individuals or entities that are not residents of that state. These taxes are often applicable to multistate passthrough entities because they receive income from multiple jurisdictions. Here are the key components of nonresident withholding taxes:

- **Income Source:** Nonresident withholding taxes come into play when income is generated within a specific state. This can include allocable share of business income, rental income, interest, dividends, and more.
- **Withholding Tax:** When a multistate PTE has income sourced to a state where a PTE owner lacks residency, the state may impose tax obligation to withhold a portion of the PTE owner's apportioned allocable income and remit it to the state's tax authority. This withholding is typically a percentage of the income, oftentimes the highest marginal individual tax rate in the state.

Withholding obligations oftentimes do not satisfy a nonresident PTE owner's individual filing requirement at the state level. The withholding taxes merely serve as the PTE making what is essentially an estimated tax payment on behalf of the PTE owner. When the nonresident PTE owner files their nonresident return with the state, the PTE owner may be able to claim a payment/credit to offset the taxes calculated on the nonresident individual tax return. Further, the individual taxpayer may be able to use the withholding taxes toward a credit for taxes paid to other states on the resident individual return, as applicable.

Withholding taxes paid by the PTE should be indicated to the PTE owner for the applicable states on the state K-1s to be provided to shareholders. As an example, California requires income subject to withholding and to be reported by the PTE to the PTE owner on Form 592-B and also reported on the California Schedule K-1. For a partnership, this would include the following reporting:

Resident and Nonresident Withholding Tax Statement

CALIFORNIA FORM **592-B**

☐ Amended

Part I Withholding Agent Information

Name of withholding agent (from Form 592, 592-PTE, or 592-F)		SSN or ITIN
Address (apt./ste., room, PO box, or PMB no.)		☐FEIN ☐CA Corp no. ☐CA SOS file no.
City (if you have a foreign address, see instructions.)	State ZIP code	Daytime telephone number

Part II Payee Information

Name of payee		SSN or ITIN
Address (apt./ste., room, PO box, or PMB no.)		☐FEIN ☐CA Corp no. ☐CA SOS file no.
City (if you have a foreign address, see instructions.)	State ZIP code	

Part III Type of Income Subject to Withholding. Check the applicable box(es)

A ☐ Payments to Independent Contractors
B ☐ Trust Distributions
C ☐ Rents or Royalties
D ☐ Distributions to Domestic (U.S.) Nonresident Partners/Members/ Beneficiaries/S Corporation Shareholders
E ☐ Estate Distributions
F ☐ Elective Withholding
G ☐ Elective Withholding/Indian Tribe
H ☐ Allocations to Foreign (non-U.S.) Nonresident Partners/Members
I ☐ Other _____

Part IV Tax Withheld

1 Total income subject to withholding	1		
2 Total resident and/or nonresident tax withheld (excluding backup withholding)	2		
3 Total backup withholding	3		

Partner's name | **Partner's identifying number**

	(a) Distributive share items	(b) Amounts from federal Schedule K-1 (Form 1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
Deductions	12 Expense deduction for recovery property (IRC Section 179)				
	13 a Charitable contributions				
	b Investment interest expense				
	c 1 Total expenditures to which an IRC Section 59(e) election may apply				
	2 Type of expenditures				
	d Deductions related to portfolio income				
	e Other deductions. Attach schedule				
Credits	15 a Total withholding (equals amount on Form 592-B if calendar year partnership)			●	▶
	b Low-income housing credit				
	c Credits other than line 15b related to rental real estate activities				
	d Credits related to other rental activities				
	e Nonconsenting nonresident members' tax allocated to partner				
	f Other credits – Attach required schedules or statements				

Lastly, it is important to distinguish that this tax is paid by the PTE on behalf of the PTE owner but is not ultimately imposed on the PTE. As such, withholding taxes are usually treated as either a PTE distribution to the PTE owner, or alternatively for cash flow tight organizations, a "Loan to/Receivable from PTE

Owner" for the amount of the withholding tax paid. The loan/receivable can either be offset by future declared and paid distributions from the PTE or require contributions to the PTE to satisfy the PTE owner's obligation to the PTE. Withholding taxes paid should not be deducted by the PTE in determining PTE taxable income. The withholding taxes would be deductible by the individual PTE owner on Schedule A (1040) and subject to the $10,000 annual SALT limitation.

III. Composite taxes

Nonresident composite taxes are a tax method used by certain states in the United States to simplify the tax compliance process for multistate passthrough entities. These taxes are typically imposed on nonresident partners or shareholders who earn income from the entity's operations within the state. Instead of requiring each nonresident owner to file an individual state tax return, some states allow multistate passthrough entities to calculate and remit a composite tax on behalf of these nonresident owners, which can in many cases serve as the filing requirement of the nonresident and remove the filing requirement of the nonresident individual income tax return. The composite taxes do not apply to residents of the applicable state.

- **Income Source:** Nonresident composite taxes apply to owners or shareholders of multistate passthrough entities who do not reside within the state but receive an allocable share of apportioned/allocated income from the entity's activities within that state.
- **Composite Tax Rate:** The composite tax rate is typically a flat percentage of the nonresident PTE owner's allocable apportioned income sourced within the state. The rate may vary depending on the state's tax laws, but it is often the highest individual marginal tax rate.

Similar to nonresident withholding taxes, composite taxes are paid on behalf of PTE owners in satisfaction of the PTE owner's nonresident activity within a given state for the specific PTE. Assuming all allocable apportioned share of PTE income for a PTE owner is included on composite tax returns for all PTE activities, the composite usually mitigates any need to file a nonresident tax return within a given state, thereby simplifying state tax return filing requirements with respect to the individual PTE owner.

Example: ***Facts***
John, a FL resident, is a PTE owner in Partnership 1, Partnership 2, and 3 S Corporation. Partnership 1, Partnership 2, and 3 S Corporation all operate in multiple states with income taxes. John is included on PTE composite returns within all states where the three PTEs operate.

Conclusion
Because John is included on PTE composite returns in all states where the three PTEs operate and all applicable states treat composite tax returns as substitutes for nonresident individual returns absent any other state sourced income, John will have no state filing obligations with respect to the multistate activities of his PTE ownership interests.

Further, because John is a resident of FL, which does not have an income tax, John will have no resident state return.

Thus, John will file his federal return for all relevant income and deductions, including those related to his allocable share from the PTE ownership interest, and will have no resulting state tax filing obligations.

Again, similar to nonresident withholding, it is important to distinguish that the composite tax is paid by the PTE on behalf of the PTE owner but is not ultimately imposed on the PTE. As such, composite taxes are

usually treated as either a PTE distribution to the PTE owner, or alternatively for cash flow tight organizations, a “Loan to/Receivable from PTE Owner” for the amount of the composite tax paid. The loan/receivable can either be offset by future declared and paid distributions from the PTE or require contributions to the PTE to satisfy the PTE owner’s obligation to the PTE. Composite taxes paid should not be deducted by the PTE in determining PTE taxable income. The composite taxes would be deductible by the individual PTE owner on Schedule A (1040) and subject to the $10,000 annual SALT limitation.

The amount of composite taxes paid should be indicated by the PTE to the PTE owner on the related state schedules K-1 or related schedules and/or statements provided to the PTE owner.

IV. Passthrough entity taxes

On November 9, 2020, the IRS issued Notice 2020-75, stating that the Treasury Department and IRS intend to issue proposed regulations clarifying SALT deduction limitations. Per the guidance, any “specified income tax payments” are deductible by partnerships and S corporations in computing their non-separately stated income or loss for the tax year of the payment. Specified income tax payments are any amount imposed on and paid by a partnership or S corporation to a state to satisfy its income tax liability. As such, these payments are not subject to the SALT deduction limitation for partners and shareholders who itemize their deductions and are fully deductible. Notice 2020-75 states that the proposed regulations described in the notice apply to payments made on or after November 9, 2020. Additionally, Notice 2020-75 allows taxpayers to apply the rules to payments made in a taxable year of the partnership or S corporation ending after December 31, 2017 and before November 9, 2020. These “specified income tax payments” became known as Passthrough Entity Taxes (PTETs) and represent an alternative in states that may otherwise impose a mandatory withholding or composite tax regime subject to the SALT limitation on itemized deductions on Schedule A.

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

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

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

Practice Note: Beware of incomplete or incorrect guidance

Because these taxes are in a rapidly changing environment, it is important to be aware of what applicable state guidance is being released. For example, prior to the passage of the Indiana PTET, the instructions to the Indiana Individual Income Tax Return (IT-40), which have a most recent revised date of September 2022, specifically permit a credit for taxes paid to other states for both withholding and composite taxes but explicitly disallow the credit for those related to PTETs. However, Indiana later signed into law the PTET retroactive to January 1, 2022, which also permitted the PTET to become a creditable tax, while most state forms and instructions relevant to tax year 2022 remained outdated. This is a simple example of why vigilance is necessary to arrive at the correct answer for the PTEs with multistate activities.

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

V. Other items of consideration

Not only should the optimization of taxes be considered but a whole host of other issues must be considered. Some passthrough entity tax (PTET) items to consider include following:

- Is the PTET elective or mandatory?
- Are estimated payments required?
- What voting procedure and percentage of ownership is required to make the election?
- Is the election binding for the current year or future years? Is revocation possible?
- What forms are used to make the election?
- Does the operating agreement or corporate charter permit the PTET election?
- Are all partners/shareholders included in the PTET election?
- Are guaranteed payments reduced by the partner's share of the PTET tax expense?
- How are excess PTE tax credits/refunds addressed for federal income tax purposes?
- Is self-employment income reduced by the PTET?
- Are loss carryforwards allowed for PTET purposes? Would any ASC740/Deferred Tax Accounting be required by an audit team given their materiality thresholds?
- For state purposes, what deductions will be included in the taxable income base for PTET purposes (e.g., charitable contributions, gains for changes in ownership structured as either an asset sale or stock sale)?
- Because most states disallow deductions for state purposes, will there be a different basis in partnership interest/S corporation stock that must be accounted for on the state return when the PTE owner sells their interest?
- How should owners be notified of which states filed withholding, composite, or the PTE tax was executed?
- And many, many more questions could be relevant…

A. Bookkeeping for nonresident withholding and composite taxes

Because nonresident withholding/composite taxes ultimately are imposed on the PTE owner, these payments do not represent deductions to the PTE and should be recorded as what is essentially balance sheet only transactions. This can be done in two separate ways:

1. **Distribution Approach:** When the withholding/composite tax payment is made, the reduction in cash and the reduction in equity is via a PTE owner distribution.

Example: ***Facts – Standard Distribution Approach***
AB S corporation has two 50/50 shareholders, Shareholder A and Shareholder B. AB S corporation is required to make a total $30,000 of nonresident state composite payments on behalf of Shareholders A and B. AB S corporation records the composite tax payment utilizing the distribution approach as follows:

DR	Distributions – Shareholder A	$15,000	
DR	Distributions – Shareholder B	$15,000	
CR	Cash		$30,000

Conclusion
Because the payments made were with regard to withholding taxes, AB S Corporation will record a distribution for the state withholding payments. These payments are not deductible as PTETs for AB S corporation.

With this approach, if the only distributions paid for the year are related to withholding/composite taxes, the result would appear to be a disproportionate distribution.

Example: ***Facts – Distribution Approach/Disproportionate Distributions***
AB S corporation has two 50/50 shareholders, Shareholder A and Shareholder B. AB S corporation is required to make $25,000 of nonresident state composite payments on behalf of Shareholder A, and no withholding or composite taxes are made on behalf of Shareholder B. AB S corporation records the state composite tax payment utilizing the distribution approach as follows:

DR	Distributions – Shareholder A	$25,000	
CR	Cash		$25,000

Conclusion
Absent any other distributions, the result is a disproportionate distribution in favor of Shareholder A over Shareholder B, which violates the required per-share, per-day S corporation requirements and could result in an involuntary termination of the S election. Oftentimes, a work-around for this would be the entity recording a distribution payable to shareholder B as follows:

DR	Distributions – Shareholder B	$25,000	
CR	Distribution Payable – Shareholder B		$25,000

While this would serve as a work-around, Shareholder B will be receiving a basis reduction without the cash, and to the extent the distribution would be in excess of basis, the shareholder would be subject to capital gain. As such, these sorts of work-arounds should be considered only under extreme advisement.

2. **PTE Owner Receivable Approach:** Under the shareholder receivable approach, the payment of withholding/composite taxes creates a receivable from the PTE owner. This receivable then can be offset by future distributions, or if the entity is in liquidation proceedings, require the owner to satisfy the PTE owner contribution with a capital contribution.

Example: ***Facts – PTE Owner Receivable Approach***

CD Partnership is a 50/50 partnership with two partners, Partner C and Partner D. Partner C is subject to state withholding taxes in the amount of $20,000. CD Partnership is not required to make any state withholding/composite payments on behalf of Partner D. Utilizing the PTE owner receivable approach, CD records the following entry for the payment of Partner C's state withholding taxes:

DR	Partner C Rcvbl-State W/H/Composite Taxes	$20,000	
CR	Cash		$20,000

Conclusion

As provided by the partnership agreement, any future distributions declared to Partner C will be offset by the receivable before any cash is paid to Partner C. The next distribution declared was $100,000 split 50/50 between Partners C and D. In considering partner receivables, the distribution would be recorded as follows:

DR	Distribution – Partner C	$50,000	
DR	Distribution – Partner D	$50,000	
CR	Partner C Rcvbl-State W/H/Composite Taxes		$20,000
CR	Cash – Partner C		$30,000
CR	Cash – Partner D		$50,000

It is important to think very analytically when discussing complex multistate income tax issues in the passthrough entity context. The simple illustrations provided thus far serve as a springboard for the thinking about and understanding these issues, and it is important to understand that each state is going to be different regarding their requirements for withholding taxes, composite taxes, and PTETs, so an ongoing dialog with the client is essential to understand what additional states the PTE client is engaging in to be able to provide the best advice and planning.

B. Bookkeeping for PTETs

When dealing with PTETs the bookkeeping is still simple enough as the payment/accrual will generally serve as the deductible expense.

Example: ***Facts***

Partnership ABC has two equal partners, A and B. Partnership ABC pays State X PTE income tax of $50,000. The payment is recorded as follows:

DR	*State Tax Expense – State X*	*$50,000*	
CR	*Cash*		*$50,000*

Conclusion

State X allows partners A and B to each claim a $25,000 credit against their own personal income tax liability owed to State X. Per Notice 2020-75, the $25,000 that each partner receives is ***not*** *subject to the $10,000 SALT deduction limitation as it is deducted in arriving at ordinary taxable income for Partnership ABC.*

Though the above is simple enough, it is essential that taxpayers still receive the information necessary to determine any applicable adjustments or credits on their individual state tax returns.

C. Tax planning with regard to resident state PTE owners

When a partnership or S corporation operates in only one state, most practitioners would forego the notion of electing the PTET regime for resident PTE owners, which wasn't often available in the withholding/composite regimes. However, if the resident state allows, the benefit may be significant to avoid the SALT cap limitation.

