

# Chapter 1: New Developments

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**Note.** Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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## INFLATION REDUCTION ACT OF 2022<sup>1</sup>

On August 16, 2022, President Biden signed into law the Inflation Reduction Act of 2022. The legislation contains several tax-related provisions that are expected to increase federal tax revenue by \$90.7 billion over the next 10 years.<sup>2</sup> Several of those provisions are identified in the following section.

- **Corporate minimum tax**<sup>3</sup> — A 15% minimum tax applies to corporations with \$1 billion or more of annual average net book income in the previous three years. The tax applies to tax years beginning after December 31, 2022.

**Note.** The Joint Committee on Taxation estimates this will impact approximately 150 companies. However, many additional companies should expect to run the calculation to determine whether it applies to them.<sup>4</sup>

- **Excise tax on stock repurchase by public corporations**<sup>5</sup> — The legislation imposes a 1% excise tax on stock repurchases after December 31, 2022. The value of new stock issued reduces the amount subject to the tax. The tax does not apply if repurchases are less than \$1 million or contributed to an employee pension or similar plan. The tax is not deductible.
- **Premium tax credit**<sup>6</sup> — The legislation extends the premium tax credit and its expanded eligibility through 2025. Its provisions eliminate the credit's phaseout for households with annual incomes above 400% of the federal poverty line. The provisions also increase premium credit amounts by adjusting the percentage of annual income that eligible households are required to contribute toward the premium. The provision is effective for tax years beginning after December 31, 2022.

**Note.** For more information on the premium tax credit, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Individual Taxpayer Issues. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

- **Prescription drug pricing reform**<sup>7</sup> — Starting in 2026, Medicare can negotiate lower prices for 10 drugs (increases to 20 drugs in 2029). A 95% sales tax penalty is applied on companies who refuse to negotiate.<sup>8</sup> Out-of-pocket drug costs are maxed at \$2,000 annually for Medicare recipients effective January 1, 2025. Insulin costs are capped at \$35 per month for Medicare recipients. The legislation has additional drug cost caps that apply primarily to Medicare recipients.
- **Increased funding for the IRS**<sup>9</sup> — \$80 billion is allocated to increase enforcement by the IRS and improve taxpayer compliance. This allocation includes enhancements to IRS resources, taxpayer services, operations support, and other resources.

<sup>1</sup> *Inflation Reduction Act*, PL 117-169.

<sup>2</sup> *Joint Committee on Taxation, Estimated Budgetary Effect of the Revenue Provisions of Title I-Committee on Finance, of an Amendment in the Nature of a Substitute to H.R. 5376, "An Act to Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14"* (JCX-18-22), Aug. 9, 2022.

<sup>3</sup> *Inflation Reduction Act*, PL 117-169, §10101.

<sup>4</sup> *Letter to the Honorable Ron Wyden*. Barthold, Thomas. Aug. 1, 2022. Joint Committee on Taxation. [[www.finance.senate.gov/imo/media/doc/CAMT%20JCT%20Data.pdf](https://www.finance.senate.gov/imo/media/doc/CAMT%20JCT%20Data.pdf)] Accessed on Aug. 19, 2022.

<sup>5</sup> *Inflation Reduction Act*, PL 117-169, §10201.

<sup>6</sup> *Ibid.*, §12001.

<sup>7</sup> *Ibid.*, §§11001, 11201, and 11406.

<sup>8</sup> *Ibid.*, §11003(a), implementing IRC §5000D(d).

<sup>9</sup> *Ibid.*, §10301.

- **Excess business losses (EBL)**<sup>10</sup> — Following passage of the Tax Cuts and Jobs Act (TCJA), noncorporate taxpayers were subject to EBL limitations during the TCJA period. IRC §461(l) is amended to extend the applicable date to January 1, 2029.

**Note.** For more information on the EBL limitation and reporting requirements, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Net Operating and Excess Business Losses. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

- **Incentives for biodiesel, renewable diesel, and alternative fuels**<sup>11</sup> — Tax credits for alternative fuels and alternative fuel mixtures and biodiesel and renewable diesel are extended through December 31, 2024.
- **Energy efficient home improvement credit**<sup>12</sup> — Energy credits under IRC §25C are extended to December 31, 2032. The credit is increased to 30% with an **annual** limit per taxpayer of \$1,200 (\$600 limit per item) rather than a lifetime limitation. Limits for the amounts spent on windows (\$600) and doors (\$250 for any exterior door and \$500 in the aggregate for all exterior doors) are increased and required energy-efficiency standards will be modified. The credit is allowed on expenditures on any dwelling unit used by the taxpayer as a residence. Starting in 2025, taxpayers must submit a product identification number to claim the associated credit. A 30% credit (limited to \$150) is available for home energy audits.
- **Residential clean energy credit**<sup>13</sup> — The credit for the purchase of solar electric property, solar water heating property, fuel cells, geothermal heat pump property, small wind energy property, qualified biomass fuel property, and qualified battery storage technology is extended through December 31, 2034. The rate is 30% through 2032, reduced to 26% in 2033, and 22% in 2034.
- **Energy efficient commercial buildings deduction**<sup>14</sup> — A qualifying building with increased efficiency of 25% over a reference building may receive a deduction of \$0.50 per square foot. The amount is increased by \$0.02 for additional improvements, with a maximum deduction of \$1.00 per square foot.
- **New energy efficient home credit**<sup>15</sup> — The credit is extended through December 31, 2032, for eligible contractors who build and sell qualifying energy-efficient new homes.
- **Clean vehicle credit**<sup>16</sup> — A maximum nonrefundable credit of \$7,500 is available to buyers of qualifying plug-in electric vehicles. Similarly, the **credit for previously owned clean vehicles**<sup>17</sup> provides buyers of previously owned qualified clean vehicles a \$4,000 maximum credit, limited to 30% of the purchase price. For **qualified commercial clean vehicles**,<sup>18</sup> a credit is available for the lesser of 15% of the vehicle's cost or the incremental cost of the vehicle to a comparable vehicle. These credits do not apply to vehicles acquired after December 31, 2032.
- **Alternative fuel refueling property credit**<sup>19</sup> — Extended through December 31, 2032, this 30% credit applies to the cost of any qualified alternative fuel vehicle refueling property installed by a business or at a taxpayer's principal residence.

<sup>10</sup> Ibid, §13903.

<sup>11</sup> Ibid, §13201.

<sup>12</sup> Ibid, §13301.

<sup>13</sup> Ibid, §13302.

<sup>14</sup> Ibid, §13303.

<sup>15</sup> Ibid, §13304.

<sup>16</sup> Ibid, §13401.

<sup>17</sup> Ibid, §13402.

<sup>18</sup> Ibid, §13403, implementing IRC §45W.

<sup>19</sup> Ibid, §13404.

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## CARES ACT UPDATE

On August 5, 2022, President Biden signed two bills extending the statute of limitations to prosecute fraud for Paycheck Protection Program (PPP) loans and economic injury disaster loans (EIDL), each previously established under the Coronavirus Aid Relief, and Economic Stimulus (CARES) Act. The PPP and Bank Fraud Enforcement Harmonization Act of 2022,<sup>20</sup> and the COVID-19 EIDL Fraud Statute of Limitations Act of 2022,<sup>21</sup> both extend the statute of limitations to 10 years from the date of the fraud offense. According to the U.S. Small Business Administration (SBA), in October 2020, there were \$78.1 billion in potentially fraudulent EIDL loans, plus an additional \$6.7 billion associated with identity theft. The SBA also identified more than 70,000 potentially fraudulent PPP loans for \$4.6 billion.

**Note.** For more information on PPP and EIDL loans, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

## DIGITAL ASSETS

The IRS estimates that the tax gap (the amount between what is due and what is paid) for 2021 is up to \$1 trillion annually. Commissioner Rettig attributes some of the increase in this gap to the rise in popularity of the \$2 trillion virtual currency sector.<sup>22</sup> With more than 19,000 virtual currencies and platforms as of the summer of 2022,<sup>23</sup> the IRS is taking notice of how taxpayers are earning and spending virtual currency and, most importantly, how they are reporting the virtual currency on their tax returns.

