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CPE NETWORK TAX REPORT

JANUARY 2022 VOLUME 35, ISSUE 1

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- Underfunding of IRS
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EXECUTIVE SUMMARY

PART 1. CURRENT DEVELOPMENTS

Tax is a dynamic field with constant changes and updates from the Internal Revenue Service, Congress, and the courts. This material highlights some of those updates and changes that have occurred since the last program.

Learning Objective: Upon completion of this segment, the user should be able to analyze current issues in taxation, including analyzing FBAR penalties for failure to report, determining the tax offsets when an offer in compromise is accepted, and assessing the period for the IRS to recover an erroneous refund.
[*Running time 31:44*]

PART 2. INDIVIDUAL TAXATION

The §121 exclusion allows the nonrecognition of gains on the sale of a personal residence of up to $250,000 ($500,000 MFJ). This provision may also be used for certain partial exclusions if the requirements are not fully met. Practitioners should be aware of the nuances of the rules when advising clients that may be considering a sale or exchange of a personal residence.

Learning Objective: Upon completion of this segment, the user should be able to analyze aspects of the IRC Section 121 exclusion on the sale of a personal residence, including applying the requirements of a qualifying sale or exchange, determining the amount of exclusion, and evaluating the reporting requirements. [*Running time 34:28*]

PART 3. BUSINESS TAXATION

The number of IRS audits has decreased. However, when business clients are involved in audits, it can be stressful for both the client and the practitioner. This material addresses some aspects of both small business and corporate audits including the types of audits, frequency of audits, some common audit issues, Schedule UTP, and eggshell audits.

Learning Objective: Upon completion of this segment, the user should be able to analyze aspects of small business and corporate audits, including assessing the use of DIF and UI-DIF scoring, describing the use of Schedule UTP, and analyzing eggshell audits.
[*Running time 33:30*]

ABOUT THE SPEAKERS

Ian J. Redpath, JD, LLM, is a nationally recognized tax attorney and consultant from Buffalo, New York and is a principal in the Redpath Law Offices. Mr. Redpath has published numerous articles on contemporary tax issues and co-authored several books on tax topics. He has extensive national and international experience in developing, writing, and presenting professional CPE programs. In addition to his active tax practice, he serves as Chairman of the Department of Accounting and Director of Graduate Accounting Programs as well as Professor of Taxation and Forensic Accounting at Canisius College in Buffalo.

Robert C. Lickwar, CPA is a tax partner with the accounting firm of UHY LLP in Farmington, Connecticut. Mr. Lickwar has more than 30 years' experience in public practice and has worked exclusively with privately held businesses and owners to provide compliance services and sophisticated tax planning strategies, including like-kind exchanges, tax-efficient workouts and restructurings, reorganizations, and estate planning services. He is also a nationally recognized presenter on many federal, state, and local tax issues.

Shiny Rachel Mathew, CPA, JD, is a Tax Attorney, Accountant, Business Owner, Best-Selling Author, Public Speaker, and Oklahoma Bar Association Tax Section Chair. She co-owns and manages a nationwide tax firm with over 100 employees across eight states. She loves making the topics of tax policy, tax strategy, tax administration, tax cases, and tax law easy to understand for all. Shiny has been working in the field of taxes and accounting since 1999. She continues to serve through education and has spoken hundreds of times to audiences across the country.

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	Basic Tax professional experience
	Basic Governmental professional experience
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PART 1. CURRENT DEVELOPMENTS

Experts' Forum

This month we join Ian Redpath for Experts' Forum, a popular feature in which we review recent developments in taxation. We begin with a discussion about a Fifth Circuit Court of Appeals case in which the IRS assessed penalties related to FBAR reporting.

Let's join Ian.

A. *U.S. v. Bittner*

CA5

Mr. Redpath

Hi, everybody, I'm Ian Redpath. Welcome to the program. This is the segment where we go over some of the things that have happened since the last time we spoke, with the IRS, the courts, and get an update as to some of the interesting things that have happened. So let's kind of jump right in and start off with a Fifth Circuit Court of Appeals case called Bittner, B-I-T-T-N-E-R. And this was really interesting because in the Bitner case, the IRS assessed penalties for FBAR reporting. The question here is, how does that penalty apply? Because Bittner had a number of different accounts. The IRS came in, and the IRS assessed the FBAR penalties for each account that they had and said the penalty applies for any accounts with an aggregate value of more than $10,000.

Now, the problem is the Ninth Circuit Court of Appeals—now, remember this is the Fifth Circuit—the Ninth Circuit Court of Appeals has held that the $10,000 nonwillful failure to file an FBAR penalty applies per FBAR, not per financial account. And so it doesn't matter how many accounts are on the FBAR, the penalty applies to the FBAR itself. And that, again, relates to the nonwillful FBAR penalty. So again, per form, not per account. Now, that Ninth Circuit Court of Appeals case is a new case; it is a 2021 case. So, the Ninth Circuit Court of Appeals looked at it and said, per FBAR.

The IRS said, no, no, no, no, the penalty goes per account that's listed on the FBAR, which in this particular case is rather significant. They had 25 or more, 25 known foreign financial accounts that were required to be reported. One FBAR, 25 FBARs. Penalty on 25 or penalty on one FBAR? Rather significant. So the IRS came in, and the IRS assessed $2.72 million in penalties versus $10,000. Rather significant issue for the taxpayer. So the taxpayer obviously argued that the FBAR reporting requirement is per FBAR; it has nothing to do with the number of accounts that you have. It's a penalty for failing to disclose on the return, the FBAR return.

He tried to say reasonable cause. They didn't buy that, that the accountant screwed up. Typical, right? Everybody wants to blame the accountant for a problem. So, they didn't go with reasonable cause. So the only question was, for the years in question, did they have to report or penalize on each of the returns, each of the accounts that should have been reported on the FBAR?

And what happened is that the Fifth Circuit disagrees with the Ninth Circuit; and the Fifth Circuit in this case said that the penalty is per reportable account. In other words, if you have to report that account on an FBAR, the penalty applies to each account. They also said that Section 5314 of the code doesn't create the obligation to file an FBAR. It gives the secretary the authority to regulate how to comply with the requirement to report the accounts. Therefore, the penalty applies per account.

Is the Supreme Court going to step in? Is this going to be appealed to the Supreme Court? There are some significant dollars here. So, we're going to wait and see what happens with this. As we enter the 2021 filing season, filing our 2021 tax returns, this is something that's really important as we talk to our clients who may have reporting requirements with FBARs. Significant, significant question to be addressed; and in circuits that haven't addressed the question, now we've got a split in the circuits. So, you need to talk with the client and say, here's the authority. Make sure that we report; on the safe side, make sure we report all of the accounts, and make sure the client understands the importance of reporting all of the accounts. So, a warning here for our clients as we go into the 2021 filing season.

B. Revenue Ruling 2021-20

Revenue Ruling 2021-20. It may not have an implication, but it may have implications for clients who are invested in low-income housing, so this discusses the 4% floor that applies. Section 42(b(3) was added to the code by the Taxpayer Certainty and Disaster Tax Relief of 2020 and it provided for a minimum 4% credit for buildings that don't qualify for the 9% floor that are placed in service after December 31st of 2020. So, for our purposes, placed in service in 2021. What this does is the revenue ruling says that we're looking at the application, so any building that receives an allocation of a housing credit dollar amount after December 31st and any building or any portion of which is financed by tax-exempt bonds issued after 2020, the effective date. However, there became issues as to when was it taken out? Bonds issued pursuant to a drawdown loan? As part of a single issue? If the bonds were in place in 2020, but amounts exceeded the lesser of the $50,000 or 5% issue price? Basically, what happens here is this revenue ruling sets out three scenarios. And so, if you have clients with low-income housing and the issue is does this 4% floor apply because the 9% floor doesn't apply, then I would refer you to this revenue ruling because it goes over three basic scenarios dealing with the 2020 rule.

C. SBSE-05-1021-0063, Interim Guidance on Refund Recoupments

We have some interim guidance, SBSE-05-1021-0063. We have interim guidance on refund recoupments And this is an internal memo, as these are. The acting director of the collection policy announced that the IRS is revising its policy of offsetting taxpayer refunds in an offer in compromise situation. And so, if you have a client in an offer in compromise situation or you're considering this, pay attention to this one because it does significantly change the policy. Currently, the Internal Revenue Service manual provides that overpayments can be used to offset the taxpayer's outstanding tax liabilities for periods that extend through the calendar year in which the offer in compromise is accepted. That's the current Internal Revenue Manual prior to the revision. Beginning on November 1, 2021, so now in place, the IRS is no longer going to offset taxpayer refunds for periods that are included in the offer in compromise, so they won't offset any tax during the period. Now, if you've done offer in compromise, you know it's not unusual because you know you have to continue to be current in your taxes. And so, it's not unusual that the IRS will use any refunds and apply it against those taxes that you're seeking to compromise. Benefits the government. They're no longer able to do that. And so, they're also going to revise—and it's in process now—Form 656, the offer in compromise form. They're in the process of revising it to reflect this change. So, this guidance is temporary. It is in effect from November 1 of 2021, and it expires October 28th of 2023. So, it's a temporary revision of what is in the Internal Revenue Manual.

D. *Hadsell v. U.S.*

DC CA

So we have an interesting case, Hadsell (H-A-D-S-E-L-L); it's from the District Court, the Northern District of California. And this is something that I think we take for granted. You know, we don't even really think about it. But it could have potential implications for some clients who have potential offsets against their taxes, their refunds.

So, Hadsell files a 2016 return. Hadsell says I have a refund due of $9,547; I want that applied to my 2017 taxes. Right on the 1040, right? I'm going to have that applied to my taxes for next year. Very common, right? We see that all the time. That is actually referred to as the credit election. And those amounts are the credit election funds. That's a term that we don't usually use;

but it's called a credit election, and the credit election funds, that $9,547. So, Hadsell files his 2017 tax return, has applied that against the taxes due. Files the 2018 tax return. And assuming that everything has been paid, and as we move forward, waits. And in July of 2018, the IRS gives a notification, says you owe us money.

And now, Hadsell finds out that they applied the 2016 refund, the amount that he had elected to carry forward to 2017. Now they're saying, "Oh no. We're applying that to offset your child support obligations from the State of California."

Well, there's an argument here, did they have proper notice from the State of California? That's not really the issue that we need to deal with right now. The real issue for this is now the court is saying, "Well, when can that election be binding? When can the IRS come in and can they actually do an offset?" Hadsell says, "You know what? When I filed my 2017 tax return and I applied that against my taxes, that's it. I mean, you can't come back to me later and say, 'Oh no, no, we're not accepting that,' and assess additional tax. I mean, I should be able to rely on that."

It makes sense, right? Common sense? No, no, no. IRS says "No. We essentially have three years in which to assess tax on the return; and therefore, within that period of time, we can take those funds, that refund, and offset it against your child support obligation. We can offset it against other offsets that are available." So, the court looked at this and the court said, "Well, okay. What's the law? How do we look at this?" And they weren't persuaded by Hadsell saying when I filed my 2017 and applied it to my taxes.

So 2016, I said, "Take this amount and apply it to my next year's taxes." That's what I said on my 1040 in 2016. In 2017, I applied that as a prepayment of my taxes, an estimated tax, filed my taxes. In 2018, I have filed my taxes. And now, you're coming back and saying I still owe from 2016, and penalties and interest, and that you applied it differently. And I'm finding out in 2018. Well, the question is, is that within the three years? Well, yes, it is. Therefore, according to this district court, the IRS had the right to make that offset, even though they made the credit election by putting it on the 1040 in 2016; in 2017, they applied it as an estimated payment, reduced their tax liability by it. 2018, they've been relying on this for, again, any refund carryover to 2018. And now, all of a sudden, you're assessing me taxes for 2017 and 2018. That's just not fair, because now you just suddenly decide not to apply it, but to offset it.

The court said, "Yes, they have the absolute right to do that." So, this is something I don't think we really think about. You know, if your client has potential offsets, you know those can be open for the entire statute, for the entire limitations period that the IRS has to assess. So, keep that in mind. Interesting case, really interesting case.

E. Notice 2021-64

We have Notice 2021-64. This really involves amendments, and it goes through amendments under 401 and 403B plans to be qualified. There were certain remedial amendments that have to be made, and some can be retroactive. But what this does is list the remedial amendments, and that's statutory and regulatory changes in the plan that have to be made. And it's broken into two parts. Part A covers the requirements that would be required on amendment to the plan; and Part B includes requirements that the IRS anticipates will not require amendments to the plans but might require amendments to some plans because of some unusual provision.

And so what this does is give a list of requirements for changes in the plan that were created by the American Rescue Plan Act.… If in fact, the American Rescue Plan potentially made changes to an existing plan, you might want to look at this because this really details what you need to change and what you might want to change.

F. Revenue Procedure 2021-53

We also have some guidance, Rev. Proc. 2021-53; and you know, if you have clients that are engaged and invested in REITs or RICs, it provides temporary guidance on cash and stock distributions by publicly offered REITs and RICs. Again, it temporarily reduces the minimum aggregate amount of cash that the distributing shareholders can receive to not less than 10% of the total distribution for Section 301 to apply to the distribution and creates a safe harbor. So, you might want to look at that.

G. ABA Letter to IRS Commissioner Rettig

The ABA, in a letter to the Commissioner, very interestingly, they are highly recommending that professional corporations be included in the consolidated return rules so that you could have a series of related affiliated corporations, professional corporations, that could file consolidated returns. Very interesting, very interesting approach. One of the reasons they said that is that there's a proliferation of professional corporations basically brought on by COVID, that the telehealth industry has created a lot of related corporations for professionals, especially doctors. Health care professionals have set up related corporations. And you have this consolidated return election; obviously, it's irrevocable, but what they're saying is these should be added. Professional corporations should be added to the list so that they can file consolidated returns. This is the ABA, the American Bar Association; but it's also supported by others. For example, KPMG's National Office has supported a similar thing. And it gives several alternative rules, but very interesting.

H. Private Letter Ruling 2021-47015

We have Private Letter Ruling 2021-47015. This was an interesting one because the IRS waived the 60-day rollover requirement because the taxpayer's failure was due to an error by the financial institution. They deposited the amount into a traditional IRA rather than the Roth, and so it didn't qualify for the rollover. They said, "We're going to give you additional time because yes, your financial institution screwed up."

I. IRS Publication 5186

Now, some of our viewers out there are not CPAs but are enrolled agents. So, I want to bring to your attention that Publication 5186 has been revised. And Publication 5186 is a great resource now for the enrolled agents; and it determines when and gives guidance on when you need to enroll, when you need to renew your enrollment. It's based on the last digit of your Social Security number. It also details again how your continuing education requirements—again, based on the last digit of the enrolled agent's Social Security number—remember that it has to be renewed. The EA has to renew their status every three years based upon that last digit. The IRS also has a web page maintaining your enrolled agent status; and that is on the IRS web page, www.IRS.gov. Again, I would refer you to that if you are an enrolled agent. It's a great resource. The IRS has done a very good job in that case.

J. *Sauter v. Commissioner*

CA5

We have kind of an interesting case, Sauter, S-A-U-T-E-R, Fifth Circuit Court of Appeals. It's an unpublished opinion. Sauter keeps taking some unusual positions because he's always coming up with and taking the IRS to court on some unusual positions. In this case, they just upheld the penalty for making a frivolous argument, a $2,500 penalty. Sauter tried to argue that his income from his engineering design work was not taxable income. And the reason is, he says, Section 7701A26 says that a trade or business, including the performance of the functions of public office; and so, therefore, that excludes his business. The IRS said, "No. When you say 'including' does not mean it excludes everything else. Those are two different words, 'include' and 'exclude.'" Interestingly enough, he made almost the identical argument on a prior return. So, this isn't new; and he appealed that and lost. So, he keeps using the same argument, keeps appealing it. He gets penalized for a frivolous argument. He appeals it, and he loses. So, kind of an interesting case there.

K. *Blommer v. Commissioner*

CA9

There's an interesting case; it's the Blommer versus the Commissioner. In Blommer versus the Commissioner, Ninth Circuit Court of Appeals, what happened here is the question is jurisdiction. And the Tax Court dismissed the petition because the petition that was filed was filed untimely. Basically, they said 90 days is 90 days. Therefore, it doesn't matter if you have an equitable argument, 90 days is 90 days. Your petition's filed late.

Now, last month, we talked about the fact that there are some cases right now going through, not directly on the filing of the petition, but dealing with these statutory deadlines. Is there a potential of an equitable argument? And so, while this case clearly says no, last month we talked about maybe, maybe there's some light at the end of the tunnel. But right now, 90 days is 90 days, and that case was thrown out.

L. *Sand Investment Co., LLC v. Commissioner*

Then we have Sand versus the Commissioner. It's a Tax Court case. Interesting case because what happened was you're having a TEFRA partnership audit. They impose penalties on the underpayments relating to the partnership's disallowed charitable contributions. The manager has to sign off. So, the revenue agent proposes the penalties. The manager signs off. Everything's fine, right? Well, Code Section 6751B requires the immediate supervisor to sign off. But what happened here, interesting argument is they said, wait a second. During the entire term of the audit, there was manager 1. But at the time that the audit was concluded, there was a new manager. Well, who is the immediate supervisor? Is that signature of manager 1 who was essentially the manager for the entire audit—is that what's required, or does immediate supervisor mean the person who supervised the audit? Or could it be either one? Basically, what the court said here is that the partnership's objection that manager 2, not manager 1, was that immediate supervisor wasn't availing.

Basically, the entire audit was work that was under manager 1. That was all the relevant work. And that person clearly qualified as an immediate supervisor. Also, manager 2 could have qualified as an immediate supervisor. And so, either one could have qualified as the immediate supervisor in this particular case.

M. *U.S. v. Page*

DC AZ

Now we have another interesting case called Page. Page is in a district court for Arizona. The district court, they dismissed as untimely the IRS's attempt to recover $491,000 of an erroneous refund. They filed it more than two years after "making the refund." So, the question became when does the statute start? The Ninth Circuit, which includes Arizona, says that it's binding. The refund is made on the date the taxpayer received the refund. Now, you know, we have to look at this because there's a split [between] the ninth and the seventh. The Seventh Circuit says that the refund is made on the date the check clears the Federal Reserve and the payment to the taxpayer is authorized by the Treasury. So, two different dates, which could be significant here. When did you get it? When did it clear the Federal Reserve?

Page gets a check on May 5th of 2017 but doesn't cash it until April 5th of 2018. The IRS doesn't file suit until March 31 of 2020. So, they filed suit to collect it. The government argued that the complaint was timely because the statute began to run on April 5th [2018], the date they cashed the check, they deposited the check. The District Court, again following the precedent of the Ninth Circuit, said no, it's when they received it. Well, there's no exact evidence as to when they received the check. The IRS sent the check on May 5th [2017]. It was deposited on April 5th of the following year, 2018. So, what's the start of the two-year date?

Well, the court looked at it and said following the precedent that no, it would be the date that it was received. However, we don't exactly know that date. But the IRS said clearly that date was not over a year later; it wasn't over a year later, it was at least within a reasonable time. And so, they rejected the argument and said, you have a record of when you sent it, you have some certainty that it is within two years at least of the date you sent the check. And so, therefore, that is the date. There's kind of a general rule that the IRS uses that it's seven days after something is mailed. And they said it's not the clearance date. So, two different rules applying in two different circuit courts, so we have to really watch out for that.

I want to thank you for joining me today. Please be safe. Thanks for joining me, and I'll see you next month.

Current Material: Experts' Forum

By Ian J. Redpath, JD, LLM

A. *U.S. v. Bittner*

CA5

The Fifth Circuit Court of Appeals upheld a District Court decision holding that, for purposes of the FBAR penalty, each failure to report a qualifying foreign account is a separate reporting violation. The Ninth Circuit has held that the penalty applies per FBAR, not per account to be reported on the FBAR.