Example: ***Facts***

Mark and John are 50/50 shareholders in MJ S corporation, which operates only in state Y. Mark and John have no other states with income tax nexus. State Y permits S corporations to elect PTETs for PTE owners resident to state Y. State Y has an individual tax rate of 4.5%. MJ S corporation is planning $67,500 cash flow related to taxes structured as either: (1) a distribution to owners to pay their personal estimated taxes, or (2) estimated tax payments made prior to year end and claimed as a deduction.

Prior to the deduction, MJ S corporation has $1,500,000 estimated ordinary taxable income prior to PTET tax deductions.

Mark and John both file Form 1040 with married filing jointly and with total itemized deductions of $40,000 and $50,000, respectively. Both claim a $200,000 salary from MJ S corporation, and both are subject to the SALT limitation prior to the consideration for PTET. Assume each shareholder claims a §199A QBI deduction of $143,250 if the PTETs are deducted and $150,000 if PTETs are filed.

Conclusion

In working through the facts as follows, we arrive at a net tax benefit of $23,160 from claiming the PTET in the resident state as available.

PTETs Elected	Mark	John	Total
Wages	200,000	200,000	
S Corporation *	716,250	716,250	
Itemized Deductions	(40,000)	(50,000)	
QBI	(143,250)	(143,250)	
Taxable Income	733,000	723,000	
Income Taxes	**235,243**	**231,743**	**466,986**

No PTETs Elected	Mark	John	Total
Wages	200,000	200,000	
S Corporation	750,000	750,000	
Itemized Deductions	(40,000)	(50,000)	
QBI	(150,000)	(150,000)	
Taxable Income	760,000	750,000	
Income Taxes	**246,590**	**243,556**	**490,146**
Total Tax Savings	11,347	11,813	**23,160**

** $1,500,000 - $67,500 of PTETs = $1,432,500 * 50% = $716,250*

In the context of a partnership where self-employment taxes apply to a partner's entire allocable share of partnership profit and loss, there may be even greater opportunity for planning assuming the taxpayer does not exceed the SE income taxable base.

Example: ***Facts***

BA Attorneys, LLC has two 50/50 partners, Barb and Brenda. They each claim an $80,000 guaranteed payment from the LLC. After the consideration of the guaranteed payments, the BA Attorneys, LLC reports $160,000 of ordinary taxable income. Both are resident to state X and have no nexus in any other state. State X permits resident partners to claim the PTETs. State X maintains a flat individual tax rate of 4%. As such, BA Attorneys, LLC has planned cash flow of $7,000 for taxes to be reported as distributions or paid as estimated tax payments for purposes of claiming the PTETs.

Barb and Brenda both file as single taxpayers. They claimed itemized deductions in the amount of $22,000 and $25,000, respectively, and both are subject to the SALT limitation. Because this activity is an SSTB, assume the taxpayers each claim an estimated §199A QBI deduction of $14,875.

Conclusion

In working through the facts as follows, we arrive at a net tax benefit of $2,590 from claiming the PTET in the resident state as available.

PTETs Elected	Barb	Brenda	Total
Guaranteed Payments	80,000	80,000	
LLC Income	76,500	76,500	
SE Taxes	(11,056)	(11,056)	
Itemized Deductions	(22,000)	(25,000)	
QBI	(14,875)	(14,875)	
Taxable Income	108,569	105,569	
Income Taxes	19,456	18,736	
SE Taxes	22,113	22,113	
Total Taxes	41,569	40,849	82,418

No PTETs Elected	Barb	Brenda	Total
Guaranteed Payments	80,000	80,000	
LLC Income	80,000	80,000	
SE Taxes	(11,304)	(11,304)	
Itemized Deductions	(22,000)	(25,000)	
QBI	(14,875)	(14,875)	
Taxable Income	111,821	108,821	
Income Taxes	20,237	19,517	
SE Taxes	22,647	22,607	
Total Taxes	42,884	42,124	85,008
Total Tax Savings	1,315	1,275	**2,590**

The most important thing to remember is that these calculations are going to be extremely context specific, and if a client cares to optimize their taxes and minimize their effective tax rates, this is certainly an area where practitioners can look to do that for a client.

VI. Example

Example 1:

- Two partners: Bob (60%) and Brian (40%); both are Florida residents.
  - Bob itemizes his deduction: $10,000 real estate taxes, $100,000 charity.
  - Brian claims the standard deduction.
  - Assume SE taxes do not apply to either taxpayer and the QBI deduction is unavailable/phased out.
- Taxable in 2 states: California 50% and North Dakota 50%.
- California:
  - AB Partnership elects the PTET tax at 9.3% in 2024.
  - 2023 PTET paid in 2024 was $150,000.
- North Dakota:
  - ND applies nonresident withholding at a rate of 2.5% in 2024.
  - 2023 withholding tax paid in 2024 was $47,000.

Partnership - Tax Year 2024

Gross Profit	3,150,000
CA 2023 PTET Paid 2024	(150,000)*
Ordinary Taxable Income	3,000,000

***Note:** No deduction for 2023 withholding tax paid as that is an expense of the partner rather than the partnership.

California Taxable Income

Federal Taxable Income	3,000,000
Addback - State Taxes Deducted	150,000
California Taxable Income	3,150,000
Income Apportioned to California (50%)	1,575,000
PTE Tax 2024 paid in 2025	146,475

California Notes:

- Absent other filing obligations, Bob and Brian have no California filing obligations. The partners will still receive California state K-1s.
- PTET will be deductible by the partnership in determining ordinary taxable income in the year paid.

North Dakota Taxable Income

Federal Taxable Income	3,000,000
Addback - State Taxes Deducted	150,000
North Dakota Taxable Income	3,150,000
Income Apportioned to North Dakota (50%)	1,575,000

	Allocable ND Income	ND Withholding Taxes (2.9%)
Bob Allocable Share of Apportioned ND Income	945,000	27,405
Brian Allocable Share of Apportioned ND Income	630,000	18,270
Total	1,575,000	45,675

		60% Itemized Deductions Bob - Federal 1040	40% Standard Deduction Brian - Federal 1040
AGI (60% to of AB Partnership)		1,800,000	1,200,000
Itemized Deductions			
Real Estate Taxes	10,000		
Withholding	27,405		
Deductible state taxes (max $10,000)	10,000		
Charitable	100,000		
Total Itemized or Standard Deduction		(110,000)	(13,850)
Taxable Income		1,690,000	1,186,150
Income Tax		585,632	399,208
NIIT		60,800	38,000
Total Tax		**646,432**	**437,208**

Note the California PTET taxes were deducted in determining the partner's allocable share of AB partnership income.

Interest: Thinking Beyond Section 163(j)

Interest: Thinking Beyond Section 163(j)

Learning objectives

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

- Differentiate between business interest expense, investment interest expense, and personal interest expense and recognize the differences in deductibility and the various limitations and exceptions of each type;
- Recognize debt recharacterization and repayments; and
- Understand interest tracing for mixed-use debt proceeds.

I. Interest in general

Given the higher interest rate environment, interest deductions and income are an increasing item of concern. While the hot topic since the passage of TCJA has been the business interest limitation of §163(j), there are a number of issues related to interest that still must be considered when serving taxpayers and providing the most complete and accurate tax advice. This advice can relate to private debt arrangements, convertible debt, and interest tracing for mixed-use debt proceeds.

A. Business interest

Internal Revenue Code Section 163 outlines the rules pertaining to the deduction of interest expenses for taxpayers. It encompasses various provisions governing the deductibility of interest paid or accrued by individuals, businesses, and other entities.

Generally, §163(a) allows taxpayers to deduct **interest expenses incurred in carrying on a trade or business**, as well as investment interest, subject to certain limitations and conditions. Business interest expenses are generally fully deductible unless limitations apply. However, the deduction for investment interest expense is capped at the amount of the taxpayer's net investment income.

B. Personal interest

Under §163(h) of the Internal Revenue Code, personal interest refers to the interest expenses that are generally not deductible for individual taxpayers. Personal interest includes interest paid or accrued on debts that are not used for specific purposes considered to be investment or business-related. In the case of a taxpayer other than a corporation, **personal interest means any interest other than the following**:

1. Interest allocable to a trade or business (other than the trade or business of being an employee);
2. Investment interest;
3. Interest expense taken into account for an activity to which the passive activity rules of §469 apply;
4. Any qualified residence interest;
5. Interest related to imposed taxes; and
6. Student loan interest as defined in §221.

It's essential for taxpayers to differentiate between personal interest and interest related to investments or business activities. Deductibility of interest is subject to various limitations and exceptions outlined in the tax code.

C. Niche interest topics

IRC §163 includes provisions for other specialty interest topics. These topics often apply to taxpayers with more complicated debt instruments in the financial services, private equity, venture capital, and angel investing; though, some elements can apply to the average taxpayer with some exposure to debt securities within the brokerage account.

1. Original Issue Discount (§163(e))

Representing the most common specialty interest topics, OID arises when a debt instrument is issued at a price lower than its face value, resulting in the investor recognizing the discount as interest income over the term of the debt instrument rather than at the time of the debt's maturity.

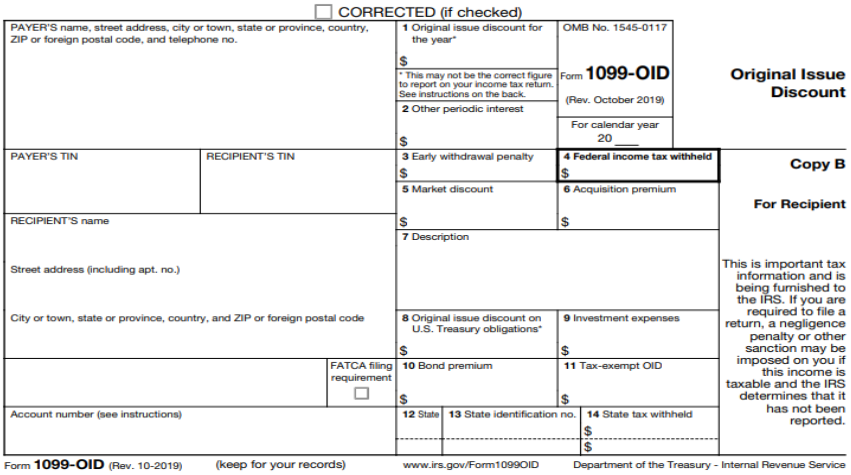
Example 1: A corporate bond with a face value of $1,000 is issued at a discounted price of $900. The bond matures in five years and has an annual interest rate of 5%. However, due to being issued at a discount, it falls under the OID rules.

The OID is the difference between the face value and the issue price:
OID = Face Value - Issue Price
OID = $1,000 - $900 = $100

OID is typically accrued over the life of the debt instrument using constant-yield method or some other acceptable method specified by the IRS. The investor includes the OID amount in their taxable income annually, even though the cash payment of interest might not be received until maturity.

OID is taxable as interest income to the holder of the debt instrument. For tax purposes, the investor includes the OID in their income according to a predetermined schedule, even if they haven't received any cash payments during that period.

If a taxpayer is reporting qualified stated interest and OID on an obligation that doesn't fall under the category of a specified private activity bond, both the qualified stated interest and the OID may be reported to the taxpayer from the borrower on Form 1099-OID. There's no requirement to submit both Forms 1099-INT and 1099-OID for this purpose. On Form 1099-OID, the qualified stated interest should be reported in box 2, while the OID should be reported in box 1, 8, or 11, as applicable. Nevertheless, the taxpayer has the option to report the qualified stated interest on Form 1099-INT and the OID on Form 1099-OID.



☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

1 Original issue discount for the year* $

* This may not be the correct figure to report on your income tax return. See instructions on the back.

2 Other periodic interest $

OMB No. 1545-0117

Form **1099-OID** (Rev. October 2019)

For calendar year 20 ___

Original Issue Discount

PAYER'S TIN | RECIPIENT'S TIN

3 Early withdrawal penalty $

4 Federal income tax withheld $

5 Market discount $

6 Acquisition premium $

RECIPIENT'S name

Street address (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

7 Description

8 Original issue discount on U.S. Treasury obligations* $

9 Investment expenses $

FATCA filing requirement ☐

10 Bond premium $

11 Tax-exempt OID $

Account number (see instructions)

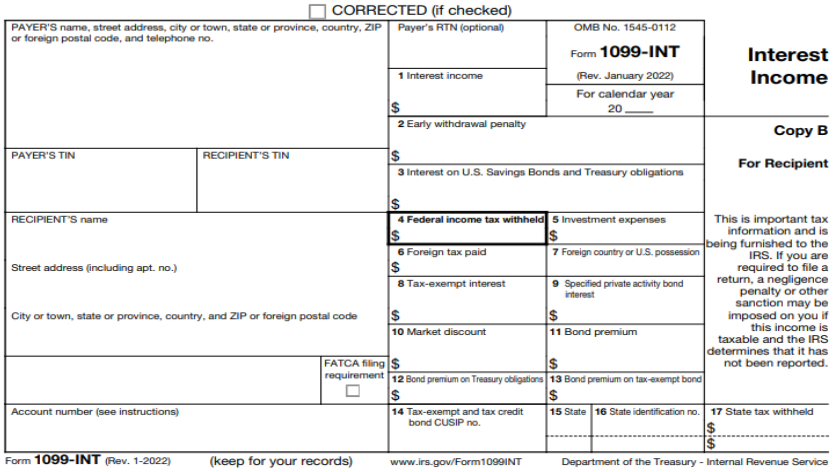
12 State | 13 State identification no. | 14 State tax withheld $ $

Copy B

For Recipient

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-OID** (Rev. 10-2019) (keep for your records) www.irs.gov/Form1099OID Department of the Treasury - Internal Revenue Service



☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

Payer's RTN (optional)

1 Interest income $

OMB No. 1545-0112

Form **1099-INT** (Rev. January 2022)

For calendar year 20 ___

Interest Income

2 Early withdrawal penalty $

PAYER'S TIN | RECIPIENT'S TIN

3 Interest on U.S. Savings Bonds and Treasury obligations $

RECIPIENT'S name

Street address (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

4 Federal income tax withheld $

5 Investment expenses $

6 Foreign tax paid $

7 Foreign country or U.S. possession

8 Tax-exempt interest $

9 Specified private activity bond interest $

10 Market discount $

11 Bond premium $

FATCA filing requirement ☐

12 Bond premium on Treasury obligations $

13 Bond premium on tax-exempt bond $

Account number (see instructions)

14 Tax-exempt and tax credit bond CUSIP no.

15 State | 16 State identification no. | 17 State tax withheld $ $

Copy B

For Recipient

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-INT** (Rev. 1-2022) (keep for your records) www.irs.gov/Form1099INT Department of the Treasury - Internal Revenue Service

2. Applicable High Yield Discount Obligations (§163(i))

Under §163(i) of the Internal Revenue Code (IRC), the term "applicable high yield discount obligation" (AHYDO) refers to certain debt instruments with original issue discount (OID) that are subject to specific interest deductibility limitations.