### VIRTUAL CURRENCY

**Note.** Virtual currency is a general term for all forms of intangible money. Cryptocurrency is a specific type of virtual currency characterized by privacy, decentralization, security, and encryption. The term virtual currency is used in these materials to agree with the IRS's usage.

Virtual currency functions as a medium of exchange, a unit of account, and/or a store of value.<sup>24</sup> In some environments, it acts like “real” currency (i.e., actual hard currencies such as the U.S. dollar), except virtual currency does not have legal tender status in any jurisdiction (other than the country of El Salvador<sup>25</sup>). Virtual currency can be digitally traded between users and exchanged into U.S. dollars and other real or virtual currencies<sup>26</sup> or exchanged for goods and services.

The exchange occurs on **platforms** or crypto exchanges, which are marketplaces where individuals set up accounts to buy and sell virtual currency. Examples of popular platforms are Coinbase, Gemini, and Kraken.<sup>27</sup> These platforms are required to provide information reporting to users starting in 2023 (discussed later).

<sup>20</sup> *PPP and Bank Fraud Enforcement Harmonization Act of 2022*, PL 117-166.

<sup>21</sup> *COVID-19 EIDL Fraud Statute of Limitations Act of 2022*, PL 117-165.

<sup>22</sup> *Tax cheats cost the U.S. \$1 trillion per year, I.R.S chief says*. Rappeport, Alan. Apr. 13, 2021. New York Times. [www.nytimes.com/2021/04/13/business/irs-tax-gap.html] Accessed on Jul. 24, 2022.

<sup>23</sup> *Crypto firms say thousands of digital currencies will collapse, compare to early dot com days*. Kharpal, Arjun. Jun. 3, 2022. CNBC. [www.cnbc.com/2022/06/03/crypto-firms-say-thousands-of-digital-currencies-will-collapse.html] Accessed on Jul. 24, 2022.

<sup>24</sup> IRS Notice 2014-21, 2014-16 IRB 938.

<sup>25</sup> *Bitcoin becomes legal tender in El Salvador*. Margulies, Ben. Sep. 7, 2021. Central Banking. [www.centralbanking.com/central-banks/currency/digital-currencies/7873556/bitcoin-becomes-legal-tender-in-el-salvador] Accessed on Jul. 29, 2022.

<sup>26</sup> *Ibid.*

<sup>27</sup> *The Best Crypto Exchanges of 2022*. Powell, Farran. Jul. 20, 2022. Forbes. [www.forbes.com/advisor/investing/cryptocurrency/best-crypto-exchanges/] Accessed on Jul. 21, 2022.

Virtual currencies and their associated platforms can be either regulated or unregulated. An example of **regulated virtual currency** is an electronic form of monetary assets issued by a central authority (i.e., a currency that is backed and supported by a regulated institution like a country's central bank). Conversely, **unregulated virtual currency** is all the other types of electronic funds that are not controlled by a centralized authority, such as Bitcoin.<sup>28</sup>

## Types of Virtual Currency

**Single flow** virtual currency is purchased with “real” currency but then cannot be converted back into real currency, i.e., it only flows in one direction. This is often associated with a **closed currency** that only exists as a medium of exchange within its specific environment. For example, a virtual currency that only has value within a gaming system and cannot be exchanged for value outside of the game is considered a closed currency. Similarly, airline miles or other rewards programs that can only be converted to values within the program are closed currencies.<sup>29</sup>

Conversely, **convertible virtual currency** is a virtual currency that has an equivalent value in real currency or that acts as a substitute for real currency (e.g., Bitcoin, Ethereum).<sup>30</sup> The virtual currency can then be converted back into tangible funds exchanged in the “real” world.

## Definitions

Digital assets come with a unique set of terms, some of which are defined next.

**Blockchain.**<sup>31</sup> Blockchain is a digital ledger that stores data. As it pertains to digital assets, blockchain is a decentralized database hosted across multiple computers that stores information about digital asset transactions. Over time, new “blocks” of data are added to the chain. Blockchain is considered a secure system because before a new block can be added to the blockchain, it must be verified by the majority of the computers that are on the database. **Cryptography** generally secures the transactions, meaning the computers on the database must solve intricate mathematical equations to administer a transaction. The reward for processing these transactions is usually payment in digital assets.

**Hard Fork, Soft Fork, and Air Drops.**<sup>32</sup> A **hard fork** occurs when a virtual currency undergoes a protocol change resulting in a permanent diversion from the legacy distributed ledger. This may result in the creation of a new virtual currency on a new distributed ledger in addition to the legacy virtual currency on the legacy distributed ledger. Essentially, one virtual currency becomes two virtual currencies, similar to a stock split. In a hard fork, the two new versions of virtual currency are not compatible with each other.

If an individual's virtual currency goes through a hard fork, but the individual does not receive any new virtual currency, whether through an **airdrop** (a distribution of virtual currency to multiple individuals' distributed ledger addresses) or some other kind of transfer, there is no taxable income. If a hard fork is followed by an airdrop and the individual receives new virtual currency, the individual has taxable ordinary income. The ordinary income is the fair market value (FMV) of the new virtual currency when the individual receives it (i.e., when the transaction is recorded on the distributed ledger), assuming the individual has dominion and control over the virtual currency (i.e., can sell, dispose of, transfer, or exchange the virtual currency.)

The individual's basis in the virtual currency following a hard fork is the FMV when they receive it.

<sup>28</sup> *Virtual Currency*. Investopedia. [www.investopedia.com/terms/v/virtual-currency.asp] Accessed on Jul. 27, 2022.

<sup>29</sup> *Ibid*; *What Is a Virtual Currency?* Levy, Adam. Jun. 28, 2022. The Motley Fool. [www.fool.com/investing/stock-market/market-sectors/financials/cryptocurrency-stocks/virtual-currency/] Accessed on Jul. 27, 2022.

<sup>30</sup> *Virtual Currency*. Investopedia. [www.investopedia.com/terms/v/virtual-currency.asp] Accessed on Jul. 27, 2022.

<sup>31</sup> *What is Blockchain?* Rodeck, David and Curry, Benjamin. Apr. 28, 2022. Forbes. [www.forbes.com/advisor/investing/cryptocurrency/what-is-blockchain] Accessed on Jul. 27, 2022.

<sup>32</sup> *Understanding Hard Forks in Cryptocurrency*. CryptoCurrency Facts. [cryptocurrencyfacts.com/understanding-hard-forks-cryptocurrency] Accessed on Jul. 27, 2022.

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In a **soft fork**, a distributed ledger undergoes a protocol change that does not result in a diversion of the ledger. This does not create a new virtual currency. The individual is in the same position after the soft fork as they were before, and therefore, do not have any income to recognize.

## NONFUNGIBLE TOKENS (NFT)<sup>33</sup>

NFTs have been steadily gaining in popularity since 2014. An NFT is a digital asset that represents a real item like artwork, music, videos, sports highlights, collectibles, etc. Similar to virtual currency, NFTs are exchanged online, use the same underlying programming, and exist on the blockchain. Whereas virtual currency is nearly infinite in supply, NFTs have unique identifying codes and act like digital collectors' items. They are nonfungible, meaning they cannot be exchanged for one another as they are unique items. An NFT can only have one owner at a time which is recorded on the blockchain that verifies ownership.

NFTs are subject to capital gains rates; however, they may be subject to the maximum 28% rate on collectibles<sup>34</sup> as well as the net investment income tax.<sup>35</sup> The IRS has not ruled on how NFTs should be treated for tax purposes, but it likely depends on how the recipient uses the NFT (e.g., investment, trading, brokering, collecting, etc.).

## IRS APPROACH

The IRS treats virtual currency as **property**.<sup>36</sup> As property, the tax treatment depends on what the virtual currency represents to the individual in possession of it. The individual may be a miner, trader, investor, merchant, or someone who uses virtual currency as a medium of exchange in a similar manner as any other traditional currency.

