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IRS issues final regulations regarding information return e-file requirements

The e-file threshold drops significantly on January 1, 2024.

By Mike Giangrande, J.D., LL.M.
Federal Tax Editor

The IRS has issued final regulations amending the rules for e-filing information returns due on or after January 1, 2024.[1] Specifically, the final regulations:

- Generally require electronic filing of information returns for taxpayers that are required to file at least 10 or more returns in a calendar year;
- Require filers to aggregate almost all information return types covered by the regulations to determine whether a filer meets the 10-return e-filing threshold;
- Eliminate the e-filing exception for income tax returns of corporations that report total assets under $10 million; and
- Require partnerships with more than 100 partners to e-file information returns, and require partnerships that must file at least 10 returns of any type during the calendar year to e-file their partnership return.

Practice Pointer

These final regulations expanding the number of taxpayers that must e-file their information returns come on the heels of the IRS's new online portal for preparing and filing 1099s, which went live in January 2023. The new portal, known as the Information Returns Intake System (IRIS), is a free electronic filing service that requires no special software.

Tax professionals who wish to take advantage of the IRIS system when most information returns are due in January 2024 should take steps far in advance to sign up for the system. The IRIS system can be accessed at:

www.irs.gov/filing/e-file-forms-1099-with-iris

Waivers and exemptions

Taxpayers can file waiver requests to avoid the e-filing threshold if taxpayers can establish undue hardship or where their religious beliefs conflict with the electronic filing threshold. But, with the IRS's free online filing system for 1099s (which is due to expand to more forms), and the ease with which commercially available software can e-file returns, requesting a waiver is sure to be the more difficult road forward.

Taxpayer First Act

The Taxpayer First Act of 2019 authorized the Department of the Treasury and the IRS to issue regulations that reduce the 250-return e-file threshold for information returns.[2] However, the IRS's delay in issuing the final regulations prevented the 10-return threshold from officially taking effect until now.

[1] T.D. 9972

[2] Taxpayer First Act §2102

Nonwillful FBAR penalty applies per form, not per account

The Supreme Court sides with the taxpayer in a 5-4 split.

By Kathryn Zdan, EA
Editor

The Supreme Court has resolved the split between the Fifth and Ninth Circuit courts of appeal regarding whether the FBAR penalty is applied per account that is not reported or per "report" (i.e., per FBAR form that is not filed) when it ruled the penalty is applied per form. The FBAR penalty is $10,000 for a nonwillful violation. (The willful violation penalty, which was not at issue in ***Bittner***, is the greater of $100,000 or 50% of the account

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balance.). Obviously, the difference between these penalties being assessed per form or per account is substantial.

The Court heard ***Bittner v. U.S.***,[1] the Fifth Circuit case, in which the taxpayer was born and educated in Romania, and later moved to the U.S. and became a U.S. citizen. He returned to Romania and had a great deal of success in his business and investing ventures, and maintained dozens of bank accounts in Romania. However, he was unaware of his FBAR filing responsibility as a U.S. citizen and never filed FBARs during the years he lived in Romania. For the tax years at issue (2007–2011), the taxpayer had: 51 accounts in 2007, 43 in 2008, 42 in 2009, 41 in 2010, and 43 in 2011.

The IRS assessed $2.72 million in FBAR penalties for tax years 2007–2011, calculating the penalties on a per-account basis. A district court held that the penalties were applied per FBAR form rather than per account, and reduced the penalty to $50,000 ($10,000 per form). The Fifth Circuit appeals court examined what constitutes "a violation," focusing on the language in 31 USC §5314(a), which requires that an FBAR be filed when a taxpayer "makes a transaction or maintains a relation … with a foreign financial agency." The appeals court read this in conjunction with the regulations as a requirement to report each account rather than the requirement to file the FBAR in a particular manner (i.e., filing a "single report").

The Supreme Court, in a 5-4 decision, concluded that 31 USC §5314 does not mention **accounts** or their number, but it does address the duty to file **reports**, which must include various kinds of information about an individual's foreign transactions. The penalty provision in §5314 ties the penalty amount to the number of violations (of the duty to file a report), not the number of accounts. Also, while §5321 does assess penalties based on the number of accounts for certain willful violations, the Court determined that Congress declined to specify in the language of §5321 that nonwillful penalties are imposed on a per-account basis.

For more information on FBAR filings generally, see "Reporting foreign financial accounts" in this issue of *Spidell's Federal Taxletter®*.

[1] ***Bittner v. U.S.*** (February 28, 2023) ___ U.S. ___; ***U.S. v. Bittner*** (CA 5 2021) 19 F.4th 734; ***U.S. v. Bittner*** (E.D. Tex. 2020) 469 F.Supp.3d 709; the Ninth Circuit case was ***U.S. v. Boyd*** (CA 9 2021) 991 F.3d 1077

Tip reporting issues for restaurant owners

Remember that the employer will be responsible for tax on underreported tips, not the employee.

By Steve Yukelson, CPA
Guest Contributor

Complying with the IRS tip reporting rules is a responsibility faced by many restaurant owners. In general, tips are discretionary payments made by customers to employees. Tips can be paid in cash, credit cards, and through tip pools from other employees (indirect tips).

A tip is voluntary; that said, a service charge that is required to be paid by the customer is not a tip. An example of a service charge required to be paid would be an 18% service charge added to parties of eight or more, even if it is called a gratuity or a tip.

Tip reporting, generally

Employees who receive $20 or more in cash tips in any calendar month must provide their employer with a written statement by the 10th day of the month after the tips are received.[1] There is a penalty for the failure of an employee to report tips to his or her employer.[2]

IRS Publication 1244, Employee's Daily Record of Tips and Report to Employer, is a log that employees can use for tip reporting purposes. Alternatively, many point-of-sale (POS) systems are able to collect and generate this information. Those POS systems allow each tipped employee to input their cash tips prior to clocking-out at the end of each shift.