AHYDO is a term used to categorize debt instruments issued by corporations where the OID exceeds a specified threshold and the interest payable on the debt is considered excessive. The threshold for identifying an AHYDO is typically based on the greater of the applicable federal rate (AFR) plus 5% or the AFR plus the actual yield to maturity (YTM) of the instrument plus 5%. If a debt instrument falls under the classification of an AHYDO, the issuer might face limitations on the interest deduction. Generally, the issuer of an AHYDO is restricted from claiming a deduction for interest payments that exceed the instrument's stated interest amount over the term of the debt.

The determination of whether a debt instrument is an AHYDO involves complex calculations comparing the instrument's OID to the threshold rates specified by the IRS. If the OID of the debt instrument exceeds the threshold and the stated interest is significantly higher than the benchmark rates, it could be classified as an AHYDO. The AHYDO rules are designed to prevent corporations from issuing debt with excessive OID and to limit the tax advantages associated with high-yield debt instruments. The AHYDO rules are complex and have significant implications for corporations issuing debt instruments with OID.

3. Convertible Corporate Debt Instruments (§163(l))

Congress introduced §163(l) in 1997 due to concerns about corporations issuing debt that resembled equity more than traditional debt, which was not appropriate for claiming interest deductions.[1] Under §163(l)(1), no deduction is permitted for interest paid or accrued on a disqualified debt instrument. However, §163(l) doesn't impact how a disqualified debt instrument is categorized as debt or equity or the treatment of its holder (the 1997 Bluebook).

A disqualified debt instrument includes any corporation's debt that is "payable in equity," encompassing either: (i) equity of the issuer or a related party to the issuer; or (ii) equity held by the issuer or a related party. For §163(l) purposes, two parties are related if their relationship is described in §267(b) or 707(b).

Section 163(l)(3) stipulates that debt is considered "payable in equity" if a significant amount of the principal or interest is:

a) Mandated to be paid in, converted into, or determined based on the equity's value;
b) Payable in, convertible into, or determined based on the equity's value at the issuer's discretion; or
c) Payable in, convertible into, or determined based on the equity's value at the discretion of a related party to the issuer (the related-party option test).

As part of the disqualified debt test above, there must be ***"substantial certainty" the option will be exercised***. Section 163(l)(3)(C) also states that debt is treated as payable in equity if it's part of an arrangement reasonably anticipated to result in one of these situations.

Furthermore, the statute indicates that debt is considered payable in equity if: (i) a substantial portion of the principal or interest might be obligated at the holder's or a related party's discretion to be paid in, converted into, or determined based on the equity's value; and (ii) there's a high likelihood that the option will be exercised (the holder option test).

Example 2: ***Facts – PLR 201517003***

Taxpayer borrowed foreign currency from indirect, foreign Parent under a convertible promissory note for refinancing. Interest was payable only at maturity (thus, OID rules applied), and prepayment required Parent's consent. Parent couldn't call the loan early without default or a change-in-control. At maturity, Parent could convert the loan into Taxpayer shares based on a pre-determined formula. The conversion feature, initially "out-of-the-money" (i.e., the conversion price at which the debt can be converted into equity is higher than the current market price of the issuer's stock), allowed potential foreign tax benefits. Parent could treat accrued interest as capital gain, offset by equivalent capital loss carry-forwards, reducing home country taxation on the income generated from the note. The ruling focused on the tax implications of the convertible note's features.

Conclusions – PLR 201517003

The ruling (PLR 201517003) addressed whether the conversion feature of a note would disallow interest expense under §163(l) in an inbound financing transaction. Section 163(l) disallows interest deductions on "disqualified debt instruments" payable in equity. The ruling clarified that the general rule for conversion features, where interest is disallowed only if conversion is "substantially certain," took precedence over automatic disallowance under clause (A) relating to related parties. The IRS emphasized legislative intent

[1] *Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, at 193 - the 1997 Bluebook).*

favoring convertible debt as valid in most cases. The ruling did not assess the substantial certainty of conversion but highlighted the legislative history, indicating §163(l) wasn't intended for convertible debt with an exercise price significantly higher than the fair market value at the debt's issue date. The foreign tax benefit wasn't contingent on converting the debt into equity.

Takeaway
The application of §163(l) should be considered in structuring intercompany debt financing, especially if the debt has convertible or equity-linked features, and also that modifications to the debt may trigger a new §163(l) analysis.

II. Interest allocation rules

When taxpayers borrow funds, the funds can ultimately be used for a variety of expenditures, some of which might relate to deductible trade or business activities – whereas others might be for personal activities.

Example 3: John executes a home-equity line of credit, where he borrows $100,000 incurring a 10% interest rate. John uses 60%, or $60,000, of the proceeds to invest in a passive activity. The remaining 40%, or $40,000, of the loan proceeds were utilized for personal expenditures. During the tax year, $10,000 of interest expense is incurred.

How should the interest expense be treated?

Reg §1.163-8T provides rules for allocating interest expense to different types of expenditures, which ultimately uses a tracing method. The regulation applies to taxpayers who incur interest expense on debt that is not directly traceable to a specific expenditure. In other words, the regulation applies to situations where the taxpayer borrows money for general purposes and uses it to fund various expenditures, such as personal, passive, portfolio, business, and investment expenditures. The regulation does not apply to situations where the taxpayer borrows money for a specific purpose and uses it only for that purpose, such as buying a home or a car. In such cases, the interest expense is directly traceable to the specific expenditure and is deductible or non-deductible according to the rules applicable to that expenditure.

In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures.

The regulation requires taxpayers to allocate their interest expense among different categories of expenditures, such as personal, passive, portfolio, business, and investment.

- ***Personal expenditures*** are those that are not related to any income-producing activity, such as living expenses, education, medical expenses, etc.
- ***Passive expenditures*** are those that are related to passive activities, which are activities that involve the conduct of a trade or business in which the taxpayer does not materially participate, such as rental real estate, limited partnerships, etc.
- ***Portfolio expenditures*** are those that are related to portfolio income, which is income from interest, dividends, annuities, royalties, etc.
- ***Business expenditures*** are those that are related to the conduct of a trade or business in which the taxpayer materially participates, such as operating expenses, inventory costs, wages, etc.

- ***Investment expenditures*** are those that are related to the production of income that is not portfolio income or passive income, such as expenses for acquiring or improving property held for investment purposes.

These concepts apply even in passthrough entities with a variety of activities being carried on within one tax filing entity: trade/business activities, investment activities, passive activities, etc.

Practice Note: Complicated Schedule K and Debt

When looking at a complicated Schedule K on a Form 1065 or 1120-S with notable borrowings, the Balance Sheet should remind a tax practitioner to consider the implications of interest tracing as it may relate to various activities within a single tax filing entity.

A. The tracing method overview

The tracing method is the default method that applies to tracing debt proceeds and the related interest under the Reg. §1.163-8T. Under the tracing method, ***the taxpayer allocates interest expense to each category of expenditures based on the use of the borrowed funds during the taxable year.*** The taxpayer must keep adequate records to substantiate the use of the borrowed funds and the allocation of interest expense.

Example 4: ***Facts***
Margaret, a small business owner, pledges a portion of their inventory as collateral for a loan to expand their business operations. However, instead of using the loan amount for business purposes, Margaret diverts a significant portion of it to renovate their personal residence.

Conclusion
Despite the loan being secured by the business inventory, the interest expense accrued on this loan used for personal renovations is allocated as a personal expenditure. This is the case even though the debt is backed by business assets because the funds were used for a personal, non-business-related purpose.

Example 5: ***Facts***
John executes a home-equity line of credit, where he borrows $100,000 at a 10% interest rate. John uses 60%, or $60,000, of the proceeds to invest in a passive activity. The remaining 40%, or $40,000, of the loan proceeds were utilized for personal expenditures. During the tax year, $10,000 of interest expense is incurred.

How should the interest expense be treated?

Conclusion

Category	Expenditures	Allocation	Interest	Treatment
Investment in a passive activity	60,000	60%	6,000	Subject to §469 on Form 8582
Personal expenses	40,000	40%	4,000	Nondeductible interest (§163(h))
	100,000	100%	10,000	

The $6,000 interest expense allocated to the passive activity investment is factored into John's income or loss computation under §469, relating to the specific activity to which that interest pertains. According to §163(h), John is ineligible to deduct the $4,000 interest expense allocated to personal expenses (except if that interest qualifies as qualified residence interest, as defined by §163(h)(3)).

B. Debt classification

Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used or treated as used to make the expenditure and ending on the earlier of:

1. The date the debt is repaid; or
2. The debt and interest expense which remain unexpended will default to an investment interest expense treatment.

Example 6: ***Facts***

On January 1, Nick, a calendar year taxpayer, borrows $1,000 at an interest rate of 11 percent, compounded semiannually. Nick immediately uses the debt proceeds to purchase an investment security. On July 1, Nick sells the investment security for $1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the $1,000 debt for the entire year.

Conclusion

The $1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the $1,000 debt is allocated in accordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive activity expenditure on the date the interest was paid. Thus, the $55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional $3 of interest expense for the period from July 1 through December 31 ($55 × .055) is allocated to the investment expenditure. The remaining $55 of interest expense for the period from July 1 through December 31 ($1,000 × .055) is allocated to the passive activity expenditure.

Start Date	End Date	Days	Weighted-Average	Outstanding Debt	Personal	Passive	Portfolio	Business	Investment
1-Jan	30-Jun	181.00	49.59%	1,000					496
1-Jul	31-Dec	184.00	50.41%	1,000		504			
		365.00	100.00%	1,000		504			496
		Interest on $1,000 @ 11% =		110		55.45			54.55

Example 7: ***Facts***

David, a calendar year taxpayer, borrows $100,000 at 10% annual interest on January 1 and immediately uses the proceeds to open a noninterest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, David uses $20,000 of the debt proceeds held in the account for a passive activity expenditure. On September 1, David uses an additional $40,000 of the debt proceeds held in the account for a personal expenditure.

Conclusion

From January 1 through March 31 the entire $100,000 debt is allocated to an investment expenditure for the account. From April 1 through August 31, $20,000 of the debt is allocated to the passive activity expenditure, and $80,000 of the debt is allocated to the investment expenditure for the account. From September 1 through December 31, $40,000 of the debt is allocated to the personal expenditure, $20,000 is allocated to the passive activity expenditure, and $40,000 is allocated to an investment expenditure for the account. Further, the interest will be allocated to the activities based in accordance with the allocation of the debt.

Start Date	End Date	Days	Weighted-Average	Outstanding Debt	Interest @ 10% on $100,000	Personal	Passive	Portfolio	Business	Investment	Check
1-Jan	31-Mar	90.00	24.66%	$100,000	$2,466					$2,466[1]	-
1-Apr	31-Aug	153.00	41.92%	$100,000	$4,192		$838[2]			$3,353[3]	-
1-Sep	31-Dec	122.00	33.42%	$100,000	$3,342	$1,337[4]	$668[5]			$1,337[6]	-
		365.00	100.00%		$10,000	$1,337	$1,507	-	-	$7,156	

[1] $100,000 / $100,000 * $2,466 = $2,466
[2] $20,000 / $100,000 * $4,192 = $838
[3] $80,000 / $100,000 * $4,192 = $3,353 (rounded)
[4] $40,000 / $100,000 * $3,342 = $1,337
[5] $20,000 / $100,000 * $3,342 = $668
[6] $40,000 / $100,000 * $3,342 = $1,337

C. Accrued interest

Accrued interest is treated as a debt until it is paid and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest is allocated. As an alternative, compound interest accruing on such debt (other than compound interest accruing on interest that accrued before the beginning of the year) may be allocated between the original expenditure and the new expenditure on a straight-line basis (i.e., by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of twelve 30-day months for purposes of allocating interest on a straight-line basis. No election is required for this alternative treatment but should be adopted as an accounting for a specific debt and applied consistently.

Example 8: ***Facts***

On January 1, Nick, a calendar year taxpayer, borrows $1,000 at an interest rate of 11 percent, compounded semiannually. Nick immediately uses the debt proceeds to purchase an investment security. On July 1, Nick sells the investment security for $1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the $1,000 debt for the entire year.

Conclusion
Under this method, Nick will allocate $56.50 of interest expense (180/360 x $113) to the investment expenditure and the remaining $56.50 of interest expense would be allocated to the passive activity expenditure.

The amount of interest expense that accrues during any period is determined by taking into account relevant provisions of the loan agreement.

D. Debt recharacterization

Occasionally, debt expenditures may be recharacterized/reallocated. Debt allocated to an expenditure is reallocated to another expenditure on the earlier of:

- The date on which proceeds from a disposition of such asset are used for another expenditure; or
- The date on which the character of the first expenditure changes (e.g., from a passive activity expenditure to an expenditure that is not a passive activity expenditure) by reason of a change in the use of the asset.

Example 9: ***Facts***
On January 1, 20X1, Matthew borrows $10,000 at an interest rate of 11 percent, compounded annually. The entirety of interest and principal on the debt is slated to be repaid as a lump sum on December 31, 20X5. Immediately upon securing the loan, Matthew channels the borrowed funds toward a passive activity business expenditure.

Matthew engages substantially in the business activity during 20X3, 20X4, and 20X5. Consequently, the debt is assigned to a passive business activity expenditure from January 1, 20X1, through December 31, 20X2, and to a former passive business activity expenditure from January 1, 20X3, through December 31, 20X5.

Conclusion
Adhering to the terms outlined in the loan agreement, the interest expense accruing during any given period is calculated based on annual compounding. Therefore, the distribution of the interest expense related to the debt is determined in accordance with these regulations.

Start Date	End Date	Days	Weighted-Average	Outstanding Debt	Interest @ 11% on Out/S Bal.	Personal	Passive	Portfolio	Business (Former Passive Activity)	Investment	Check
1/1/20X1	12/31/20X1	365.00	100.00%	10,000	1,100		1,100				-
1/1/20X2	12/31/20X2	366.00	100.00%	11,100	1,221		1,221				-
1/1/20X3	12/31/20X3	365.00	100.00%	12,321	1,355		255		1,100		-
1/1/20X4	12/31/20X4	365.00	100.00%	13,676	1,504		283		1,221		-
1/1/20X5	12/31/20X5	365.00	100.00%	15,180	1,670		315		1,355		-
					6,699	-	3,146	-	3,553	-	-

20X1: ($10,000 / $10,000)*$1,100 = $1,100 Passive
20X2: ($11,100 / $11,100)*$1,221 = $1,100 Passive
20X3: ([$1,100 + $1,221] / $12,321)*$1,355 = $255 Passive
($10,000 / $12,321)*$1,355 = $1,100 Former Passive
20X4: ([$1,100 + $1,221 + $255] / $13,676)*$1,504 = $283 Passive
([$10,000 + $1,100] / $13,676)*$1,504 = $1,221 Former Passive
20X5: ([$1,100 + $1,221 + $255 + $283] / $15,180)*$1,670 = $315 Passive
([$10,000 + $1,100 + $1,221] / $15,180)*$1,670 = $1,355 Former Passive

E. Debt repayments

When repaying a portion of a debt that is allocated to multiple expenditures, the following order is observed under the regulations:

1. Amounts allocated to personal expenditures; THEN
2. Amounts allocated to investment expenditures and passive activity expenditures (excluding passive activities described in item 3); THEN
3. Amounts allocated to passive activity expenditures related to active participation in rental real estate activities (as defined in §469(i)); THEN
4. Amounts allocated to former passive activity expenditures; THEN
5. Amounts allocated to trade or business expenditures.