## Miners

New virtual currency is generated and brought into circulation in a process called **mining**.<sup>37</sup> Miners acquire virtual currency as compensation for processing complex, encrypted mathematical equations.<sup>38</sup> A miner includes the FMV of virtual currency as of the date of receipt in gross income and reports the income on Schedule C, *Profit or Loss from Business*. Income may be earned by mining activities constituting a trade or business that the taxpayer does not undertake as an employee. In this case, the income is subject to self-employment (SE) tax.<sup>39</sup>

If a miner does not carry on their mining activity to make a profit, the activity may be considered a hobby. The miner cannot use a loss from the activity to offset other income. In determining whether a miner is carrying on the activity for profit, the following factors should be considered.<sup>40</sup>

- The activity is carried on in a businesslike manner.
- The time and effort put into the activity indicate the miner intends to make it profitable.
- The miner depends on the income for their livelihood.
- Losses are due to circumstances beyond the miner's control (or are normal in the start-up phase of the type of business).
- The miner changes methods of operation in an attempt to improve profitability.

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<sup>33</sup> *What Is An NFT? Non-Fungible Tokens Explained*. Conti, Robyn and Schmidt, John. Apr. 8, 2022. Forbes. [[www.forbes.com/advisor/investing/cryptocurrency/nft-non-fungible-token](http://www.forbes.com/advisor/investing/cryptocurrency/nft-non-fungible-token)] Accessed on Jul. 27, 2022.

<sup>34</sup> IRC §§1(h)(4) and (5)(A).

<sup>35</sup> IRC §1411.

<sup>36</sup> Rev. Rul. 2019-24, 2019-44 IRB 1004; IRS Notice 2014-21, 2014-16 IRB 938.

<sup>37</sup> *Frequently Asked Questions*. Bitcoin. [[bitcoin.org/en/faq#how-are-bitcoins-created](http://bitcoin.org/en/faq#how-are-bitcoins-created)] Accessed on Jul. 27, 2022.

<sup>38</sup> *Ibid*; *Dealing with cryptocurrency during tax season*. D'Avolio, Mike. Feb. 2, 2018. Accounting Today. [[www.accountingtoday.com/opinion/dealing-with-cryptocurrency-during-tax-season](http://www.accountingtoday.com/opinion/dealing-with-cryptocurrency-during-tax-season)] Accessed on Jul. 27, 2022.

<sup>39</sup> IRS Notice 2014-21, 2014-16 IRB 938.

<sup>40</sup> IRS Pub. 535, *Business Expenses*.

- The miner (or their advisors) has the knowledge needed to carry on the activity as a successful business.
- The miner was successful in making a profit in similar activities in the past.
- The activity makes a profit in some years.
- The miner can expect to make a future profit from the appreciation of the assets used in the activity.

## Traders

Traders approach trading investment property as a full-time business rather than as a hobby and generally receive their primary income from trading activities. Their trades are frequent, regular, continuous, and substantial. They trade solely for their own accounts.<sup>41</sup> The IRS typically considers the following factors when determining whether a taxpayer is deemed a trader or an investor.<sup>42</sup>

- The length of the holding period for securities bought and sold
- The frequency and dollar amount of trades made during the year
- The extent to which the taxpayer pursues the activity to produce income for a livelihood
- The amount of time the taxpayer devotes to trading activities

Traders can use the capital gain rates unless they make a mark-to-market (MTM) election.<sup>43</sup> Traders who make an MTM election must recognize gains and losses for each tax year based on increases and decreases in the FMV of their holdings.<sup>44</sup> Losses are ordinary rather than capital, and there is no \$3,000 annual limitation.<sup>45</sup>

A “securities trader” is not subject to SE tax from selling securities.<sup>46</sup> However, virtual currency does not meet the definition of a security under IRC §475(c)(2).

## Investors

Investors manage virtual currency through buying, selling, and storing virtual currency on a virtual currency exchange, such as Coinbase. Gains and losses on virtual currency are treated as property and generate capital gains or losses.

**Gains and Losses.**<sup>47</sup> If a taxpayer sold, exchanged, or transferred any virtual currency they held as a capital asset (investment) during the year, the capital gain or loss is figured on Form 8949, *Sales or Other Dispositions of Capital Assets*, and reported on Schedule D, *Capital Gains and Losses*, in U.S. dollars. The gain or loss from the sale of virtual currency is the difference between the taxpayer’s adjusted basis in the virtual currency and the amount the taxpayer received in exchange for the virtual currency.

Whether the gain or loss is **short-term or long-term** depends on the holding period of the virtual currency. The holding period begins on the day the individual acquires the virtual currency and ends on the day they dispose of the virtual currency. Currency held for one year or less is a short-term capital gain or loss. If the currency was held for more than one year, long-term capital gain or loss rules apply.

<sup>41</sup> See, e.g., *Endicott v. Comm’r*, TC Memo 2013-199 (Aug. 28, 2013).

<sup>42</sup> IRS Pub. 550, *Investment Income and Expense*.

<sup>43</sup> *Ibid.*

<sup>44</sup> IRC §475(f).

<sup>45</sup> IRC §475(d)(3).

<sup>46</sup> *Topic Number 429 — Traders in Securities (Information for Form 1040 Filers)*. Jul. 22, 2022. IRS. [[www.irs.gov/taxtopics/tc429](http://www.irs.gov/taxtopics/tc429)] Accessed on Jul. 27, 2022.

<sup>47</sup> *Frequently Asked Questions on Virtual Currency Transactions*. Mar. 23, 2022. IRS. [[www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions](http://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions)] Accessed on Jul. 27, 2022.

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Because virtual currency is considered property (i.e., a capital asset), a taxpayer who pays for a service or purchases property in virtual currency has a capital gain or loss. The gain or loss is the difference between the FMV at the time of payment and the taxpayer's adjusted basis in the virtual currency.

**Basis.** The basis in virtual currency depends on how the individual acquired the currency and how they are using the virtual currency. Additionally, basis depends on whether the virtual currency units are specifically identified. A taxpayer who sells, exchanges, or otherwise disposes of virtual currency has the option to specifically identify which units were disposed. Absent this procedure, the IRS will deem the units were disposed of on a first in, first out (FIFO) basis. **Adjusted basis** is the basis increased by certain expenditures and decreased by certain deductions.

**Virtual Currency Purchased with Real Currency.** Cost basis in virtual currency is the amount spent to acquire the virtual currency, including fees, commissions, and other acquisition costs in U.S. dollars.

**Virtual Currency Received for Services.** The basis in virtual currency received in exchange for services is the FMV of the virtual currency when the individual received it. If the virtual currency is not traded on any exchange and does not have a published value, then the FMV of the virtual currency received is the FMV of the property or services exchanged when the transaction occurred.

**Virtual Currency Received for Property.** The basis in virtual currency an individual receives in exchange for property is the FMV of the virtual currency (in U.S. dollar) when the taxpayer receives the virtual currency.

**Property Received for Virtual Currency.** An individual who transfers virtual currency in exchange for property takes a basis in the property equal to the property's FMV at the time of the exchange. The transaction must be at arm's length.

**Caution.** The previous information is taken from the Frequently Asked Questions (FAQs) that the IRS publishes, which is not considered substantial authority. As such, practitioners should exercise professional skepticism when relying on them for guidance.

## Practitioner Planning Tip

FAQs published in the Internal Revenue Bulletin have precedential value (i.e., taxpayers can rely on, cite, and use the FAQs).<sup>48</sup> For FAQs that are not published in the Internal Revenue Bulletin, a taxpayer's reasonable reliance on an FAQ (even one that is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply.<sup>49</sup> When relying on guidance, a practitioner should print the document or digitally save the FAQ. Additionally, the practitioner should record the date the source document was accessed.

<sup>48</sup> *General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs*. Feb. 24, 2022. IRS. [[www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs](http://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs)] Accessed on Aug. 8, 2022.

<sup>49</sup> See Treas. Reg. §1.6664-4(b) and 4(d).



## Broker Reporting<sup>50</sup>

Starting in 2023, the IRS requires **brokers** to provide reporting statements to individuals with virtual currency transactions. The definition of brokers is expanded to include any person who is responsible for regularly providing any service facilitating transfers of digital assets (e.g., virtual currency) on behalf of another person for compensation.<sup>51</sup> Therefore, any **platform** on which individuals buy or exchange virtual currency will be responsible for furnishing relevant information.