A U.S. person who fails to report a reportable account by filing an FBAR may be subject to a penalty. The amount of the penalty depends on whether the violation was willful or nonwillful. The maximum penalty for a nonwillful violation of the reporting requirements in §5314 is $10,000 (adjusted for inflation for violations after 2015) unless there is "reasonable cause" for the failure to comply. [31 USC §5321(a)(5)(B)(i)]

The Court of Appeals for the Ninth Circuit (CA9) has held that the $10,000 nonwillful failure to file an FBAR penalty applies per FBAR, not per financial account (e.g., bank account) required to be reported on the form. This CA9 ruling aligns with all district court rulings concerning this issue.

Bittner, a naturalized U.S. citizen, returned to his native Romania in 1990. Bittner was unaware that, as a U.S. citizen, he had to report his interests in certain foreign accounts; so, he never filed FBARs while he lived in Romania. When he returned to the U.S. in 2011, he hired a CPA to prepare his outstanding FBARs. These original FBARs were deficient in that they failed to report 25 or more foreign financial accounts, so he hired a new CPA who filed corrected FBARs. The IRS assessed penalties of $2.72 million in nonwillful FBAR penalties—$10,000 for each unreported account. When the IRS sued to collect, Bittner defended by claiming reasonable cause and also that the penalty applied per FBAR.

The district court rejected Bittner's reasonable cause defense, but held that the maximum penalty applied per annual FBAR, not per reportable account. On appeal, the Fifth Circuit (CA5) reversed the district court, holding that FBAR penalties apply per reportable foreign financial account, not per annual FBAR. The decision rested on what constitutes a "violation" of §5314. According to the court, the "text, structure, history and purposes of the statutory and regulatory provisions" show that the "violation" of §5314 that is subject to the FBAR penalty is the failure to report a reportable account, not the failure to file an FBAR. Section 5314 does not create the obligation to file an FBAR; instead, it gives the Treasury Secretary the authority to regulate how to comply with the requirement to report reportable accounts.

B. Revenue Ruling 2021-20

In this revenue ruling, the IRS discusses when the 4% floor applies for the low-income housing credit. It provides three scenarios involving low-income housing financing. In all three situations, the 4% floor does not apply as post-2020 financing was de minimis.

Section 42(b)(3), added to the Code by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), provides a minimum 4% credit rate (4% floor) for buildings to which the 9% floor does not apply and that are placed in service after December 31, 2020. It applies to:

(1) any building that receives an allocation of housing credit dollar amount after December 31, 2020, and

(2) any building any portion of which is financed by tax-exempt bonds issued after December 31, 2020.

The IRS's ruling covers the following three situations in which buildings were financed with tax-exempt bonds or low-income housing tax credit allocations:

1. Does the minimum 4% floor apply to Building 1, which was financed in part with a draw-down tax-exempt bond that was issued in 2020 and on which one or more draws are taken after December 31, 2020?

The 4% floor does not apply because Reg. §1.150-1(c)(4)(i) treats bonds issued pursuant to a draw-down loan as part of a single issue. Thus, the issue date of the bonds was in 2020 because the amounts drawn exceeded the lesser of $50,000 or 5% of the issue price. The date of issue did not change because of a subsequent draw after 2020.

2. Does the 4% floor apply to Building 2, which was financed in part with proceeds of a tax-exempt bond that was issued in 2020 and in part with proceeds of a different tax-exempt bond that was issued in a de minimis amount after December 31, 2020?

   The 4% floor does not apply because this building's post-2020 de minimis bond issue satisfied the effective date requirement in §42(b)(3).

3. Does the 4% floor apply to Building 3, which received a housing credit dollar allocation in 2020 and a de minimis additional allocation after December 31, 2020?

   The 4% floor does not apply to this building because the principles that govern de minimis amounts of bonds apply equally to de minimis allocations.

C. SBSE-05-1021-0063, Interim Guidance on Refund Recoupments

In an internal memo, the IRS's Acting Director of Collection Policy announced that the IRS is revising its policy of offsetting taxpayer refunds after an offer in compromise has been accepted. This guidance is effective November 1, 2021 and expires on October 28, 2023.

Currently, the Internal Revenue Manual (IRM) provides that taxpayer refunds for tax overpayments should offset the taxpayer's outstanding tax liability for tax periods extending through the calendar year in which the taxpayer's OIC is ***accepted***. Beginning with OICs accepted on or after November 1, 2021, the IRS will no longer offset a taxpayer's refunds for tax periods ***included*** in the taxpayer's Form 656, *Offer in Compromise*. However, offsets of refunds for nontax debts will continue to occur before the OIC is accepted and for tax debts not included in the taxpayer's OIC. Form 656 will be updated to remove the refund offset requirement after the offer acceptance date.

D. *Hadsell v. U.S.*

DC CA

A magistrate judge denied the taxpayer's motion for summary judgment on his §7433 damage claim. He alleged that the IRS acted negligently under §6402 by offsetting his "credit election funds" against purported past-due child support obligations without any basis for doing so. Taxpayer's underlying theories, that IRS never received proper notice from state authority certifying his alleged past-due child support or that IRS's offsets were untimely in any event, were made after his credit elections were irrevocable and were rejected.

The issues regarding the status and nature of child support obligations were beyond the scope of review in a §7433 claim. The taxpayer's theory of credit election irrevocability was based on misreading of §6513.

Mr. Hadsell timely filed an income tax return for the tax year 2016 and reported an overpayment of $9,547. He indicated on the Form 1040 that the overpayment was to be applied to his 2017 liability. According to Mr. Hadsell's allegations, the IRS did not notify him until July 9, 2018 that it did not apply the credit election made in his 2016 tax return and instead treated his overpayment as a refund subject to offset. He contends the election should have been deemed paid against his 2017 tax liabilities and any deficiencies in his 2017 and 2018 tax returns are the result of the IRS's failure to honor his 2016 credit election. The government maintains that the subject offsets were mandated by §6402(c) for past-due child support payments.

The taxpayer's reported overpayment is subject to an assessment; and the IRS has three years from the filing of the return to make an assessment. [§6501(a)] This is consistent with the government's contention that language in §6402(a) providing that "the Secretary, *within the applicable period of limitations*, may credit the amount of such overpayment," is commensurate with the three-year assessment period. The regulations promulgated under §6402(b) provide that notwithstanding a taxpayer's credit election, the IRS "within the applicable period of limitations" may credit an overpayment of income tax against tax and non-tax debts in order of priority, including past-due support assigned to a state and past-due support not assigned to a state. [§301.6402-3(a)(6)] Thus, the election is not binding until the period of assessment for the return expires.

E. Notice 2021-64

The IRS has issued the 2021 Required Amendments list. The Required Amendments list establishes the end of the remedial amendment period and the plan amendment deadline for changes in qualification requirements for individually designed plans qualified under §§401 or 403(b).

To be a "qualified plan," a plan must comply with certain statutory and regulatory requirements. When those requirements change, a qualified plan has a "remedial amendment period" during which the plan may be amended retroactively to comply with the new qualification requirements. Reg. §1.401(b)-1 describes the provisions that may be amended retroactively and the remedial amendment period during which retroactive amendments may be adopted.

Generally, the Remedial Amendments (RA) list includes statutory and regulatory changes in plan requirements that are first effective during the plan year in which the list is published. The RA list is divided into two parts:

1. Part A contains one plan requirement change. This plan requirement change affects plans that participate in the special financial assistance program for financially troubled multiemployer plans created by the American Rescue Plan Act of 2021, and

2. Part B does not contain any changes that may require a plan amendment.

F. Revenue Procedure 2021-53

The IRS has issued a revenue procedure that provides temporary guidance on cash and stock distributions by publicly offered REITs and RICs. This guidance temporarily reduces the minimum required aggregate amount of cash that distributee shareholders may receive to not less than 10% of the total distribution for §301 to apply to such distribution. The revenue procedure temporarily reduces the minimum cash limitation percentage of any distribution to 10% of the total distribution thus modifying the safe harbor in Rev. Proc. 2017-45, 2017-35 IRB 216. This temporary modification is effective with respect to distributions declared by a publicly offered REIT or publicly offered RIC on or after November 1, 2021 and on or before June 30, 2022.

G. ABA Letter to IRS Commissioner Rettig

The American Bar Association (ABA) Tax Section wrote a letter to IRS Commissioner Chuck Rettig on November 18, 2021 asking the IRS to issue a revenue ruling and a revenue procedure addressing when professional corporations are includible in an affiliated group for consolidated return purposes, stressing the need for urgency as professional corporations become more commonplace. A proliferation of professional corporations has been spurred by COVID-19, according to the ABA's letter, which cites the growing telehealth industry. Without IRS action, the ABA says, there will continue to be uncertainty regarding which professional corporations are members of an affiliated group that must be included in its consolidated returns. Because the consolidated return election is irrevocable, each return could be invalidated if each member is not accurately accounted for.

The ABA offered two approaches for crafting the revenue procedure:

- "Alternative 1" would apply the revenue ruling on a prospective basis to protect taxpayers from potentially invalidated returns.

- "Alternative 2" would give taxpayers the option to either conform with the revenue ruling on a prospective basis or be grandfathered in if previously taken action is inconsistent with the guidance.

H. Private Letter Ruling 2021-47015

The IRS waived the 60-day rollover requirement where taxpayer's failure to timely roll over funds was due to error by his financial institution which deposited stated amount into traditional IRA rather than Roth IRA. So, taxpayer was granted 60-day extension from date the PLR was issued to contribute stated amount into Roth IRA, which would be considered a rollover contribution provided all other requirements of §402(c)(3) were met.

I. IRS Publication 5186

The IRS has produced Publication 5186 (Do you know when to renew your enrollment) to help enrolled agents determine when they need to renew their enrollment based on the last digit of their Social Security number. The publication also details how much continuing education an enrolled agent needs to complete, again based on the last digit of the agent's Social Security number. Remember, EAs must renew their status every three years based on the last digit of their SSN.

J. *Sauter v. Commissioner*

CA5

In an unpublished opinion, the Fifth Circuit rejected an individual's argument that compensation he received for engineering design work was not income. The Appeals Court also upheld the Tax Court's decision to impose a $2500 penalty on the individual for making frivolous arguments. This was the second time the taxpayer had used a similar argument.

Sauter claimed that $85,000 he received as compensation for his engineering design work was not gross income because §7701(a)(26) defines a "trade or business" as "including the performance of the functions of a public office." Sauter claimed that this definition of trade or business necessarily excluded from income his compensation for an engineering design.

The Court noted that §61 is clear that "gross income" is all income from whatever source derived, which includes compensation for services. It noted that "when used in a definition, the words 'includes' and 'including' do not exclude other things otherwise included in the meaning of the term defined."

K. *Blommer v. Commissioner*

CA9

The Court found that the Tax Court properly dismissed taxpayer's deficiency petition as untimely filed. The Tax Court had concluded that it lacked jurisdiction over Blommer's petition because the petition was untimely. [*Scar v. Comm'r*, 814 F.3d 1363, 1366 (9th Cir. 1987] The Tax Court may exercise its jurisdiction only when the IRS issues a notice of deficiency and the taxpayer files a timely notice for redetermination. [*Wilson v. Comm'r*, 41 AFTR 2d 78-438 (9th Cir. 1977] The 90-day period for petitioning the Tax Court commences on the date of mailing the notice of deficiency.

L. *Sand Investment Co., LLC v. Commissioner*

This case involves the imposition of penalties in a TEFRA partnership case. The question is whether the IRS complied with §6751(b) when imposing various accuracy-related penalties on underpayments relating to the partnership's disallowed charitable deduction. The Tax Court determined that the revenue agent who was originally supervised by team manager 1 at the start of partnership exam, but who was transferred to new team manager 2 while partnership exam was ongoing, had manager 1 as her "immediate supervisor" for the section's purposes. As such, because manager 1 timely approved agent's initial penalty determination before the final partnership administrative adjustment (FPAA) was issued, the Code section was satisfied. The partnership's objection that manager 2, not 1, was agent's immediate supervisor was not persuasive in that, when considering the ordinary meaning of "immediate supervisor" plus the facts that the relevant work on which agent was being supervised involved partnership exam and that manager 1 was the individual overseeing that exam, it was clear that manager 1 vs. 2 was "immediate supervisor." The fact that manager 2 later signed the penalty approval form did not change the result.

M. *U.S. v. Page*

DC AZ

A district court in Arizona dismissed as untimely the IRS's attempt to recover a $490,000 erroneous refund. The government filed its suit more than two years after "making the refund."

Under §7405, the government may recover an erroneous refund only if it files suit within two years after "making of such refund." Precedent in the Ninth Circuit holds that a refund is "made" on the date the taxpayer received the refund check. [*Carter*, (CA9 1990) 66 AFTR 2d 90-5293] There is, however, a split between the Ninth and the Seventh circuits on this issue. Under Seventh Circuit precedent, a refund is "made" on the date the check clears the Federal Reserve and payment to the taxpayer is authorized by the Treasury. [*Greene-Thapedi*, (CA7 2005) 95 AFTR 2d 2005-1114]

In this case, the IRS sent Jeffrey S. Page a $490,000 refund check on May 5, 2017. Page cashed that check on April 5, 2018. The refund was erroneous and the IRS filed suit to recover it on March 31, 2020. The IRS's complaint did not allege or identify either the date on which Page received the erroneous refund check or the date that the check cleared the Federal Reserve. The IRS argued that the suit was timely because the statute of limitations began to run on April 5, 2018 when Page deposited the erroneous refund check.

The district court was not persuaded by the government's arguments. First, the government argued that its right to sue to recover the erroneous refund did not ripen until Page cashed the check because that is when the government considers the refund "complete." So, the statute of limitations did not begin to run until this same point in time. That conflicts with the Ninth Circuit precedent. Second, the government argued that relying on the check clearance date would provide more certainty in cases when the date the taxpayer received the check is unknown. The court also rejected this argument because the IRS has a record of when it sent the check and thus knows "with certainty" that it has two years from the date it sent the check to file an erroneous refund suit.

The district court rejected the government's attempt to distinguish *Carter* because *Carter* did not address the specific issue of this case, i.e., what happens when the IRS does not know when the taxpayer received the refund check. The court found that the government's argument in favor of the check clearance rule assumed that the erroneous refund check cleared the Federal Reserve on the date it was deposited. The court noted that while the check could have cleared the Federal Reserve on the date it was deposited, the government did not mention in its complaint the date the check cleared the Federal Reserve. So, it appeared to the court that the government was basing this argument on the date the taxpayer deposited the check while relying on case law stating that the check clearance date controls when the limitation's period begins to run. The court followed the Ninth Circuit precedent.

A. Discussion Problems

A new client, Ivan, has approached you about filing past-due FBARs. The client has multiple foreign accounts. You believe there is a strong possibility that the penalty for nonwillful failure to file will be assessed.

Your client, Jose, filed a tax return for 2019 that reported an overpayment. The client elected to have the overpayment applied to his 2020 tax liability. In filing his 2020 tax return, you treated the amount as an estimated tax payment. Jose just received a notice that the IRS offset the 2020 refund against his child support obligation. The IRS is now showing that Jose underpaid his taxes for 2020; they are demanding additional tax, penalties, and interest on the unpaid amount.

In December 2021, you filed an offer in compromise for a client, Janice. In preparing her 2021 tax return, you determine that a large refund is due.

Required:

1) Discuss the possible penalties that Ivan may be facing for nonwillful failure to file the FBARs.

2) Discuss the issues concerning Jose's tax credit election funds.

3) What will the IRS do with the 2021 overpayment?

B. Suggested Answers to Discussion Problems

1) There is a split in the circuits regarding the application of the nonwillful FBAR penalties for failure to report. The Fifth Circuit holds that the penalties apply per account to be reported on an FBAR while the Ninth Circuit holds that it is per FBAR regardless of the number of accounts. This can make a significant difference for Ivan. A determination needs to be made as to how to proceed in Ivan's circuit.

2) The IRS and courts have held that the credit election funds may be credited against tax and non-tax debts by the IRS any time before the applicable period for assessment or three years from filing of the return.

3) Since the offer in compromise was filed after November 1, 2021, the IRS will not offset the refund against any tax that is included in the offer in compromise.

PART 2. INDIVIDUAL TAXATION

Sale of a Residence

Dealing with the sale of a residence is not a simple process. IRC Section 121 allows a maximum gain exclusion of $250,000 for individuals or $500,000 for married taxpayers. With the advent of COVID, people are migrating away from the metropolitan areas. Home sale prices are sky-rocketing. We're seeing gains far in excess of the Section 121 exclusion. Ian Redpath and Bob Lickwar discuss the key factors that impact the tax treatment of gain from the sale of a residence, including how to determine basis, how to qualify for the Section 121 exclusion, when the two-year rule applies, and whether a reduced exclusion amount might be available.

Let's join Ian Redpath and Bob Lickwar as they discuss the sale of a residence.

Mr. Redpath

Bob, welcome to the program.

Mr. Lickwar

Hi, Ian. Thanks for having me. Glad to be here.

Mr. Redpath

Always great to have you here and to get your insight. This is something that sometimes seems like it should be simple, but it's really something practitioners see all the time, which is when someone sells their primary residence or even sells a residence. I often find there's a lot of confusion as to, well, okay, what's included? What are the costs of sale? What can I deduct? What can't I deduct? How do I determine my proceeds? And then we've got the 121 exclusion issues that can come up. Maybe you have a second marriage, you have a death and then a remarriage. There's all these issues that really do add a little complexity here.

Mr. Lickwar

Yes. There's no question about that, Ian; and of course our tax system, anytime we use the word simple only means it's complex. I mean, look at SIMPLE plans. This is becoming a bigger issue and I think an issue that people need to refresh themselves with, especially here, where I am in the Northeast, as people migrate away from the big cities, Ian. They're moving away from the metropolitan areas with the advent of COVID. The prices are going crazy. We're seeing gains that are far in excess of the half-million dollar exclusion. And we're seeing sales well within the two-year period. Can we use the reduced exclusion if we don't necessarily meet the two-year rule, because we know that we can only generally exclude one gain every two years?

Mr. Redpath

Yes. And the point you're making, I thought a great investment right now would be in U-Haul trucks, because if you're in the Northeast United States trying to get a U-Haul truck—I think if you're in Florida or Texas or some of the Sunbelt states, it's easy to get one—but if you're up in the Northeast United States for those, no, there's not a lot of U-Haul trucks available. And that's actually true. U-Haul said, "We don't have trucks available up here." So many people are renting trucks now to move to other locations.

So, as you said, this has become a really big issue. And the housing prices, the housing market nationally, it's rising. You mentioned Connecticut, I'm in New York, and housing prices have just skyrocketed. I know my wife said to me that we should downsize. And I said, "What you mean is we should upsize significantly in price." So, downsize? What does that mean anymore? Because it's like a car right now, right? You get a great price on yours, but can you get into something else? What is it going to cost you? And as you said, this exclusion is there, and it may not be covering everything today. One of the things I think is a confusion if you don't do this work to any great degree is a closing statement. You know that when the house closes, there's going to be a closing statement; but Bob, as a practitioner, what are you looking for on that closing statement so that you can determine the gain or loss that's been realized?

Mr. Lickwar

Normally, and I go through this with my younger staff all the time, it seems that many of them, for whatever reason, often have a difficulty starting with which column they're looking at, buyer or seller. What I'm normally looking at from the seller's perspective, Ian, are any types of cost that can reduce the gain from the disposition of the property. And what I'd be looking for is usually on page two. I'll see a line on page one of the return that says adjustments that don't favor the seller. But if I look at the backside of the closing statement, the HUD-1, we used to call them, I still call them a HUD-1. I'm always corrected. That's okay, I'm a dinosaur. They know what I'm getting at.

I'll look for the commissions paid to the broker. I'll also look at the conveyance taxes paid to the state or the town because here in the Northeast and most states, there are conveyance taxes or there's stamp taxes that are paid. I'll look for things like seller credits, because many times the sellers will give a credit, for example, for like a boiler that needs to be replaced, or there's windows that are broken that need to be replaced. Any of those types of items will be costs of sale, and they will increase my basis and/or reduce the gain on the potential sale of the property.