For expenditures falling within the same category (i.e., different personal expenditures), the repayment order is based on the sequence of allocation or reallocation, allowing for flexibility on the same day.
In the case of continuous borrowings through a line of credit or similar arrangement, the following rules apply:

- **Same Rate:** Borrowings with the same fixed or variable interest rate are treated as a single debt.
- **Differing Rates:** Borrowings or portions with different fixed or variable rates are treated as separate debts, and repayment follows the order outlined in the loan agreement.

Example 10: ***Facts***

Jimmy borrows $100,000 (referred to as "Debt A") on July 12. Immediately upon obtaining the funds, Jimmy deposits them into an account and utilizes the debt proceeds for the following expenditures on the specified dates:

- August 31: $40,000 for passive activity expenditure #1.
- October 5: $20,000 for passive activity expenditure #2.
- December 24: $40,000 for a personal expenditure.

Conclusion

On January 19 of the following year, B repays $90,000 of Debt A (leaving $10,000 of Debt A outstanding).

In accordance with the regulations, the debt attributable to personal expenditures is treated as paid first, followed by passive activities. If there are multiple expenditures within the classification, the repayment is allocated in the order of the expenditures. Thus, the debt attributed to the earliest expenditure will be treated as paid first.

For Jimmy, the $40,000 of Debt A allocated to the personal expenditure, the $40,000 allocated to passive activity expenditure #1, and $10,000 of the $20,000 allocated to passive activity expenditure #2 are treated as repaid.

Classification	[A] Debt Expend.	[B] Amount Repaid	[A] - [B] Out/S Debt
Passive #1	40,000	40,000	-
Passive #2	20,000	10,000	10,000
Personal	40,000	40,000	-
	100,000	90,000	10,000

Example 11: ***Facts***

Sharon secures a line of credit where the interest for any borrowing is based on the lender's "prime lending rate" on the borrowing date plus two percentage

points. The loan agreement specifies that repayments are considered in the order of borrowings.

Sharon initiates Borrowing #1, obtaining $30,000 on the line of credit. She immediately allocates $20,000 to a personal expenditure ("Personal Expenditure #1") and $10,000 to a trade or business expenditure ("Trade or Business Expenditure #1").

Subsequently, Sharon borrows an additional $20,000 with Borrowing #2, allocating $15,000 to a personal expenditure ("Personal Expenditure #2") and $5,000 to a trade or business expenditure ("Trade or Business Expenditure #2"). Sharon later repays $40,000 of the total borrowings.

Conclusion – Same Prime Rate for Borrowings #1 and #2
In cases where the prime lending rate plus two percentage points remains consistent on both Borrowing #1 and Borrowing #2 dates, the borrowings are treated as a unified debt. Sharon is deemed to have repaid $35,000 of debt allocated to Personal Expenditure #1 and Personal Expenditure #2, along with $5,000 of debt allocated to Trade or Business Expenditure #1.

	Classification	[A] Debt Expend.	[B] Amount Repaid	[A] - [B] Out/S Debt
Debt #1	Personal #1	20,000	20,000	-
	Trade or Business #1	10,000	5,000	5,000
Debt #2	Personal #2	15,000	15,000	-
	Trade or Business #2	5,000	-	5,000
		50,000	40,000	10,000

Conclusion – Different Prime Rate for Borrowings #1 and #2
In cases where the prime lending rate plus two percentage points differs between Borrowing #1 and Borrowing #2, the borrowings are treated as distinct debts. According to the loan agreement, the $40,000 repayment is allocated first to Borrowing #1 totaling $30,000, and the remaining repayment of $10,000 ($40,000 - $30,000) to Borrowing #2. Consequently, Sharon is considered to have repaid $20,000 of debt allocated to Personal Expenditure #1, $10,000 of debt allocated to Trade or Business Expenditure #1, and $10,000 of debt allocated to Personal Expenditure #2.

	Classification	[A] Debt Expend.	[B] Amount Repaid	[A] - [B] Out/S Debt
Debt #1	Personal #1	20,000	20,000	-
	Trade or Business #1	10,000	10,000	-
		30,000	30,000	-
Debt #2	Personal #2	15,000	10,000	5,000
	Trade or Business #2	5,000	-	5,000
		20,000	10,000	10,000

Debt #1 Repayment	30,000
Debt #2 Repayment	10,000
Total Debt Repayment	40,000

Practice Note: Debt Arrangements and Borrowings

Be vigilant in identifying clients with new investments or recently initiated businesses. Inquire about any changes in debt arrangements and the use of borrowed proceeds to ensure accurate tracing of interest expenses associated with borrowings. Attention to these details will enhance precision in tax reporting and deduction calculations.

A common place this may be missed is in starting a Schedule C business. Because a Schedule C doesn't present a Balance Sheet, tax practitioners may pay little attention to it and miss any debt arrangements. Further, there may be personal debt borrowings with interest that could be attributable to the Schedule C (e.g., interest expense on a Home Equity Line of Credit).

For business returns (Forms 1120, 1120-S, and 1065), it requires a thorough review of the financials to assess increases in debt levels and the nature and use of the expenses to determine the activities to which the interest should be traced.

III. Debt-financed distributions

A. Context for these distributions

The consequences of interest tracing rules take on a distinctive nature when applied to pass-through entities (PTEs) distributing debt proceeds to their owners. Consider a real estate partnership opting to unlock value from an appreciated property through mortgage refinancing and subsequent distribution of the proceeds to its partners. Here and under the requirements of Notice 89-35, the partnership assumes the responsibility of delineating the portion of the distribution attributed to debt proceeds (termed a debt-financed distribution) and communicates to the partners their respective allocated interest expenses. Subsequently, the partners must assess the deductibility of the interest expense on their individual tax returns, considering the specific utilization of the debt-financed distribution.

Because we are in a particularly high-interest environment, the implications of these rules are increasingly relevant and should be considered, particularly in real estate deals where cash-out refinancing arrangements are prevalent.

B. Allocation of debt proceeds to distributions – Standard and Optional Allocation Rule

When disclosing the amount of separately stated interest expense subject to tracing for owners, the pass-through entity must delineate the segment of debt proceeds deemed as debt-financed distributions. Notably, this amount may not encompass the entire distribution to the owners, and the entity has discretion as to how this amount is determined. The Tracing Rules previously discussed are the default rules for determining the expenditures of the proceeds.

Optional Allocation: Under IRS Notice 89-35, the entity can opt for allocating debt proceeds to expenditures within the same year, capped at the total expenditures. Under this election, total debt-financed distributions would be calculated as the total distributions during the year minus total entity expenditures during the year. If total expenditures surpass the distributions, none of the distributions would be classified as debt-financed; instead, they would be deemed as originating from other revenue or existing cash prior to the loan.

Example 12: ***Facts***
AB Partnership borrows $50,000, and the amount of proceeds used to finance a distribution was $10,000.

Conclusion
The result would be $10,000 attributable to financing a distribution, and thus, 20% of interest expense on the loan would be allocated to debt-financed distributions and reported on Schedule K.

C. Reporting debt-financed distributions

After determining the total amount of debt-financed distributions, the identification of interest subject to tracing is the next step, as this is a separately stated item on Schedule K-1 (Form 1065), box 13, code AC or K-1 (Form 1120-S), box 12, code AC. The deductibility of the owners' separately stated interest hinges on the utilization of their debt-financed distribution, which is where the previously discussed interest tracing rules come into play.

Owners may categorize their separately stated interest as a passive expense, investment interest, or a business expense, or deem it non-deductible if allocated for personal expenses. If utilized for various purposes, the interest expense must be proportionally allocated across these categories. Preserving the ability to trace interest to a deductible purpose is crucial, especially if a debt-financed distribution remains unspent or uninvested; thus, partners should avoid commingling it with other funds. Establishing a separate account dedicated to debt-financed distributions and directing funds for investment directly from that account is a recommended best practice, but this assumes the PTE owner is aware the distribution is debt-financed at the time of receipt. As the entity pays down the loan, the portion of the remaining balance attributed to debt-financed distributions diminishes, leading to a proportional reduction in separately stated interest subject to tracing.

As the pass-through entity makes repayments on the loan, the segment of the outstanding loan balance linked to debt-financed distributions diminishes; debt-financed distributions traced to personal expenditures will be treated as paid first, followed by investment activities, then passive business activities, and lastly those traced to non-passive business activities. Thus, the interest attributable to the outstanding loan balances and its related classifications will be treated accordingly year-over-year. With this, the Schedule K, box 13, code AC reporting is not sufficient. PTEs should report annually the initial debt attributable and outstanding debt to the debt-financed distribution for PTE owners to correctly determine the interest treatment on their respective returns. This can be done as a footnote on the PTE K-1s.

Example 13: ***Facts***

Jane receives a $2,000 debt-financed distribution from AB Partnership. She allocates the proceeds as follows: $1,200 for business expenses reported as a Schedule C activity, $400 for investment expenses, and $400 as personal expenses. Schedule K-1, box 13, code AC debt-financed interest expense totaled $200.

Conclusion

In the first year, the separately stated interest reported on Schedule K-1, box 13, code AC totaling $200 will be treated and reported on Form 1040 in the following manner:

- Business Interest - Schedule C: $120 of interest expense deduction [($1,200 Sch C / $2,000 Total) * $200 Box 13, code AC].
- Investment Interest – Form 4952/Schedule A: $40 of interest will be allocated as investment interest deduction [($400 to Form 4952 / $2,000 Total) * $200 Box 13, code AC].
- Personal Interest – Nondeductible: $40 of interest will be nondeductible personal interest expense [($400 to personal expenditures / $2,000 Total) * $200 Box 13, code AC].

		[A] Total	[B] Sch C	[C] Form 4952/Sch A	[D] Personal
Year 1	**Distr. Proceeds**	**2,000**	**1,200**	**400**	**400**
	Tracing %		60%	20%	20%
	Interest Exp.	**200**	**120**	**40**	**40**

Example 14: ***Facts (continued from Example 13)***
In the second year, the pass-through entity starts repaying the loan, resulting in a decrease in both the total loan balance and the traced balance. Jane's K-1 now reports $1,600 of the debt-financed distribution still subject to tracing and $160 of interest on Schedule K-1, box 13, code AC.

Conclusion
When repaying a loan, the portion used for personal expenditures is considered repaid first, followed by investment and passive activity expenditures, and then trade or business expenditures. As a result, the owner's interest allocation changes in the second year.

The $400 personal expenditure is no longer considered, and the separately stated interest is now allocated 75% ($1,200/$1,600) to business expense and 25% ($400/$1,600) to investment interest expense.

- Business Interest - Schedule C: $120 of interest expense deduction [($1,200 Sch C / $1,600 Total) * $160 Box 13, code AC]
- Investment Interest – Form 4952/Schedule A: $40 of interest will be allocated as investment interest deduction [($400 to Form 4952 / $1,600 Total) * $160 Box 13, code AC]

		[A] Total	[B] Sch C	[C] Form 4952/Sch A	[D] Personal
Year 1	**Distr. Proceeds**	**2,000**	**1,200**	**400**	**400**
	Tracing %		60%	20%	20%
	Interest Exp.	**200**	**120**	**40**	**40**
Year 2	**Distr. Proceeds**	1,600	1,200	400	-
	Tracing %		75%	25%	
	Interest Exp.	**160**	**120**	**40**	

Since the enactment of TCJA, §163(j) and the related regulations have garnered much attention, but there are still established rules to remember. Because the interest rate environment is much different than it was only a couple of years ago, the character of debt will be another source of scrutiny in IRS examinations regarding interest deduction, which goes beyond the mechanics of §163(j). These issues can arise when dealing with mixed-use debt proceeds or debt-financed distributions. Part of quarterly and annual touch points with clients should include discussions regarding new debt arrangements to understand the nuances of the proceeds and to stay ahead of any potential issues the client may face and to thoroughly manage the risk exposure with tax return positions.

Business Developments and Tax Considerations

Business Developments and Tax Considerations

Learning objectives

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

- Better understand the changes around depreciation;
- Understand changes to §174 Research & Experimental Expenditures;
- Describe recent developments concerning Form 1099-K reporting; and
- Describe the recent developments concerning FinCEN requirements.

I. Legislative updates

A. Depreciation changes

1. Electronic filing requirements for information returns

The Taxpayer First Act (TFA), enacted July 1, 2019, streamlined electronic filing requirements for information returns. Prior to the TFA, any organization filing at least 250 information returns was required to do so electronically. The TFA provided the Secretary of the Treasury with the authority to prescribe regulations that decrease, in accordance with the TFA, the number of returns a filer may file without being required to file returns and other documents electronically.

Under this authority, the Secretary of the Treasury may require any person who must file at least 10 returns during a calendar year to file the returns electronically. This requirement was designed to enhance efficiency, accuracy, and timeliness in tax reporting processes. Additionally, this requirement encouraged the transition to electronic filing to reduce errors and processing delays associated with paper filings. Although initially intended to be gradually implemented over a span of several years, the IRS announced a delay of these requirements until corresponding regulations were formally issued.

On February 23, 2023, the Department of the Treasury and the IRS published T.D. 9972, *Electronic-Filing Requirements for Specified Returns and Other Documents*, making several important changes, including:

- Providing that the new reduced threshold for filing information returns from 250 to 10 was generally effective beginning January 1, 2024 (for tax year 2023 returns);
- Requiring filers to aggregate almost all information return types covered by the regulation (with the exception of Form 940 and 941) to determine whether the filer meets the 10-return threshold and is required to e-file their information returns -- prior to this requirement, the 250-return threshold was applied separately to each type of information return covered by the regulation;
- Eliminating the e-filing exception for income tax returns of corporations that report total assets under $10 million at the end of their taxable year; and
- Requiring partnerships with more than 100 partners to e-file information returns, and requiring partnerships required to file at least 10 returns of any type during the calendar year to e-file their partnership return.

On January 23, 2023, the IRS launched the Information Returns Intake System (IRIS), a free web-based platform to help taxpayers file Form 1099 series information returns electronically. IRIS allows taxpayers

to enter data to create forms by either keying in the information or uploading a .csv file. Additionally, taxpayers can use IRIS to create, upload, edit and view information and download completed copies of 1099 series forms for distribution and verification. Any entity with an Employer Identification Number (EIN) can file electronically via IRIS for calendar year 2022 and beyond. Other benefits of IRIS include:

- IRIS e-file security standards to keep information safe and protected;
- IRIS automatically detects filing errors and provides alerts for missing information;
- Filers can submit automatic extensions and make corrections to information returns filed through the IRIS platform;
- Filers can submit up to 100 forms per submission;
- When using the IRIS, the IRS acknowledges receipt of the return in as early as 48 hours; and
- The IRIS platform retains issuer information from year to year, as well as prior years filed through IRIS.