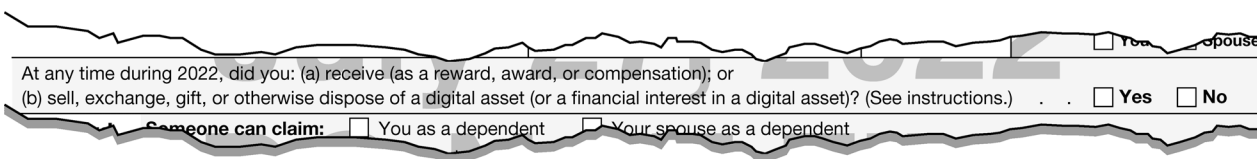
**Note.** The specific form details have not yet been released, but the presumption is that the information provided to individuals exchanging or investing in virtual currency will be similar to the information provided to investors on Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*.

## REPORTING ISSUES

The increased IRS focus on digital asset transactions has resulted in additional reporting requirements for those involved in buying and exchanging digital assets.

### Checkbox on Form 1040, U.S. Individual Income Tax Return<sup>52</sup>

The draft 2022 Form 1040 includes the following question regarding digital assets on page 1 (subject to change pending final release of the form).



Taxpayers should check “no” if they did not buy or exchange any digital assets during the year. Additionally, taxpayers whose **only** digital asset activities fall within any of the following circumstances should also select “no.”

- **Held** digital assets in their own wallet or account
- **Transferred** digital assets between their own wallets or accounts
- **Purchased** digital assets using real currency
- Engaged in a combination of the aforementioned activities

**Note. Wallets** keep private keys (passwords to access digital assets) safe and accessible.<sup>53</sup> A wallet can be a **hard wallet** (e.g., physical hardware similar to a universal serial bus (USB) stick or key fob) or **soft wallet** (e.g., desktop software or mobile app). Discussion of the numerous different wallet types and their advantages and disadvantages is beyond the scope of this chapter.

<sup>50</sup> *Infrastructure Investment and Jobs Act of 2021*, PL 117-58; IRC §6045(g); *Reporting Requirements For Cryptocurrencies And NFTs Begin In 2023*. Erskine, Matthew. Jan. 6, 2022. Forbes. [www.forbes.com/sites/matthewerskine/2022/01/06/reporting-requirements-for-cryptocurrencies-and-nfts-begin-in-2023] Accessed on Jul. 27, 2022.

<sup>51</sup> IRC §6045(c).

<sup>52</sup> IRS News Rel. IR-2022-61 (Mar. 18, 2022).

<sup>53</sup> *What is a crypto wallet?* Coinbase. [www.coinbase.com/learn/crypto-basics/what-is-a-crypto-wallet] Accessed on Jul. 27, 2022.

# 2022 Workbook

A taxpayer who engages in any of the following digital asset transactions must select “yes.”

- Receipt of digital assets as payment for goods or services provided
- Receipt or transfer of digital assets for free (without providing any consideration) that does not qualify as a bona fide gift
- Receipt of new digital assets from mining or staking activities

**Note.** Staking activities generate passive income from earning rewards for holding certain digital assets.<sup>54</sup> A detailed explanation of staking is beyond the scope of these materials.

- Receipt of digital assets from a hard fork
- Exchange of digital assets for property, goods, or services
- Exchange/trade of a digital asset for another digital asset
- Sale of digital assets
- Any other disposition of a financial interest in digital assets

**Example 1.** George purchases his favorite latte from his local coffee shop. He sees one of the payment methods is virtual currency. He remembers he bought some virtual coins and uses some to pay for the latte. As a taxpayer, George needs to be aware that he has just created a reportable event, a capital gain or loss.

Two days later, George gets a notification from his digital wallet provider that he now owns part of a virtual coin. This airdrop was part of a promotion from the coffee shop for using virtual currency. This airdrop has now created a new reportable event. Both events are reported on his next tax return as separate line items on his Form 8949.



## Practitioner Planning Tip

Practitioners need to be aware of the different types of virtual events which require reporting and update clients on reporting events. Practitioners should also educate their clients on obtaining the necessary information to report.

<sup>54</sup> *What is Staking?* Coinbase. [[www.coinbase.com/learn/crypto-basics/what-is-staking](https://www.coinbase.com/learn/crypto-basics/what-is-staking)] Accessed on Jul. 27, 2022.

**Example 2.** Howie works on a project with a high-tech company. When the job is complete, the company offers to pay Howie in virtual currency either on the day he completes the job or by a bank transfer in 10 days. He accepts the virtual currency the same day and has the currency deposited to his personal account because he does not have one for his business.

Howie tells his accountant, Pete, about the payment when he brings in his monthly work. Pete discovers that Howie still has the currency in his digital wallet. Pete asks Howie to provide the following information regarding the virtual currency payment.

- The date Howie received the virtual currency
- The amount to account for the income
- The value of the virtual currency on the date of receipt

Fortunately, Howie is a sole proprietor (cash basis) and adjusting book entries account for the income. Howie reports income equal to the FMV of the virtual currency on the date of receipt. Pete advises Howie to convert the virtual currency to U.S. dollars as soon as possible after receipt and move the amount into a separate business account to eliminate or minimize a capital gain or loss.

**Example 3.** Use the same facts as **Example 2**, except Howie’s entity is taxed as an S corporation. Howie can deposit the FMV of the virtual currency from his personal funds to the S corporation. He can sell the virtual currency and report a gain or loss on his personal return from the sale because it was his personal account. Howie can then deposit the equivalent cash to the S corporation. If the value on the date of the deposit was less than the FMV of the day of receipt, then Howie must make up the difference from his personal funds. The loss is reported on his personal return.

**Example 4.** Use the same facts as **Example 3**, except that the digital wallet belongs to the S corporation. Howie must determine what its policy is for handling virtual currency. If there is a need to pay corporate expenses using virtual currency, the S corporation should keep the funds and use them as needed. If the corporation decides to accept virtual currency but not hold on to it, then a sale should occur as soon as possible to eliminate or minimize gains or losses. The FMV as of the date of receipt is again reported as income and any gain or loss will be reported on the corporate return’s Schedule D.

### Practitioner Planning Tip

The Inflation Reduction Act of 2022 calls for an increase of tax enforcement activities to “provide digital asset monitoring and compliance activities” as part of the \$80 billion allocated to enhance IRS resources.<sup>55</sup> With the IRS’s increased scrutiny of digital assets, tax practitioners should consider adding questions to their client organizer to determine if a taxpayer has reportable digital asset transactions and documenting their answers. Sample digital asset questions for an organizer can be found in the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Individual Taxpayer Issues.

<sup>55</sup> *Inflation Reduction Act*, PL 117-169, §10301.

# 2022 Workbook

## Voluntary Disclosure Practice<sup>56</sup>

Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*, is used by taxpayers with potential criminal exposure for willful violation of tax law to comply with tax laws. In February 2022, the form was expanded to include additional information on virtual currency. The following segment of Form 14457 shows the expanded schedule for virtual currency information.

**Add Virtual Currency**

13. Schedule of virtual currency

- List **ALL** domestic and foreign noncompliant virtual currency you owned or controlled or were the beneficial owner of, either directly or indirectly.
- The listings must cover the entire disclosure period as outlined in the instructions below.
- This includes assets acquired or disposed of during the disclosure period.
- This includes assets held through entities you owned or controlled or were the beneficial owner of, either directly or indirectly.

**Note:** The entities will be further identified in Part II of this application.

- Click "Add Virtual Currency" button below for additional assets.

---

**Virtual Currency 1**

Name of virtual currency

---

Identifying number or other designation (see instructions)	Date asset acquired	Date asset disposed	Check appropriate box
			<input type="checkbox"/> Domestic <input type="checkbox"/> Offshore

Account holders

---

<b>Add Virtual Currency</b>
Hide Part II

---

Catalog Number 61637F www.irs.gov Form **14457** (Rev. 2-2022)

The voluntary disclosure must be timely, accurate, and complete. Additionally, the taxpayer must work with the IRS to determine the correct tax liability and then fully pay the tax along with any interest and penalties.