But I'll also be very careful to look for items that are left blank that say POC. POC means paid out of closing. And in many times, Ian, when you test the commissions that are paid, normally you're looking at 4, 5, or 6% of the sales price, and you may not get there. Something may say POC. You're going to want to always ask the question on those POC items. Sometimes the attorneys are paid outside of the closing. So, those attorneys' fees in getting the sale done will be deductible or reduce the… gain on the sale as well.

Mr. Redpath

You mentioned something earlier, and it depends on where you live. But for example, if you're in New York City, the transfer taxes can be significant on the transfer of real estate.

Mr. Lickwar

They're huge, Ian.

Mr. Redpath

And states. So, New York, you can have state transfer tax on that. That's paid at the time of the transfer. And also, you can have city, like New York City, transfer taxes on real estate. They can be really significant. I just want to say, let's say the real estate taxes, because you don't usually have a situation where the taxes are going to be paid on the day of closing, but you have to allocate the taxes daily. So the seller, maybe the seller has already paid the taxes for the year, but they can only deduct, as taxes, they can only deduct the taxes for the period that they actually owned the property, yet they paid all of it.

And likewise, maybe they paid none of it or part of it, but the buyer is paying the rest of the taxes. And that I think becomes a confusion because what you deduct on your 1040 as taxes is going to be the taxes, not that you paid, the taxes allocated to you. And that would appear on the closing statement, right? And so what do we need to do? What is the concern? So, if you're the seller and you have paid all of the tax for the year, you paid all of it, what is the concern as you're looking at it, because that's not what the closing statement's going to show, right?

Mr. Lickwar

That's correct. In Connecticut, Ian, we assess on October 1st of each year; and we assess, for example, on October 1st, 2021. The tax becomes due and payable in two installments. The first one is July 1st of the following year. The second is January 1st of the subsequent, subsequent year. So let's say that I sell my residence on September 30th. I've made my tax payment on July 1st, the preceding July 1st. So, that covers the six-month period between July and December.

I'll be reimbursed for one half of those taxes when I close. I will have to reduce the amount of my state tax, real estate tax deduction, by the amount that I'm reimbursed in closing. That is under, of course, the tax benefit rule. Okay, I've taken a deduction, I'm recovering the tax. Now, the tax benefit rule. But another interesting thing that our audience should be concerned with is from the buyer's perspective. Let's assume that I have to pay for those taxes, which I'm doing.

Those will be a tax deduction. No, the payments to the escrow account will not be; they're not deductible until the escrow agent actually disperses to the town. But an interesting thing that you often see is that sometimes the seller has back taxes, maybe from two to three years ago. And there's a misconception that the buyer will be allowed a deduction for those taxes paid. Well, I hate to tell you that any taxes that are not the current taxes are actually a cost of acquisition and will be added to the basis of the property and deductible at such time as you sell the property as an adjustment to the gain or loss.

Mr. Redpath

Another adjustment, Bob, as you mentioned, if the buyer is paying my portion of the tax as the seller, my portion of the tax that the buyer is paying is an adjustment to the proceeds. Now, I'm going to get a deduction. I'm going to get a deduction, but it is going to adjust. I have to add that to the proceeds that I'm getting. And again, if you just think about it, it's income to me, really; somebody else has paid an obligation of mine. It's almost like discharge of debt, right? They've discharged me of my debt, my tax debt. That's income to me. Well, how it's done is you need to adjust the purchase price to reflect that. What does the buyer do? Well, the buyer can't deduct the taxes, as you pointed out, that were for my time owning the property. So, the buyer's paid it. So, what is it? Well, they upped their basis by that. That has to be a basis adjustment.

Mr. Lickwar

And again, Ian, that's only for the older taxes. That's not for the current tax. The current tax, a reimbursement will merely reduce the current-year reduction, or if it was paid in a prior year, it would be other income to the extent there was a tax benefit received. But it's the older taxes, the taxes that are more than a year old, that's going to affect basis and proceeds respectively.

Mr. Redpath

One of the things that I always find when you have a house that someone's had for many years, and that house now has appreciated significantly. They're selling it, and you ask that question, "What's your basis in the house?" And you get that look. "Well, I paid…." Well, I know, but that's what you paid 30 years ago. What's happened since? And do you have any records? So, how do you address that with a client, Bob?

Mr. Lickwar

Well, most of the time, Ian, they can't even find the original acquisition cost. So I say, thank God for Zillow, right? I can just go on to Zillow and find out what it went for. No, I mean, the answer there, Ian, is a lot of times to get the original acquisition cost, you can head down to the local assessor's office or head to the town clerk's office and get a record of the original purchase price. If you don't have invoices to substantiate the new roof, the new kitchen, the IRS is probably going to say that you don't add anything to basis.

Now, that's the case in a lot of cases, Ian, but we all know that every practitioner is going to be their client's advocate here. And the use of estimates on tax returns is a common practice. So to the extent, Ian, that the client cannot substantiate those improvements, I think we're all making estimates of things that are done as long as they appear reasonable in the circumstances. A lot of this has been mitigated by the fact that up to a half million dollars in gain is excluded in qualifying circumstances. And I think that's the actual reason that the law was changed.

Many of our clients still think when you sell your residence, to be able to exclude the gain, you have to reinvest the proceeds in a new residence. That rule has been gone since 1997. So the half-million dollar exclusion really does help mitigate a lot. But if you have a client with a gain in excess of a half a million, it's a really fine line you're walking if the client cannot document or have documentation of their home improvement.

Mr. Redpath

You know, Bob, it's half a million, but that's assumed married or deemed married.

Mr. Lickwar

That's correct.

Mr. Redpath

The problem is what I see a lot, Bob, is I see an older person. They're selling their home now. Maybe they're moving somewhere else. They're moving to warmer climates from where I live. And no, we don't have any snow in Buffalo yet, just so you know, there's no snow yet. People sometimes think in Buffalo we get snow and then we get July 4th. So, there's nothing in between.

Mr. Lickwar

When the wind hits that lake, Ian.

Mr. Redpath

When it comes off the lake, and then they built the… The Bills have their stadium in the middle of the snow belt. That's on the TV all the time. But the fact of the matter is that you do have a lot of clients now who are single, they're widowed, but they've been maybe widowed for four or five years. Whether they're downsizing or they're now going to move into an assisted living, there's all these different potentials. So unfortunately now, you are potentially looking at a $250,000 exclusion. And when you look at it, "We bought the house in 1965, and now that house is… We bought it in 1965 for $35,000 or $30,000," which was a lot of money in those terms.

I think if you look at it, it's probably close to $200,000 in today's dollars, but you're selling it in today's dollars. And maybe that house is worth half a million; maybe it's worth even more. And all of a sudden, you have this huge gain and you're single, and you got the $250,000 exclusion. So, that's where I'm seeing a lot of issues with this exclusion. It sounds great when you say half a million dollars of gain, but in today's housing environment, I mean, are we going to have another housing crisis as we did in 2007, 2008, when all the prices crashed? Even those that crashed now have gone up in value. So, it's a significant issue, I think, to look at. And the other thing is, I've had clients say, "Oh, well, I had to paint the house. I put in some new landscaping to sell it. Don't I get to subtract that?" No.

Mr. Lickwar

That's the old fixing up expenses. Right, Ian?

Mr. Redpath

Right.

Mr. Lickwar

Yes. And you got to be really careful with those types of expenses because clearly improvements like adding a new kitchen or replacing the roof, at least the last roof you replaced, not every roof that you replaced, will add to the basis of the property, but those little things, Ian, like painting, or patching some holes where you held pictures, and things like that. Those are maintenance expenses. Those are actually repairs and maintenance expenses. And I think this is a great time to ask you, Ian, and I know you addressed this, in a widow situation where the house was purchased for $35,000, I'm sure you considered the fair market value at date of death of the other spouse. And if you're in a community property state, such as California, high taxes aren't really all what they're cooped up to be.

But at least in those community property states, you get a basis adjustment for the full fair market value of the property, not just the spouse's half. Another little thing, Ian, that I think people are unaware of and they probably want to forget are the repair and maintenance regulations under Section 263. And under Section 263, the repair and maintenance regs, everybody was gung-ho about getting to deduct the cost of a roof when they placed it on a building.

There was a little known provision in there that people aren't familiar with that basically says, if you do an improvement to a non-business property, like a residence, say you add a kitchen, and you do other work at the same time, like painting or other places, you can actually make an election under 263 to treat that as part of one project and capitalize the entire amount. I'm just curious as to how many people really even knew that's in there, or can remember it in the busyness of tax season.

Mr. Redpath

So, how do you make the election?

Mr. Lickwar

You basically just put it on your tax return. You put an election statement in, and you make sure you keep the records to substantiate it.

Mr. Redpath

But you have to make an election statement. You have to have a statement?

Mr. Lickwar

You do. You have to put an election statement in the return. Just basically copy the section of the reg and put it into your tax software. And that should be good.

Mr. Redpath

We've kind of danced around a little bit today in mentioning the $250,000 and $500,000 and the 121 exclusion. I want to say, your point about if someone has died to go back and say, okay, so what was the value? Because in a non-community property state, let's say you purchased it for $30,000, you got $15,000 your basis, but you get to step up the other half by half of the fair market value that was reported. Community property, you get to increase the whole value. You go right to fair market value. So, don't forget that if someone comes in and they had owned the property with a spouse, the spouse passed away, don't forget to adjust that basis. It's not $30,000 anymore. It's community property state, full fair market value, half the fair market value plus your $15,000 in that example.

Mr. Lickwar

Also, don't forget the two-year rule. Right?

Mr. Redpath

Right.

Mr. Lickwar

The two-year rule says, basically, you can use the half-million dollar exclusion if the spouse is able to sell within that two-year period of time.

Mr. Redpath

Exactly.

Mr. Lickwar

As you mentioned and appropriately mentioned, the problem is you're getting a good price for your residence now. In fact, I keep checking on Zillow every day as I hit close to 60 years old now to say, okay, my mortgage has been paid off for a while. Thank God for that. And I'm lucky to have been able to do that, but what am I going to find as far as inventory goes? I'm going to sell my house and then buy a condo that's going to cost me more. That's really the problem.

Mr. Redpath

Oh, it's like trying to get a car right now.

Mr. Lickwar

Or a dishwasher.

Mr. Redpath

Yes. Every week I get an email saying, we'd like to buy your car back. The one I just bought last December. So I stopped into the dealer and I said, "Seriously? This is what you're willing to pay, which is more than I paid for it in December?" He said, "Yes, except I can't get you into a new car. So, I will pay you that, but we can't get you another car. So, what do you want to do?" It's getting similar with housing these days. So with $250,000, $500,000, and you mentioned a two-year rule. What do you need to meet to qualify for the exclusion?

Mr. Lickwar

Well, Ian, in the case of a single-owned property, it's a two-in-five year rule. You have to have owned the property and used it as a principal residence for at least two of the last five years. That could be 730 days during a… Well, let me do the math really quick here, a 1,796-day period, unless it could be 97 if you hit two leap years in there. So 730 days.

And also if you're married, the ownership requirement can be met by just one spouse, but the use requirement needs to be met by both spouses. It's really a technical rule, but it's become more complicated in the last few years, and it's become complicated because people are spending time in multiple jurisdictions. For example, all of the snowbirds leave New York and they head down to Florida. They think because they have a Florida license plate on their car, that they're now Florida residents, but now they're going to sell the place up in Buffalo. And they're saying, "Well, I'm still a resident of New York." Well, are you really? And what will the IRS look at? The IRS will apply tests similar to those that the states would apply. Where are you getting your mail? Where do you vote? Where do you spend most of your time? What is truly your primary residence? I think this becomes a bigger and bigger issue with the snowbirds.

Mr. Redpath

And as you mentioned, one of the factors they look at. Where are your cars registered? Where's your driver's license from? They'll look, where are your bank accounts? Do you keep your bank accounts—and you used New York—do you keep your bank accounts in New York, or do you keep your bank accounts in Florida? If you're still working part-time, where are you working from? I'm working remotely, but it's still my New York business. Well, I don't care if you're working from Florida, you're working from home there, but it's still your New York-based business. And they'll even look at where's your family live.

So if all of your family still lives in New York or Connecticut, really? Your principal residence is in Florida? So yes, this is all of these. I actually had a case where an individual, the attempt was to make the person a Florida resident for state income tax and a Canadian residence for federal. Yes, I'm just going to say it was an interesting case, that one. When we tried to argue that one in appeals, it was an interesting case.

Mr. Lickwar

You didn't win, I'm taking?

Mr. Redpath

I'll prefer to defer that answer to another time. You can't win them all. By the way, the attorney and the accountant who put this together really did a very good job. It was just kind of, sometimes you're going to lose no matter how good a job you do. It was just a little too aggressive. I'll put it that way.

This two out of five, and they don't have to be the same period, right? Like the ownership period and the use period don't have to be the same. So, I could actually occupy it when I didn't own it. And that occupancy would count towards my two years. So it's two out of five to own, two out of five. Normally, they'd be the same period, but they don't have to be, right? They could be two different time periods in that five years.

Mr. Lickwar

Yes. For example, I can rent and then eventually buy.

Mr. Redpath

Exactly. It could also be a situation where you're not there because, for example, my mother, I put her in assisted living. Well, she's not living at home, but the home is still in her name. It's still her home, but she's not residing there. Well, okay. How long did she not reside there? Well, she met the two out of five years of ownership, and two out of five, even though, for a period of time, she was residing elsewhere. So, it also fits that type of situation, which is not uncommon.

Mr. Lickwar

One of the questions that I always get, "So, we're going to move, Bob, and we're going to sell our residence. We haven't had much luck." That would be a rare thing over the last year and a half, more common beforehand. "In order to help make ends meet, we're going to rent the property. Does that change the classification of the property from a principal residence?" The answer is yes, it does, but eventually. And as long as you can sell within that three-year period of time after you've moved out, assuming you meet the ownership and use rules, you're still going to meet the two of five, even though you're now renting the property.

So you're still going to have three years to sell the property and be able to claim the gain exclusion. You will have to recoup, in income, any depreciation deductions that you took as unrecaptured Section 1250 gain. But you can convert a property to rental property for a three-year period, as long as you can sell it within that three-year period. And there, Ian, documentation is extremely important so that you can prove to the IRS when you actually did abandon principal residence use. That can be things like your U-Haul bill or your plane tickets down to Florida or wherever it is you move to.

Mr. Redpath

And if you haven't met the two-year test and you're widowed, and you dispose of it, you can actually use your spouse's time residing there to meet that two-year test. So, that's kind of an exception. Also, if you have vacant land next door that you're selling as part of it, you can include the vacant land in it, even though you're not residing on it. It just happened to be a vacant lot that you own next to you. The other thing is what if you had a fire and the property was burned down? "Well, I didn't reside there." That's okay. You can still use that time if you go back and reside in the old residence. So, there's all sorts of little twists and turns here. One that you mentioned though, that we do miss, is okay, what if I don't meet this test? Are there exceptions where I still might at least get a partial exclusion?

Mr. Lickwar

There certainly are, Ian. If I'm forced to move, for example, for health reasons, let's say that the doctor says, "You just can't live in this climate. You have a condition." Perhaps that's an avenue. If you have to change jobs and your job is 50 miles farther from the residence than it was beforehand, that can qualify you. And there are also plenty of unforeseen circumstances that the IRS has issued via regulation.

The regulation cite is 121-3 and contains all of those things. If there's a medical issue, you're going to want to make sure that it's documented. Have a doctor's note, so to speak. So there are plenty of circumstances, Ian, where you can use a partial exclusion that is in contradiction to the once-every-two-year rule. Going back to the land sale just for a second. Occasionally, we see a sale of adjacent land prior to the sale of the residence. If the piece of land is sold, the gain will be recognized. However, if the residence itself is sold within a two-year period of time, we can actually go back and treat that land sale as part of the original residence sale.

So, be careful on that. It's not where you're selling lots in a trade or business, but it's where say you have seven acres and you use it as part of the residence. Maybe you've got your garden back there, the grandkids ride the dirt bikes or the electric bikes. Electric bikes is a new term to me. I'm just trying to get over it. They ride whatever it is they do back there, Ian, but it's all part of the residence. And you can actually kind of combine those sales, even though they happen separately.

Mr. Redpath

How would you report that? So you've already reported the sale.

Mr. Lickwar

You would report the exclusion in the year. You'd report the exclusion on the sale of the land in the year of sale. And if you didn't sell the residence within two years, you'd actually go back and amend and report the gain.

Mr. Redpath

If you reported the gain, would you go back and amend then and report the exclusion, then allocate the exclusion to it?

Mr. Lickwar

Absolutely.

Mr. Redpath

Here's one that I think a lot of people, especially right now with a lot of home office issues during COVID. So, you have a home, you have a home office, you are taking a home office deduction. If you don't take a deduction, you don't worry about it. Well, can you take the exclusion if you've been taking a home office deduction?

Mr. Lickwar

Absolutely. There's no requirement unless you're talking about a separate structure. There's no requirement to allocate a portion of the purchase price to the home office. The only thing you really have to worry about is the depreciation deductions claimed after May 6th, 1997. If you have a structure that houses the business, say a construction business, that is not part of the residence, that's a different issue. The sale of that building that's used exclusively in the construction business will generate a non-excludable gain.

Mr. Redpath

But your depreciation recapture's still ordinary income. You're not going to get an exclusion.

Mr. Lickwar

Yes. It's unrecaptured 1250 gain. Absolutely. So, it's very important to keep good records.

Mr. Redpath

What if you, as many people do... It's amazing how many people have 300 square feet for a home office. Exactly 300 square feet. I don't know. That's like a magic number, right? "I have 300 square feet." What if you use the safe harbor, the $5 per square feet up to 300. The IRS has said, it's amazing; everybody's got 300 square feet as their home office. What if you used that?

Mr. Lickwar

They've all taken out the measuring tape.

Mr. Redpath

And it worked out exactly to be 300 square feet. What about that? Do you have to recapture anything there or do you get the full exclusion?

Mr. Lickwar

No. Unlike taking the standard mileage rate on your automobile, Ian, there's no depreciation component to that $5 a square foot, 300 square foot limitation. So you don't have to worry about depreciation recapture. And maybe that's a small advantage, Ian. I've never really been a, "Let's not take the home office deduction because it sticks out like a sore thumb." If the facts and circumstances are right, Ian, I've always recommended the home office deduction. It's perfectly legitimate.

Mr. Redpath

Yes, if you can justify it, you can prove it, why wouldn't you take it?

Mr. Lickwar

I agree.

Mr. Redpath

I think the problem is that the safe harbor, while it simplifies things, it also opens itself up to people saying, "I have a home office," that they can't necessarily justify. If they had filled out the entire form and made all the allocations, the client may not have been as forthcoming that, "Yes, I really do have a home office." That 300 square feet, the IRS, they're not targeting it, but they're certainly making comments about suddenly all these returns have 300 square feet of home office.

Mr. Lickwar

Honestly, Ian, what did they expect?

Mr. Redpath

Right. Well, of course. Bob, I want to thank you for being here. You said it right in the beginning, and it was so important that this is a topic that we see quite often, yet I think we kind of forget really all the ins and outs of the 121 exclusion and the things to look at. If you're a staff person, I think a firm should go over with staff people, what is a closing statement? What do these items mean on a closing statement? How do we adjust for these when we see them? Because it can have a really large implication on that return. So, Bob, really great insight into this. I want to thank you for being here as always. Great, great information. And to our viewers, thanks for being here and be safe.

Exclusion of Gain on the Sale of a Principal Residence

By Ian J. Redpath, JD, LLM

A. Introduction

There are many occasions during a person's life that they may sell their personal residence. This is usually due to a change in circumstances, such as a new job, marriage, divorce, or children. Often, it is due to "downsizing" and/or retirement. A person's personal residence is a personal use asset that is considered a capital asset to the individual. The sale can result in a gain or loss.

B. Losses

A personal residence is a personal use asset for the taxpayer. If the sale results in a loss, it is not recognized because it is a personal loss. Of course, this is seldom the case unless there is a deflationary environment such as occurred during the 2018 housing crisis. Personal losses are nondeductible. [§65(c)]

C. Gains

Unlike losses, a realized gain from the sale of personal use assets is recognized. It is generally taxed as capital gain—long- or short-term depending on the holding period. If the asset has been held for a year and a day, it qualifies for long-term treatment. Short-term gains enter the netting process but are not given any special rate reductions. Long-term capital gains are eligible for special rates. A personal residence is a capital asset and, if held for the long-term holding period, falls into the residual category—subject to maximum rates of 0%/15%/20% depending on the taxpayer's taxable income.