For purposes of tip reporting, a "food or beverage operation" is any business activity that provides food or beverages for on-site consumption, but this term does not include fast-food operations. A "large" food or beverage establishment is any trade or business:[3]

- That is a food or beverage operation where tipping of employees serving food or beverage by customers is customary; and
- That normally employed more than 10 employees on a typical business day during the preceding calendar year.

A large food and beverage establishment is required to provide information concerning their employees' tip income to the IRS by filing Form 8027, Employer's Annual Information Return of Tip Income. Form 8027 reports, among other items, the total charged tips and the total charged receipts showing charged tips. It also reports the gross receipts from food and beverages.

Conspicuously absent on Form 8027 is reporting of both cash tips and cash sales. The intentional omission of that information from Form 8027 serves as a roadmap for the IRS to pursue potential action against the employer for underreported tips. The instructions to Form 8027 contain a worksheet to help the employer determine if employees are reporting all their tips, including cash tips. A quick method to determine if employees are properly reporting all their tips is to compare the rate of tips reported on credit sales to the rate of tips reported on cash sales.

Tax reporting of tips and service charges

Service charges are treated differently from tips for federal tax purposes. Any portion of a service charge that is distributed to an employee is treated as wages, and the amount is to be included on Form W-2 as wages. Service charges are not included in the employee's daily tip record and are not reported as tips on Form 8027.

Wages and tips are subject to income tax and FICA withholding. The employer must match the FICA tax. However, food and beverage establishments are allowed an income tax credit for certain FICA payments during the tax year with respect to employee cash tips.[4] The credit is equal to the employer's FICA obligation attributable to tips. An employer should not take on the risk of underreporting tips when the government has minimized the cost to properly report them.

Let the games begin: the 8% myth

Many tipped employees erroneously believe that they are only required to report 8% of the food and beverage income that they generated as tip income, even though the tip amount that they actually received is greater. Nothing could be further from the truth! IRC §61 defines gross income as all income from whatever source derived. It encompasses nearly every type of increase in wealth that is not specifically excluded, and tips are not specifically excluded.

It is the employer that will be responsible for tax on underreported tips, not the employee. In a 2002 Supreme Court decision, the Court determined that the IRS has the authority to assess the employer's share of FICA taxes due on employee's tip income without first examining the tip records of the individual employee.[5] In this landmark case, the IRS conducted a "compliance" check and discovered that tip income reported by the restaurant for the years at issue was far less than the tip amounts recorded on credit card slips during that same period of time. The IRS assessed a substantial amount of past due FICA taxes against the employer

because the employer had knowledge of the tip amounts that should have been reported by employees.

Allocating tips

If the total tips reported by all employees at a large food or beverage establishment equal less than 8% of the establishment's gross receipts, the employer is required to allocate tips to employees who have reported tips to the employer that total less than 8% of the establishment's gross receipts.[6] The allocation is made to each directly tipped employee performing services for the establishment who has a reporting shortfall for the payroll period. (No allocation is made to indirectly tipped employees.)

Generally, the amount allocated is the difference between the total tips reported by employees and 8% of the gross receipts, other than nonallocable receipts.

This summary merely scratches the surface of the compliance requirements placed upon a food and beverage establishment. More information for employees on reporting tips can be found in IRS Publication 531, Reporting Tip Income:

www.irs.gov/pub/irs-pdf/p531.pdf

Voluntary tip reporting program in the works

The IRS issued a notice that proposes creating a revenue procedure that would establish the Service Industry Tip Compliance Agreement (SITCA) program, a voluntary tip reporting program between the IRS and employers in various service industries (excluding gaming industry employers).[7] The SITCA program is designed to improve tip reporting compliance, would decrease reporting burdens, and would replace the:

- Tip Rate Determination Agreement (TRDA);
- Tip Reporting Alternative Commitment (TRAC); and
- Employer designed TRAC (EmTRAC).

Participating employers would receive protection from liability under the rules that define tips as part of an employee's pay for calendar years in which they remain compliant with program requirements.

The IRS will accept comments on the proposed revenue procedure, to be submitted by May 7, 2023.

You can see details at:

www.irs.gov/irb/2023-06_IRB#NOT-2023-13

About the author

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1 IRC §6053
2 IRC §6652(b)
3 IRC §6053(c)(4)
4 IRC §45B
5 *U.S. v. Fior d'Italia, Inc.* (2002) 536 U.S. 238
6 See instructions to Form 8027
7 IRS Notice 2023-13

Reporting foreign financial accounts

Understand which types of accounts need to be reported and by whom.

By Kathryn Zdan, EA
Editor

Taxpayers who maintain foreign financial accounts may be required to report those accounts to the U.S. government. The report itself (aka the FBAR) is filed with the Financial Crimes Enforcement Network (FinCEN), but the IRS holds enforcement authority. Both FinCEN and the IRS operate under the Department of the Treasury umbrella.

The basics

Any U.S. person must report annually to the IRS certain information about an account if the following conditions apply:[1]

- The U.S. person has a financial interest in or signature authority (or other authority that is comparable to signature authority) over any financial account in a foreign country; and
- The aggregate value of all foreign financial accounts exceeds $10,000 (as measured in U.S. currency) at any time during the calendar year.

The form used for the reporting is FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), which is due April 15 with an automatic six-month extension to October 15. These dates coincide with the filing deadlines for individual income tax returns, so if either of these dates falls on a holiday or weekend, the due date is the next regular business day. **Note:** The FBAR is filed separately from the tax return. However, most commercial income tax preparation software will e-file the form at the same time the taxpayer e-files their income tax return.