**Note.** For more information on the Voluntary Disclosure Practice, including Form 14457, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: IRS Update. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

## Foreign Reporting

Because many virtual currencies are held in foreign countries, there are various additional filing requirements of which taxpayers should be aware.

**Financial Crimes Enforcement Network (FinCEN).**<sup>57</sup> The Bank Secrecy Act (BSA)<sup>58</sup> requires an annual report from U.S. persons who have financial interests in or signature authority over foreign financial accounts. The annual report is the FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR). The FBAR is required for persons who have:

- A financial interest in or signature authority over at least one financial account located outside of the United States, and
- An aggregate value of all foreign financial accounts exceeding \$10,000 at any time during the calendar year reported.

<sup>56</sup> IRS News Rel. IR-2022-33 (Feb. 15, 2022).

<sup>57</sup> 31 CFR 1010; 31 CFR 103.27.

<sup>58</sup> Titles I and II of PL 91-508, as amended, codified at 12 USC 1829b, 12 USC 1951–1959, and 31 USC 5311–314 and 5316–5332.

FinCEN has clarified that although **administrators** who issue and redeem virtual currency **are required** to file FBARs, **users** of virtual currency for their own purposes **are not**.<sup>59</sup> An administrator is engaged in the process of putting virtual currency into circulation and has the authority to withdraw the virtual currency from circulation. A user obtains virtual currency to purchase services or products on their own behalf, regardless of how they obtain the virtual currency (e.g., mining, earning, harvesting, purchasing, etc.).

**Foreign Account Tax Compliance Act (FATCA).** U.S. taxpayers with foreign financial assets with an aggregate value of more than the reporting threshold (at least \$50,000; \$100,000 for married filing jointly) are required under FATCA to report information for those assets on Form 8938, *Statement of Specified Foreign Financial Assets*. Form 8938 must be attached to the taxpayer's income tax return.<sup>60</sup>

Virtual currency does not currently qualify **under the BSA** as a foreign financial account. However, virtual currency in foreign accounts may qualify **under FATCA** as a foreign financial account. Therefore, FATCA filing requirements apply to taxpayers who hold virtual currency in foreign accounts.<sup>61</sup>

**Note.** Currently, the FBAR regulations do not define a foreign account holding virtual currency as a type of reportable account.<sup>62</sup> For that reason, at this time, a foreign account holding virtual currency is not reportable on the FBAR (unless it is a reportable account under 31 CFR §1010.350 because it holds reportable assets besides virtual currency). However, FinCEN intends to propose to amend the regulations implementing the BSA to include virtual currency as a type of reportable account under 31 CFR §1010.350(c).

## RECENT DEVELOPMENTS

### Operation Hidden Treasure<sup>63</sup>

In March 2021, the IRS announced an initiative focused on identifying taxpayers who are not reporting their income from virtual currency transactions on their tax returns. The IRS is looking for markers of fraud related to virtual currency, such as structuring transactions to fall under the \$10,000 threshold, thereby avoiding certain filing requirements and using shell corporations to hide the income. The goal is to make virtual currency transactions less anonymous and ensure that taxpayers are appropriately paying tax on their income.

This aligns with the *John Doe* summons the IRS issued in 2021.<sup>64</sup> The IRS sought information from Kraken (a digital platform) on its users who conducted at least \$20,000 in virtual currency transactions between 2016 and 2020. The IRS was acting on the belief that many of those users failed to comply with IRS laws.

<sup>59</sup> *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*. FIN-2013-G001 (Mar. 18, 2013) and *Application of FinCEN's Regulations to Virtual Currency Mining Operations*. FIN-2014-R001 (Jan. 30, 2014).

<sup>60</sup> *Summary of FATCA Reporting for U.S. Taxpayers*. Nov. 19, 2021. IRS. [[www.irs.gov/businesses/corporations/summary-of-fatca-reporting-for-us-taxpayers](http://www.irs.gov/businesses/corporations/summary-of-fatca-reporting-for-us-taxpayers)] Accessed on Jul. 21, 2022.

<sup>61</sup> *FinCEN Seeks to Establish FBAR Requirement for Cryptocurrency Accounts in 2021*. Oberheiden, Nick. May 27, 2021. The National Law Review. [[www.natlawreview.com/article/fincen-seeks-to-establish-fbar-requirement-cryptocurrency-accounts-2021](http://www.natlawreview.com/article/fincen-seeks-to-establish-fbar-requirement-cryptocurrency-accounts-2021)] Accessed on Jul. 21, 2022.

<sup>62</sup> FinCEN Notice 2020-2.

<sup>63</sup> *Operation Hidden Treasure Is Here. If You Have Unreported Crypto, Get Legal Advice*, Moore, Guinevere. Mar. 6, 2021. Forbes. [[www.forbes.com/sites/irswatch/2021/03/06/operation-hidden-treasure-is-here-if-you-have-unreported-crypto-its-time-to-get-legal-advice](http://www.forbes.com/sites/irswatch/2021/03/06/operation-hidden-treasure-is-here-if-you-have-unreported-crypto-its-time-to-get-legal-advice)] Accessed on Jul. 21, 2022.

<sup>64</sup> *Court Authorizes Service of John Doe Summons Seeking Identities of U.S. Taxpayers Who Have Used Cryptocurrency*. May 5, 2021. Department of Justice. [[www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1](http://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1)] Accessed on Jul. 22, 2022.

# 2022 Workbook

## **Form 8300, Report of Cash Payments Over \$10,000 in a Trade or Business<sup>65</sup>**

An individual, company, corporation, partnership, association, trust, or estate that receives more than \$10,000 in a single transaction or related transaction in business must file Form 8300. The \$10,000 threshold was expanded to include virtual currency under the Infrastructure Investment and Jobs Act that amended IRC §6050I. Therefore, businesses that accept virtual currency may be required to file Form 8300.

## **IRS Letters<sup>66</sup>**

In 2019, the IRS began a campaign sending out letters to taxpayers who may not have properly reported their virtual currency transactions or paid their associated income tax. The letters provide information to help taxpayers understand how to fix errors and understand their required filing obligations. The IRS sent out three types of letters:

- **Letter 6173** — Sent to taxpayers who did not file a federal income tax return reporting their virtual currency transactions for one or more tax years between 2013 and 2017.
- **Letter 6174** — Sent to taxpayers with one or more virtual currency accounts who may not know the requirements for reporting the virtual currency transactions to the IRS.
- **Letter 6174-A** — Sent to taxpayers with one or more virtual currency accounts who may not have properly reported the virtual currency transactions to the IRS.

Sample letters of all three types are shown on the following pages.

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<sup>65</sup> *Infrastructure Investment and Jobs Act of 2021*, PL 117-58; *Form 8300 and Reporting Cash Payments of Over \$10,000*. Aug. 19, 2021. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/form-8300-and-reporting-cash-payments-of-over-10000](http://www.irs.gov/businesses/small-businesses-self-employed/form-8300-and-reporting-cash-payments-of-over-10000)] Accessed on Jul. 27, 2022.

<sup>66</sup> IRS News Rel. 2019-132 (Jul. 26, 2019).

## Letter 6173



Department of the Treasury  
Internal Revenue Service  
[Operating Division / Program Name]  
[Street address]  
[City, State ZIP]

Date:  
07/16/2019  
Taxpayer ID number:  
  
Hotline telephone number:  
  
eFax number:  
  
Respond by:

[Recipient name]  
[Address line 1]  
[Address line 2]  
[Address line 3]

### Reporting Virtual Currency Transactions

Dear [Name]:

#### Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency and may not have met your U.S. tax filing and reporting requirements for transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on [www.irs.gov](http://www.irs.gov) and in Notice 2014-21, found at [www.irs.gov/pub/irs-drop/n-14-21.pdf](http://www.irs.gov/pub/irs-drop/n-14-21.pdf), which describes how general tax principles for property transactions apply to transactions using virtual currency.

For one or more of tax years 2013 through 2017, we haven't received either a federal income tax return or an applicable form or schedule reporting your virtual currency transactions.