Generally, any realized gains will be recognized for tax purposes. However, there are provisions in the Code that provide for the total or partial postponement or exclusion of recognition of realized gains. Section 121 is one such provision. It is applicable to the sale of a personal residence. Taxpayers meeting the requirements of §121 may, but are not required to, exclude up to $250,000 ($500,000 married filing jointly) of realized gain on the sale of a principal residence. This is an exclusion or permanent nonrecognition of the gain. Any gain in excess of this exclusion amount normally will be considered a long-term capital gain subject to preferential residual rates of tax.

Example: Julia and Peter Smith bought their principal residence in 2010 for $400,000. In September of 2021, they sold their home for $350,000. This results in a loss of $50,000 ($350,000 – $400,000). Since it is a personal use asset, the loss is permanently disallowed. However, assume they sold it for $800,000 and file a joint return. The sale generates a realized gain of $400,000 ($800,000 – $400,000). They may choose to exclude up to $500,000 of gain from recognition; thus, no gain is recognized from the sale. If it is sold instead for $920,000, they will have a realized gain of $520,000 ($920,000 – $400,000). They can exclude up to $500,000 of the realized gain; and the remaining $20,000 of gain is considered a long-term capital gain that will go into the capital gain/loss netting process as a residual long-term gain subject to the 0%/15%/20% preferential rates.

D. Principal Residence

The §121 exclusion applies to realized gains from the sale of a principal residence. This term is often misconstrued as meaning a principal home such as a house or condominium. This is a two-part test. First, the property must be a residence; and then, it must be the principal residence of the taxpayer and not a secondary residence. Reg. §1.121-1(b)(1) states: "Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law."

Once it is determined to be a residence, inquiry must be made to determine if it is the "principal" residence of the taxpayer. Reg. §1.121-1(b)(2) provides:

"In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence include, but are not limited to -

(i) The taxpayer's place of employment;

(ii) The principal place of abode of the taxpayer's family members;

(iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;

(iv) The taxpayer's mailing address for bills and correspondence;

(v) The location of the taxpayer's banks; and

(vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated."

Vacant land may be included as part of the principal residence under certain circumstances. Reg. §1.121-1(b)(3) provides that vacant land is not included unless:

"(A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;

(B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;

(C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and

(D) The requirements of section 121 have otherwise been met with respect to the vacant land."

Example: Jeni and Don own a home in Detroit and a condominium in Miami. They use the condominium four months out of the year and reside in Detroit the rest of the year. They are licensed to drive in Michigan, register their cars in Michigan, are registered to vote in Michigan, and belong to a number of organizations in Detroit. The home in Detroit appears to be their "principal residence."

E. Requirements of §121

To qualify for the §121 exclusion, at the date of the sale, the residence must have been *owned* and *occupied* (*used*) by the taxpayer as the principal residence for at least two years during the five-year period ending on the date of the sale [§121(a)]. While the two-year periods commonly coincide with each other, it is not necessary as long as both periods are met. Additionally, the periods of ownership and use need not be continuous unbroken periods of time. Per Reg. §1.121–1(c)(1), taxpayers must document 730 (365 × 2) days of ownership and use during the five-year period that ends on the sale date. Remember, they are two separate tests.

The five-year window enables the taxpayer to qualify for the §121 exclusion even though the property is not his/her principal residence at the date of the sale. In applying the use test, short absences such as vacations or other seasonal absences are counted as periods of use. In addition, any short-term rental of the property is ignored. [Reg. §1.121–1(c)(2)(i)] In addition to the ownership and use requirements, §121 can be used by a taxpayer only once every two years. [Reg. §1.121–1(c)(2)(i)]

Example: Serena purchased a home in Northern California in June 2010. She lived there until she took a new job in San Diego on March 1, 2017. From March 1, 2017 until she sold the house on June 30, 2021, she only used the home occasionally since she lived in an apartment near her job. The five-year test window runs from July 1, 2016 to the date of sale. She meets the ownership test because she owned the house for two of the five years. However, she fails the use test. During the five-year window, she used the house as her principal residence from August 1, 2016 to March 1, 2017 or less than two years.

Example: Pedro rents a condominium to live in for his new job. He rents it from 2014 through January 17, 2018, when he decides to purchase it. On January 18, 2018, he purchases the condominium. On February 1, 2019, due to a decline in health, Pedro moves into his son's home. On May 25, 2021, while still living with his son, he sells the condominium. The §121 exclusion applies because he *owned* it for at least two years out of the five years preceding the sale (from January 19, 2018 until May 25, 2021) and he *used* it as his principal residence for at least two years during the five-year period preceding the sale (from May 26, 2016—the beginning of the five-year window—until February 1, 2019).

Example: Cade sells his former principal residence on August 16, 2021. He had purchased it on April 1, 2013 and lived in it until July 1, 2020, when he converted it to rental property. Even though the property is rental property on August 16, 2021, rather than a principal residence, the sale qualifies for the §121 exclusion. During the five-year period from August 17, 2016 to August 16, 2021, Cade owned and used the property as his principal residence for at least two years.

If a married couple files a joint return, the exclusion amount is increased to $500,000 if the following requirements are met [§121(c)(2)(B)]:

- Either spouse meets the at-least-two-years *ownership* requirement.
- Both spouses meet the at-least-two-years *use* requirement.
- Neither spouse sold a principal residence within the prior two years and used the §121 exclusion.

It should be noted that a person may use their own $250,000 exclusion if they fail to qualify for the increased married filing jointly amount. Additionally, a surviving spouse can use the $500,000 exclusion amount on the sale of a personal residence for the two years following the deceased spouse's death. If the sale occurs in the year of death, a joint return must be filed by the surviving spouse.

Example: Megan sells her personal residence (adjusted basis of $200,000) for $650,000. She has owned and lived in the residence for six years. Her selling expenses are $40,000. Megan is married to Chris and they file a joint return. Chris has not owned the residence but has resided in it as his principal residence since they married three years ago. Because the realized gain of $410,000 is less than $500,000, no gain is recognized. If Chris had only resided there for one year, then Megan could still use her own $250,000 exclusion and treat the balance of the gain as a long-term capital gain.

In certain circumstances, the two-year ownership and use requirements and the "only once every two years" rules could create a hardship for taxpayers. This is not equitable if the situation was outside the control of the taxpayer(s). As a result, under the following special circumstances, the requirements are waived [§121(c)(2)(B)] and a partial exclusion may be allowed:

- Change in place of employment,
- Health issues, or
- Other unforeseen circumstances.

Reg. §1.121−3 and IRS Publication 523 (*Selling Your Home*) provide further guidance on the situations providing waivers.

The change in place of employment will apply if, due to a change in employment, the distance between the taxpayer's old residence and new job location is an increase of at least 50 miles from the taxpayer's old residence and old job location. The distance from the new residence is not relevant. The residence must be the taxpayer's principal residence at the time of the change in employment. This will also apply to self-employed persons moving the proprietorship to a new location.

The health exception uses either a general facts and circumstances approach or a safe harbor established in the Regulations. If a physician recommends a change of location due to health issues (or to obtain specialized care), the safe harbor is met. A move for general health or well-being does not qualify.

If the reason for the sale or exchange of the residence is an unanticipated event, it may qualify as an unforeseen circumstance. An unforeseen circumstance is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. [Regs. §1.121-3(e)] Under a safe harbor, the primary reason is deemed to be unforeseen circumstances if any of the following events occur during the period the taxpayer owns and uses the property as a principal residence. [Regs. §1.121-3(e)(2)] The safe harbor includes:

- Involuntary conversion of the residence;
- Natural or human-made disasters or acts of war or terrorism resulting in a casualty to the residence;
- Death of a qualified individual;
- Cessation of employment, resulting in eligibility for unemployment compensation;
- Change in employment or self-employment that results in the taxpayer being unable to pay housing costs and reasonable basic living expenses for the taxpayer's household;
- Divorce or legal separation; or
- Multiple births resulting from the same pregnancy.

If none of the listed is the reason, the taxpayer can claim that the general facts and circumstances justify the exception.

Example: Peter and Mary are engaged and buy a house. They live in it as their personal residence for 18 months when they mutually agree to call off the wedding. Peter moves out of the house. However, Mary cannot afford to make the payments alone, so they sell the house. Although the sale does not fit under the safe harbor events, the broken engagement is an unforeseen event and would most likely quality under the "facts and circumstances" approach.

F. Partial §121 Exclusion

When one of the exceptions applies, a partial exclusion is allowed. The exclusion amount ($250,000 or $500,000) is multiplied by a fraction, the numerator of which is the number of qualifying months and the denominator of which is 24 months. The resulting amount is the excluded gain. [§121(c)(1)] The IRS uses the following:

Step 1 Determine the shortest of the following 3 periods:

1. Your time of residence in the home during the 5-year period leading up to the sale _____
2. Your time of ownership of the home leading up to the sale _____
3. The time that has elapsed between the sale and the date you last sold a home for which you took the exclusion if you had done so _____

Step 2 Take the smallest period from Step 1 (you may use days or months) and divide that number by 730 (if using days) or 24 (if using months). _____

Step 3 Multiply the result from Step 2 by $250,000. Stop here if not married filing jointly. _____

Step 4 Repeat Steps 1–3 for your spouse and add the two results. _____

C) Your exclusion limit is $___________. Unless you have taxable gain from business or rental use (see *Business or Rental Use of Home*), only gain in excess of this amount is taxable. [IRS Publication 523]

Example: On October 1, 2020, Jason and Laney, who file a joint return and live in Memphis, sell their personal residence. They have owned and lived in it for ten years. They had a realized gain of $475,000 and used their full §121 exclusion. On October 2, 2020, they purchased a new principal residence in Memphis for $525,000. In August 2021, Laney is transferred by her employer to their Las Vegas office. Jason and Laney sell their Memphis residence on August 2, 2021 and purchase a residence in Las Vegas. The realized gain on the sale of the Memphis property is $210,000. Because it is the result of a change in employment, it qualifies for a partial exclusion.

The partial exclusion is determined:

Realized gain:	$210,000
§121: 10 months/24 months X $500,000 =	$208,333
Recognized Gain:	$ 1,667

As long as the requirements of §121 are met, the exclusion is available. However, if the taxpayer deducted any depreciation, then the realized gain is recognized to the extent of the depreciation deductions taken. [§121(d)(6)] The depreciation could be the result of renting the property or taking depreciation for a home office deduction. In addition, to the extent that a proration of the property not within the dwelling was used for other than a personal residence (for example, using a stable for horse riding business), the §121 exclusion will not apply to an allocable portion of the gain. The allocation method is the same as used to allocate depreciation.

If a taxpayer or taxpayer's spouse are a member of the Uniformed Services or the Foreign Service, or an employee of the intelligence community in the United States, the five-year test period for ownership and residence may be extended for up to another ten years. An individual is on qualified official extended duty if for more than 90 days or for an indefinite period, the individual is:

- At a duty station that is at least 50 miles from his or her main home, or
- Residing under government orders in government housing.

This allows the two-year residence test to be met even if the taxpayer did not actually live in the residence for at least two years during the five-year period ending on the date of sale. The period of suspension cannot last more than ten years. Together, the ten-year suspension period and the five-year test period can be as long as, but no more than, 15 years. Taxpayers may only suspend the five-year period on one property at a time. The taxpayer makes the election under §121(d)(9) by filing a return for the taxable year of the sale or exchange of the taxpayer's principal residence and does not include the gain in gross income.

G. Reporting

The §121 exclusion automatically applies if the taxpayer is eligible. The taxpayer must have a completed Form 8949 reporting the sale or exchange. In Column (f), use Code H to report the exclusion. In Column (g), report the amount of the exclusion being applied as a negative number. Remember that if there are other adjustments, such as additional costs of sale or other basis adjustments, they will be combined with the exclusion amount and reported on the same columns. In Column (f), use as many Codes as apply to the amounts in Column (g). The amounts in Column (g) are combined for the total adjustment.

If the principal residence is sold on an installment basis, the exclusion may still be used. Any excluded gain is not included in gross profit when figuring the gross profit percentage.

A. Discussion Problems

Your client, Julia, age 30, has owned her principal residence (adjusted basis of $100,000) for five years. During the first three years of ownership, she occupied it as her principal residence. During the past two years, she was in graduate school out of the area, so she rented out the residence. During graduate school, she married Richard. After graduate school, Julia and Richard returned to the location of her principal residence but decided to purchase a larger home. She purchased another residence for $500,000; and they moved into it immediately after returning. She listed her old residence for sale at $390,000. Due to a slow real estate market, she receives an offer of $360,000 11 months after listing. They plan to file a joint return.

Required:

1) If Julia accepts the offer, does she qualify for the §121 exclusion? Would it make a difference if she rejects the offer and accepts one for $380,000 24 months after the listing?

2) If she qualifies, how much would the exclusion be in each of the scenarios?

3) If she qualifies for any amount of exclusion, how would it be reported if she also had selling expenses of $5,000?

B. Suggested Answers to Discussion Problems

1) The facts indicate that this is her principal residence. Thus, the question is whether she meets the requirements of §121. She has owned the residence for two of the last five years ending on the date of the sale. If she sells it 11 months after the listing, she will still meet the two of five years and thus qualify for the exclusion. If she does not accept the first offer but accepts the second offer, she will meet the two of five ownership test, but now does not meet the two of five use test. The facts do not indicate any previous sales, so the only once every two years test will be met.

2) Because Richard did not have any period of occupancy as a principal residence, they will not quality for the $500,000 exclusion even if filing jointly. Julia will be able to take the full $250,000 exclusion.

3) Julia will report the transaction on Form 8949 and carry over to Schedule D. In this case, she will report proceeds of $360,000 and a basis of $100,000. She will report in Column (f) Code H for the exclusion and the proper Code for the expenses (it is E but not part of the question). The exclusion plus expenses will be added together and entered as a negative number. In this case, you have proceeds of $360,000 – basis of $100,000. The exclusion plus expenses equal $255,000. This result is a net long-term capital gain of $5,000 [$360,000 – $100,000 = $260,000; $260,000 – ($250,000 + $5,000) = $5,000].

PART 3. BUSINESS TAXATION

IRS Audits of Corporations

In recent years, the Internal Revenue Service has been significantly impacted by budget cuts and loss of talent. With the IRS being underfunded and under-resourced, their ability to conduct audits and collections has been hindered. At the same time, recent legislation has continued to complicate corporate taxation, which can be confusing for taxpayers, practitioners, and the IRS. Because the percentage of corporations being audited by the IRS is extremely low, there is concern that certain corporations are abusing the system and taking advantage of the situation. Ian Redpath and Shiny Mathew discuss corporate tax breaks, the ramifications of playing the audit lottery or taking aggressive tax positions, and IRS audits of corporations, including eggshell audits.

Let's join Ian Redpath and Shiny Mathew as they discuss IRS audits of corporations.

Mr. Redpath

Shiny, welcome to the program.

Ms. Mathew

Thanks Ian. It's so good to be here.

Mr. Redpath

It's great to have you here. Great to get your insight on this. I know you do a lot of work, and your firm does a lot of collection things. We've got a lot going on in the collections area, but one of the issues that we hear all the time in the press are all the corporate tax breaks that are being taken, and how corporations may be, I'm not going to say scamming the system, but certainly utilizing the system to their benefit. We should start and say, well, the IRS, don't they have enough people to take care of all of this? What's going on? Because major companies, we used to always think that the IRS basically had offices there. That they were there constantly auditing them. So what's really going on here with the IRS?

Ms. Mathew

An important first point is, I agree with you, it's not that we're talking about corporations scamming the IRS. We're talking about how accounting works and how the IRS works and just diving and digging in a little more to what's not really talked about in the public and that's some of these unrecognized tax breaks and how they're being utilized. If we were to step back, I think the first thing we need to understand is the funding at the IRS. For the last decade or more, since 2010, the IRS has had their budget slashed every year consecutively. And so we're seeing a problem that has been growing over the last 10 years as a result of the IRS budget being cut. And as the IRS budget has been cut, they have lost talent during those years, they been unable to hire to replace talented senior individuals who can handle some of these more complex matters and complex audits, and they have been grossly underfunded and under-resourced in terms of manpower and ability to pull audits of all these corporation. And simultaneously, we're seeing the corporations themselves have an uptick in the number of tax breaks that they are claiming. One thing I was very excited to talk about today is how these tax breaks on their corporate tax returns are treated if they're not being audited on the tax return themselves.

Mr. Redpath

Yes. I think the lack of enforcement and a lot of this, honestly, and I don't care which side of the political aisle you're on because we're not here to talk politics, but the fact of the matter is that there's been a lot of discussion and actually on both sides of the aisle of IRS abuses. And I think, sometimes when there's a perceived abuse, there's also a reaction to that whether it's real or not, and sometimes an overreaction. And so, we've had this kind of a push and pull and, you can go all the way back. And it's not political to say we can go back to Nixon. And people said he used the IRS but we had a reaction to that. Congress reacted and said, "Oh, well, IRS, what are we going to do? Well, we're going to cut the IRS because they've been engaging in these activities." I'm sure it goes back even before that, but I remember that was one of the things with Nixon, going back that far, that he was using the IRS.

And then we had the issues with the not-for-profits during the Obama administration. So there always tends to be an overreaction to a perception. And now we're paying for it, I guess we can say in some respects, or not paying for it by these guys.

Ms. Mathew

Yes. And I agree with you. I don't think that the IRS should be viewed politically. The IRS is the arm of the government that collects taxes on the revenue earned by the country and by individuals who are outside of the country making money. I think that should be very apolitical. It's a question of how much the tax rates should be. That's a whole other conversation. But the actual functionality of the IRS to collect on whatever is the law is what the IRS is tasked with and should be funded to do. But they're severely underfunded in their primary responsibilities.

Mr. Redpath

You brought up an excellent point. I think, unfortunately, we don't decouple the IRS from the tax law. And so, when you have discussions about well, we're going to raise the tax rates, somehow the IRS gets dragged into that even though, as you said, the IRS is essentially or should be apolitical. And when they sit and write the tax laws, they generally are not working to write regulations, for example, that are political. They're writing regulation to meet what Congress has passed. So let Congress do the law that's political, and then the IRS is just there to enforce and collect as you said; but we tend to couple that into the discussions I think far too often, and not looking at their function. Where do we stand with that right now? Because I know all over the press, there were issues of, well, the president wants to increase dramatically the funding to the IRS for audits and collection. Where do we stand on that?

Ms. Mathew

Yes. And I'm going to dissect this point just a little bit, and that is, President Biden has discussed increasing the budget of the IRS, and the IRS commissioner supports that. I believe the former IRS commissioner also has indicated his support of that. I want to make the point that we're not talking about tax cheats, we're not talking about tax evaders, we're not talking about concealing money. Funding the IRS means giving the IRS the ability to conduct audits of tax returns, to ensure that the tax breaks and deductions and credits that are being claimed are being claimed properly. Right now, the IRS has significantly, drastically slashed the number of tax returns that they're auditing. Frankly, right now we're seeing that they're not even getting through processing the returns themselves, let alone auditing. And the IRS only has a very short three-year statute of limitations window from when that tax return's processed to audit that tax return in a timely way. And then they've lost the opportunity, which is really what we're seeing with these corporations. Why I wanted to mention it is because when these corporations are taking tax breaks on their tax returns, taking a deduction, we are talking about complex multilayered tax deductions that do require adequate resources on the IRS's end to dig into. It's not a matter of you can look at a tax return at face value and say yes or no.