A "U.S. person" is:[2]

- A citizen or resident of the United States (including a green card holder);[3]
- An entity created, organized, or formed in the United States or under the laws of the United States, any state, the District of Columbia, the U.S. territories and insular possessions, or any Indian tribes. An "entity" includes, but is not limited to, a corporation, partnership, trust, and limited liability company; or
- An estate formed under the laws of the United States.

If a U.S. person has a financial interest in 25 or more foreign financial accounts or signature or other authority over 25 or more foreign financial accounts, they only need to provide the number of financial accounts and certain other basic information on the report. For example, in item 14a of Part 1 of the Form 114, the taxpayer will check the "Yes" box and enter the total number of accounts, and they will leave blank Parts II and III of the form (but they must maintain records of that information).[4]

Applicable financial accounts

Financial accounts that are required to be reported on the FBAR (FinCEN Form 114) include:[5]

- Bank accounts such as savings and checking accounts, and time deposits;
- Securities accounts, such as brokerage accounts, securities derivatives accounts, or other financial instruments accounts;
- Commodity futures or options accounts;
- Insurance or annuity policies with a cash value (such as a whole life insurance policy);
- Mutual funds or similar pooled funds (i.e., a fund available to the public with a regular net asset value determination and regular redemptions); and
- Any other accounts maintained in a foreign financial institution or with a person performing the services of a financial institution.

Foreign hedge funds and private equity funds are not reportable on the FBAR.

A foreign account holding virtual currency is not reportable on the FBAR unless it also holds other reportable assets. Virtual currency funds aren't currently reportable under the existing regulations,[6] but FinCEN has indicated its intention to propose amending the regulations to include virtual currency as a type of reportable asset.[7]

A foreign financial account is a financial account maintained with a financial institution located outside the U.S. The location of the account, not the nationality of the financial institution, determines whether an account is "foreign" for FBAR purposes.[8] As an example, an account maintained with a branch of a U.S. bank physically located in Germany is a foreign financial account. However, an account maintained with a branch of a French bank physically located in Texas is not a foreign financial account.

A debit card account is a financial account, and a credit card account may be treated as a financial account in certain circumstances.[9] Generally, a credit card would not be considered a financial account. However, a "secured" credit card account where the credit card is secured by a separate deposit account would be a financial account for FBAR purposes. Also, in a scenario where a taxpayer makes large advance payments to a credit card account in a foreign country and makes cash advances against the card totaling an amount beyond the limit of the credit card, it could be argued that the taxpayer is using the credit card as a debit card and that the credit card is a financial account for FBAR purposes.[10]

Financial interest in an account

Generally, a U.S. person has a financial interest in a foreign financial account if:

- The U.S. person is the owner of record or holder of legal title, regardless of whether the account is maintained for the benefit of the U.S. person or for the benefit of another person; or
- The owner of record or holder of legal title is one of certain listed entities, which include:
  - An agent, a nominee, attorney, or a person acting in some other capacity on behalf of the U.S. person with respect to the account; or
  - Any of certain entities controlled by the U.S. person.

Example of financial interest in an account: Rico is a U.S. citizen, and his brother Pete maintains bank accounts in Mexico on Rico's behalf. The accounts are in Pete's name, but Pete only accesses the accounts upon Rico's instructions.

Rico has a financial interest in the Mexican bank accounts for FBAR reporting purposes. If Pete is a U.S. citizen or resident, Pete also will report the same accounts on his own FBAR filing.

If the account owner of record or holder of legal title of a foreign financial account is an entity, and a U.S. person directly or indirectly owns either more than 50% of the total value of a corporation's stock (or 50% of the profits in the case of a partnership) or more than 50% of the voting power, the U.S. person has a financial interest in that foreign account. **Note:** The 50% owner and the entity both have to report the account.

A U.S. person has a financial interest in a foreign financial account if the owner of record or holder of legal title is a trust and the U.S. person is:[11]

- The grantor of the trust; and
- Has ownership interest in the trust under the grantor trust rules.

A U.S. person has a financial interest in a foreign financial account if the owner of record or holder of legal title is a trust and the U.S. person has a present beneficial interest, either directly or indirectly, in more than 50% of the assets of the trust, or the U.S. person receives more than 50% of the trust's current income for the calendar year.[12] **Note:** The trust and the beneficiary both have to report the account.

A U.S. person with only a remainder interest in a trust with a foreign financial account is not required to report the trust's foreign financial account because a remainder interest is not considered a present beneficial interest for FBAR purposes.

Signature authority

Signature or other authority is the authority of an individual (alone or with another individual) to control the disposition of assets held in a foreign financial account by direct communication (written or otherwise) to the bank or other financial institution that maintains the account.[13]

This includes taxpayers who:[14]

- Are employees with signature authority over an employer's foreign bank accounts; or
- Have power of attorney that grants signature authority, even if that right is not exercised.

Example of power of attorney: Tiegan is a U.S. resident and has power of attorney for her elderly parents' accounts in Canada, but she has never exercised the power of attorney. She is required to file an FBAR (FinCEN Form 114) if the power of attorney gives her signature authority over the financial accounts (and they meet the reporting requirements), regardless of whether she ever exercised that authority.

Taxpayers with signature authority over 25 or more foreign financial accounts must enter the total number of accounts on item 14b and complete items 34–43 in Part IV for each person on whose behalf the taxpayer has signature authority.

You can see the FBAR at:

https://bsaefiling1.fincen.treas.gov/lc/content/xfaforms/profiles/htmldefault.html

Need more information?

For a more detailed discussion of the FBAR and its various requirements, sign up for Spidell's 2023 Post Tax Season Update and Review webinar, where we will cover maximum account values, joint accounts, recordkeeping requirements, penalties, and more. See a list of dates and other topics covered at caltax.com.