#### What you need to do by the "respond by" date above

Take one of the following actions:

- If you failed to file one or more income tax returns, file the delinquent returns and report your virtual currency transactions as soon as possible. For more information see [www.irs.gov/filing](http://www.irs.gov/filing)
- If you made a mistake on your income tax return, such as not reporting your virtual currency transactions or incorrectly calculating your income, gain, or loss; you can file an amended return. For more information, visit [www.irs.gov/forms-pubs/about-form-1040x](http://www.irs.gov/forms-pubs/about-form-1040x)
- If you believe you followed all tax and information reporting requirements relating to your virtual currency accounts, mail or eFax the following to the address or eFax number shown at the top of this letter.
  - A statement of facts explaining your position. Include a complete history of previously reported income from your virtual currency transactions. Explain the actions you took to become compliant with U.S. reporting requirements and provide copies of previously filed documents that confirm your compliance.
  - Your contact information, including your telephone number, complete address, and the address where you receive mail (if different).

Letter 6173 (6-2019)  
Catalog Number 72154R

# 2022 Workbook

## Letter 6173 (continued)

- The following statements with your signature and date:

I, \_\_\_\_\_, declare under penalties of perjury that I have examined this entire document, including all attachments and accompanying statements, and that the enclosed is true, correct, and complete.

I also understand with respect to any submission that the IRS reserves the right to make further contacts with me and my representatives to clarify any written explanation or any other documents. Statements and documents sent under this option will be checked against information received from banks, financial advisors, and other sources for accuracy.

\_\_\_\_\_  
**Signature** \_\_\_\_\_ **Date**

Please note that there is a 10MB limit for data sent to the eFax number. If your electronic file exceeds this size, either mail your documents or fax the information in multiple, smaller transmissions to fit the size requirements.

**Do not send original returns or amended returns for processing via eFax.** Instead, send original returns to the address below and include a copy in your response to this letter. Write "Letter 6173" at the top of the first page of the amended or delinquent return. Mail the originals to:

Internal Revenue Service  
2970 Market Street  
Philadelphia, PA 19104

If you need more time, send a request for a 30-day extension to the address above by the "respond by" date shown at the top of this letter.

**If we don't hear from you by the "respond by" date**

We may refer your tax account for examination. Please be aware that underpayments of tax are subject to interest and penalties.

**Someone may represent you**

If you want someone to represent you in this matter, send a completed Form 2848, Power of Attorney and Declaration of Representative, with your response to the address above.

**Additional information**

You can find the forms and publications for reporting your virtual currency transactions by visiting our website at [www.irs.gov/forms-pubs](http://www.irs.gov/forms-pubs) or by calling 800-TAX-FORMS (800-829-3676).

If you have questions, you can call the hotline telephone number shown at the top of this letter and leave a message. We'll respond to all messages within three business days.

Thank you for your cooperation.

Sincerely,

[Name]  
Program Manager

**Letter 6173 (6-2019)**  
Catalog Number 72154R



## Letter 6174



Department of the Treasury  
Internal Revenue Service  
[Operating Division / Program Name]  
[Street address]  
[City, State ZIP]

Date:  
07/16/2019  
Taxpayer ID number:  
  
Hotline telephone number:  
  
Tax form:  
Form 1040

[Recipient name]  
[Address line 1]  
[Address line 2]  
[Address line 3]

### Reporting Virtual Currency Transactions

Dear [Name]:

#### Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency but may not know the requirements for reporting transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

#### What you need to do

After reviewing the information below, if you believe you didn't accurately report your virtual currency transactions on a federal income tax return, you should file amended returns or delinquent returns if you didn't file a return for one or more taxable years. If you do not accurately report your virtual currency transactions, you may be subject to future civil and criminal enforcement activity. For more information, visit [www.irs.gov/filing](http://www.irs.gov/filing).

When filing amended or delinquent returns, write "Letter 6174" at the top of the first page of the return. Mail the original amended or delinquent return to:

Internal Revenue Service  
2970 Market Street  
Philadelphia, PA 19104

#### Reporting virtual currency transactions

Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on [www.irs.gov](http://www.irs.gov) and in Notice 2014-21, found at [www.irs.gov/pub/irs-drop/n-14-21.pdf](http://www.irs.gov/pub/irs-drop/n-14-21.pdf), which describes how general tax principles for property transactions apply to transactions involving virtual currency.

You must report virtual currency transactions on your return, regardless of whether you received a payee statement for the transaction (such as a Form W-2, Form 1099, etc.).

Letter 6174 (6-2019)  
Catalog Number 72273Z

# 2022 Workbook

## Letter 6174 (continued)

Common schedules for reporting virtual currency transactions include the following:

### **Schedule C**

If you were an independent contractor and received payment in virtual currency, you must report it in gross income for the amount of the virtual currency's fair market value, measured in U.S. dollars, as of the date and time you received the virtual currency. Gross income derived by an individual from a trade or business, carried on by the individual as other than an employee, is reported on Schedule C. This constitutes self-employment income and is subject to the self-employment tax.

For more information, you can refer to the instructions for Schedule C.

### **Schedule D**

If you sold, exchanged, or disposed of virtual currency (e.g. Bitcoin, Ether), or used it to pay for goods or services, you have engaged in a reportable transaction and may have a tax liability. These transactions may be reportable on Schedule D. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You should maintain and review all transaction records, including bank, wallet, and exchange reports and statements to determine your basis, amount received, and other information needed for reporting on Schedule D.

For more information, you can refer to the instructions for Schedule D.

### **Schedule E**

If you received supplemental income in the form of virtual currency, including income from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs, you may need to report this on Schedule E. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You may also need to file supplemental forms (e.g. Form 8582, Passive Activity Loss Limitations). See the instructions for Schedule E for any other circumstances that may apply.

For more information, you can refer to the instructions for Schedule E.

### **Additional Resources**

- Publication 17, Your Federal Income Tax (For Individuals)
- Instructions for Form 1040, U.S. Individual Income Tax Return
- Instructions for Form 8949, Sales and Other Dispositions of Capital Assets
- Instructions for Form 1041, U.S. Income Tax Return for Estates and Trusts
- Instructions for Form 1120, U.S. Corporation Income Tax Return
- Instructions for Form 1120-S, U.S. Income Tax Return for an S Corporation
- Instructions for Form 1065, U.S. Return of Partnership Income

You can get the forms, instructions, and publications mentioned in this letter by visiting our website at [www.irs.gov/forms-pubs](http://www.irs.gov/forms-pubs) or by calling 800-TAX-FORM (800-829-3676).

**You do not need to respond to this letter.**

Letter 6174 (6-2019)  
Catalog Number 72273Z

## Letter 6174 (continued)

If you have questions, you can call the hotline telephone number shown at the top of this letter and leave a message. We'll respond to all messages within three business days.

Thank you for your cooperation.

Sincerely,

[Name]

[Title]

**Letter 6174 (6-2019)**  
Catalog Number 72273Z

# 2022 Workbook

## Letter 6174-A



Department of the Treasury  
Internal Revenue Service  
[Operating Division / Program Name]  
[Street address]  
[City, State ZIP]

Date:  
07/16/2019  
Taxpayer ID number:  
  
Hotline telephone number:  
  
Tax form:  
Form 1040

[Recipient name]  
[Address line 1]  
[Address line 2]  
[Address line 3]

### Reporting Virtual Currency Transactions

Dear [Name]:

#### Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency but may not have properly reported your transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

#### What you need to do

After reviewing the information below, if you believe you didn't accurately report your virtual currency transactions on a federal income tax return, you should file amended returns or delinquent returns if you didn't file a return for one or more taxable years. If you do not accurately report your virtual currency transactions, you may be subject to future civil and criminal enforcement activity. For more information, visit [www.irs.gov/filing](http://www.irs.gov/filing).

When filing amended or delinquent returns, write "Letter 6174-A" at the top of the first page of the return. Mail the original amended or delinquent return to:

Internal Revenue Service  
2970 Market Street  
Philadelphia, PA 19104

#### Reporting virtual currency transactions

Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on [www.irs.gov](http://www.irs.gov) and in Notice 2014-21, found at [www.irs.gov/pub/irs-drop/n-14-21.pdf](http://www.irs.gov/pub/irs-drop/n-14-21.pdf), which describes how general tax principles for property transactions apply to transactions involving virtual currency.