It is a matter of interpretation and how these corporations, if they're publicly traded, how they have to recognize it. It's an unrecognized tax break, at least until they get out of the three-year statute of limitations window. And after that, if the IRS doesn't audit them or doesn't disallow it, now that becomes a recognized tax break. They can claim it as a savings in the billions of dollars, and that's profit that they've now gained that they can distribute to their shareholders. And if you couple that with the number of corporations that are doing this every year. And I'd say that's not coincidental, in my opinion, and that's my editorial, because as the number of audits has declined, the number of tax breaks open for interpretation by corporations and by the IRS has increased, and so we're in the trillions of dollars of tax breaks being claimed that just the IRS does not have the manpower to audit. And even if they did, they're a little outgunned when it comes to the private sector.

Mr. Redpath

Well, you know something, and I go back to a basic concept that, you're not supposed to play the audit lottery. You're not supposed to say what are the chances of getting audited? Okay, I'm going to take that deduction because the chances of getting caught are pretty slim. That's unethical. Circular 230, the Statements on Responsibility and Tax Services, it's unethical to play the audit lottery. Yet, clients will come in; and if I feel comfortable, I will say, "Look, here's a position. I believe we can take it." Because I'm not going to recommend. And I would hope none of our viewers, and I'm sure you would never recommend a position to be taken that I know is wrong. I have to believe that either I have substantial authority or I have a reasonable basis and I disclose it. So the law's pretty clear on what to do when you have these types of positions that you believe to be correct. Substantial authority, you can take the position without disclosing it; reasonable basis, but not substantial authority, you can take the position, you need to disclose it. But you know what, I still have clients that will come in and say, "Well, what's the chance of getting audited?"

That's a reasonable question from a client. And if I say, "Discussions today, probably not," they're probably going to say, "Okay, do it." But I've had clients in the past where I've said, "Well, this is an issue the IRS is targeting." They said, "Well, I don't want to get audited. Don't take it." "Okay, fine." That's their decision, but it really should be up to them to make that decision. But we should not be recommending any position that we don't believe is correct. And that I think we have to start as a baseline, that the audit lottery is not what we're talking about here.

Ms. Mathew

No, we're not talking about the audit lottery. But I will say that tax law is very open for interpretation. And I use the case of Coca-Cola versus the IRS, that's a great example where the IRS… Coca-Cola had been audited in the '90s

. They had a 1996 closing agreement with the IRS. It told them what was going to be excess profits, how they should tax their subsidiaries that were overseas. And they had used that closing agreement to continue using that formula to claim and report the taxes that were due. And it was through this case that the IRS audited Coca-Cola through the 2000s and now the result of the tax court case is the tax court agreed with the IRS that Coca-Cola was not to use that closing agreement that the IRS had provided to them in the '90s, but that had expired and that now there was a new formula and they owed $3.3 billion.

I have my own editorial opinion on that; but putting that aside, it goes to show the broader point which is tax law is not black and white. It is all situations. If we're talking about what's the amount of the standard deduction, okay, that's black and white. Who gets to take a child tax credit, that's black and white. But when you're talking about foreign nationals and corporations overseas and subsidiaries. As in the Coca-Cola case, here's your bottling company, here's your holding company—or not holding company, I can't remember the name of what they called it, but it was a subsidiary. And you have these layers and layers that are open for interpretation. We were saying before the IRS is apolitical, but the Congress is writing the legislation. But the piece that the IRS plays in that is, they are the ones that write and roll out the regulations. We're still seeing regulations being rolled out even now from the 2017 Tax Cuts and Jobs Act on how to interpret it.

Mr. Redpath

There is a fine line. And, for example, it's not always the multi-national. If I'm looking at something, "Okay, do I capitalize this? Can I expense it? What does it fit under? Does it fit under the repair regs, for example?" Cost segregation, huge issue with cost segregation. How can I classify this? And so, there's so much that's open to interpretation. The issue is whether you are interpreting or making it up. And if you're making it up and playing the audit lottery, that still is unethical.

But certainly that's what we get hired to do, is to take positions. I've taken positions and had clients, as I mentioned, say, "You know what, even though I believe you that you believe it's correct…" And I said, "I've gotten authority for this, I'm not just making it up, I'm interpreting the authority, but I believe we're correct." They'll say, "Well, no, I don't want to be that aggressive." Because they're always afraid of getting audited. I always tell people that an audit is your chance to show how smart you are. Because I don't think you take a position that you didn't believe was correct.

Ms. Mathew

I was going to say, that's the number one source of audits that I represent is referrals I get from other CPAs. Because they say, "I have a conflict here. This is what my client gave me. And I don't want to tell the IRS this is what my client gave me, and I just need somebody else to take the law and defend the client." So my number one source of new cases is actually other accountants and CPAs who say, "I just feel a conflict here because I don't want to have to testify against my client."

Mr. Redpath

That's a point that I really think is extraordinarily important, because especially if there's even the hint of fraud, the first thing that you need to do as an accountant is back off. "I don't want to know anything more." You don't have a privilege there. "I don't want to know anything more. You need to contact an attorney." And by the way, as a CPA, I think you need to make sure that you're protected. You should at least talk to someone to make sure that, "Is there something here where I might have some liability? Are they're going to go after me?" But unfortunately, far too often, the accountant gets too far involved with that. And the next thing you know, the IRS, if it goes that far, the IRS is bringing them in to testify, even if it's civil in tax court, they're bringing them in to testify. And you may have a conflict, as you mentioned.

Ms. Mathew

Right. And I think that also brings up a point that's not talked about a lot with the eggshell audits, where you have the IRS knowingly opening an audit on a taxpayer where they may have a reason to believe there may be some fraud or a reason to bring a criminal case, but then they open this civil audit, and under the guise of just reviewing the tax return and you're handing over all the documentation related to the tax preparation, unknowing that the IRS is building their criminal case with all the testimony, all the documentation. They're getting all the evidence without any of the legal protection that the taxpayer would have been afforded had litigation actually been brought. And now, the IRS can build this criminal case against the taxpayer in advance.

Mr. Redpath

This is a huge issue that a lot of accountants are not aware of, and you mentioned it, they're called eggshell audits.

Ms. Mathew

I also think that when it comes to these audits, one more point that practitioners, accountants and attorneys, CPAs and attorneys need to take as a piece of advice, heed as a piece of advice, if I were to come full circle to what you were talking about before on the underfunding of the IRS. It would be that the IRS is going to drag out these audits. If we're tying this all together, the IRS wants to take their time on an audit. Well, there's an eggshell audit to build up a criminal case or it's a straightforward civil audit. You would benefit yourself and your client, and it would behoove you to rush the audit; let's push it through. Because the IRS does not have the manpower to investigate it with a fine tooth comb as they would like to, even if they wanted to, if you're putting the pressure on; and they have an obligation if you have this paper trail saying, "Okay, where are we at now?" "Okay, what's the status now?" I would like to know back from this on Friday. You know, you're giving them windows of time to respond. You as a practitioner have a right to ask for those responses from the IRS. And I think too often, we are just saying, "Okay, well, it's just a hurry up and wait game. Let's give it to the IRS and then let's sit back." Because we're also busy on our end as well, we might as well just wait however many months the IRS takes to respond. But my tip to practitioners is it actually benefits you to push it; push an audit through as fast as you can.

And that's really what's going to benefit you and your client, not because it saves time, but because the IRS doesn't have the manpower and funding to do fast audits. They'll say, "Okay, let's just get this done, get this out of here because this person is asking for a response."

Mr. Redpath

What is your position on… when the IRS comes in and says, "Hey, we want you to extend the statute of limitations. Please sign here." What's your thoughts on that?

Ms. Mathew

This is going to be the most attorney answer ever, but it depends. It really does depend. Sometimes when you have a client that's being audited, they themselves don't have the documentation they need to provide to the auditor. They haven't put it together; they haven't compiled it. We need time on our end. So, if I have a strong feeling that the client is able to piece this together, then it potentially benefits both sides to extend the statute of limitations. But like I said before, if I can put documentation together as quickly as possible to provide it to the auditor and prove our position, I find more often than not, it actually benefits the client, the taxpayer, to push audits as fast as you can than to extend statutes. Extending statutes is playing the IRS's game; they want more time. They always want more time.

Mr. Redpath

Right. That's an excellent point that a lot of times it is that. I asked an agent once. He wanted me to extend the statute, and I said, "Okay, these are the only items that we haven't completed in the audit. We'll limit it to that." "No, no, no. You've got to extend the statute." I said, "Well, there's no reason to because we've completed almost everything. What are we going to extend it for?" Like you said, it often depends, but more and more, we're going to get that. With the understaffing, we're going to get, "Oh, we want to just automatically extend the statute of limitations on audits." It's not something that you have to do automatically. And the IRS has limited authority to do a jeopardy assessment. They can't just come in. And because they've screwed up as far as the timing, they don't technically have the right to just do a jeopardy assessment because we ran out of time.

Ms. Mathew

Right. Absolutely. I know a lot of people are scared if you push through an audit, the revenue agent just disallows the expenses claimed. Well, you still have rights. You close that audit; you get that assessment; you appeal it. You petition the tax court. You're likely not going to go to tax court. You're likely going to have someone, an appeals person, before you ever even get on a docket that will look it over with you.

Mr. Redpath

Yes. That's a good point. I have seen that where the IRS in the audit, they just, "Okay, we're denying everything." And when that goes up to appeals, quite frankly, at least in my experience, when the appeals officer sees that, they're like, "Oh, come on." All of a sudden, you look really good on any position you take because they realize how just unreasonable that position was to deny everything.… Well, they never deny the income. They always claim the income. They always deny the expenses.

Ms. Mathew

Exactly!

Mr. Redpath

One thing I wanted to close with is talk a little bit about this, a big thing that they're doing with larger companies, which is the idea of these uncertain tax positions. And that's a big area that larger corporations are using to save money, I guess. What's going on with that?

Ms. Mathew

Just as we had opened with the IRS's decline in their ability, in their funding, to audit large corporations. If you have over $20 billion in assets, the IRS audit rate I believe is down 63%, the last time I checked by some estimates, which means you're more than likely not going to be audited. And so, as we discussed, because so much of this tax law in more complex areas is open for interpretation, frankly, I'm on the side that would be more aggressive. I would not take a conservative approach in applying tax law and see how do you maximize tax savings. And we're not talking about tax cheats. We're not talking about doing anything illegal. We're talking about using tax law and interpreting it to a position that's most favorable for your client, or in the case with these major corporations, that saves the most money. I think I absolutely agree that everybody should only pay what they're required to pay in taxes. That's our job as practitioners to identify what are the tax benefits, deductions, credits that any individual or entity can take, legally take and claim and reduce their tax liability. In these cases, you have these tax breaks that some are more questionable than others. But would they pass the sniff test of authority? It's a question mark.

And that question mark or the number of corporation tax credits and deductions being claimed is rising as the number of audits of these same corporations is declining. And I think that's a major issue. I think Congress should recognize the trillions of dollars that we're losing as a country because of the lack of resources for the IRS in funding these audits.

Mr. Redpath

And this is a huge area. Some of our viewers may be familiar with ASC 740-10, but maybe even more so, there's still a lot of people refer to it as FIN 48, which is, how do you report for financial accounting purposes this uncertain tax position? And I think this is what they're doing, is they're using this as a methodology of, "Okay, we have a footnote on our financial statement." So what is this? What is FIN 48? It's codified now as 740-10.

Ms. Mathew

Well, for one, they're able to just hold it there. Like you said, as a placeholder, but these companies know that the statute of limitations is three years. And once that gets outside that window, that can no longer be audited. And because it's no longer audited, that means even if it was questionable, you've now claimed it, and the IRS can't now come back and disallow it. So, what may have been a placeholder now can be a true savings to the company, and savings translates potentially then into profits and increases that margin that previously wasn't able to be claimed. And I know Ian, you wrote an entire paper on this point. I'll say you're the expert on this over me.

Mr. Redpath

You said it correctly. What's happening is under the financial accounting rules, they're taking a position and the decision is this is more likely than not, greater than 50% likelihood of the tax, either accepting or rejecting, they're footnoting it. There's also Form UTP, but you have to have essentially $10 million in assets. UTP is questionable as to how much information should you provide—but the IRS had to come out with what is essentially, they call it the rule of restraint, to say, "We're not going to use the UTP as a method of forcing you to tell us what you did. Show us the rocks to look under," which is essentially what the UTP says. "Well, tell us what is the basis of this uncertain tax position? What is the uncertain tax position? We shouldn't have to go into an audit to find it. You tell us on UTP, what is it that's uncertain. Then will come in and audit it."

The IRS is going to come out and say, "With the UTP, we have to have a rule of restraint that says, we're not going to do it for that purpose." I think from a practitioner standpoint, if you have to prepare the UTP, I would get an attorney involved, and just for that reason. "What information do I have to provide on that UTP?" You don't want to get too detailed, or you are going to trigger an audit. Now, I will tell you that one thing the IRS was doing when they had more staff is, and now they'll do it even more so, is they were looking at footnotes and saying, "Okay, are these companies taking an uncertain tax position on their financial statements?" But if they're not publicly traded, the IRS isn't going to see that.

Ms. Mathew

Right. And it's easy for us to say the IRS is underfunded. But let's just say the IRS is handed $80 billion tomorrow. Say, they get a check for $80 billion. This is not the type of thing where you just say, "Well, let's just hire some kids that just passed the CPA and hire them to audit these companies." You need some experienced, highly trained individuals with expertise in [these areas]. And when I say in these areas, even that's too broad, because we are talking about distilling tax law down into such piecemeal on each of these individual areas that it's not going to be easy from the IRS's end even if they were handed a fat check today.

Mr. Redpath

You said it. The IRS, the senior level people have been retiring from the IRS. And these types of audits require senior level people, people with a lot of experience in these areas to know what they're looking for, to know what the companies are doing, to know which rocks to look under, and even when they pick the rock up, what is it they're actually looking for?

Ms. Mathew

Right. Exactly. Even if I were to teach, let's just say, hypothetically, teach a specific area of law, well, you put this brand new person now in a room against the army of accountants and attorneys that some corporation has. And then they pick apart the IRS's argument on why it's wrong. Have you prepared this person to rebuff that argument now, not just tell them the basics?

Mr. Redpath

Right. And I think as you've mentioned with the underfunding and what's been going on and the retirements… And again, I'm not trying to say that corporations are doing anything illegal. That's not the issue here. The issue is, as you said, people taking an aggressive position, one that doesn't necessarily mean you're right. You think you're right or you wouldn't take it; but that doesn't mean you ultimately would be right. It's just, the IRS is not prepared to say you're wrong.

Ms. Mathew

Exactly. And I think that is an important clarification. I'm definitely not saying any of these corporations are doing anything illegal. They're not. It's openly known that this is happening. And it's a matter of the IRS not being in a position to audit. We don't know. We just don't know. Would it have been disallowed? We don't know. And because we don't know, those corporations should classify those dollars in some way. They're required to by the accounting method that they're using; they're required to classify that in a particular way for those dollars after it's outside of the statute of limitations. And they're doing that according to the law.

Mr. Redpath

Their interpretation of the law.

Ms. Mathew

Yes.

Mr. Redpath

We talked about, there's an audit lottery, and you're not allowed to play the audit lottery; but this is legally playing the audit lottery, I guess. We're not taking a position we know is wrong because we know we won't get caught. We're taking a position that we believe to be correct; but we don't believe we're going to get audited either.

Ms. Mathew

Yes. So my tip is, we all should have $20 billion in assets and decrease our likelihood of being audited.

Mr. Redpath

Right. There you go. Shiny, thanks for being here today. I really appreciate it. A lot of good insight into what's going on with the IRS and some of the things to look at, and also, what practitioners should be looking at in handling even small audits or small businesses, things that they should do. So thanks for being here and thanks for your insight.

Ms. Mathew

Absolutely. Thank you so much for having me. I enjoyed it.

Small Business and Corporate Audit Issues

By Ian J. Redpath, JD, LLM

A. Introduction

According to the IRS Data Book 2020 published in June of 2021, the number of IRS audits has dropped. This includes both small business audits and corporate audits. Only 0.97% of corporations had their returns audited. In Publication 5364 (Rev. 9-2019), the IRS estimated the tax gap for all taxes to be $441 billion. They estimate they will receive $60 billion, leaving a net tax gap of $381 billion. Of this gap, 2% relates to small corporations (those with less than $10 million in assets) and 6% to large corporations (those with more than $10 million in assets). The largest area of tax gap is with individuals, with small business income accounting for 25% of the total gap. That is over twice that of all corporations.

Small business audits are critical to the IRS given they have the highest degree of noncompliance. An example is in the area of S corporations. According to IRS data, only about 2% of all S corporation returns were audited in 2019, despite the growth in S corporation entities.

Statistics indicate that the IRS looks more closely at small businesses that file Schedule C than if that business would file their business tax returns as an S corporation, partnership, or C corporation.

B. Small Business Audits

Most audits are triggered by a few items. Among the most common are mathematical errors, outlier figures, and dubious expense categories, which are common reasons for tax audits of small and mid-size businesses. The IRS will also receive tips from disgruntled employees, ex-employees, and sometimes spouses in divorce matters. In addition, in the DIF (Discriminant Inventory Function) System, the computer assigns a numeric score to each individual and some corporate returns. This will select returns that have too many questionable items outside established norms. Additionally, there is an Unreported Income DIF (UI DIF) that is used for two purposes:

- To rate the probability of *inaccurate information*
- To rate the probability of *omitted income* on a tax return

Both steps are evaluated in conjunction with the other. The IRS may flag a tax return for many different reasons; but the most common reasons why a small business may be audited include the following scenarios:

- Claiming business losses for multiple years;
- Reporting unexpected, high income levels; and/or
- Taking several substantial deductions.

The most common mistake that causes a business to be audited is when the total sales reported is less than the total of Forms 1099 filed for the business. Also common are math errors that lead to highly unusual results, such as adding an extra digit to expenses (i.e.: $10,000 rather than $1,000).

The IRS conducts three types of audits:

- Correspondence
- Office and
- Field Audits.

A correspondence audit is the most common type of IRS audit and is generally viewed as being easier to manage than either of the others. A correspondence audit occurs when the IRS identifies possible errors in a tax return and sends the taxpayer a letter describing each error in detail. These audits can be corrected or explained away by sending the IRS additional documentation. An office audit is generally limited to several items on a return and takes place via face-to-face or electronic means. The most thorough type of IRS audit is a field audit, where an IRS auditor may visit the taxpayer's place of business in person. In this case, the examiner will often go through the tax return and require adequate documentation of items. Essentially, they are looking at the entire return.

C. Corporations

As previously noted, corporations account for a very small percentage of the tax gap. This may account for why there are only a small number of audits. Audits of a corporation will focus on many of the same issues as a small unincorporated business. However, there are other issues unique to C corporations because of the equity structure and separate nature of the entity for tax purposes.

One often audited area is the reasonableness of compensation. In the S corporation area, it is to determine if the compensation paid to owner/employees is unreasonably low. Income not resulting from the conduct of a trade or business by an individual or by a partnership of which the person is a member is not includible in computing the individual's net earnings from self-employment. Accordingly, amounts which a shareholder is required to include in gross income by reason of the provisions of §1373 of the Code should not be included in computing net earnings from self-employment. [Rev. Rul. 59-221, 1959-1 CB 225] It has recently come to light that President Biden and his wife routed approximately $13 million in income from book sales and speeches in 2017 and 2018 through S-corporations, CelticCapri Corp. and Giacoppa Corp. The corporations paid the Bidens less than $800,000 in salary during that period and saved up to $500,000 in FICA/SE according to a Congressional Research Service report. The spokesperson for the Bidens says they were paid a "reasonable salary," so it is a non-issue. The issue of reasonable compensation is always an issue practitioners must confront with S corporation shareholder/employees. The inquiry is whether the compensation is "unreasonably low." The issue has recently been further emphasized after the Treasury Inspector General for Tax Administration (TIGTA) Report #2021-30-042 (Report) dealing with underreporting of compensation in S corporations. In December 2009, the Government Accountability Office (GAO) calculated S corporation owners underreported compensation by $23.6 billion in tax years (TY) 2003 and 2004. It reported that stakeholder representatives, one of which was tax preparer groups, indicated there was limited guidance on officer/shareholder compensation. The GAO used IRS data to report that approximately 13% of S corporation owners paid inadequate compensation to avoid employment taxes. In August 2016, the U.S. Department of the Treasury's Office of Tax Analysis reported that 90% of S corporations have only one shareholder, and 98% have fewer than five. It also reported that there were 371,000 S corporations with labor costs but no issued Form W-2, *Wage and Tax Statement,* for owners or other employees. This should be an area of increased government audit activity going forward.