1 31 U.S.C. §5314; 31 CFR §1010.350
2 31 CFR §1010.350(b)
3 The FBAR instructions use the residency tests in Treas. Regs. §7701(b)
4 31 CFR §1010.350(g)
5 31 CFR §1010.350(c)
6 31 CFR §1010
7 FinCEN Notice 2020-2
8 31 CFR §1010.350(c)(4)(ii)
9 CAA 200603026
10 See CCA 200603026 for four scenarios involving the use of foreign credit cards
11 31 CFR §1010.350(e)(2)(iii); IRC §§671–679
12 31 CFR §1010.350(e)(2)(iv)
13 31 CFR §1010.350(f)(1)
14 IRS Publication 5569, Report of Foreign Bank & Financial Accounts (FBAR) Reference Guide, available at: www.irs.gov/pub/irs-pdf/p5569.pdf

IRS postpones disaster filing and payment deadlines to October 16

The extension applies to certain taxpayers in Alabama, California, and Georgia.

By Sandy Weiner, J.D.
Contributing Editor

The IRS is granting filing and payment postponements to October 16, 2023, to taxpayers in most California counties, as well as taxpayers located in specified counties in Alabama and Georgia (see "Disaster areas" below).[1]

The extended deadline period applies to any returns due on or after December 27, 2022,[2] (January 8 for some California counties;[3] January 12 for taxpayers in specified Alabama and Georgia counties[4]) and before October 16, 2023. The extended deadlines apply to the following filing and payment deadlines that fall within the extended deadline period:

- Individual income and trust tax returns normally due April 18, 2023;
- Business return filings normally due between March 15 and April 18, 2023, as well as any fiscal-year returns that are due within the extended deadline period (this includes fiscal-year returns on extension if the extended due date falls before October 16, 2023);
- Estate tax returns with deadlines falling within the extended deadline period;
- Extension requests and payments normally due by the original due date of the taxpayer's return (e.g., March 15 and April 18, 2023, for individuals and calendar-year business entities);
- Fourth quarter 2022 estimated tax payments normally due on January 17, 2023, and the 2023 first, second, and third quarter estimated tax payments normally due on April 18, June 15, and September 15, 2023;
- IRA and health savings account (HSA) contributions;
- Quarterly payroll and excise tax returns, normally due on January 31, April 30, and July 31, 2023;[5] and
- Other deadlines listed in Revenue Procedure 2018-58 (e.g., IRC §1031 deadlines).

Planning opportunities

A big "bonus" that this extension relief provides is that individuals and employers can make contributions to retirement accounts for the 2022 tax year up until the October 16, 2023, filing deadline. This provides taxpayers with more time to set aside money to deposit into a retirement account and claim a larger contribution deduction.

Who qualifies?

All taxpayers that have an address of record located in the disaster area automatically qualify for extension relief. There is no need to contact the IRS to obtain relief. The IRS will simply look to see if the taxpayer's zip code is in the area. A taxpayer does not have to prove that they were directly impacted by the storms, floods, mudslides, or tornados to qualify for the relief.

Taxpayers who live outside the disaster area are also eligible for relief if their records necessary to meet a deadline occurring during the postponement period are located in the affected area. This frequently occurs if the taxpayer's tax professional is in the disaster area. In this situation, the taxpayer or the taxpayer's tax professional (with a power of attorney) must contact the IRS's disaster hotline for relief at:

(866) 562-5227

Disaster areas

At the time we went to press, all taxpayers who live in California are automatically eligible for relief unless they live in the following California counties: Imperial, Kern, Lassen, Modoc, Plumas, Shasta, and Sierra counties.[6]

In Alabama, the disaster relief extends to taxpayers in Autauga, Barbour, Chambers, Conecuh, Coosa, Dallas, Elmore, Greene, Hale, Mobile, Morgan, Sumter, and Tallapoosa counties.[7]

In Georgia, the impacted counties are: Butts, Crisp, Henry, Jasper, Meriwether, Newton, Pike, Spalding, and Troup counties.[8]

Are the states granting extensions as well?

At the time we went to press, Alabama and California had announced that they would be following the October 16, 2023, automatic extension relief.[9]

Can we file now and pay later?

Many taxpayers and their tax professionals are asking whether taxpayers can file their returns now and pay the tax on October 16, 2023. The answer is yes. However, it's important to:

- Make sure that the taxpayer remembers to make the payment on October 16, 2023, to avoid any interest or late-payment penalties; and
- Anticipate that the IRS will likely send late-payment notices when they process the return and don't see a corresponding payment. This will likely be easily resolved but may take a considerable amount of time on the phone to straighten out. Some tax professionals are still filing extension requests to avoid the issuance of any notices.

[1] IR-2023-33 available at www.irs.gov/newsroom/irs-may-15-tax-deadline-extended-to-oct-16-for-disaster-area-taxpayers-in-california-alabama-and-georgia

[2] IRS announcement CA-2023-02, available at www.irs.gov/newsroom/irs-announces-tax-relief-for-victims-of-severe-winter-storms-flooding-landslides-and-mudslides-in-california

[3] IRS announcement CA-2023-01, available at: www.irs.gov/newsroom/irs-announces-tax-relief-for-victims-of-severe-winter-storms-flooding-and-mudslides-in-california

[4] IRS announcements AL-2023-01 GA-2023-01 available at: www.irs.gov/newsroom/irs-announces-tax-relief-for-victims-of-january-12-severe-storms-straight-line-winds-and-tornadoes-in-alabama and www.irs.gov/newsroom/irs-announces-tax-relief-for-victims-of-severe-storms-straight-line-winds-and-tornadoes-in-georgia

[5] Filing of Extensions/Extension of Time to File FAQ #3, available at: www.irs.gov/businesses/small-businesses-self-employed/faqs-for-disaster-victims#affectedtaxpayersandrecords

[6] CA-2023-01, CA-2023-02

[7] AL-2023-01

[8] GA-2023-01

[9] www.revenue.alabama.gov/aldor-extends-filing-deadline-for-taxpayers-in-declared-disaster-areas/

IRS not taxing specified state tax payments

The announcement brings welcome relief to taxpayers.