You must report virtual currency transactions on your return, regardless of whether you received a payee statement for the transaction (such as a Form W-2, Form 1099, etc.).

Letter 6174-A (6-2019)  
Catalog Number 72597M

## Letter 6174-A (continued)

Common schedules for reporting virtual currency transactions include the following:

### **Schedule C**

If you were an independent contractor and received payment in virtual currency, you must report it in gross income for the amount of the virtual currency's fair market value, measured in U.S. dollars, as of the date and time you received the virtual currency. Gross income derived by an individual from a trade or business, carried on by the individual as other than an employee, is reported on Schedule C. This constitutes self-employment income and is subject to the self-employment tax.

For more information, you can refer to the instructions for Schedule C.

### **Schedule D**

If you sold, exchanged, or disposed of virtual currency (e.g. Bitcoin, Ether), or used it to pay for goods or services, you have engaged in a reportable transaction and may have a tax liability. These transactions may be reportable on Schedule D. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You should maintain and review all transaction records, including bank, wallet, and exchange reports and statements to determine your basis, amount received, and other information needed for reporting on Schedule D.

For more information, you can refer to the instructions for Schedule D.

### **Schedule E**

If you received supplemental income in the form of virtual currency, including income from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs, you may need to report this on Schedule E. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You may also need to file supplemental forms (e.g. Form 8582, Passive Activity Loss Limitations). See the instructions for Schedule E for any other circumstances that may apply.

For more information, you can refer to the instructions for Schedule E.

### **Additional Resources**

- Publication 17, Your Federal Income Tax (For Individuals)
- Instructions for Form 1040, U.S. Individual Income Tax Return
- Instructions for Form 8949, Sales and Other Dispositions of Capital Assets
- Instructions for Form 1041, U.S. Income Tax Return for Estates and Trusts
- Instructions for Form 1120, U.S. Corporation Income Tax Return
- Instructions for Form 1120-S, U.S. Income Tax Return for an S Corporation
- Instructions for Form 1065, U.S. Return of Partnership Income

You can get the forms, instructions, and publications mentioned in this letter by visiting our website at [www.irs.gov/forms-pubs](http://www.irs.gov/forms-pubs) or by calling 800-TAX-FORM (800-829-3676).

**You do not need to respond to this letter.** Note, however, we may send other correspondence about potential enforcement activity in the future.

Letter 6174-A (6-2019)  
Catalog Number 72597M

# 2022 Workbook

## Letter 6174-A (continued)

If you have questions, you can call the hotline telephone number shown at the top of this letter and leave a message. We'll respond to all messages within three business days.

Thank you for your cooperation.

Sincerely,

[Name]

[Title]

**Letter 6174-A (6-2019)**  
Catalog Number 72597M

## SCHEDULES K-2 AND K-3

The IRS attracted little attention in summer 2021 when it announced new schedules to be used by partnerships and S corporations in connection with their foreign income.<sup>67</sup> Because only a small percentage of domestic entities have foreign operations, it was assumed that this announcement would have little significance for the millions of entities with no foreign operations, income, or taxes.

Updated information about the new schedules provided on January 18, 2022, carried a different message, however.<sup>68</sup> In its announcement of changes to the instructions for Schedules K-2 (Form 1065), *Partners' Distributive Share Items — International*, and K-3 (Form 1065), *Partners' Share of Income, Deductions, Credits, etc. — International*, the IRS added a paragraph indicating that the schedules could still be required if a U.S. partner or shareholder files a tax return claiming a credit for foreign taxes paid. The added paragraph threatened an avalanche of small business returns requiring Schedules K-2 and K-3, even though the underlying entities had only U.S.-based income and assets. In this situation, information from a domestic partnership or S corporation could affect the partner's or shareholder's Form 1116, *Foreign Tax Credit*.<sup>69</sup> A separate announcement applied similar new rules to S corporation shareholders, who should expect to receive Schedules K-2 (Form 1120-S), *Shareholders' Pro Rata Share Items — International*, and K-3 (1120-S), *Shareholder's Share of Income, Deductions, and Credits, etc. — International*.<sup>70</sup>

One might wonder why the IRS would implement such dramatic changes in the reporting of foreign income, deductions, and credits, especially just before the filing season for calendar year 2021 partnership and S corporation returns started. It has been speculated that the IRS was concerned that reporting items had no common format, making it difficult to ensure that information affecting foreign tax credits was being reported properly, if at all.<sup>71</sup> It seemed that every financial adviser, hedge fund, and publicly traded partnership devised its own format for disclosing the increasingly complex information requested by the IRS. Given the lack of standardization, the IRS may have determined that the rules limiting the application of the foreign tax credit were not being observed with the necessary attention to detail. The structure of Schedule K-2 provides a centralized structure to this information, even though it is a long and complex form. Schedule K-3 extracts a particular partner's or shareholder's portion of information from the entity's Schedule K-2. The information on Schedule K-3 can then be reported on that individual's tax return.

**Note.** Schedules K-2 and K-3 also apply to partnerships required to file Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, if there are items relevant to determining U.S. tax under international provisions of the Code. For more information on Form 8865, see the 2015 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Foreign Asset Disclosure. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

<sup>67</sup> IRS Notice 2021-39, 2021-27 IRB 3.

<sup>68</sup> *Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)*. Jan. 18, 2022. IRS. [[www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065](http://www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065)] Accessed on Jul. 25, 2022.

<sup>69</sup> This discussion is also relevant to Form 1118, *Foreign Tax Credit — Corporations*, although this discussion does not describe the effect on corporations.

<sup>70</sup> *Changes to the 2021 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S)*. Jan. 18, 2022. IRS. [[www.irs.gov/forms-pubs/changes-to-the-2021-s-corporation-instructions-for-schedules-k-2-and-k-3-form-1120-s](http://www.irs.gov/forms-pubs/changes-to-the-2021-s-corporation-instructions-for-schedules-k-2-and-k-3-form-1120-s)] Accessed on Sep. 8, 2022.

<sup>71</sup> *Complying with new schedules K-2 and K-3*. Samtoy, John. Feb. 11, 2022. The Tax Adviser. [[www.thetaxadviser.com/newsletters/2022/feb/complying-new-schedules-k-2-k-3.html](http://www.thetaxadviser.com/newsletters/2022/feb/complying-new-schedules-k-2-k-3.html)] Accessed on Jul. 25, 2022.

# 2022 Workbook

## EXCEPTION FOR 2021 RETURNS ONLY

IRS guidance released on February 16, 2022, allowed a partnership or S corporation to avoid filing 2021 Schedules K-2 and K-3 if the entity was unaware of any partners **requesting** the information provided on the schedules.<sup>72</sup> One safe way of determining this is asking if any partners or shareholders pay enough foreign taxes to have a filing requirement for Form 1116. If none did, then the schedules were not relevant for 2021.

The following conditions **must** all be met to create an exception to filing Schedules K-2 and K-3 for **2021 only**.<sup>73</sup>

- None of the direct partners in a partnership were foreign partnerships, corporations, individuals, estates, or trusts.
- The partnership or S corporation did not have **any** foreign activity.
- The partnership or S corporation did not pay or accrue **any** foreign taxes.
- The partnership or S corporation must not have owned any assets that could generate foreign-source income.
- The partnership must **not** have reported any foreign activity in box 16 (foreign transactions) of its 2020 Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, or any activity associated with its Schedule K, *Partners' Distributive Share Items*, line 20c (other items and amounts) on Form 1065, *U.S. Return of Partnership Income*.
- An S corporation must **not** have reported any foreign activity in box 14 (foreign transactions) of its 2020 Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*, or any activity associated with its Schedule K, *Shareholder's Pro Rata Share Items*, line 17d (other items and amounts) on Form 1120-S, *U.S. Income Tax Return for an S Corporation*.
- The partnership or S corporation must be **unaware** of any partner or shareholder requesting information that would appear on Schedule K-2 or K-3.