In the C corporation area, the inquiry is whether the compensation is unreasonably high. It may be disguised dividends to avoid double taxation. It may also be a device to make deductible items that may not otherwise be deductible.

When the focus is on the reasonableness of a company's salary deduction for a non-owner employee, for example, auditors consistently refer to certain factors, some of which include special skill sets, the worker's level of responsibility, and the salary that similar companies would realistically offer the same employee. Additionally, if other family members are employed, is their compensation reasonable in relation to the services they are providing the corporation or the responsibilities of their position within the company?

A part of an IRS audit of small or closely held corporations may focus on stock issuance transactions to ensure they are legitimate and not used to disguise sales or other types of transactions, especially if assets are transferred to the corporation for stock. Auditors may review records to see if shares were sold at fair market value or at a discount. If discounted too much, auditors may suspect that the stock transaction was done for reasons other than to raise capital.

Schedule M-1 is an area of interest to auditors if the corporation is maintaining its regular books and records on other than a tax basis. The Schedule M-1 on Form 1120 is used to reconcile book income/loss to the income or loss calculated using tax principles. IRS auditors regularly review the detail behind the reconciliation, such as the adjusting entries made and application of the correct rules. Of particular interest is a corporation with large financial statement income per Schedule L Balance Sheet and little or no taxable income.

D. Schedule UTP

Income for financial statements may differ from taxable income based on the differences in the rules. U.S. Generally Accepted Accounting Principles have long required that income tax be accrued for all events recognized for financial reporting purposes. In 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, codified as ASC 740-10, requiring businesses to analyze all tax positions that are less than certain. Only those positions that are more likely than not to produce benefit can be recognized in accruing tax. The likely outcomes of recognized positions are then computed and assigned probabilities. The most favorable set of outcomes that achieves 50% probability is then recognized. This is known as the measurement step. The business must then record tax expense or benefit, liabilities, and assets, as so measured. The uncertain tax positions must be disclosed as part of the financial report.

In 2010, the IRS came out with Schedule UTP (uncertain tax positions). Schedule UTP requires the reporting of each U.S. federal income tax position taken by an applicable corporation on its U.S. federal income tax return for which two conditions are satisfied:

1. The corporation has taken a tax position on its U.S. federal income tax return for the current tax year or for a prior tax year.

2. Either the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements, or the corporation or related party did not record a reserve for that tax position because the corporation expects to litigate the position.

The instructions explain that the Schedule seeks the reporting of tax positions consistent with the reserve decisions made by the corporation for audited financial statement purposes under applicable accounting standards. For a corporation subject to FIN 48 (ASC 740-10), a tax position is considered "sufficiently certain so that no reserve was required," and therefore need not be reported on Schedule UTP, if the position is "highly certain" within the meaning of FIN 48 (ASC 740-10). If the corporation reconsiders whether a reserve is required for a tax position and eliminates the reserve in an interim audited financial statement issued before the tax position is taken on a return, the corporation need not report the tax position to which the reserve relates on the Schedule UTP.

A corporation must file Schedule UTP for the current tax year if:

1. The corporation files Form 1120, U.S. Corporation Income Tax Return; Form 1120-F, U.S. Income Tax Return of a Foreign Corporation; Form 1120-L, U.S. Life Insurance Company Income Tax Return; or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return;

2. The corporation has assets that equal or exceed $10 million;

3. The corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year; and

4. The corporation has one or more tax positions that must be reported on Schedule UTP.

The IRS issued a policy of restraint with regards to Schedule UTP in Announcement 2010-76. LB&I examiners cannot request, in any open examination, documents that are privileged under the attorney-client privilege, the tax advice privilege, or the work product doctrine, notwithstanding whether these documents have been provided to an independent auditor as part of a financial statement audit unless the privilege has been otherwise waived. Any outstanding requests for such documents should be withdrawn. Additionally, taxpayers may redact the following information from any copies of tax reconciliation workpapers they are asked to produce during an examination:

- Working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP.

- The amount of any reserve related to a tax position reported on Schedule UTP.

- Computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position.

E. Eggshell Audits

The eggshell audit is an examination that could result in a high risk of a large penalty for willfulness including but not limited to the 75% fraud penalty being assessed or worse, a criminal referral. It could be that the taxpayer has incriminating evidence of fraud or other willful action that the agent is not yet aware of; or in what may be called a reverse eggshell audit, the agent is aware of the possible criminal activity, and the civil process is being used to gather evidence for a criminal referral. The taxpayer, and by extension the practitioner, is "walking on eggshells."

It is important that a CPA or EA have the client seek legal representation if the practitioner suspects it could be or is becoming an eggshell audit. The potential of criminal referral requires some legal determinations of what can and should be disclosed. The biggest risk with the eggshell audit is that taxpayers will provide more information than necessary and self-incriminate themselves. And, because there is no 5th amendment right in a civil setting, the risk of self-incrimination is high. While a taxpayer is required to answer all questions honestly and accurately, he/she is not required to self-incriminate himself/herself. If the taxpayer makes intentional misrepresentations or omissions, it can lead to a criminal investigation. However, taking the 5th will assuredly alert the auditor that there are criminal issues and that they should stop the civil audit and refer the matter to the criminal division.

The main objective in an eggshell audit is to prevent a criminal investigation and keep the matter a civil examination. The lesser objective is to avoid civil fraud penalties and minimize adjustments. Section 6663 imposes a 75% penalty on the portion of underpayment attributable to fraud. There are three likely outcomes:

1. Revenue Agent does not discover criminal issues;
2. Revenue Agent discovers some or all criminal issues but is convinced to keep matter a civil examination; or
3. Revenue Agent makes a referral to Criminal Investigations (CI).

It is important to perform due diligence and prepare thoroughly for the examination. Start by reviewing all returns and information available and then having a "heart-to-heart" meeting with the client. Practitioners may want to consider a forensic examination, perform analyses of bank deposits and net worth/lifestyle, and identify all possible criminal offenses. They should familiarize themselves with any possible privileges that could be asserted.

According to the Internal Revenue Manual, a criminal referral is likely if firm indications of fraud exist. I.R.M. 25.1.2 describes indications of fraud, including omissions, inability to explain large items, substantial overstatements, two sets of books, fictitious items, etc.

It should be emphasized that legal counsel should be brought in as soon as there is an indication that this may be an eggshell audit.

F. Conclusion

There are a myriad of issues in the audits of small businesses and corporations. While there are many similarities, there are also many distinct issues. The odds of a client getting audited are small but, when it happens, it is nonetheless stressful for the client. Care should be taken to be vigilant as the IRS has increased the use of eggshell audits. If a practitioner believes it is a reverse eggshell audit, they should consider having the client engage legal counsel to spearhead the audit from the outset. If it is later discovered that there are possible disclosures that could lead to a criminal referral, a practitioner should recommend the client engage counsel at that point.

GROUP STUDY MATERIALS

A. Discussion Problems

Your client, Jamie, has a small business operated as a sole proprietorship. Jamie's Schedule C shows some unusually large deductions, including for meals and travel. Jamie has received an audit notice and wonders why he might have received it.

SmithCo, Inc. is a large publicly traded corporation. In preparing their financial statements, your office has determined that they need to set up a reserve on a position you have taken on the return. It has been footnoted in the financial statements.

Paul brings in an audit notice on a return another office prepared. It includes rental real estate, a small sole proprietorship, and a number of passive investments. In the process of preparing for the audit, Paul mentions that he was not forthcoming with information when the return was prepared. He mentions that he has "manipulated" the figures in a number of areas and provided misleading information to his prior accountant. He did this to reduce what would have been a substantial tax liability.

Required:

Address each of the issues fairly raised in the above fact patterns.

1) Discuss items that may have triggered an audit in Jamie's situation.

2) Discuss the need for a Schedule UTP for SmithCo.

3) Discuss how to proceed with the audit for Paul.

B. Suggested Answers to Discussion Problems

1) Most audits are triggered by a few items. Among the most common are outlier figures and dubious expense categories. The IRS will also receive tips from disgruntled employees or ex-employees. In addition, in the DIF (Discriminant Inventory Function) System, the computer assigns a numeric score to each individual and some corporate returns. This will select returns that have too many questionable items outside established norms. Additionally, there is an Unreported Income DIF or UI DIF that is used for two purposes:

    - To rate the probability of inaccurate information
    - To rate the probability of omitted income on a tax return

    Among the most common reasons why a small business may be audited include taking several substantial deductions. Additionally, the most common mistake that causes a business to be audited is when the total sales reported is less than the total of Forms 1099 filed for the business.

Any of these or a combination could be the reason.

2) Schedule UTP requires the reporting of each U.S. federal income tax position taken by an applicable corporation on its U.S. federal income tax return for which two conditions are satisfied.

    - The corporation has taken a tax position on its U.S. federal income tax return for the current tax year or for a prior tax year.
    - Either the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements, or the corporation or related party did not record a reserve for that tax position because the corporation expects to litigate the position.

    The instructions explain that the Schedule seeks the reporting of tax positions consistent with the reserve decisions made by the corporation for audited financial statement purposes under applicable accounting standards.

3) This appears to be an eggshell audit. From the discussion, Paul has willfully manipulated the numbers to create a false tax return. This could result in possible criminal referral. The goal of the audit is to keep it civil, and secondarily, to avoid the 75% civil fraud penalty. There is also a possibility that the IRS believes that Paul has committed tax fraud and is going to use the civil process to gather information before a criminal referral. You cannot knowingly mislead the IRS, although you shouldn't volunteer information that isn't requested. This is a fine line for anyone to walk; therefore, it would be wise to recommend to Paul that he obtain legal counsel to take the lead in this audit.

GLOSSARY OF KEY TERMS

Coronavirus Aid, Relief, and Economic Security Act (CARES Act)—H.R. 748, also known as the CARES Act, is the third coronavirus relief package and was signed into law on March 27, 2020. This bill had bipartisan support in both the Senate and House and contains both tax and non-tax provisions applicable to individuals and businesses.

Eggshell Audit—Eggshell audit is not a formal term but is commonly used to describe a situation in which a taxpayer is facing a civil tax audit and could potentially be referred for criminal prosecution.

Infrastructure Investment and Jobs Act—Public Law No. 117-58, also known as the Bipartisan Infrastructure Framework, was signed into law by President Biden on November 15, 2021 and includes approximately $1.2 trillion in spending to include funding for broadband access, clean water, electric grid renewal, and transportation and road provisions, along with tax-related provisions.

Offer in Compromise—The IRS has the ability to "compromise" a civil or criminal tax liability after assessment and before referral to the Department of Justice. The taxpayer may seek a compromise based on doubt as to collectibility, doubt as to liability, or to promote effective tax administration. The process is known as offer in compromise (OIC) and constitutes an agreement between a taxpayer and the IRS to accept less than full payment.

Section 121 Exclusion—The Section 121 exclusion, also known as the personal residence exclusion, is provided by IRC Section 121 and allows homeowners to exclude a certain portion of gain when selling their primary residence. Provided certain requirements are met, individuals can exclude from gross income up to $250,000 of gain; certain married couples filing jointly can exclude up to $500,000.

Setting Every Community Up for Retirement Enhancement (SECURE Act)—Part of the Further Consolidated Appropriations Act, 2020 (H.R. 1865, P.L. 116-94, the SECURE Act was enacted on December 20, 2019. It provides expanded opportunities for individuals for retirement savings and makes a number of administrative simplifications. It also includes a change to the kiddie tax.

Tax Cuts and Jobs Act (TCJA)—Public Law No. 115-97, an act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, was signed into law by President Trump on December 22, 2017. Although not the official name for the new legislation, it is most commonly referred to as the Tax Cuts and Jobs Act (TCJA).

CUMULATIVE INDEX 2022

BY TOPIC

BY CITATION

BY SPEAKER

Choose the best response and record your answer in the space provided on the answer sheet.

1. According to Ian Redpath, which of the following is correct regarding the $10,000 nonwillful failure to file an FBAR penalty?

   A. The Fifth Circuit Court of Appeals has held that the penalty applies per FBAR, not per financial account.
   B. The Ninth Circuit Court of Appeals has held that the penalty applies per FBAR, not per financial account.
   C. The Fifth and Ninth Circuit Courts of Appeals both held that the penalty applies per FBAR, not per financial account.
   D. The Fifth and Ninth Circuit Courts of Appeals both held that the penalty applies per financial account, not per FBAR.

2. According to Ian Redpath, which of the following discusses the 4% floor that may apply for the low-income housing credit?

   A. IRS Publication 5186
   B. Revenue Procedure 2021-53
   C. Revenue Ruling 2021-20
   D. SBSE-05-1021-0063

3. According to Ian Redpath, in which of the following cases did the Tax Court uphold the IRS's authority to apply credit election funds to past-due child support payments?

   A. *Blommer v. Commissioner*
   B. *Hadsell v. U.S.*
   C. *Sauter v. Commissioner*
   D. *U.S. v. Page*

4. According to Ian Redpath, which of the following is a great resource specifically for enrolled agents?

   E. IRS Publication 5186
   F. Revenue Procedure 2021-53
   G. Revenue Ruling 2021-20
   H. SBSE-05-1021-0063

5. According to Ian Redpath, in which of the following cases was the taxpayer assessed a frivolous argument penalty?

   A. *Blommer v. Commissioner*
   B. *Hadsell v. U.S.*
   C. *Sauter v. Commissioner*
   D. *U.S. v. Page*

Continued on next page

6. According to Ian Redpath and Robert Lickwar, which of the following is correct regarding the IRC Section 121 exclusion?

   A. The maximum amount for single taxpayers is $250,000.
   B. The maximum amount for married filing jointly taxpayers is $250,000.
   C. The maximum amount for both single and married filing jointly taxpayers is $250,000.
   D. The maximum amount for single taxpayers is $500,000.

7. According to Ian Redpath and Robert Lickwar, which of the following is correct regarding back taxes (more than one year old) paid by a buyer at the time of closing on a personal residence?

   A. They may be deducted in the current year.
   B. They may be deducted in the current year or added to the basis of the residence.
   C. They must be deducted in the current year.
   D. They must be added to the basis of the residence.

8. According to Ian Redpath and Robert Lickwar, to be able to exclude any gain for homes sold after 1997, the proceeds must be reinvested in a new residence within what period of time?

   A. One year
   B. Two years
   C. Five years
   D. No longer a requirement

9. According to Ian Redpath and Robert Lickwar, which of the following generally increases the basis of a personal residence?

   A. Remodeling the kitchen
   B. Painting the interior
   C. Painting the exterior
   D. Planting a vegetable garden

10. According to Ian Redpath and Robert Lickwar, which of the following is ***not*** correct regarding the two-in-five year rule?

    A. The taxpayer must have lived in the residence in two of the last five years.
    B. The taxpayer must have lived in and owned the residence in the same two of the last five years.
    C. The taxpayer must have lived in and owned the residence two of the last five years.
    D. The taxpayer must have owned the residence two of the last five years.

Continued on next page

11. According to Ian Redpath and Shiny Mathew, which of the following is correct regarding playing the "audit lottery?"

    A. Best practices include playing the audit lottery if the risk of audit is low.
    B. Circular 230 recommends playing the audit lottery.
    C. It is unethical to play the audit lottery.
    D. The Statements on Responsibility and Tax Services recommend playing the audit lottery.

12. According to Ian Redpath and Shiny Mathew, which of the following is recommended if a CPA suspects a client is involved in any level of fraud?

    A. Consult an attorney.
    B. Consult an enrolled agent.
    C. Consult another CPA.
    D. Ignore the suspicion until more evidence is available.

13. According to Ian Redpath and Shiny Mathew, which of the following do they generally find to be most beneficial to the taxpayer?

    A. Agree to an extension of the statute of limitations whenever requested by the IRS.
    B. Drag an IRS audit out as long as possible.
    C. Let the IRS dictate the speed of the audit.
    D. Push an IRS audit through as fast as possible.

14. According to Ian Redpath and Shiny Mathew, ASC 740-10 (previously FIN 48) provides guidance for reporting which of the following for financial accounting purposes?

    A. Unacceptable Tax Position
    B. Uncertain Tax Position
    C. Unreportable Tax Position
    D. Untenable Tax Position

15. According to Ian Redpath and Shiny Mathew, which of the following is least likely to be audited by the IRS?

    A. C corporations with one stockholder
    B. C corporations with less than 100 stockholders
    C. C corporations with less than $1 million gross income
    D. C corporations with more than $20 billion in assets

CPE Network®
Tax Report
Volume 35, Issue 1 January 2022

Subscriber Survey

Evaluation Form

Please take a few minutes to complete this survey related to the **CPE Network® Tax Report** and return it by mail to 2395 Midway Road, Carrollton, Texas 75006, Attn: Managing Editor. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to **CPLgrading@thomsonreuters.com.**

How would you rate the topics covered in the January 2022 **CPE Network® Tax Report?** Rate each topic on a scale of 1–5 (5=highest):

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
Experts' Forum	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
Sale of a Residence	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
IRS Audits of Corporations	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|

Which segments of the January 2022 issue of **CPE Network® Tax Report** did you like the most, and why?

____

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Which segments of the January 2022 issue of **CPE Network® Tax Report** did you like the least, and why?

____

____

____

____

What would you like to see included or changed in future issues of **CPE Network® Tax Report**?

____

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____

____

Are there any other ways in which we can improve **CPE Network® Tax Report**?

____

____

____

____

How would you rate the effectiveness of the speakers in the January 2022 **CPE Network® Tax Report**? Rate each speaker on a scale of 1–5 (5 highest):

	Overall	**Knowledge of Topic**	**Presentation Skills**
Ian Redpath	|______|	|______|	|______|
Robert Lickwar	|______|	|______|	|______|
Shiny Rachel Mathew	|______|	|______|	|______|

Which of the following would you use for viewing CPE Network® A&A Report? DVD ☐ Streaming ☐ Both ☐

Are you using **CPE Network® Tax Report** for: CPE Credit ☐ Information ☐ Both ☐ ____________________________

Were the stated learning objectives met? Yes ☐ No ☐ ____________________________

If applicable, were prerequisite requirements appropriate? Yes ☐ No ☐ ____________________________

Were program materials accurate? Yes ☐ No ☐ ____________________________

Were program materials relevant and contribute to the achievement of the learning objectives? Yes ☐ No ☐ __________

Were the time allocations for the program appropriate? Yes ☐ No ☐ ____________________________

Were the supplemental reading materials satisfactory? Yes ☐ No ☐ ____________________________

Were the discussion questions and answers satisfactory? Yes ☐ No ☐ ____________________________

Were the audio and visual materials effective? Yes ☐ No ☐ ____________________________

Specific Comments: ____

____

Name/Company ____

Address ____

City/State/Zip ____

Email ____

Once Again, Thank You…
Your Input Can Have a Direct Influence on Future Issues!

CPE Network®

CPE Group Attendance Sheet

Firm/Company Name: ____________________

Account #: ____________________

Location: ____________________

Program Title: CPE Network Tax Report, January 2022 Date: ________

Name	Email	Total Hrs	IRS PTIN ID (if applicable Tax only)	Sign In	Sign Out

I certify that the above individuals viewed and were participants in the group discussion with this issue/segment of the CPE Network® newsletter, and earned the number of hours shown.

Instructor Name: ____________________ Date: ________

E-mail address: ____________________

License State and Number: ____________________

Group Study PO Box 115008, Carrollton, TX 75011 -5008 Fax (888) 286.9070 CPLgrading@thomsonreuters.com

CPE Network/Webinar Delivery Tracking Report

Course Title	
Course Date:	
Start Time:	
End Time:	
Moderator Name, Credentials, and Signature Attestation of Attendance:	
Delivery Method:	Group Internet Based
Total CPE Credit:	3.0
Instructions:	During the webinar, the moderator must verify student presence a minimum of 3 times per CPE hour. This is achieved via polling questions. Sponsors must have a report which documents the responses from each student. The timing of the polling questions should be random and not made known to students prior to delivery of the course. Record the polling question responses below. Refer to the CPL Network User Guide for more instructions. Partial credit will not be issued for students who do not respond to at least 3 polling questions per CPE hour.
Brief Description of Method of Polling	Example: Zoom: During this webinar, moderator asked students to raise their hands 3 times per CPE hour. The instructor then noted the hands that were raised in the columns below.