Example: In 2024, ABC Corporation is required to file seven 2023 Forms 1099-MISC, one 2023 Form 1099-INT, one 2023 Form 1099-DIV, as well as 2023 Form 1120. Since ABC Corporation is required to file 10 tax year 2023 returns during the 2024 calendar year, ABC Corporation must file all of the above forms electronically, including Form 1120.

Notice 2010-13 provided procedures for corporations, electing small business corporations, and other tax-exempt organizations that are required to file returns under §6033, to request a waiver of the requirement to file electronically Form 1120, Form 1120-F, Form 1120-S, Form 990, Form 990-PF, and returns, amended returns, and superseding returns in the Form 1120 series and Form 990 series as required by regulations and IRS publications. Following the release of TD 9972, the IRS issued Notice 2023-60, obsoleting Notice 2010-13.

Notice 2024-18 obsoletes Notice 2023-60 and provides for certain administrative exemptions from the electronic filing requirement. Regulations outlined under TD 9972 provided an exemption for filers for whom using the technology required to file in electronic form conflicts with their religious beliefs (religious exemption). Notice 2023-60 required Form 1120, 1120-S, 1120-F, and 1065 filers to file Form 8508, *Application for a Waiver from Electronic Filing of Information Returns*, to apply for a religious exemption before filing their returns.

Notice 2024-18 modifies this requirement and specifies that most filers claiming the religious exemption have the option to notify the IRS that they qualify for a religious exemption in advance of filing returns and other documents. Such filers are encouraged to notify the IRS in advance that they are claiming a religious exemption by filing a Form 8508, in accordance with the form's instructions.

Notice 2024-18 also specifies that filers of Forms 1120, 1120-F, 1120-S, and 1065 who are claiming the religious exemption must not File Form 8508, but instead, such filers must file returns and other documents in paper form following the paper filing requirements provided by applicable IRS revenue procedures, publications, forms, instructions, or other guidance. Additionally, such filers of the above forms who qualify for the religious exemption must print in bold letters "Religious Exemption" at the top of page 1 of the return they file in paper form.

It is important to note that information return penalties apply to taxpayers who don't file or furnish their required information return or payee statement correctly by the due date of the return. The IRS charges penalties for each information return that was not filed correctly on time.

2. Bonus depreciation

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

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

The TCJA generally requires 100% bonus depreciation for property placed in service after September 27, 2017. A taxpayer may elect, for any class of property, to not deduct any special AFYD depreciation allowance for all such in such class. To make an election, the taxpayer must attach a statement to a timely filed return (including extensions) indicating the class of property for which they are making the election and that, for such class they are not to claim any special depreciation allowance. The election must be made separately by each person owning qualified property (for example, by the partnership, by the S corporation, or by the common parent of a consolidated group). Once made, the election cannot be revoked without IRS consent.

Qualified property for which §168(k) does not apply:

- Listed property used 50% or less in a qualified business use.
- Any property required to be depreciated under the ADS system (that is, not property for which you elected to use ADS).
- Property placed in service/ disposed of in the same tax year.
- Property converted from business use to personal use in the same tax year acquired. Property converted from personal use to business use in the same or later tax year may qualify.
- Property for which an election not to claim any special depreciation allowance is made (Elect out).
- Any property used in certain trades or businesses that has had floor plan financing indebtedness.

Depreciation ordering rules are as follows:

1. First, basis is reduced by any amount attributable to personal use (if applicable).
2. Next, any §179 deduction is taken.
    - In 2024, the maximum §179 expense deduction is $1,220,000, and the purchase price of all eligible property cannot exceed $3,050,000 or the maximum amount that may be expensed under §179 is reduced.
    - The §179 deduction is further limited to taxable income.
    - The §179 deduction generally only applies to §1245 property.
3. Then, basis is reduced by any credits requiring an adjustment to basis.
4. Next, the §168(k) bonus depreciation allowance is taken.

- Bonus depreciation is not limited to taxable income (i.e., can create a net loss that can be carried forward to future tax years).
- Bonus depreciation can generally be claimed on §1245 or §1250 property.

5. Last, the regular depreciation deduction under MACRS is taken.

***Example**:* On July 4, 2024, XYZ Corp purchased for $2,220,000 qualifying 5-year MACRS property (equipment) eligible for §179 expensing and considered qualified for §168 bonus depreciation purposes. XYZ Corp did not purchase any other qualifying property during 2024.

XYZ is allowed a $1,220,000 §179 deduction (maximum for 2024).

Reducing the equipment's basis by $1,220,000 results in a $1,000,000 depreciable basis.

XYZ applies the 2024 bonus depreciation rate of 60% to the $1,000,000 depreciable basis, resulting in $600,000 of §168 bonus depreciation.

A $400,000 depreciable basis remains after reducing the depreciable basis by the $600,000 of §168 bonus depreciation.

XYZ calculates regular MACRS depreciation on the remaining $400,000 basis ($400,000 * 0.20), resulting in $80,000 of MACRS depreciation.

In total, XYZ's total 2024 depreciation is $1,900,000:
- §179 expense: $1,220,000
- §168 bonus: 600,000
- MACRS: $80,000

3. Qualified improvement property (QIP)

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

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

The CARES Act reclassifies QIP as 15-year property (20-year ADS life) and allows businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life. The CARES Act QIP fix is effective for property placed in service after December 31, 2017. [1]

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

[1] CARES Act §2307.

4. Guidance on bonus depreciation elections

Rev. Proc. 2019-33 (July 30, 2019) enables taxpayers to make or revoke bonus depreciation elections under §168(k)(5) – plants, (7) – election not to deduct additional first-year depreciation, or (10) – election to deduct 50%, not 100% additional first-year depreciation; for property acquired after 9/27/17 and placed in service during a tax year including 9/28/17.

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

On September 13, 2019, the IRS and Department of Treasury issued final and proposed regulations regarding the first-year bonus depreciation deduction under §168(k).[2] The September 2019 final regulations adopted the August 2018 proposed regulations with few modifications. Neither the final nor proposed regulations fixed the "retail glitch" for Qualified Improvement Property (QIP) in the TCJA.

On September 21, 2020, the IRS and Department of Treasury released the second round of final regulations, making further clarifications to §168(k) bonus depreciation under the TCJA.[3] In addition, the final regulations address the CARES Act QIP fix. The CARES Act reclassified QIP as 15-year property (20-year ADS life) and allowed businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life but stated that the improvement must be "made by the taxpayer." The final regulations clarify that an improvement is made by a taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself, or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract. On the other hand, the final regulations state that if a taxpayer acquired nonresidential property in a taxable transaction and such property had an existing improvement placed in service by the seller of such property, the existing improvement is not considered to have been made by the taxpayer. Property with preexisting QIP transferred in a nonrecognition event does not qualify for bonus depreciation, since the basis of the QIP is dependent upon the transferor's basis.

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

Lastly, the final regulations provide additional guidance regarding the five-year lookback period for determining whether property was previously owned by the taxpayer. The September 2019 proposed regulations created a safe harbor that required taxpayers to look back five years to determine whether property was eligible as used property. Without a safe harbor, taxpayers would have had to trace an

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2 T.D. 9874, REG-106808-19.
3 T.D. 9916.

asset's history back to when it was first placed in service by any taxpayer to determine prior ownership interests. The September 2020 final regulations confirm that only the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property are taken into account when utilizing the five-year safe harbor. The "placed-in-service year" is the current calendar year in which the property is placed in service by the taxpayer. The September 2020 final regulations clarify that the five calendar years immediately prior to the current calendar year in which the property is placed in service by the taxpayer, as well as the portion of that calendar year up to the placed-in-service date of the property, should be considered in determining whether the taxpayer previously had a depreciable interest.

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

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

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

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

5. Passenger vehicles and SUVs

The TCJA changed the depreciation limitations for passenger vehicles placed in service after December 31, 2017. If the taxpayer doesn't claim bonus depreciation, the greatest allowable depreciation deduction in 2024 is:

- $12,400 for the first year;
- $19,800 for the second year;
- $11,900 for the third year; and
- $7,160 for each later taxable year in the recovery period. [4]

When the taxpayer claims AFYD bonus depreciation, $20,400 is the maximum first-year depreciation on a passenger auto.

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[4] Rev. Proc. 2024-13.

But an SUV or truck weighing more than 6,000 pounds is not subject to these limits. Only §179 limits the first-year depreciation of an SUV to $30,500 in tax year 2024. A vehicle under 6,000 pounds is limited to first-year depreciation of $20,400.

6. Section 179 expense

a. Increased amounts: The Act increases the annual limitation to $1,000,000, with the phaseout starting at $2,500,000 for tax years beginning after December 31, 2017.[5] The amounts are indexed for inflation for years after 2018.[6] For 2024 the amounts are indexed to $1,220,000 for the annual limit and $3,050,000 for the phaseout threshold.

b. The Act expands qualified property to include the following improvements to nonresidential real property referred to as qualified real property:[7]

- Roofs;
- Heating, ventilation, and air conditioning systems;
- Fire protection and alarm systems;
- Security systems; and
- Any other building improvements that aren't elevators or escalators, don't enlarge the building, and are not attributable to internal structural framework (QIP).

Qualified real property is not included as §179 property unless the taxpayer elects to do so. The election is made by listing the property on the Form 4562.

c. SUV limitation: The $25,000 SUV limitation and the overall §179 amounts will be adjusted for inflation using the C-CPI-U for years after 2018. The $25,000 SUV limit was not adjusted for inflation in prior years. The amount for 2024 indexed for inflation is $30,500.

d. Section 179 for rental activities: Section 179 expensing is available for qualified property used to furnish lodging or in connection with furnishing lodging for tax years after December 31, 2017.[8]

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5 I.R.C. §179(b).
6 I.R.C. §179(b)(6).
7 I.R.C. §179(f).
8 I.R.C. §179(d)(1).

B. Changes to §174 Research & Experimental Expenditures

Section 41 provides a research and development (R&D) tax credit for direct research expenses, including:

- In-house research expenses, such as any wages paid or incurred to an employee for qualified services performed by such employee, any amount paid or incurred for supplies used in the conduct of qualified research, and any amount paid or incurred to another person for the right to use computers in the conduct of qualified research; and
- Contract research expenses, generally meaning 65% of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.

Under §41, the term "qualified research" means research:

> *With respect to which expenditures may be treated as expenses under §174, which is undertaken for the purpose of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for a purpose.*

To qualify for the R&D tax credit, the taxpayer's qualified research must meet the above definition.

Under §174, research and experimental expenditures must:

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

Section 174 includes all costs incurred incident to the development or improvement of a product, or a component or subcomponent of the product, as well as the costs of obtaining a patent. Section 1.174-2(a)(3) defines the term "product" to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. Section 174 expenses must be reasonable under the circumstances. It is important to note that if an expense meets the above §174 requirements, it must still meet §41 requirements to be considered a qualified research expense for purposes of the §41 credit.

Examples of specified research or experimental expenditures include (but are not limited to):

- **Labor Costs**: Labor costs of full-time, part-time, and contract employees and independent contractors who perform, supervise, or directly support specified research or experimental activities.
    - Labor costs include all elements of compensation other than severance compensation, including basic compensation, stock-based compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan.
- **Materials and Supplies Costs**: Costs of materials and supplies, including tools and equipment that are not depreciable under §168, which are used or consumed in the

performance of specified research or experimental activities or in the direct support of specified research or experimental activities.

- **Cost Recovery Allowances**: Depreciation, amortization, or depletion allowances with respect to property used in the performance of or in the direct support of specified research or experimental activities.
- **Patent Costs**: Costs of obtaining a patent, such as attorneys' fees paid in making and perfecting a patent application.
- **Certain Operation and Management Costs**: Rent, utilities, insurance, taxes, repairs and maintenance costs, security costs, and similar overhead costs with respect to facilities, equipment and other assets used in the performance of or in the direct support of specified research or experimental activities.
- **Travel Costs**: Travel costs incurred for the performance of or in the direct support of specified research or experimental activities.

Section 174 includes §41 expenses but is more expansive in scope than §41, as it comprises all costs (including indirect costs) related to the development of a product, including:

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

The TCJA prohibits taxpayers from receiving both the §41 and §174 deduction in order to prevent a double benefit scenario. The TCJA specifies that expenses for the §41 credit must first be included in specified R&E expenditures under §174. Under the TCJA, per §280(c)(1) if the amount of the credit determined for the taxable year under §41 exceeds the amount allowable as a deduction for such taxable year for qualified research expenses or basic research expenses, the amount chargeable to capital account (i.e., the amount of the capitalized R&E expenditures) for the taxable year for such expenses shall be reduced by the amount of such excess.

Example: A taxpayer has a $100,000 research credit and an allowable $85,000 qualified research expense deduction. Under this scenario, the taxpayer must reduce the capitalized portion of the R&E expenditures by $15,000 (the difference between the $100,000 credit and $85,000 deduction). Alternately, the taxpayer may avoid this scenario by instead electing to reduce the credit under §280C(c)(2) on a timely filed tax return.

Expenses incurred before 1/1/2022:

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

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

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

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

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

- The ordinary testing or inspection of materials or products for quality control;
- Costs paid or incurred by general and administrative service departments that only indirectly support SRE activities;
- Efficiency surveys;
- Management studies;
- Consumer surveys;
- Costs to register an internet domain name or trademark;
- Costs to input content into a website;
- Costs to host a website;
- Advertising or promotions;
- Interest on debt to finance specified research or experimental activities;
- The acquisition of another's patent, model, production or process; or
- Research in connection with literary, historical, or similar projects.

Expenses incurred on or after 1/1/2022:

The TCJA made major changes to §174, including:

- No longer permitting immediately expensed R&E expenditures;
- Requiring R&E and software development costs to be capitalized and amortized over five years (15 years for foreign research); and
- Disallowing a deduction for unamortized R&E expenditures upon a disposition.

Some taxpayers might not realize they actually have §174 expenses. For example, some taxpayers may have believed that certain expenses in question were deductible §162 expenses (ordinary and necessary). Prior to the TCJA, this was not an issue as both §174 and §162 were fully deductible.

On September 8, 2023, the IRS issued Notice 2023-62, announcing that the Department of the Treasury and IRS intend to issue proposed regulations addressing a variety of issues regarding the capitalization and amortization of specified research or experimental (SRE) expenditures under §174 as amended by the TCJA. Generally, the proposed regulations apply for taxable years ending after September 8, 2023; however, taxpayers may generally choose to rely on these proposed regulations for taxable years beginning after December 31, 2021 if consistently applied.