By Sandy Weiner, J.D.
Contributing Editor

On February 10, 2023, the IRS announced that they will not require taxpayers to report specified payments made in 2022 to taxpayers by 17 states and may only subject to tax a portion of certain state tax payments made by six states.[1] As noted below, Illinois and New York issued both an excludable tax payment and a state tax refund, a portion of which may be taxable.

State tax payments are generally subject to tax unless a specific exception applies, such as the IRC §139 disaster relief exclusion or the general welfare exclusion. The IRS acknowledged that these state tax payments at issue were "related to" general welfare and disaster relief, but did not specially state that either of these exclusions applied to any given state's payments.

Rather, the IRS stated that given the "complex fact intensive inquiry that depends on a number of considerations" in evaluating whether an exclusion would apply, it had "determined that in the interest of sound tax administration and other factors" (i.e., the fact that tax season had already begun) the taxpayers in these states would not have to report these payments.

Which payments are fully excludable?

The following payments are fully excludable for federal income tax purposes in 2022:

Excludable State Tax Payments

State	State tax payment	Additional information
Alaska	Supplemental Energy Relief Payment	https://pfd.alaska.gov/payments/tax-information
California	Middle Class Tax Refund	www.ftb.ca.gov/about-ftb/newsroom/middle-class-tax-refund/index.html
Colorado	Colorado Cash Back	https://leg.colorado.gov/bills/sb22-233
Connecticut	Child Tax Rebate	https://portal.ct.gov/DRS/Credit-Programs/Child-Tax-Rebate/Overview
Delaware	Relief Rebate Program	https://finance.delaware.gov/2022-delaware-relief-rebate-program/
Florida	Pandemic Temporary Assistance to Needy Families	No website currently available
Hawaii	Act 115 Refund	https://tax.hawaii.gov/act-115-ref/
Idaho	2022 Tax Rebate	https://tax.idaho.gov/taxes/tax-pros/tax-update/2022-tax-rebates/
Illinois*	Individual Income Tax Rebate	https://tax.illinois.gov/programs/rebates.html
Indiana	Automatic Taxpayer Refund #1 and #2	www.in.gov/dor/individual-income-taxes/automatic-taxpayer-refund/
Maine	Pandemic Relief Payments	www.maine.gov/governor/mills/relief-checks
New Jersey	ITIN Holders Director Assistance Program	www.state.nj.us/treasury/taxation/itinfaq.shtml
New Mexico	Multiple rebate and relief programs	www.tax.newmexico.gov/rebates-and-economic-relief-payments/
New York*	Supplemental Child Credit and Supplemental Earned Income Tax Credit	www.tax.ny.gov/pit/child-earned-payments.htm
Oregon	One-Time Assistance Payments	www.oregon.gov/dor/programs/individuals/Pages/OTAP.aspx
Pennsylvania	One-Time Bonus Rebates	www.revenue.pa.gov/IncentivesCreditsPrograms/PropertyTaxRentRebateProgram/pages/bonus-rebates.aspx
Rhode Island	2022 Child Tax Rebates	https://tax.ri.gov/guidance/special-programs/2022-child-tax-rebates
* Illinois and New York issued multiple payments, and in each case one of the payments was a refund of taxes, which should be treated as noted below, and one of the payments is in the category of disaster relief payment.		

State tax refund treatment

Several states issued payments in the form of tax refunds. In these instances, the taxpayer must only report the refund if the taxpayer received a tax benefit from the payment. Taxpayers who claimed the standard deduction or did not receive a tax benefit (for example, because the $10,000 tax deduction limit applied) do not have to include these tax refunds in their taxable income.

States that issued these tax refunds include:

- Georgia;
- Illinois;
- Massachusetts;
- New York;
- South Carolina; and
- Virginia.

[1] IR-2023-23 available at: www.irs.gov/newsroom/irs-issues-guidance-on-state-tax-payments-to-help-taxpayers

Who can deduct surrogacy costs?

Expenses must relate to a structure or function of the taxpayer's own body to be deductible.

By Kathryn Zdan, EA
Editor

In cases where a surrogate is used to help another individual conceive, the various costs related to surrogacy may or may not be deductible by the individual.

Generally, deductible expenses for "medical care" are amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, and those expenses are only deductible if they were incurred in the care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent.[1] There must be a causal relationship between an underlying medical condition or defect and the taxpayer's expenses, or the costs must be incurred for the purpose of affecting a structure or function of a taxpayer's body.[2]

In a private letter ruling, the IRS ruled on the deductibility of medical costs and fees arising from IVF procedures, gestational surrogacy, and related items for a legally married male same-sex couple.[3] The taxpayers' intent was to have a child with as much of their own DNA as possible, using donated sperm from one of the taxpayers and a donated egg from the other taxpayer's sister.

The taxpayers sought a ruling regarding the deduction of the following medical expenses:

- Medical expenses directly attributed to both taxpayer–spouses;
- Egg retrieval from the sister;
- Medical expenses of sperm donation;
- Sperm freezing;
- IVF medical costs performed on the surrogate;
- Childbirth expenses for the surrogate;
- The surrogate's medical insurance related to the pregnancy;
- Legal and agency fees for the surrogacy; and
- Any other medical expenses arising from the surrogacy.