			First CPE Hour			**CPE Hour 2**			**CPE Hour 3**			**FOR TR USE ONLY**
First Name	**Last Name**	**Student Email**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Certificate Issued?**

CHECKPOINT LEARNING NETWORK

CPE NETWORK®
USER GUIDE

REVISED SEPTEMBER 3, 2021

Welcome to CPE Network!

CPE Network programs enable you to deliver training programs to those in your firm in a manageable way. You can choose how you want to deliver the training in a way that suits your firm's needs: in the classroom, virtual, or self-study. You must review and understand the requirements of each of these delivery methods before conducting your training to ensure you meet (and document) all the requirements.

This User Guide has the following sections:

- **"Group Live" Format:** The instructor and all the participants are gathered into a common area, such as a conference room or training room at a location of your choice.
- **"Group Internet Based" Format:** Deliver your training over the internet via Zoom, Teams, Webex, or other application that allows the instructor to present materials that all the participants can view at the same time.
- **"Self-Study" Format:** Each participant can take the self-study version of the CPE Network program on their own computers at a time and place of their convenience. No instructor is required for self-study.
- **What Does It Mean to Be a CPE Sponsor?:** Should you decide to vary from any of the requirements in the 3 methods noted above (for example, provide less than 3 full CPE credits, alter subject areas, offer hybrid or variations to the methods described above), Checkpoint Learning Network will not be the sponsor and will not issue certificates. In this scenario, your firm will become the sponsor and must issue its own certificates of completion. This section outlines the sponsor's responsibilities that you must adhere to if you choose not to follow the requirements for the delivery methods.
- **Getting Help:** Refer to this section to get your questions answered.

IMPORTANT: This User Guide outlines in detail what is required for each of the 3 formats above. Additionally, because you will be delivering the training within your firm, you should review the Sponsor Responsibilities section as well. To get certificates of completion for your participants following your training, you must submit all the required documentation. (This is noted at the end of each section.) Checkpoint Learning Network will review your training documentation for completeness and adherence to all requirements. If all your materials are received and complete, certificates of completion will be issued for the participants attending your training. Failure to submit the required completed documentation will result in delays and/or denial of certificates.

IMPORTANT: If you vary from the instructions noted above, your firm will become the sponsor of the training event and you will have to create your own certificates of completions for your participants. In this case, you do not need to submit any documentation back to Thomson Reuters.

If you have any questions on this documentation or requirements, refer to the "Getting Help" section at the end of this User Guide **BEFORE** you conduct your training.

We are happy that you chose CPE Network for your training solutions.
Thank you for your business and HAPPY LEARNING!

Copyrighted Materials

“Group Live” Format

CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template after the executive summary of the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance

You must monitor individual participant attendance at “group live” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **attendance sheet.** This lists the instructor(s) name and credentials, as well as the first and last name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant arrives late, leaves early, or is a “no show,” the actual hours they attended should be documented on the sign-in sheet and will be reflected on the participant's CPE certificate.

Real Time Instructor During Program Presentation

"Group live" programs must have a **qualified, real time instructor while the program is being presented.** Program participants must be able to interact with the instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A "group live" program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Make-Up Sessions

Individuals who are unable to attend the group study session may use the program materials for self-study either in print or online.

- If the print materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his/their CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant's record of attendance and is awarded by Checkpoint Learning Network after the "group live" documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the "group live" session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether Checkpoint Learning Network is the sponsor for the "group live" session, it is required that the firm hosting the "group live" session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Group Study Attendance sheets; indicating any late arrivals and/or early departures)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations.

Finding the Transcript

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- https://get.adobe.com/reader/

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your "group live" session should be sent to Checkpoint Learning Network by one of the following means:

Mail: Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008

Email: **CPLgrading@tr.com**

Fax: 888.286.9070

When sending your package to Thomson Reuters, you must include ALL of the following items:

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Attendance Sheet		Use this form to track attendance during your training session.
Subscriber Survey Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to Thomson Reuters any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Group Internet Based” Format

CPE Credit

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Advertising / Promotional Page

Create a promotion page (use the template following the executive summary in the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance in a Webinar

You must monitor individual participant attendance at “group internet based” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **Webinar Delivery Tracking Report.** This form lists the moderator(s) name and credentials, as well as the first and last name of each participant attending the seminar. During a webinar you must set up a monitoring mechanism (or polling mechanism) to periodically check the participants’ engagement throughout the delivery of the program.

In order for CPE credit to be granted, you must confirm the presence of each participant **3 times per CPE hour and the participant must reply to the polling question**. Participants that respond to less than 3 polling questions in a CPE hour will not be granted CPE credit. For example, if a participant only replies to 2 of the 3 polling questions in the first CPE hour, credit for the first CPE hour will not be granted. (Refer to the Webinar Delivery Tracking Report for examples.)

Examples of polling questions:

1. You are using **Zoom** for your webinar. The moderator pauses approximately every 15 minutes and ask that participants confirm their attendance by using the "raise hands" feature. Once the participants raise their hands, the moderator records the participants who have their hands up in the **webinar delivery tracking report** by putting a YES in the webinar delivery tracking report. After documenting in the spreadsheet, the instructor (or moderator) drops everyone's hands and continues the training.
2. You are using **Teams** for your webinar. The moderator will pause approximately every 15 minutes and ask that participants confirm their attendance by typing "Present" into the Teams chat box. The moderator records the participants who have entered "Present" into the chat box into the **webinar delivery tracking report**. After documenting in the spreadsheet, the instructor (or moderator) continues the training.
3. If you are using an application that has a way to automatically send out polling questions to the participants, you can use that application/mechanism. However, following the event, you should create a **webinar delivery tracking report** from your app's report.

Additional Notes on Monitoring Mechanisms:

1. The monitoring mechanism does not have to be "content specific." Rather, the intention is to ensure that the remote participants are present and paying attention to the training.
2. You should only give a minute or so for each participant to reply to the prompt. If, after a minute, a participant does not reply to the prompt, you should put a NO in the webinar delivery tracking report.
3. While this process may seem unwieldy at first, it is a required element that sponsors must adhere to. And after some practice, it should not cause any significant disruption to the training session.
4. **You must include the Webinar Delivery Tracking report with your course submission if you are requesting certificates of completion for a "group internet based" delivery format.**

Real Time Moderator During Program Presentation

"Group internet based" programs must have a **qualified, real time moderator while the program is being presented.** Program participants must be able to interact with the moderator while the course is in progress (including the opportunity to ask questions and receive answers during the presentation). This can be achieved via the webinar chat box, and/or by unmuting participants and allowing them to speak directly to the moderator.

Make-Up Sessions

Individuals who are unable to attend the “group internet based” session may use the program materials for self-study either in print or online.

- If print materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded by Checkpoint Learning Network after the “group internet based” documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who may not have answered the required amount of polling questions.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the “group live” session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether Checkpoint Learning Network is the sponsor for the "group internet based" session, it is required that the firm hosting the session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Webinar Delivery Tracking Report)
- Copy of the program materials
- Timed agenda with topics covered
- Date and location (which would be "virtual") of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations

Finding the Transcript

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. It should look something like the screenshot below. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- https://get.adobe.com/reader/

Alternatively, for those without a DVD drive, the email sent to administrators each month has a link to the pdf for the newsletter. The email may be forwarded to participants who may download the materials or print them as needed.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your "group internet based" session should be sent to Checkpoint Learning Network by one of the following means:

Mail: Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008

Email: **CPLgrading@tr.com**

Fax: 888.286.9070

When sending your package to Thomson Reuters, you must include ALL the following items:

Form Name	**Included?**	**Notes**
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Webinar Delivery Tracking Report		Use this form to track the attendance (i.e., polling questions) during your training webinar.
Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to Thomson Reuters any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Self-Study” Format

If you are unable to attend the live group study session, we offer two options for you to complete your Network Report program.

Self-Study—Print

Follow these simple steps to use the printed transcript and DVD:

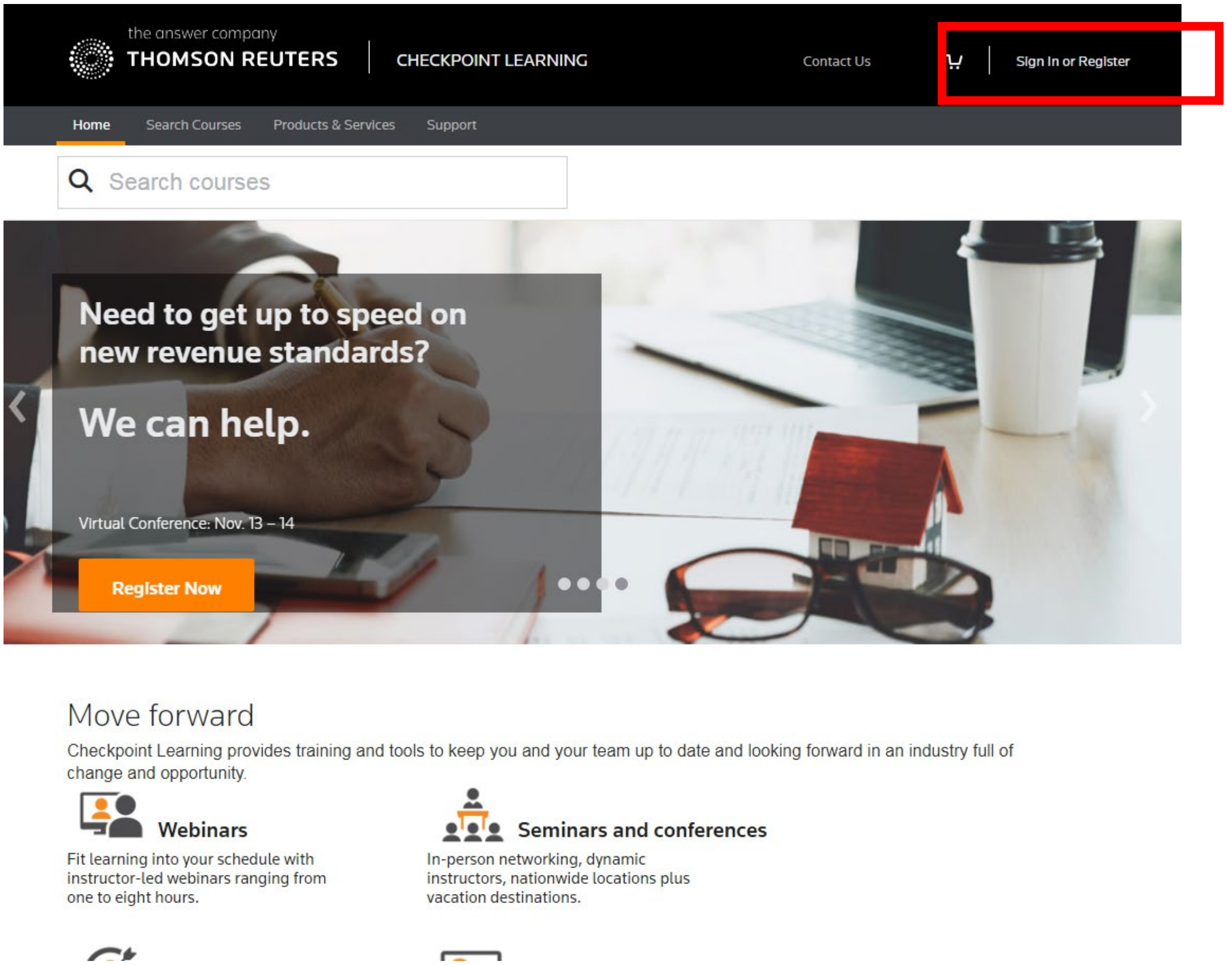
- Watch the DVD.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.
- Mail your completed quizzer and survey to:

  Thomson Reuters
  PO Box 115008
  Carrollton, TX 75011-5008

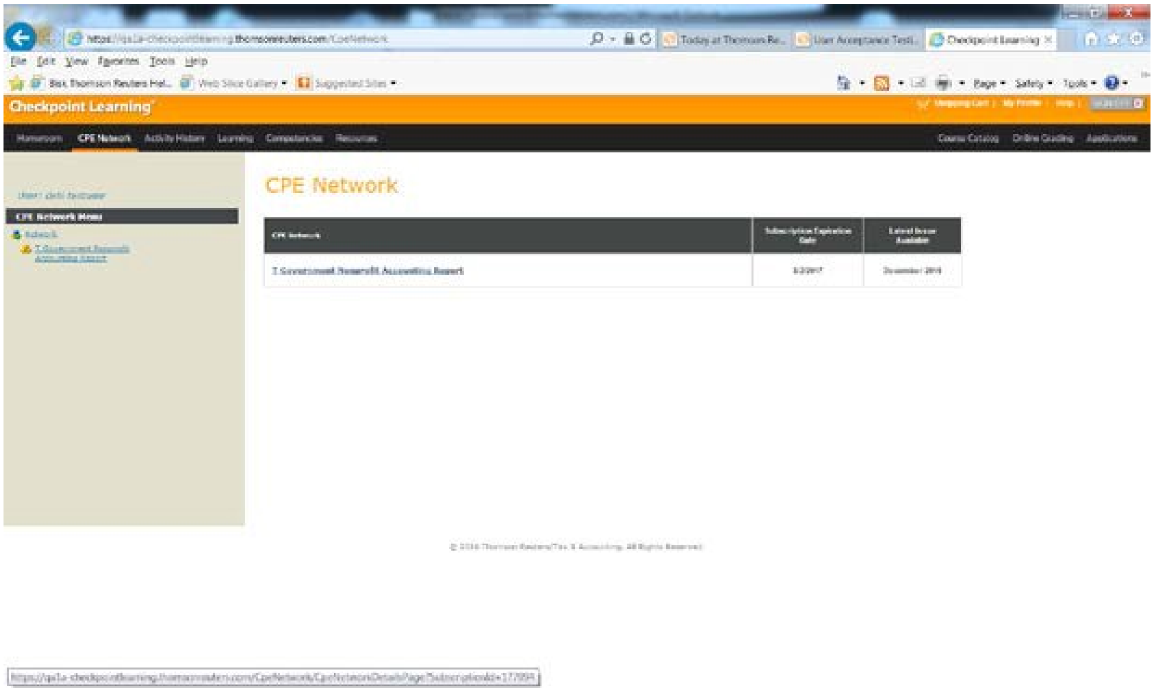
Self-Study—Online

Follow these simple steps to use the online program:

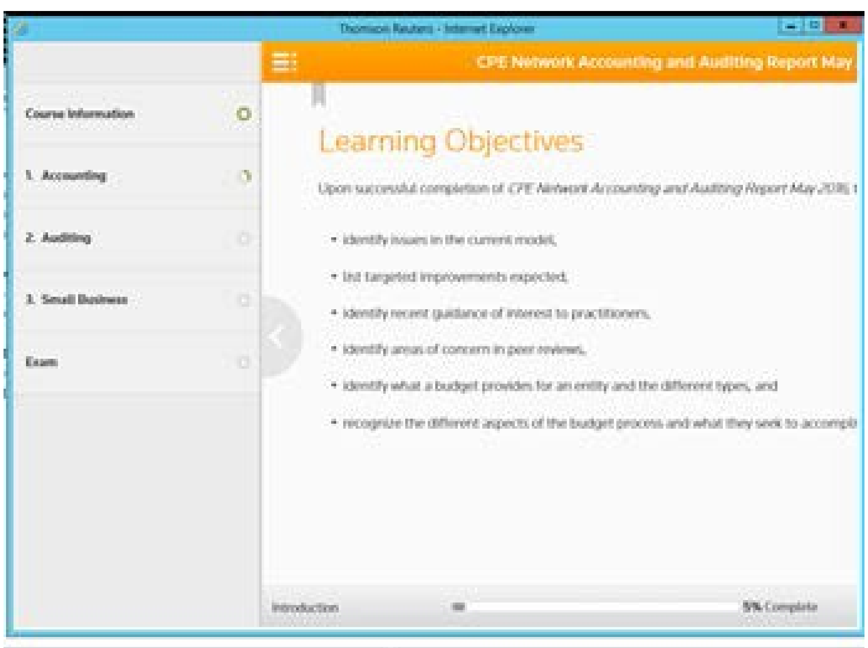
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm’s administrator in the upper right-hand margin (“Sign In or Register”).


the answer company
THOMSON REUTERS
CHECKPOINT LEARNING
Contact Us
Sign In or Register
Home
Search Courses
Products & Services
Support
Search courses
Need to get up to speed on new revenue standards?
We can help.
Virtual Conference: Nov. 13 – 14
Register Now
Move forward
Checkpoint Learning provides training and tools to keep you and your team up to date and looking forward in an industry full of change and opportunity.
Webinars
Fit learning into your schedule with instructor-led webinars ranging from one to eight hours.
Seminars and conferences
In-person networking, dynamic instructors, nationwide locations plus vacation destinations.

- In the **Network** tab, select the Network Report for the month desired.

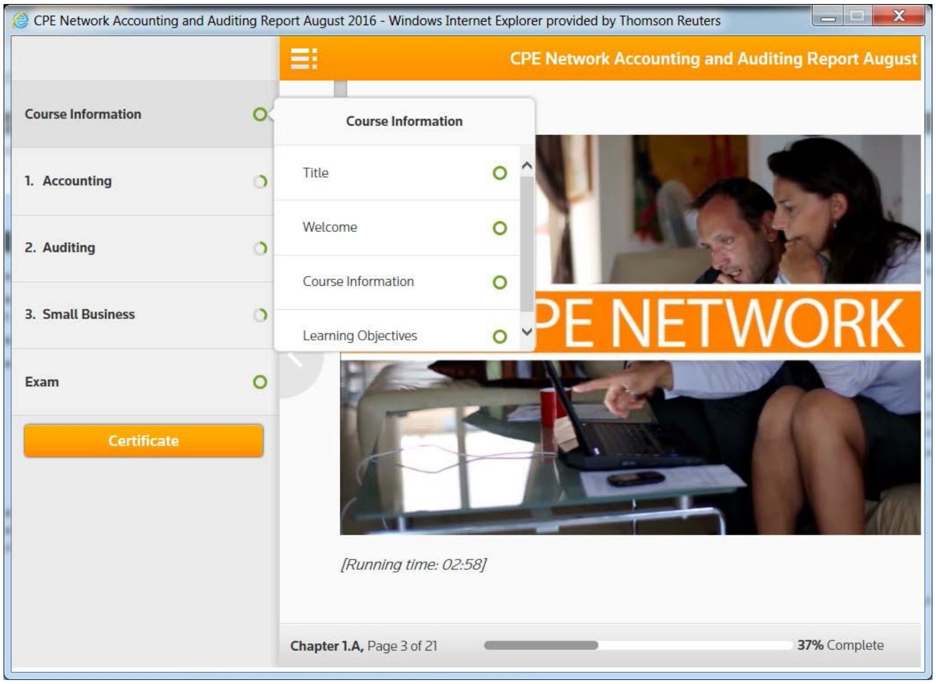


The Chapter Menu is in the gray bar at the left of your screen:

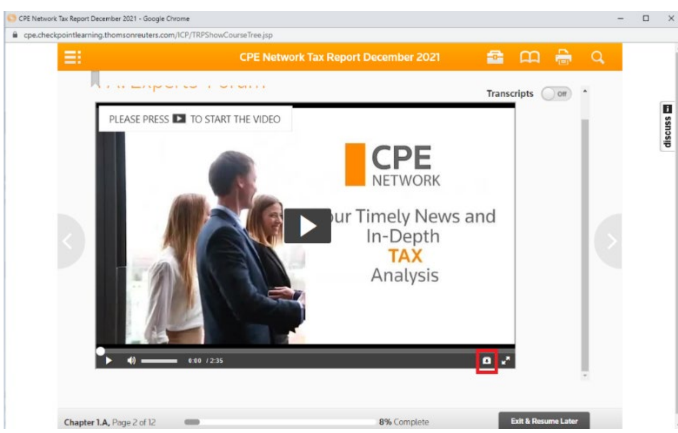


Click down to access the dropdown menu and move between the program Chapters.