The TCJA amended §174 to provide that R&E and software development costs must be capitalized and amortized over five years (15 years for foreign research) for tax years beginning after December 31, 2021. Computer software is defined as any computer program or routine (that is, any sequence of code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. Computer software generally includes system software, programming software, application software, embedded software, and all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer software also generally includes computer programs of all classes, such as operating systems, executive systems, software monitors, compilers and translators, assembly routines, and utility programs as well as application programs. The amortization period begins with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. The midpoint of the taxable year means the first day of the seventh month of the taxable year in which the specified research or experimental expenditures are paid or incurred. Essentially, the amortization period for U.S. research is spread over 6 tax years, whereas the amortization period for foreign research is spread over 16 tax years.

Software development costs are included in the definition of §174 R&E expenditures.

Activities that are treated as software development for purposes of §174 generally include but are not limited to:

- Planning the development, upgrades, and enhancements to computer software, including identification and documentation of requirements;
- Designing, upgrading, and enhancing the computer software;
- Building a model of the computer software;
- Writing source code and converting it to machine-readable code; and
- Testing the computer software and making necessary modifications until either:
  - The computer software is placed in service by the taxpayer, if developed in-house; or
  - The computer software's technological feasibility has been established, if developed for sale or licensing to others.

The following activities are not treated as software development for purposes of §174:

- In the case of computer software developed by a taxpayer to use in its trade or business:
  - Training employees and other stakeholders that will use the computer software;
  - Maintenance activities after the computer software is placed in service that do not give rise to upgrades and enhancements, such as corrective maintenance;
  - Data conversion activities; and
  - Installing the computer software.
- In the case of computer software that is developed for sale or licensing to others:
  - Activities that occur after the software is ready for sale or licensing to others, including marketing, promotions, maintenance, distribution activities, and customer support.

Special considerations must be taken in the case of a short taxable year. Notice 2023-63 provides that the amortization deduction for a short taxable year is based on the number of months in the short taxable year. The midpoint of a short taxable year is the first day of the midpoint month. In the case of a short taxable year with an even number of months, the midpoint month is determined by dividing the number of months in the short taxable year by two and then adding one. In the case of a short taxable year with an odd number of months, the midpoint month is the month for which there are an equal number of months before and after such month.

Example: ABC Corp is a calendar-year taxpayer that incorporated and began operations on October 20, 2022.

ABC Corp paid $60,000 in SRE expenditures not attributable to foreign research.

Since ABC Corp began operations on October 20, 2022, with year-end occurring on December 31, 2022, they have a three-month taxable year.

The midpoint month is November, and as a result, November 1, 2022, will be treated as the midpoint.

In 2022, ABC Corp amortizes $2,000 of SRE expenditures ($60,000 / 60 months x 2 months).

In taxable years 2023 through 2026, each a full 12-month taxable year, ABC Corp amortizes $12,000 ($60,000 / 60 months × 12 months) each year, or $48,000 in total.

In 2027, ABC Corp amortizes the remaining $10,000 ($60,000 / 60 months × 10 months).

Notice 2023-63 provides guidance to taxpayers to help determine whether costs paid or incurred for research performed under contract are SRE expenditures under §174. A research provider is the party that contracts with a research recipient to:

- Perform research services for the research recipient with respect to an SRE product; or
- Develop an SRE product that the research recipient acquires from the research provider.

A research recipient is the party that contracts with the research provider to:

- Perform research services for the research recipient with respect to an SRE product; or
- Develop an SRE product that the research recipient acquires from the research provider.

Notice 2023-63 provides that if the research provider bears financial risk under the terms of the contract with the research recipient, then costs paid or incurred by the research provider that are incident to the SRE activities performed by the research provider under the contract are SRE expenditures. Notice 2024-12 clarifies Notice 2023-63 and provides that if a research provider that does not bear financial risk under the terms of the contract with the research recipient obtains an "excluded SRE product right" but does not obtain any other SRE product right under the terms of such contract, then the costs paid or incurred by the research provider to perform SRE activities on behalf of the research recipient under such contract are not SRE expenditures.

The TCJA provides that expenses may no longer be immediately deducted. The change to the five-year amortization period is considered an accounting method change initiated by the taxpayer with IRS consent. There is no §481(a) adjustment as the provision is applied on a cutoff basis for expenditures incurred after December 31, 2021. Additionally, the TCJA disallows a deduction for unamortized SRE expenditures upon a disposition.

1. Allocation of costs

Per Notice 2023-62, to determine total SRE expenditures for a taxable year, taxpayers must allocate costs to SRE activities or another relationship that reasonably relates the costs to the benefits provided to the SRE activities. In other words, the taxpayer must reasonably allocate costs that relate to both SRE activities and non-SRE activities (for example, depreciation on a building that houses administrative offices as well as research facilities).

The allocation method used for one type of cost may be different from the allocation method used for another type of cost. Regardless, the allocation method used for each type of cost must be applied on a consistent basis. For example, if depreciation is allocated based on square footage, the same allocation method should be used for other facility costs like rent and utilities. Notice 2023-62 details a useful example demonstrating allocation rules.

Example: Company ABC, a calendar year taxpayer, is engaged in the business of manufacturing chemical products. On January 1, 2023, Company A begins a research project (which constitutes an SRE activity) to develop a new product.

Company ABC does not undertake any other SRE activities during the 2023 taxable year.

Company ABC has six departments: Manufacturing, Research, Engineering, Legal, Personnel, and Accounting.

- The Manufacturing Department does not provide any support services to the Research Department.
- The Personnel and Accounting Departments provide indirect support services to the Research Department.
- The Engineering and Legal Departments provide direct support services to the Research Department.

Company ABC incurs the following costs:

Description	Department(s)	Depreciation for 2023
10,000 sqft facility	The Manufacturing dept occupies 5,000 square feet of the facility. The other depts each occupy 1,000 square feet.	200,000
Computers, furniture, and equipment used exclusively for the SRE activity	Research Dept	150,000
Computers, furniture, and equipment used exclusively by the Engineering Dept	Engineering Dept	100,000
Computers and furniture used exclusively by the Legal Dept	Legal Dept	20,000

Description	Department(s)	Total Cost for 2023
Materials and supplies used exclusively for the SRE activity	Research Dept	50,000
Materials and supplies used by the Engineering Dept	Engineering Dept	40,000
Materials and supplies used by the Legal Dept	Legal Dept	10,000
Labor costs of Research Dept employees and their direct supervisor, each of which spends 100% of their time on the research project	Research Dept	600,000
Labor costs of all Engineering Dept employees, each of which spends 20% of their time on the research project	Engineering Dept	200,000
Labor costs of all Legal Dept employees, each of which spends 10% of their time on the research project	Legal Dept	100,000

Company ABC determines that the costs incurred by the Manufacturing, Personnel, and Accounting Departments are not treated as SRE expenditures because the activities of those departments are not SRE activities. As a result, such costs either do not, or only indirectly, support or benefit SRE activities.

Company ABC determines its total SRE expenditures for 2023 by allocating the costs described in the tables by either square footage or labor costs, as applicable.

Description	Allocation Method	Amount of SRE Expenditure
Facility Depreciation - $200,000	Research Dept: $20,000 ($200,000 × 1,000/10,000 square feet × 100% of time spent by Research Dept on the SRE activity) + Engineering Dept: $4,000 ($200,000 × 1,000/10,000 square feet × 20% of time spent by Engineering Dept on the SRE activity) + Legal Dept: $2,000 ($200,000 × 1,000/10,000 square feet × 10% of time spent by Legal Dept on the SRE activity)	26,000
Depreciation on computers, furniture, and equipment used exclusively for the SRE activity - $150,000	$150,000 × 100% use for SRE activity	150,000
Depreciation on computers, furniture, and equipment used exclusively by the Engineering Dept - $100,000	$100,000 × 20% of time spent by Engineering Dept employees on the SRE activity	20,000
Depreciation on computers and furniture used exclusively by the Legal Dept - $20,000	$20,000 × 10% of time spent by Legal Dept employees on the SRE activity	2,000

Description	Allocation Method	Amount of SRE Expenditure
Materials and supplies used exclusively for the SRE activity - $50,000	$50,000 × 100% use for the SRE activity	50,000
Materials and supplies used by the Engineering Dept - $40,000	$40,000 × 20% of time spent by Engineering Dept employees on the SRE activity	8,000
Materials and supplies used by the Legal Dept - $10,000	$10,000 × 10% of time spent by Legal Dept employees on the SRE activity	1,000
Labor costs of Research Dept employees and their direct supervisor, each of which spends 100% of their time on the research project - $600,000	$600,000 × 100% of time spent by Research Dept employees on the SRE activity	600,000
Labor costs of all Engineering Dept employees, each of which spends 20% of their time on the research project - $200,000	$200,000 × 20% of time spent by Engineering Department employees on the SRE activity	40,000
Labor costs of all Legal Dept employees, each of which spends 10% of their time on the research project - $100,000	$100,000 × 10% of time spent by Legal Dept employees on the SRE activity	10,000

Description	Department(s)	Total Cost for 2023
Electricity for the facility - $200,000	Research Dept $50,000 ($200,000 × 100,000/400,000 kilowatthours used for SRE activity) + Engineering Dept $2,000 ($200,000 × 20,000/400,000 kilowatthours used by Engineering Dept × 20% of time spent by Engineering Dept employees on the SRE activity) + Legal Department $1,000 ($200,000 × 20,000/400,000 kilowatt-hours used by Legal Dept × 10% of time spent by Legal Dept employees on the SRE activity)	53,000
Other utilities and overhead costs for the facility - $100,000	Research Dept $10,000 ($100,000 × 1,000/10,000 square feet × 100% of time spent by Research Dept on the SRE activity) + Engineering Dept $2,000 ($100,000 × 1,000/10,000 square feet × 20% of time spent by Engineering Dept on the SRE activity) + Legal Dept $1,000 ($100,000 × 1,000/10,000 square feet × 10% of time spent by Legal Dept on the SRE activity)	13,000
Other miscellaneous overhead costs incurred by the Research Dept - $50,000	$50,000 × 100% of time spent by Research Dept employees on the SRE activity	50,000
Other miscellaneous overhead costs incurred by the Engineering Dept - $50,000	$50,000 × 20% of time spent by Engineering Dept employees on the SRE activity	10,000
Other miscellaneous overhead costs incurred by the Legal Dept - $50,000	$50,000 × 10% of time spent by Legal Dept employees on the SRE activity	5,000

Effects of TCJA §174 Changes:

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

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

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

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

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

Other Considerations:

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

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

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

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

If a taxpayer's activities suggest that they have §174 expenses, the IRS will anticipate them being appropriately amortized rather than expensed. Taxpayers who have previously claimed the R&D tax credit, and now are suddenly claiming expenses under §162 may face increased scrutiny from the IRS. Additionally, it is anticipated that the IRS may scrutinize taxpayers within certain industries to ensure expenses are being correctly accounted for.

C. Like-kind exchanges -- Review and updates

1. Introduction

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

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

- Individuals;
- General partnerships;.
- Limited partnerships;
- Limited liability companies;
- C corporations;
- S corporations;
- Trusts; and
- Any other taxpaying entity.

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

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

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

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

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

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

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

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

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

Exchange expenses – Revenue Ruling 72-456 provides limited guidance regarding allowable exchange expenses, the payment of which does not create boot (i.e., potential recognized income). The following is a list that tax professionals have generally accepted as allowable exchange expenses paid out of closing costs for the purpose of reducing both realized gain and recognized gain. In other words, these expenses are not considered boot:

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

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

- Rent prorations;

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

2. Qualifying property

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

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

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

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

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

Practice note:

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

3. Like-kind property

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

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

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

The exchange of real estate that is owned for a real estate lease on property that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify for like-kind

exchange. The exchange of a life estate (this gives the holder the power to retain ownership until death) expected to last less than 30 years for a remainder interest, which gives the holder the right to take ownership when the life estate has ended, is not a like-kind exchange.

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

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

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

4. Partially nontaxable exchanges

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Practitioner Note – Realized Losses:

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

5. Time restrictions

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

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

A few notes concerning these time restrictions:

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

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

- The taxpayer may identify up to three properties of any value with the intent of purchasing at least one;
- The taxpayer may identify more than three properties with an aggregate value that does not exceed 200% of the market value of the relinquished property; or

- The taxpayer may identify more than three properties with an aggregate value exceeding 200% of the relinquished property, knowing that 95% of the market value of all properties identified must be acquired.

6. Qualified intermediaries

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

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

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

II. General business tax issues

A. Form 8300 changes

Businesses that receive more than $10,000 in cash must report such transactions to the U.S. government. On August 20, 2023, the IRS announced that beginning January 1, 2024, certain businesses are required to e-file Form 8300, *Report of Cash Payments Over $10,000*. Beginning with calendar year 2024, businesses must e-file all Forms 8300, as well as other certain types of information returns required to be filed in a given calendar year, if they're required to file at least 10 information returns other than Form 8300. The requirement for e-filing Form 8300 applies to businesses that are required to e-file certain other information returns such as Form 1099 series and Form W-2.

A person must file Form 8300 within 15 days after the date the person received the cash. If multiple payments are received toward a single transaction or two or more related transactions, and the total amount paid exceeds $10,000, the person should file Form 8300. Each time payments add up to more than $10,000, the person must file another Form 8300. If filing electronically would cause undue hardship, a business may request a waiver by submitting Form 8508, *Application for a Waiver from Electronic Filing of Information Returns.* If the IRS grants a waiver, such waiver applies to all Forms 8300 for the rest of the

calendar year. It is important to note that businesses may not request a waiver from e-filing only Form 8300.

Example 1: ABC, LLC files seven Forms W-2 and three Forms 1099-INT. ABC, LLC must e-file all their information returns during the year, including any Forms 8300.

Example 2: ABC, LLC files fewer than 10 information returns of any type, other than Forms 8300. ABC, LLC does not have to e-file the information returns and is not required to e-file any Forms 8300. However, while ABC, LLC is not required to e-file, they may still choose to do so.

If filing electronically would cause undue hardship, a business may request a waiver by submitting Form 8508, *Application for a Waiver from Electronic Filing of Information Returns*. If the IRS grants a waiver, such waiver applies to all Form 8300s for the rest of the calendar year. It is important to note that businesses may not request a waiver from e-filing only Form 8300.

B. Form 1099-K expansion

Through December 31, 2021, a two-step de minimis standard existed, in which Third Party Settlement Organizations were required to report third party network transactions of a participating payee on Form 1099-K if:

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

A Third Party Settlement Organization is a central organization that has the contractual obligation to make payments to participating payees (generally, a merchant or business) of third party network transactions. Per IRS FAQs, an example of a third party settlement organization is an online auction payment facilitator like an online marketplace, which operates as an intermediary between buyer and seller by transferring funds from the buyer to the seller for the provision of goods or services. [9]

The American Rescue Plan Act (ARPA) amended the two-step de minimis standard and instead created a single standard with a single $600 reporting threshold. This change was to take effect for years beginning after December 31, 2021; however, on December 23, 2022, the IRS announced that calendar year 2022 would be treated as a transition year. Not long after, on November 21, 2023, the IRS issued Notice 2023-74, announcing that calendar year 2023 would also be treated as a transition year. As a result, third party settlement organizations who issue Forms 1099-K must follow the $20,000/200 transaction threshold for calendar years 2022 and 2023. Taxpayers may have received a Form 1099-K at the lower threshold, despite Notice 2023-74. Due to the large number of taxpayers affected by the new reporting provisions under ARPA, the IRS plans to implement a threshold of $5,000 for tax year 2024 as part of a phase in for the $600 reporting threshold.