The IRS determined that in the taxpayers' situation, the costs and fees related to egg donation, IVF procedures, and gestational surrogacy did not qualify as deductible medical expenses under IRC §213 because these costs were not directly related to the taxpayer–spouses. However, the IRS ruled that any medical costs and fees directly attributable to the taxpayers were deductible, such as sperm donation and sperm freezing.

In making the determination, the IRS relied on two cases. In a Tax Court case,[4] a divorced father, who wasn't medically infertile, paid amounts for egg donor and IVF fees, and to a surrogate mother. The Tax Court found these payments were not deductible medical expenses because they were not paid for medical care; there was no underlying medical condition or defect that the expenses related to. The taxpayer could reproduce without medical intervention but merely chose not to.

In an Eleventh Circuit case,[5] a taxpayer who was a fertile homosexual male was denied a deduction for expenses (for medical care, identification, retention, compensation, and reimbursements of egg donors and gestational surrogates) that he incurred in the IVF process. The taxpayer argued that he was "effectively" infertile, but the court ruled that the IVF-related expenses the taxpayer incurred were not for the purposes of materially influencing or altering an action for which his own body was specifically fitted, used, or responsible (i.e., his body's function).

1 IRC §213(d)(1)

2 IRC §213(d)(1)(A)

3 PLR 202114001

4 *Magdalin v. Comm.*, TCM 2008-293

5 *Morrissey v. United States* (11th Cir., 2017) 871 F.3d 1260

Lookback period extended for certain refund claims

COVID-19–related filing postponements resulted in many refunds being inadvertently disallowed.

By Sandy Weiner, J.D.
Contributing Editor

The IRS is granting additional relief to taxpayers who filed their 2019 and 2020 tax returns by the July 15, 2020, and May 17, 2021, "postponed" filing due dates by allowing them to claim refunds of 2019 and 2020 withholding and estimated tax payments if the refund claims are filed within three years of the filing of the original returns.[1] Absent this relief, some taxpayers would not be allowed to claim refunds of these amounts because they would fall outside the allowable refund "lookback period."

Deadlines "postponed"

During the heart of the COVID-19 pandemic, the IRS provided filing and payment relief for the 2020 and 2021 tax years. The relief was provided under IRC §7508A, which allows the IRS to "postpone" certain filing and payment deadlines in the case of federally declared disasters.

As a result of this relief, taxpayers could file their:

- 2019 tax year returns by July 15, 2020, without having to request an extension;[2] and
- 2020 tax year returns by May 17, 2021, without having to request an extension.[3]

Lookback period

Federal law allows taxpayers to file a refund claim within three years from the time the taxpayer's return was filed or two years from the time the tax was paid, whichever expires later.[4] However, the amount that may be refunded is limited to the amount of tax paid within the statutory lookback period. The lookback period for taxpayers who file a refund claim within three years of filing the taxpayer's return is equal to three years *plus the period of any* ***extension*** of time for claiming the return. Otherwise, the lookback period is two years.

Deemed payments

For calendar-year taxpayers, withheld and estimated income tax payments are deemed paid on the due date of the tax return, which is generally April 15 of each year.[5] This means that for the 2019 tax year, withheld and estimated taxes are deemed paid on April 15, 2020, and for the 2020 tax year, withheld and estimated taxes are deemed paid on April 15, 2021.

The catch

The IRS COVID-19–related filing relief "postponed" the filing deadlines, it did not "extend" the time to file them; therefore, the lookback periods were not extended.[6] This meant that prior to the relief provided in IRS Notice 2023-21, taxpayers could not claim refunds of amounts withheld or estimated taxes paid in 2019 if their refund was filed after April 15, 2023, even if their refund claim was timely filed by July 15, 2023. IRS Notice 2023-21 corrects this by disregarding the following periods from the calculation of the "lookback period":

- The period beginning on April 15, 2020, and ending on July 15, 2020, for taxpayers whose due date was postponed by IRS Notice 2020-23; and
- The period beginning on April 15, 2021, and ending on May 15, 2021, for taxpayers whose due date was postponed by IRS Notice 2021-21.

Example of extended lookback period: Raul filed his 2019 tax return on July 15, 2020, as allowed by IRS Notice 2020-23. He made an error when entering the amount of his 2019 estimated tax payments on his return, which resulted in a $1,000 overpayment of his 2019 taxes.

Raul files a refund claim on July 10, 2023. Prior to IRS Notice 2023-21, the IRS would not have refunded the $1,000 because it was deemed paid on April 15, 2020, which was outside the three-year lookback period. As a result of the relief provided by IRS Notice 2023-21, the period from April 15, 2020, through July 15, 2020, is disregarded, so the estimated taxes are still deemed paid within the three-year lookback period.

1 IRS Notice 2023-21

2 IRS Notices 2020-18, 2020-20, 2020-23

3 IRS Notice 2021-21

4 IRC §6511

5 IRC §6513

6 Treas. Regs. §301.7508A-1(b)(4)

"Gifts" from employer are includable income

Payments between employers and employees will generally be presumed to be compensation.

By Kathryn Zdan, EA
Editor

A taxpayer was liable for tax on $79,581 of unreported income and a $5,133 accuracy-related penalty after she failed to convince the Tax Court that amounts transferred to her from her employer were gifts.[1]

The payments at issue were two wire payments the taxpayer received from her employer: $35,000 in 2012 and $53,020 in 2014. In 2017, the taxpayer separated from her employer, and a severance statement included a provision addressing the employee advances. The provision noted that $79,581 in advances would be written off, the taxpayer was to provide a W-9 to the employer, and that the company would issue a 1099 with the taxpayer responsible for any applicable taxes. (The difference in the amounts paid and the amount written off reflects the exchange rate between Canadian and U.S. dollars.)