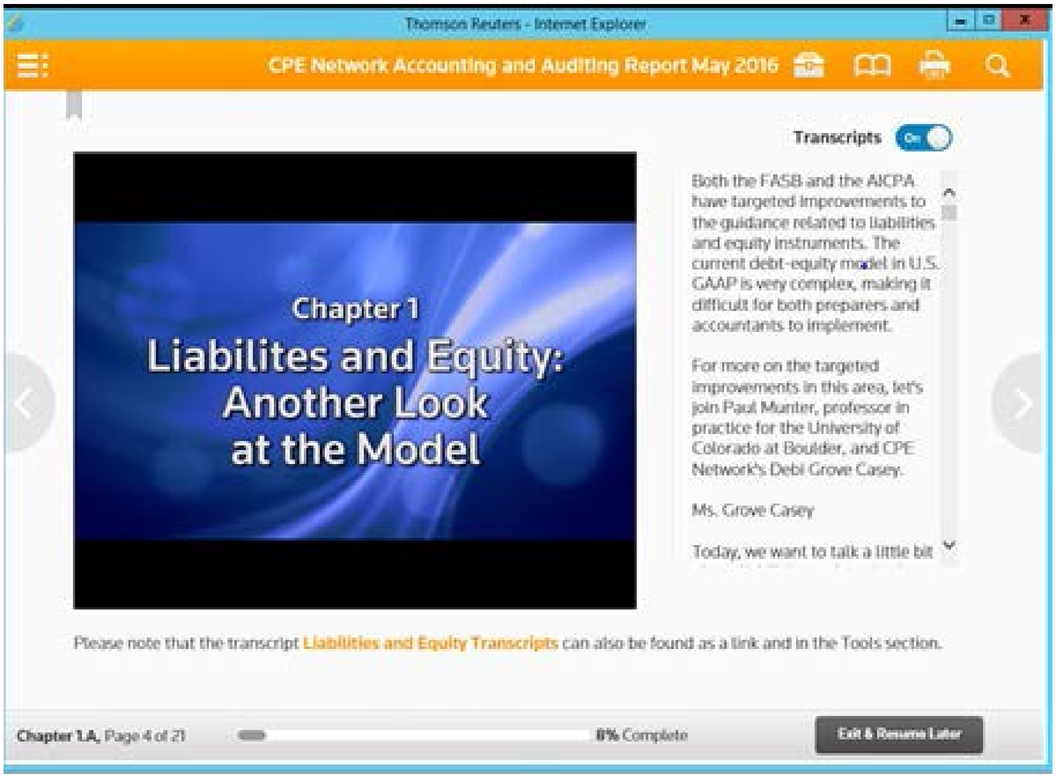
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



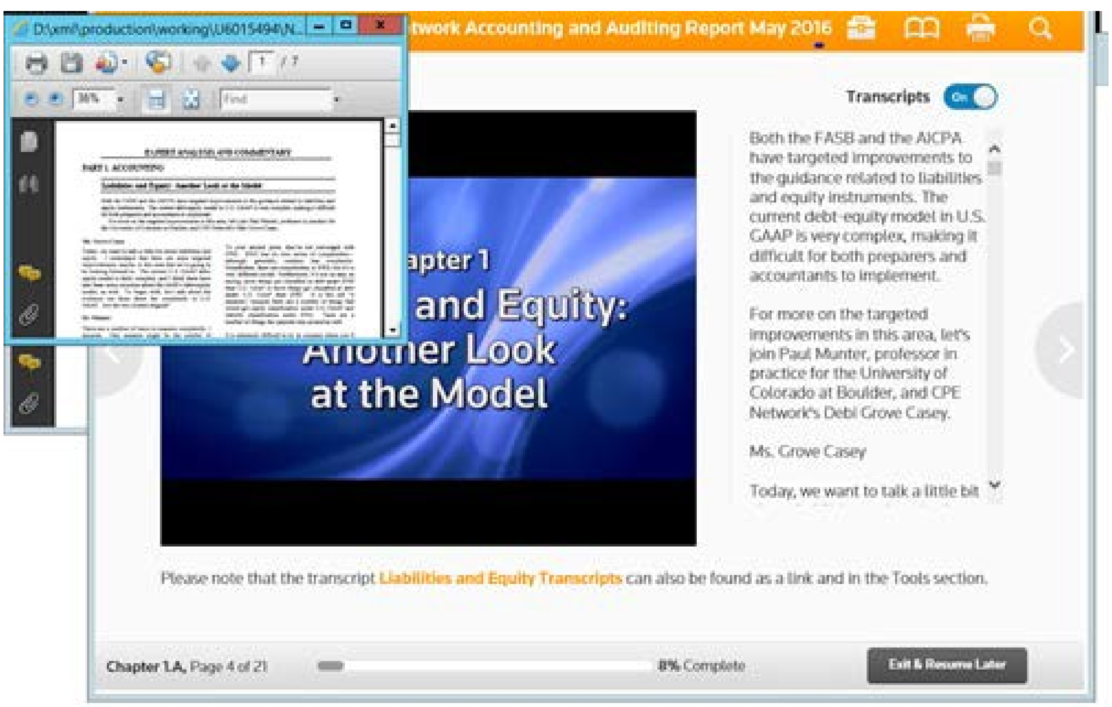
- **Each Chapter is now self-contained.** Years ago, when on the CPEasy site, the interview segments were all together, then all the supplemental materials, etc. Today, each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions. This more streamlined approach allows administrators and users to more easily access the related materials.



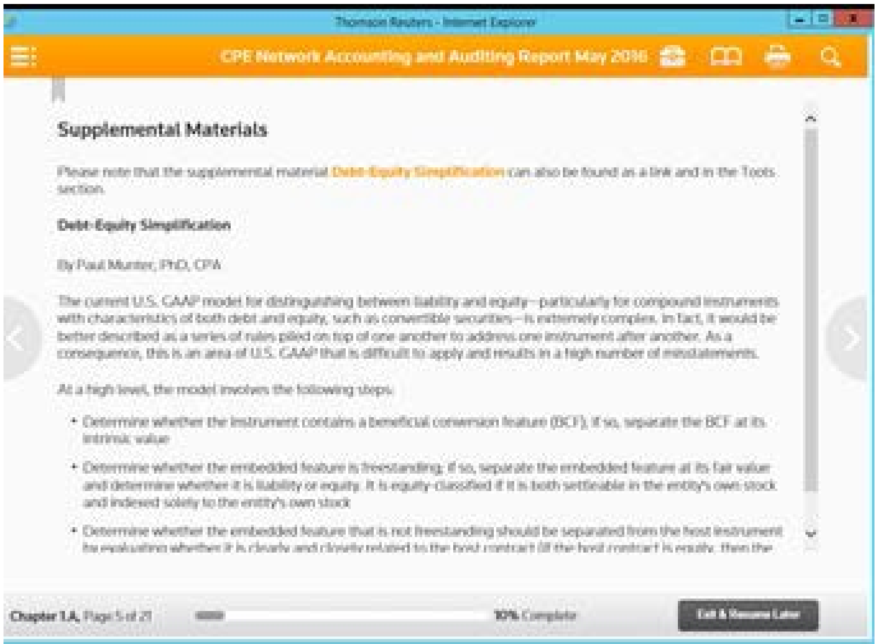
Video segments may be downloaded from the CPL player by clicking on the download button.

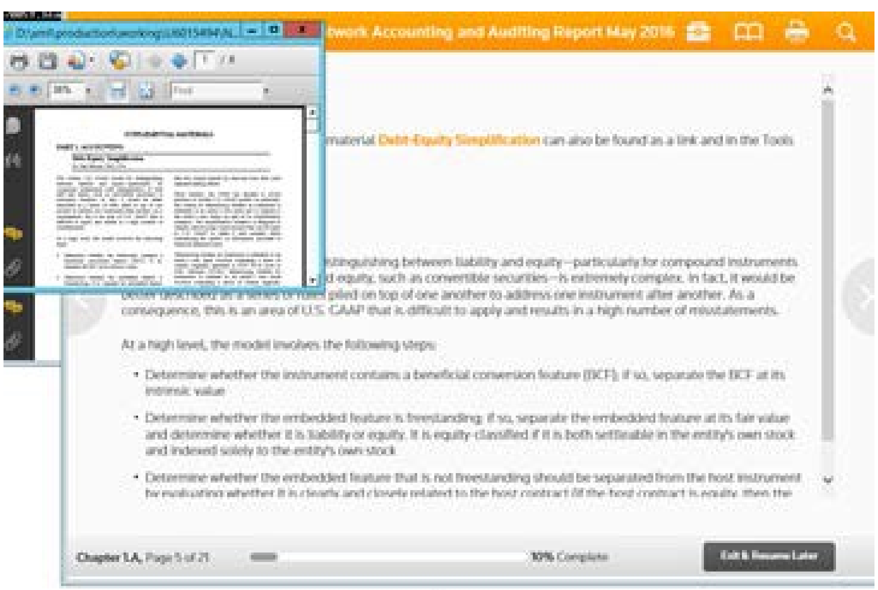


Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts** or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.



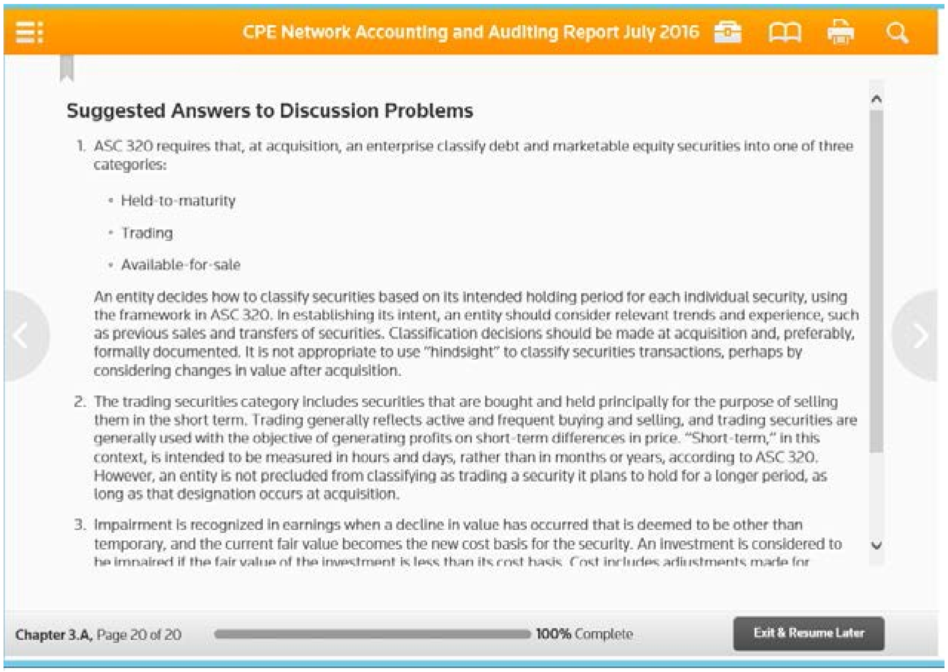
Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.





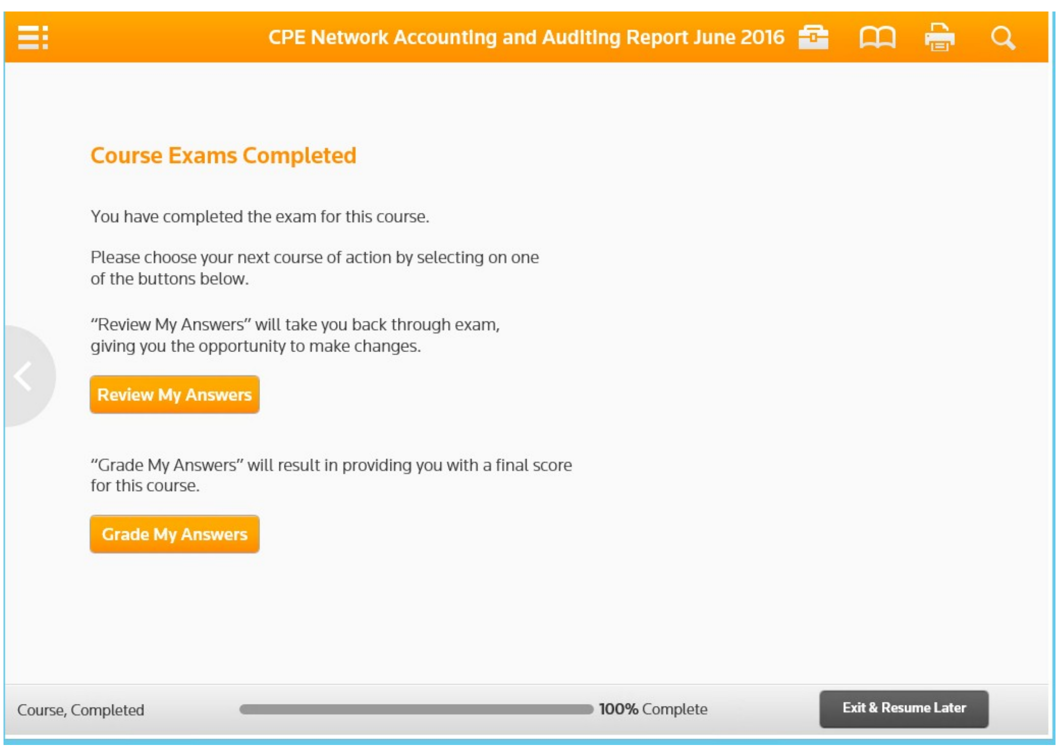
Continuing to click the arrow to the right side of the screen will bring the user to the Discussion p roblems related to the segment.

The Suggested Answers to the Discussion Problems follow the Discussion Problems.



The **Exam** is accessed by clicking the last gray bar on the menu at the left of the screen or clicking through to it. Click the orange button to begin.

When you have completed the quizzer, click the button labeled **Grade or the Review button**.



- Click the button labeled **Certificate** to print your CPE certificate.
- The final quizzer grade is displayed and you may view the graded answers by clicking the button labeled **view graded answer**.

Additional Features Search

Checkpoint Learning offers powerful search options. Click the **magnifying glass** at the upper right of the screen to begin your search. Enter your choice in the **Search For:** box.

Search Results are displayed with the number of hits.

Print

To display the print menu, click the printer icon in the upper bar of your screen. You can print the entire course, the transcript, the glossary, all resources, or selected portions of the course. Click your choice and click the orange **Print**.

What Does It Mean to Be a CPE Sponsor?

If your organization chooses to vary from the instructions outlined in this User Guide, your firm will become the CPE Sponsor for this monthly series. The sponsor rules and requirements noted below are only highlights and reflect those of NASBA, the national body that sets guidance for development, presentation, and documentation for CPE programs. **For any specific questions about state sponsor requirements, please contact your state board. They are the final authority regarding CPE Sponsor requirements.** Generally, the following responsibilities are required of the sponsor:

- Arrange for a location for the presentation
- Advertise the course to your anticipated participants and disclose significant features of the program in advance
- Set the start time
- Establish participant sign-in procedures
- Coordinate audio-visual requirements with the facilitator
- Arrange appropriate breaks
- Have a real-time instructor during program presentation
- Ensure that the instructor delivers and documents elements of engagement
- Monitor participant attendance (make notations of late arrivals, early departures, and “no shows”)
- Solicit course evaluations from participants
- Award CPE credit and issue certificates of completion
- Retain records for five years

The following information includes instructions and generic forms to assist you in fulfilling your responsibilities as program sponsor.

CPE Sponsor Requirements

Determining CPE Credit Increments

Sponsored seminars are measured by program length, with one 50-minute period equal to one CPE credit. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned. Sponsors must monitor the program length and the participants’ attendance in order to award the appropriate number of CPE credits.

Program Presentation

CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. CPE program sponsors must make the following information available in advance:

- Learning objectives.
- Instructional delivery methods.
- Recommended CPE credit and recommended field of study.
- Prerequisites.
- Program level.
- Advance preparation.
- Program description.
- Course registration and, where applicable, attendance requirements.
- Refund policy for courses sold for a fee/cancellation policy.
- Complaint resolution policy.
- Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPE credits**).**

Disclose Significant Features of Program in Advance

For potential participants to effectively plan their CPE, the program sponsor must disclose the significant features of the program in advance (e.g., through the use of brochures, website, electronic notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with non-educational activities, or when several CPE programs are offered concurrently, participants must receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration and attendance policies and procedures must be formalized, published, and made available to participants and include refund/cancellation policies as well as complaint resolution policies.

Monitor Attendance

While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must maintain a process to monitor individual attendance at group programs to assign the correct number of CPE credits. A participant's self-certification of attendance alone is not sufficient. The sign-in sheet should list the names of each instructor and her/his credentials, as well as the name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant leaves early, the hours they attended should be documented on the sign-in sheet and on the participant's CPE certificate.

Real Time Instructor During Program Presentation

"Group live" programs must have a qualified, real time instructor while the program is being presented. Program participants must be able to interact with the real time instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A "group live" program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Awarding CPE Certificates

The CPE certificate is the participant's record of attendance and is awarded at the conclusion of the seminar. It should reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early. Attached is a sample *Certificate of Attendance* you may use for your convenience.

CFP credit is available if the firm registers with the CFP board as a sponsor and meets the CFP board requirements. IRS credit is available only if the firm registers with the IRS as a sponsor and satisfies their requirements.

Seminar Quality Evaluations for Firm Sponsor

NASBA requires the seminar to include a means for evaluating quality. At the seminar conclusion, evaluations should be solicited from participants and retained by the sponsor for five years. The following statements are required on the evaluation and are used to determine whether:

1. Stated learning objectives were met.
2. Prerequisite requirements were appropriate.
3. Program materials were accurate.
4. Program materials were relevant and contributed to the achievement of the learning objectives.
5. Time allotted to the learning activity was appropriate.
6. Individual instructors were effective.
7. Facilities and/or technological equipment were appropriate.
8. Handout or advance preparation materials were satisfactory.
9. Audio and video materials were effective.

You may use the enclosed preprinted evaluation forms for your convenience.

Retention of Records

The seminar sponsor is required to retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (the original sign-in sheets, now in an editable, electronic signable format)

- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name(s) and credentials
- Results of program evaluations

Appendix: Forms

Here are the forms noted above and how to get access to them.

Delivery Method	Form Name	Location	Notes
"Group Live" / "Group Internet Based"	Advertising / Promotional Page	Transcript	Complete this form and circulate to your audience before the training event.
"Group Live"	Attendance Sheet	Transcript	Use this form to track attendance during your training session.
"Group Internet Based"	Webinar Delivery Tracking Report	Transcript	Use this form to track the 'polling questions' which are required to monitor attendance during your webinar.
"Group Live" / "Group Internet Based"	Evaluation Form	Transcript	Circulate the evaluation form at the end of your training session so that participants can review and comment on the training.
Self Study	CPE Quizzer Answer Sheet	Transcript	Use this form to record your answers to the quiz.

Getting Help

Should you need support or assistance with your account, please see below:

Support Group	**Phone Number**	**Email Address**	**Typical Issues/Questions**
Technical Support	800.431.9025 (follow option prompts	checkpointlearning.techsupport@ thomsonreuters.com	• Browser-based • Certificate discrepancies • Accessing courses • Migration questions • Feed issues
Product Support	800.431.9025 (follow option prompts	checkpointlearning.productsupport@ thomsonreuters.com	• Functionality (how to use, where to find) • Content questions • Login Assistance
Customer Support	800.431.9025 (follow option prompts	checkpointlearning.cpecustomerservicet@ thomsonreuters.com	• Billing • Existing orders • Cancellations • Webinars • Certificates