Although the IRS delayed the $600 reporting threshold requirement, the legal requirement for reporting income has not changed, regardless of the reporting threshold for providing a Form 1099-K. Taxpayers are responsible for accurately reporting all income, regardless of whether Form 1099-K (or any other information return, such as Form 1099-MISC or Form 1099-NEC) is received. It is important to note that for payment cards (credit cards, debit cards, gift cards, etc.), there is no threshold amount that has to be met to receive a Form 1099-K due to payments received through a payment card transaction. Therefore, if an individual received $0.01 of payments from a payment card transaction, they should receive a Form

[9] FS-2023-06.

1099-K for those payments. Additionally, certain states may have a lower reporting threshold for TPSOs, which could result in an individual receiving a Form 1099-K, even if the total gross payments they received in the year did not exceed the federal reporting threshold.

A reportable payment transaction is any payment card transaction and any third party network transaction. Transactions meeting the aggregate payment de minimis standard must be reported to all payees who accept payment from a third party settlement organization. The IRS released FAQs in March 2023 (FS-2023-06) detailing a variety of scenarios subject to Form 1099-K reporting.[10]

The gain or loss on the sale of a personal item may be reported on Form 1099-K. FAQ #3 reminds taxpayers that the gain on the sale of a personal item is taxable and must be reported on Form 8949, *Sales and Other Dispositions of Capital Assets*, and Schedule D, *Capital Gains and Losses* (Form 1040). Losses on the sale of personal items are not deductible. Taxpayers who receive Form 1099-K for the sale of a personal item that resulted in a loss should report the sale on Form 1040, Schedule 1 as follows:

- Proceeds should be reported on Line 8z, using the description "Form 1099-K Personal Item Sold at a Loss."
- Costs, up to but not exceeding the proceeds amount reported on Form 1099-K, should be reported on Line 24z, using the description "Form 1099-K Personal Item Sold at a Loss."

Example: Robert broke up with his fiancé, Amy, and sold her engagement ring for a loss on December 31, 2023. Robert received Form 1099-K, reporting proceeds of $1,500. Robert originally purchased the ring for $5,000 on January 31, 2023. Robert's loss is reported as follows:

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income
Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2023
Attachment Sequence No. 01

z	Other income. List type and amount: FORM 1099-K PERSONAL ITEM SOLD AT LOSS	8z	1,500	
9	Total other income. Add lines 8a through 8z			9 1,500
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			10 1,500

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2023**

z	Other adjustments. List type and amount: FORM 1099-K PERSONAL ITEM SOLD AT LOSS	24z	1,500	
25	Total other adjustments. Add lines 24a through 24z			25 1,500
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10			26 1,500

Schedule 1 (Form 1040) 2023

Alternately, taxpayers may report the sale of a personal item at a loss on Forms 8949 and Schedule D. Taxpayers should enter "L" in column (f) of Form 8949 to explain that the loss is nondeductible. Then, the amount of the nondeductible loss should be entered as a positive number in column (g). Using the same facts in the example above, Robert would report his loss as follows on Form 8949:

[10] FS-2023-06.

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.
Go to *www.irs.gov/Form8949* for instructions and the latest information.

OMB No. 1545-0074

2023

Attachment Sequence No. **12A**

1

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	**Adjustment, if any, to gain or loss** If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g).
FORM 1099-K PERSONAL ITEM SOLD AT LOSS	01/31/2023	12/1/2023	1,500	5,000	L	3,500	0

If a taxpayer sells multiple items within a single online transaction, any gain and loss must be reported separately.

***Example**:* On November 5, 2023, Jen sold two sets of concert tickets (four tickets total) in a single online transaction. She received total proceeds of $2,000: $1,200 for one set of tickets and $800 for the second set of tickets. Jen purchased the tickets for personal use on August 5, 2023. She paid $900 for the first set of tickets and $1,000 for the second set of tickets.

Jen must report the gain and loss separately, as the loss on the second set of concert tickets cannot offset the gain on the first set of tickets. Jen reports the $300 gain from the sale of one set of tickets ($1,200 sales price less $900 purchase price) on Form 8949 and Schedule D. Jen reports the $200 loss from the sale of the other set of tickets ($800 sales price less $1,000 purchase price) by entering $800 (proceeds) on Schedule 1, Lines 8z and 24z.

Form 1099-K does not adjust the gross amount of payment card/third party network transactions for any fees, refunds, chargebacks, or other costs. Taxpayers should include all fees, including any processing or selling fees, associated with the sale of their personal items in their basis when computing any gain or loss on the sale. Taxpayers should keep adequate records to substantiate any adjustments made to basis.

If a taxpayer's records are lost, destroyed, or not available due to circumstances beyond their control, and the taxpayer's return is audited, IRS examiners may allow the taxpayer to either present reconstructed records or provide oral testimony.

If a taxpayer receives a reimbursement from another individual, the reimbursement is generally not taxable, as the reimbursement is not payment for the sale of goods or services. If a taxpayer believes that Form 1099-K was issued in error or that the information on Form 1099-K is incorrect, they should contact the filer. If the taxpayer cannot get Form 1099-K corrected, IRS FAQ #8 specifies that the error should be reported on Form 1040, Schedule 1, Part I, Additional Income, Line 8z, Other Income, with an offsetting entry in Part II, Adjustments to Income, Line 24z, Other Adjustments.

***Example**:* Danielle and Alexandra went on a luxurious cruise to the Bahamas. Danielle purchased the tickets, which cost $3,000 each. Alexandra reimbursed Danielle $3,000 for the cruise tickets, and Danielle received a Form 1099-K reporting the $3,000 as gross proceeds. Danielle was unable to receive a corrected Form 1099-K. As a result, Danielle reports the following on Form 1040, Schedule 1:

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income
Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2023
Attachment Sequence No. 01

z	Other income. List type and amount: FORM 1099-K RECEIVED IN ERROR	8z	3,000		
9	Total other income. Add lines 8a through 8z			9	3,000
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			10	3,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2023**

z	Other adjustments. List type and amount: FORM 1099-K RECEIVED IN ERROR	24z	3,000		
25	Total other adjustments. Add lines 24a through 24z			25	3,000
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10			26	3,000

Schedule 1 (Form 1040) 2023

C. New FinCEN reporting requirements in 2024

Due to regulations under the Corporate Transparency Act of 2020 (CTA), most small corporations, LLCs, and partnerships will be required to report beneficial ownership information to FinCEN. Beneficial ownership information is identifying information about the individuals who directly or indirectly own or control a company. FinCEN estimates approximately 32.6 million reports will be filed initially, with an additional 5 million filings annually for the next nine years.

On September 30, 2022, FinCEN issued the Beneficial Ownership Information Reporting Requirements final rule ("final BOI reporting rule"), and on March 24, 2023, released FAQs regarding the requirements. [11] These requirements took effect as of January 1, 2024.

On March 1, 2024, in the case of *National Small Business United v. Yellen*, the U.S. District Court for the Northern District of Alabama rendered a summary judgment declaring the Corporate Transparency Act unconstitutional. This ruling has prompted the potential of similar legal challenges from other business groups. In response to the court's decision, the Justice Department, representing the Department of the Treasury, filed a Notice of Appeal on March 11, 2024. In response to the court ruling, as of March 1, 2024, FinCEN has ceased enforcement of the CTA for the plaintiffs involved in the lawsuit, which includes approximately 65,000 members of the National Small Business Association. All other entities are required to continue complying with the law.

Currently, there is no centralized database that contains complete information about owners and operators of legal entities within the United States. Most jurisdictions do not require the identification of an entity's individual beneficial owners at or after the time of formation. Many states require little to no disclosure of contact information or other information about an entity's officers or others who control the entity. The beneficial ownership information reporting requirement was created to "enhance U.S national security by making it more difficult for criminals to exploit opaque legal structures to launder money, traffic humans and drugs, and commit serious tax fraud and other crimes that harm the American taxpayer." [12]

The final regulations cite the following examples in which corporate entities were used to conceal illicit activities:

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11 87 FR 59498 (September 30, 2022) and FinCEN Beneficial Ownership Information Reporting Frequently Asked Questions (March 24, 2023).

12 87 FR 59498 (September 30, 2022).

- In June 2021, a group of individuals, using synthetic identities, worked together to fraudulently apply for $24 million of PPP loans.
- In July 2022, an individual was sentenced for using multiple shell entities to fraudulently submit 63 loan applications for PPP and EIDL loans.

Reporting companies are required to report beneficial ownership information to FinCEN. The two types of reporting companies are:

- **Domestic Reporting Companies**, defined as:
  - Corporations;
  - LLCs; or
  - Any other entity created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe.
    - Common structures include limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships.
- **Foreign Reporting Companies**, defined as:
  - Corporations, LLCs, or other entities formed under the law of a foreign country; and
  - Registered to do business in any U.S. state or in any tribal jurisdiction, by the filing of a document with a secretary of state or any similar office under the law of a U.S. state or Indian tribe.

Limited exemptions from the reporting requirement apply, and most exempt entities are already subject to federal and state information reporting.

Exempt Entities	
Securities reporting issuer	Insurance company
Governmental authority	State-licensed insurance producer
Bank	Commodity Exchange Act registered entity
Credit union	Accounting firm
Depository institution holding company	Public utility
Money services business	Financial market utility
Broker or dealer in securities	Pooled investment vehicle
Securities exchange or clearing agency	Tax-exempt entity
Other Exchange Act registered entity	Entity assisting a tax-exempt entity
Investment company or investment adviser	Large operating company
Venture capital fund adviser	Subsidiary of certain exempt entities
	Inactive entity

An entity may qualify as a large operating company if the following six conditions apply:

1. The entity employs more than 20 full-time employees (with respect to a calendar month, employees who are employed an average of at least 30 hours of service per week with an employer);
2. More than 20 full-time employees of the entity are employed in the United States;
3. The entity has an operating presence at a physical office within the United States, meaning an entity regularly conducts its business at a physical location in the United States that the entity owns or leases and that is physically distinct from the place of business of any other unaffiliated entity;
4. The entity filed a federal income tax or information return in the United States for the previous year demonstrating more than $5,000,000 in gross receipts or sales;

5. The entity reported greater than $5,000,000 as gross receipts or sales (net of returns and allowances) on the entity's IRS Form 1120, consolidated IRS Form 1120, IRS Form 1120-S, IRS Form 1065, or other applicable IRS form; and
6. When gross receipts or sales from sources outside the United States, as determined under federal income tax principle, are excluded from the entity's amount of gross receipts or sales, the amount remains greater than $5,000,000.

A beneficial owner is any individual who:

- Directly or indirectly exercises substantial control over the reporting company; or
- Directly or indirectly owns or controls 25% or more of the "ownership interests" of the reporting company.

Per FAQs, a beneficial owner typically exercises substantial control over a reporting company if they "direct, determine, or exercise substantial influence over important decisions the reporting company makes."[13] Individuals may directly or indirectly exercise substantial control. Individuals can exercise substantial control through contracts, arrangements, understandings, relationships, or otherwise.

Any senior officer is deemed to have substantial control over a company. Examples include a president, chief financial officer, general counsel, chief executive officer, or chief operating officer, as well as any other officers that perform functions similar to such roles.

Examples of directly exercising substantial control over a reporting company include:

- Board representation;
- Ownership or control of a majority of voting power or voting rights; or
- Rights associated with financing or interest.

Examples of indirectly exercising substantial control over a reporting company include:

- Controlling one or more intermediary entities that separately or collectively exercise substantial control over a reporting company; or
- Through arrangements or financial or business relationships with other individuals or entities acting as nominees.

Similarly, individuals may directly or indirectly own or control ownership interests in a reporting company. An example of a direct way of owning or controlling ownership interests is having joint ownership with one or more other individuals. Examples of indirect ways of owning or controlling ownership interests include:

- Owning or controlling one or more intermediary entities, or the ownership interests of any intermediary entities, that separately or collectively own or control ownership interests of a reporting company; or
- Owning or controlling ownership interests through another individual acting as a nominee, intermediary, custodian or agent.

There are five exceptions to the definition of a beneficial owner. When an individual who would otherwise be a beneficial owner of a reporting company qualifies for an exception, the reporting company does not have to report that individual as a beneficial owner in its BOI report to FinCEN. The five exceptions to the definition of a beneficial owner follow:

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[13] FinCEN Beneficial Ownership Information Reporting Frequently Asked Questions (March 24, 2023).

Exception 1: Minor Child

- An individual qualifies for this exception if the individual is a minor child, as defined under the law of the state or Indian tribe in which the domestic reporting company is created or the foreign reporting company is first registered.
- The reporting company may instead report information about the parent or legal guardian of the minor child.
- This exception only applies if a parent or legal guardian's information is reported in lieu of the minor child's information.
- When the minor child reaches the age of majority, the exception no longer applies, and the reporting company must file an updated BOI report providing the individual's own information.

Exception 2: Nominee, intermediary, custodian, or agent

- An individual qualifies for this exception if the individual merely acts on behalf of an actual beneficial owner as the beneficial owner's nominee, intermediary, custodian, or agent.
- In such situations, the actual beneficial owner must be reported.
- Examples of individuals who likely qualify for this exception include individuals who perform ordinary advisory or other contractual services, such as tax professionals.

Exception 3: Employee

- An individual qualifies for this exception if all of the following apply:
  - The individual is an employee of the reporting company, when applying the meaning of "employee" provided in 26 CFR 54.4980H-1(a)(15). Generally, this means that the individual is subject to the will and control of the employer in what and how to do work, and that the employer may discharge the individual from work;
  - The individual's substantial control over, or economic benefits from, the reporting company are derived solely from the employment status of the individual as an employee; and
  - The individual is not a senior officer of the reporting company.