The taxpayer attempted to have the severance statement revised; her attorney drafted a second version of the employee advance provision that would withhold the advance amounts from her total severance package. The taxpayer argued this reflected an oral agreement she had with the then-CEO of the company, with whom she was having a relationship. However, the second draft was never signed.

The taxpayer timely filed her 2017 return, but she did not report the employee advances for which she had received a 1099 (per the original severance statement). The taxpayer argued the amounts paid to her in 2012 and 2014 were gifts, evidenced by the fact that she was in a relationship with the CEO.

Gift or compensation?

Generally, amounts transferred from an employer to an employee are includable in gross income.[2] There is a strong presumption that payments made beyond an employee's salary are compensation for services and not gifts.[3]

However, a payment between an employer and an employee may be a gift when the relationship between the employer and the employee is personal and unrelated to work.[4] Regarding this argument, the taxpayer produced e-mails and text messages that purportedly established her relationship with the CEO. But the Tax Court did not find that these correspondences demonstrated that the payments were intended to be gifts.

Regarding the second draft of the severance statement, the court noted that the draft remained unsigned, and the language of the revised provision on employee advances was ambiguous at best and only reflected the taxpayer's attempt to recharacterize the payments as gifts.

The court also upheld the accuracy-related penalty because the taxpayer was aware of the provisions of the severance statement regarding the 1099 and her responsibility for any tax liability, yet she failed to report the income.

1 *Fields v. Comm.*, TCS 2022-22

2 IRC §102(c)(1)

3 *Van Dusen v. Commissioner* (9th Cir. 1948) 166 F.2d 647, aff'g (1947) 8 T.C. 388

4 *Caglia v. Comm.*, TCM 1989-143; *Harrington v. Comm.*, TCM 1958-194

Sale of home that hasn't always been a home

Understanding the nonqualified use rules is key to calculating gain on sale.

By Mike Giangrande, J.D., LL.M.
Federal Tax Editor

Generally, up to $250,000 of gain ($500,000 for married taxpayers filing a joint return) realized on the sale or exchange of a principal residence can be excluded from gross income.[1] Taxpayers are eligible for only one maximum principal residence exclusion every two years.[2]

The exclusion applies if the taxpayer owned and used the property as a principal residence for at least two years out of the five years immediately preceding the date of sale or exchange.[3]

Converting rental to residence

Under IRC §121(a), for home sales after December 31, 2008, the gain from the sale or exchange of a principal residence is not excluded from gross income for periods that the home was not used as the principal residence (nonqualified use).[4]

Nonqualified use is commonly an issue for taxpayers who convert a rental to a residence and then subsequently sell the property, hoping to exclude 100% of the gain from the sale of the home under IRC §121. However, periods during which taxpayers owned a second home and didn't use it as a principal residence is also considered nonqualified use. For example, a taxpayer who owns a vacation home and moves into it for two years before selling it must also grapple with nonqualified use issues.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction: The numerator is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, and the denominator is the period the taxpayer owned the property.

Calculation: Computing the gain with a period of nonqualified use

Follow these steps to compute the taxable gain on the sale of a principal residence:

Step 1

$$\text{Gain} \times \frac{\text{Period of nonqualified use}}{\text{Total period of ownership}} = \text{Nonqualified gain}$$

Step 2

Total gain	_____
Less nonqualified gain	(_____)
Excludable gain under IRC §121	_____
Less IRC §121 exclusion	(_____)
Gain after exclusion (not less than zero)	_____
Add nonqualified gain	_____
Total recognized gain	_____

Defining nonqualified use

A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. Nonqualified use does not include:

- Any portion of the five-year qualifying period which is after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period) (this exception allows the taxpayer up to a three-year period in which to sell the principal residence after moving out of it and still meet the two-out-of-five-year requirement);

- Any period (not to exceed an aggregate period of ten years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty (as defined in IRC §121(d)(9)(C)); and
- Any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in the regulations, unforeseen circumstances.

Depreciation recapture

The home sale exclusion does not apply to any portion of gain attributable to post-May 6, 1997, depreciation. Post-May 6, 1997, depreciation must be recaptured and included in the taxpayer's gross income. The gain attributable to post-May 6, 1997, depreciation recapture is not taken into account in determining the amount of gain allocated to nonqualified use. Depreciation recapture amounts are generally taxed at a rate of 25%.[5]

Example of rental converted to residence: Stella bought a property on January 1, 2016, for $695,000 and used it as rental property for two years, claiming $25,000 of depreciation deductions. Thus, her basis is $670,000. On January 1, 2018, Stella converted the property to her principal residence when the fair market value was still $695,000. On January 1, 2020, Stella moved out. She sold the property for $912,000 on January 1, 2022.

Sales price	$912,000
Basis	(670,000)
Gain	$242,000

The $25,000 gain attributable to the deduction for depreciation is recaptured.

Of the remaining $217,000 gain, 40% is nonqualified use (two years nonqualified out of five years total ownership). Gain attributable to nonqualified use is $86,800 (40% of $217,000).

As such, the remaining $217,000 gain is taxed as follows:

Gain	$217,000
Reduction for nonqualified use	(86,800)
Remaining gain	130,200
IRC §121 exclusion amount	(130,200)
Gain after exclusion	0
Nonqualified gain	86,800
Total recognized gain	$ 86,800

Converting a residence to a rental

One of the exceptions to qualified use is where a taxpayer converts a residence into a rental property and then sells the home within three years of the conversion. In this scenario, the taxpayer still meets the two-out-of-five-year test.

Example of use after last use as principal residence: Albert purchased his home on January 1, 2011, for $387,000 and used it as his principal residence until July 1, 2020, when he began renting it out. At that time the FMV of the property was greater than his purchase price of $387,000. On January 1, 2022, he sold the home for $675,000. There is no period of nonqualified use because the rental period occurred after the last use as a principal residence. He may exclude the entire $250,000 gain.

Depreciable basis when residence converted to a rental

The depreciable basis of a residence converted to a rental property is the lesser of:

- The property's adjusted basis; or
- Its fair market value at the time of conversion.

Example #1 of depreciable basis of former residence: Reena purchased her principal residence on May 10, 2010, for $500,000 ($200,000 allocated to land and $300,000 allocated to buildings). On June 27, 2021, Reena converted her residence to a rental property when the fair market value of her home was $800,000 ($320,000 allocated to land and $480,000 allocated to buildings).

The depreciable basis for Reena's former residence based on the lesser of basis or FMV is $300,000 (depreciable over 27.5 years) and $200,000 to nondepreciable land (the lesser of adjusted basis or fair market value at the time of conversion).

Example #2 of depreciable basis of former residence: Rick purchased his principal residence on September 12, 2017, for $500,000 ($200,000 allocated to land and $300,000 allocated to buildings). On July 9, 2021, Rick converted his residence to a rental property when the fair market value of his home was $400,000 ($160,000 allocated to land and $240,000 allocated to buildings). The depreciable basis for Rick's former residence based on the lesser of the original basis or FMV is $240,000 (depreciable over 27.5 years) and $160,000 to nondepreciable land (the lesser of adjusted basis or fair market value at the time of conversion).

[1] IRC §121

[2] Treas. Regs. §1.121-2(a)(1)

[3] IRC §121(a)

[4] IRC §121(b)(4)

[5] IRC §1(h)(E)

1040-X filers can now choose direct deposit

Individual taxpayers who electronically file Form 1040-X amended tax returns can now select that any refund be direct deposited into their bank accounts.[1] Previously, taxpayers filing amended returns could only receive paper-check refunds.

The IRS began accepting the Form 1040-X electronically in 2020 but until now did not offer direct deposit as an option for a refund.

Current processing time is more than 20 weeks for both paper and electronically filed amended returns. According to the IRS, processing an amended return remains a manual process even if it's filed electronically.

[1] IR-2023-22, available at: www.irs.gov/newsroom/new-irs-feature-allows-taxpayers-electronically-filing-amended-returns-to-choose-direct-deposit-to-speed-refunds

2022 Nontaxed Pension Income, State-by-State

We have compiled a chart listing nontaxed pension income for all 50 states. It's a great resource that is free for *Spidell Federal Taxletter*® subscribers. To download your copy, go to:

www.caltax.com/spidellweb/public/editorial/fdt/0423_pensionchart.pdf

News Briefs

IRS expands digital scanning of returns — The IRS's Digital Intake scanning initiative has already scanned 20 times more paper Forms 940 than were scanned in all of 2022. The initiative will expand soon to include Forms 1040 and 941.[1] Digital scanning is part of the effort at the IRS to transform the agency and make improvements for taxpayers. As part of the Inflation Reduction Act, the IRS has hired more than 5,000 new telephone assistors, added staff to IRS Taxpayer Assistance Centers, and held special Saturday hours, and expanded the Document Upload Tool.

1 IR-2023-41

Water rights constituted real property for §1031 purposes — The IRS ruled that water rights constituted real property for the purpose of a §1031 exchange.[2] The taxpayer, a rancher, had a license to divert water from an adjacent river (the "water rights"). The rights were unlimited and perpetual, dependent only on the presence of water in the river. The taxpayer planned to sell a portion of the water rights and reinvest the funds in real property. Real property means land and improvements to land, unsevered natural products of land, and water and airspace superjacent to land.[3] An intangible interest in such property is real property for the purposes of §1031.[4]

Note: The TCJA limited eligibility for §1031 deferrals to sales and exchanges of real property generally applicable to post-2017 exchanges.

2 PLR 202309007

3 Treas. Regs. §1.1031(a)-3(a)(1)

4 Treas. Regs. §1.1031(a)-3(a)(5)

No checkered flag from the IRS on advertising expenses — A taxpayer who was an attorney and a race car driver was denied advertising expense deductions for tax years 2008–2013 relating to his racing activity.[5] The taxpayer was a Colorado personal injury attorney who began racing cars after moving to Indiana. He maintained his Colorado practice while living in Indiana and claimed that a small decal next to his name on two windows of his racing car advertised that practice. However, the Tax Court noted that he mostly raced on tracks in the Midwest and East Coast, and questioned how this would help his Denver-based practice. The court also pointed out that if car racing were a valuable form of advertising, the taxpayer would have increased the activity or at least maintained it; however, the taxpayer acknowledged that after he moved back to Colorado in 2010, his race car "mostly sat in the garage."

5 *Avery v. Comm.*, TCM 2023-18

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Online is forever — A taxpayer's blog posts were able to be admitted as evidence for the purposes of reviewing her innocent spouse claim.[6] The Tax Court is only required to consider:[7]

- The administrative record established at the time of the determination; and
- Any additional newly discovered or previously unavailable evidence.

The IRS proposed to introduce the blog posts as evidence at the trial, but the taxpayer argued that the should be stricken from evidence because they were not previously unavailable since they were publicly posted online years before, which meant the IRS should have discovered them earlier had they exercised reasonable diligence. The IRS argued that it has only "newly discovered" the posts after the administrative record had been established. The court agreed with the IRS, concluding that the ordinary meaning of "newly discovered" is "recently obtained sight or knowledge of, for the first time."

6 ***Thomas v. Comm.*** (February 13, 2023) 160 T.C. 4

7 IRC §6015(e)(7)

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