Exception 4: Inheritor

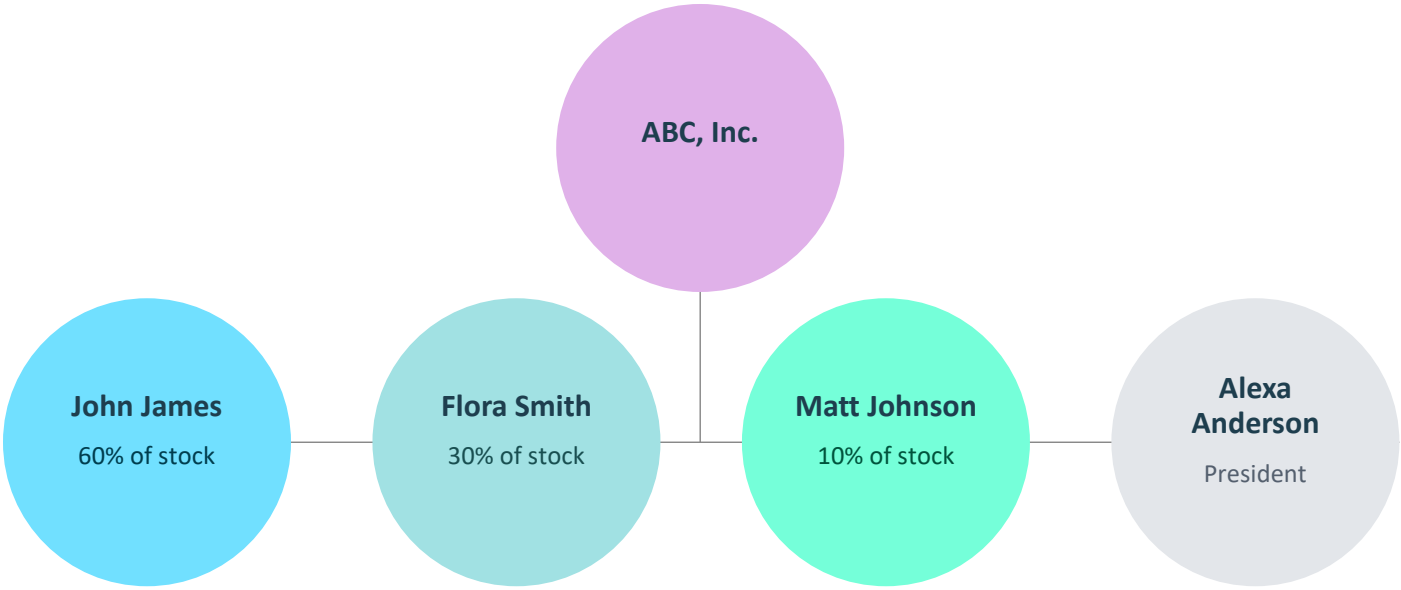
- An individual qualifies for this exception if the individual's only interest in the reporting company is a future interest through a right of inheritance, such as through a will providing a future interest in a company.
- Once the individual actually inherits the interest, the exception no longer applies, and the individual may qualify as a beneficial owner. Additionally, the reporting company may have to file an updated BOI report providing the individual's information.

Exception 5: Creditor

- An individual qualifies for this exception if the individual is a creditor of the reporting company.
- A creditor is an individual who would meet the definition of a beneficial owner of the reporting company solely through rights or interests for the payment of a predetermined sum of money, such as a debt incurred by the reporting company, or a loan covenant or other similar right associated with such right to receive payment that is intended to secure the right to receive payment or enhance the likelihood of repayment.

- An individual qualifies for the creditor exception if the individual is entitled to payment from the reporting company to satisfy a loan or debt, so long as this entitlement is the only ownership interest the individual has in the reporting company.

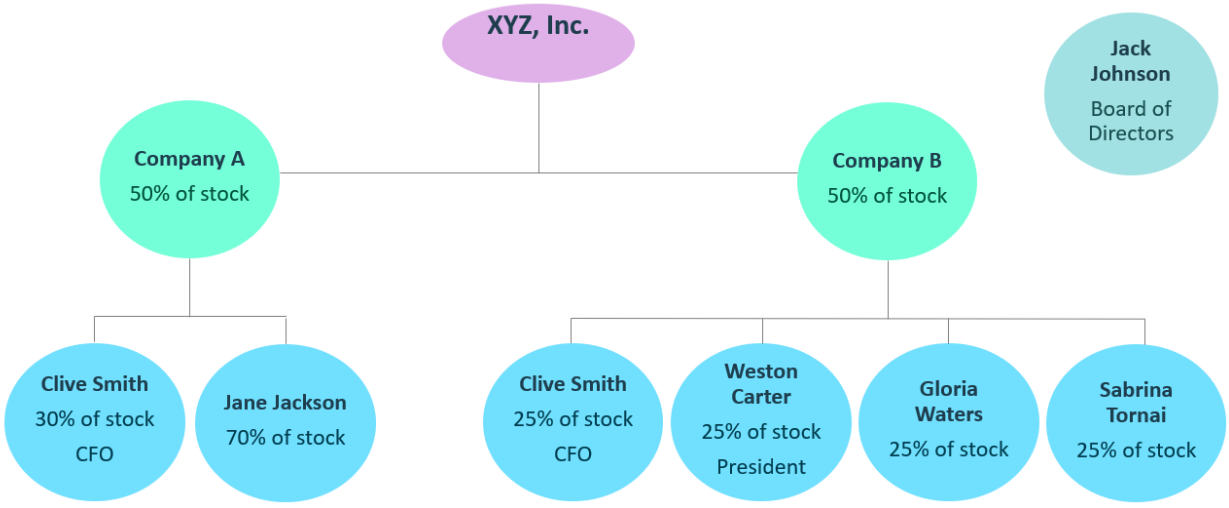
Example 1: ABC, Inc. is a reporting company that has the following organization chart:



Which individual(s) are considered beneficial owners?

- John James is considered a **beneficial owner** because he has 25% or more of the ownership interests of the reporting company, ABC, Inc.
- Flora Smith is considered a **beneficial owner** because she has 25% or more of the ownership interests of the reporting company, ABC, Inc.
- Alexa Anderson is considered a **beneficial owner** because although she does not have 25% or more of the ownership interests of the reporting company, ABC, Inc., she is a senior officer that is deemed to have substantial control over the company.
- Matt Johnson only owns 10% or more of the ownership interests of the reporting company, ABC, Inc., and he does not directly or indirectly exercise substantial control over ABC, Inc. Therefore, Matt Johnson is not a beneficial owner.

Example 2: XYZ, Inc. is a reporting company that has the following organization chart:



Which individual(s) are considered beneficial owners?

- Clive Smith is considered a **beneficial owner** because he is a senior officer (CFO), which means he exercises substantial control over the company. Additionally, Clive is also considered a **beneficial owner** who indirectly owns 27.5% of the XYZ Inc.'s stock (reporting company) through direct ownership of both Company A and Company B, which each own 50% of XYZ, Inc.
  - Clive owns 15% of XYZ Inc. (reporting company) through Company A (50% x 30%)
  - Clive owns 12.5% of XYZ Inc. (reporting company) through Company B (50% x 25%)
  - In total, Clive owns 27.5% of XYZ Inc.
- Jane Jackson is considered a **beneficial owner** because she indirectly owns 35% of the reporting company, XYZ Inc. As a result, she is considered a beneficial owner because she has 25% or more of the ownership interests of the reporting company, XYZ, Inc.
  - Jane owns 35% of XYZ, Inc. (reporting company) through Company A (50% x 70%).
- Weston Carter is considered a **beneficial owner** because he is a senior officer (CEO), which means he exercises substantial control over the company. Weston is also considered a **beneficial owner** despite only indirectly owning 12.5% of the XYZ Inc.'s stock (reporting company) through direct ownership of Company B, which owns 50% of XYZ, Inc.
  - Weston owns 12.5% of XYZ, Inc. (reporting company) through Company B (50% x 25%).
- Jack Johnson is considered a **beneficial owner** because he is on XYZ, Inc.'s board of directors and makes important decisions on XYZ Inc.'s behalf, thereby exercising substantial control over it. Jack is considered a beneficial owner despite not owning any ownership interest, because he exercises substantial control over the reporting company.
- Gloria Waters is not considered a beneficial owner because she only indirectly owns 12.5% of XYZ, Inc. and she does not exercise substantial control over XYZ, Inc.
  - Gloria owns 12.5% of XYZ, Inc. (reporting company) through Company B (50% x 25%).
- Sabrina Tornai is not considered a beneficial owner because she only indirectly owns 12.5% of XYZ, Inc. and she does not exercise substantial control over XYZ, Inc.
  - Sabrina owns 12.5% of XYZ, Inc. (reporting company) through Company B (50% x 25%).

If a reporting company is created or registered on or after January 1, 2024, the reporting company will also need to report information about itself, its beneficial owners, and its company applicants. If a reporting company was created or registered before January 1, 2024, the reporting company only needs to provide information about itself and its beneficial owners. The reporting company **does not** need to provide information about its company applicants.

A **company applicant** is:

- The individual who directly files the document that creates, or first registers, the reporting company; and
- The individual that is primarily responsible for directing or controlling the filing of the relevant document.

Note: No reporting company will have more than two applicants.

The information that a reporting company must report about itself includes:

- The company's legal name;
- Any company trade names, "doing business as" (d/b/a) names, or "trading as" (t/a) names;
- The current street address of its principal place of business if that address is in the United States, or, for reporting companies whose principal place of business is outside the United States, the current address from which the company conducts business in the United States;
- The company's jurisdiction of formation or registration; and
- The company's TIN.

The information that a reporting company must report about a beneficial owner or company applicant includes:

- The individual's name, date of birth, and current personal address; and
    - A unique identifying number for the individual from an acceptable identification document (examples include driver's licenses, passports, or identification documents issued by a U.S. state or local government or Indian tribe). Note: The reporting company must submit an image of such identification document to FinCEN.

Certain reporting companies must include information about their company applicants in their BOI reports. A reporting company is required to report its company applicants if it is either a:

- Domestic reporting company created on or after January 1, 2024; or
- Foreign reporting company first registered to do business in the United States on or after January 1, 2024.

A reporting company is not required to report its company applicants if it is either a:

- Domestic reporting company created before January 1, 2024; or
- Foreign reporting company first registered to do business in the United States before January 1, 2024.

Reporting companies that are required to report company applicants must report at least one, but at most two, company applicants. There are two categories of company applicants:

1) **Direct Filers**:
    - A direct filer is the individual who directly filed the document that created a domestic reporting company, or the individual who directly filed the document that first registered a foreign reporting company. In other words, this individual directly physically or electronically filed the document with the secretary of state or similar office.
    - The direct filer must be identified by all reporting companies that have a company applicant reporting requirement.
2) **Directs or controls the filing action**:
    - Another potential company applicant is an individual who was primarily responsible for directing or controlling the filing of the creation or first registration document. This individual is a company applicant even though the individual did not actually file the document with the secretary of state or similar office.

- Not all reporting companies that have a company applicant reporting requirement will have this individual to report.

The information that a reporting company must report about a beneficial owner or company applicant includes:

- The individual's name, date of birth, and reporting company's business street address; and
- A unique identifying number for the individual from an acceptable identification document (examples include driver's licenses, passports, or identification documents issued by a U.S. state or local government or Indian tribe).
  - Note: The reporting company must submit an image of such identification document to FinCEN.

FinCEN will issue to an individual or reporting company upon request a "FinCEN identifier," a unique identifying number, after the individual or reporting company provides certain information to FinCEN. An individual or reporting company is not required to obtain a FinCEN identifier; however, the company may include FinCEN identifiers in its BOI report instead of certain required information about beneficial owners or company applicants. Individuals (including beneficial owners or company applicants) may electronically apply for FinCEN identifiers. The individual must provide the same information required for beneficial owners and company applicants in BOI reports. After an individual submits an application, the individual will immediately receive a FinCEN identifier unique to that individual. A reporting company may request a FinCEN identifier when it submits a BOI report by checking a box on the reporting form.

A reporting company created or registered to do business before January 1, 2024, will have until January 1, 2025 to file its initial beneficial ownership information report. Under the initial BOI reporting requirements, a reporting company created or registered on or after January 1, 2024, would have 30 days to file its initial beneficial ownership information report. On November 29, 2023, FinCEN issued a final rule, extending the filing deadline from 30 days to 90 days for entities created or registered on or after January 1, 2024, and before January 1, 2025. This 90-calendar day deadline runs from the time the company receives actual notice that its creation or registration is effective, or after a secretary of state or similar office first provides public notice of its creation or registration, whichever is earlier. Under the final rule, entities created or registered on or after January 1, 2025, will have 30 days to file their initial BOI reports with FinCEN. FinCEN began accepting beneficial ownership information reports on January 1, 2024, and there is no fee for submitting the report.

If an entity previously qualified for an exemption to the reporting company definition but no longer qualifies, they must file a BOI report within 30 calendar days of the date on which the entity stopped qualifying for the exemption. If any previously reported information about the reporting company or its beneficial owner changes, the reporting company must file an updated BOI report no later than 30 days after the date on which the change occurred. It is important to note that a reporting company is not required to file an updated report for any changes to previously reported personal information about a company applicant.

FinCEN lists the following common examples which require an updated BOI report:

- Registering a new DBA.
- A change in beneficial owners, such as a new company executive, a sale that changes who meets the ownership interest threshold of 25%, or the death of a beneficial owner.

    - Note: If a beneficial owner dies, the changes must be reported within 30 days of when the deceased beneficial owner's estate is settled. Any new beneficial owners, if applicable, should be identified in the updated BOI report.
- Any change to a beneficial owner's name, address, or unique identifying number provided in a BOI report.
    - Note: If the beneficial owner's identifying document changed (for example, he or she received a new driver's license with a changed name, address, or identifying number), the reporting company also would have to file an updated BOI report with FinCEN, including an image of the new identifying document.

Entities that are required to report beneficial ownership information to FinCEN may do so electronically through FinCEN's secure BOI E-Filing site: https://boiefiling.fincen.gov. Anyone whom the reporting company authorizes to act on its behalf, including an employee, owner, or third-party service provider, may file a BOI report on the reporting company's behalf. Such individuals may be required to provide basic contact information about themselves, including their name and email address or phone number. Updated BOI reports should also be filed electronically through the secure BOI E-Filing site.

Under the CTA, FinCEN can disclose the beneficial ownership information to the following requesters:

- U.S. federal agencies engaged in national security, intelligence, and law enforcement activities;
- State, local, and tribal law enforcement agencies with court authorization;
- The U.S. Department of the Treasury;
- Financial institutions using beneficial ownership information to conduct legally required customer due diligence, provided the financial institutions have their customer's consent to retrieve the information;
- Federal and state regulators assessing financial institutions for compliance with legally required customer due diligence obligations; and
- Foreign law enforcement agencies and certain other foreign authorities who submit qualifying requests for the information through a U.S. federal agency.

As discussed, many taxpayers may be unaware of the existence of these reporting requirements that are quickly approaching. FinCEN estimates approximately 32.6 million reports will be filed initially, with an additional 5 million filings annually for the next nine years. Significant penalties can result from failure to comply with these new reporting requirements. Any person who willfully provides false or fraudulent information to a reporting company or willfully fails to file a complete initial or updated report with FinCEN is subject to a $500-per-day fine up to $10,000 and imprisonment for up to two years.

Senior officers of an entity that fails to file a required BOI report may be held accountable for that failure. An individual may also be subject to civil and/or criminal penalties for willfully causing a company not to file a required BOI report or to report incomplete or false beneficial ownership information to FinCEN.