### Practitioner Planning Tip

For 2022 and beyond, practitioners should plan to prepare Schedules K-2 and K-3 for their partnerships and S corporation clients, even if they did not have to for 2021. Fortunately, most domestic partnerships and S corporations need to complete fewer than half of the pages of Schedules K-2 and K-3.

<sup>72</sup> IRS News Rel. IR-2022-38 (Feb. 16, 2022).

<sup>73</sup> Ibid.



## PARTS I AND II

Schedule K-2 (Form 1065) is divided into 12 parts, and Schedule K-2 (Form 1120-S) uses seven parts to provide the relevant information to shareholders and partners.

Box C, immediately above part I, acts as an index. It tells the IRS what information is provided on Schedule K-2 and tells the partner or shareholder what information is provided on Schedule K-3. If a particular part of the schedule contains information, the checkbox in the “Yes” column is marked. Otherwise, the “No” column should be marked.

Part I acts in concert with box C to indicate what information is **attached** to the Schedule K-2. For example, box C may indicate that a Schedule K-2 and the associated Schedule K-3 report information in parts II and III. This denotes that basic information relating to the foreign tax credit limitation is provided on the schedule, as well as additional information needed to prepare Form 1116. Within part I, a box might be marked to indicate additional information is being provided on foreign oil and gas taxes. In many circumstances, no attachment is required so the absence of any checked boxes in part I should not raise any alarms.

Part II of Schedule K-2 provides detailed information about the type and source of partnership or S corporation income. The type of income is described in the rows under “Description” within part II, and the source’s income is identified in columns (a) through (e).

### Income Categories

Income is divided into separate categories to limit the foreign tax credit.<sup>74</sup> This is identified in IRS Publication 514, *Foreign Tax Credit for Individuals*, as **separate limit income**.<sup>75</sup> The Code and related regulations establish seven categories of income. Along with U.S. source income, the following categories of foreign source income are represented by the columns in part II.<sup>76</sup>

1. IRC §951A income
2. Passive category income
3. Foreign branch income
4. General category income
5. IRC §901(j) income
6. Certain income re-sourced by treaty
7. Lump-sum distributions

IRC §951A income requires a U.S. person who is a shareholder in a controlled foreign corporation (CFC) to include its share of global intangible low-taxed income (GILTI) as currently taxable income, regardless of whether any amount is distributed to the shareholder. A U.S. person includes U.S. individuals, domestic corporations, partnerships, trusts, and estates.<sup>77</sup> The GILTI tax was enacted to discourage U.S. corporations from making excessive profits from invested foreign assets that leverage intellectual property.<sup>78</sup> A CFC is a foreign corporation in which U.S. shareholders own more than 50% of the value of the stock or voting power. For this purpose, U.S. shareholders must own, directly or indirectly, 10% or more of the total voting power or value of all classes of the foreign corporation’s stock.<sup>79</sup>

<sup>74</sup> IRC §904.

<sup>75</sup> IRS Pub. 514, *Foreign Tax Credit for Individuals*, p. 12.

<sup>76</sup> IRC §904(d).

<sup>77</sup> IRC §§957(c) and 7701(a)(30).

<sup>78</sup> *A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act*. Pomerleau, Kyle. May 3, 2018. Tax Foundation. [taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act] Accessed on Jul. 28, 2022.

<sup>79</sup> IRC §§951(b) and 958(b); IRS Pub. 514, *Foreign Tax Credit for Individuals*.

# 2022 Workbook

## Income and Deduction Types<sup>80</sup>

In addition to organizing income and deduction by category, Schedules K-2 and K-3 group income and deductions by different types. Although most of the income and deduction types are self-explanatory, how to allocate interest expense is unclear. The instructions refer to specific regulations for interest expense without explaining the context of the regulation, just citing the regulation. Consequently, interest expense might be provided on any one of five different lines, or perhaps more than one line in certain circumstances. The following principles may be useful in determining on which line interest expense arising from a particular loan belongs. These lines are shown on the following segment of Schedule K-2.

- Line 39 allocates interest expense incurred by an affiliated group<sup>81</sup> for which Treas. Reg. §1.861-10(e) provides a deduction. These rules generally apply to bank holding companies, insurance companies, and other financial corporations.
- Line 40 allocates nonrecourse indebtedness.
- Line 41 allocates **business** interest expense, but the interest must be specifically allocated to partners or shareholders.
- Line 42 allocates investment interest expense.
- Line 43 allocates interest expense associated with a passive activity.

38	Charitable contribution								
39	Interest expense specifically allocable under Regulations section 1.861-10(e)								
40	Other interest expense specifically allocable under Regulations section 1.861-10T								
41	Other interest expense—business								
42	Other interest expense—investment								
43	Other interest expense—passive activity								
	Section 59(e)(2) expenditures,								

## Passive Income Exception<sup>82</sup>

A partnership or S corporation **must** determine the category and type of certain items of income, cost of goods sold, and the allocation and apportionment of certain deductions.

An exception is available to simplify reporting in some cases. If the entity has knowledge that all owners satisfy the following conditions, then the entity should classify the gross income and any associated deductions as **passive category income** for foreign source income.<sup>83</sup>

- All are limited partners/shareholders
- Each partner/shareholder has less than a 10% interest in the entity
- No partner/shareholder holds their interest in the entity in the ordinary course of their business

Any deductions should be treated as reducing foreign passive category income. Furthermore, the entity should not complete part II of Schedule K-2 or K-3, nor should it make any entries in part III, section 2, which pertains to interest expense apportionment.<sup>84</sup>

<sup>80</sup> Instructions for Schedule K-2 (1065 and 1120-S).

<sup>81</sup> Temp. Treas. Reg. §1.861-11T(d).

<sup>82</sup> Instructions to Schedule K-2 (1065 and 1120-S); Treas. Reg. §1.861-9(e)(4).

<sup>83</sup> Treas. Reg. §1.861-9(e)(4).

<sup>84</sup> Ibid.

## Summary

All partnerships and S corporations should expect to complete Schedules K-2 and K-3 in association with their 2022 tax returns. Nevertheless, a partnership or S corporation with only U.S. income and deductions should expect to only complete column (a) on its Schedules K-2 and K-3 for its income and deductions.

**Note.** The inclusion of Schedule K-3 likely affects the preparation of every S corporation shareholder's and every partner's individual tax return.

**Example 5.** Tor, LLC is a domestic limited liability company (LLC) with three members, each a U.S. citizen with a one-third interest in all income, expenses, and other tax attributes of the LLC. Tor has only one asset, a piece of unmortgaged rental real estate in the United States. One member, Theo, is an individual using the single filing status. He paid \$500 in foreign taxes, which results in a Form 1116 filing requirement.

Tor's tax practitioner, Alex, starts completing the Schedule K-2 by providing basic information about Tor, such as its name and employer identification number (EIN). Alex confirms that Tor is neither a withholding foreign partnership nor a qualified derivatives dealer. Because Tor only owns real estate in the United States, the answers to both questions are negative.

Tor has only domestic rental income, so the checkbox for item 2 in section C is marked "Yes," and the other 10 checkboxes are marked "No," because they do not apply.

Tor does not need to mark any of the boxes in part I, as it did not sell any personal property or pay any foreign oil and gas taxes or any other items requiring a specified attachment.

In part II, Alex writes "US" on each line to the right of the letter "A" because the income is based in the United States (without periods in "US," according to the instructions).

Alex adds Tor's rental income to the "A" line under "Gross rental real estate income" on page 1 of Schedule K-2. Tor received rent of \$36,000 during 2021, which is added to the line in the column labeled "U.S. source." Because Tor has no income in any foreign jurisdiction, Alex does not complete any other columns on this row.

The relevant segments of Tor's Schedule K-2 reflecting income follow.

# 2022 Workbook

## For Example 5

### SCHEDULE K-2 (Form 1065)

Department of the Treasury  
Internal Revenue Service

### Partners' Distributive Share Items—International

▶ Attach to Form 1065.

▶ Go to [www.irs.gov/Form1065](http://www.irs.gov/Form1065) for instructions and the latest information.

OMB No. 1545-0123

## 2021

Name of partnership: **Tor, LLC** Employer identification number (EIN): **88-9876543**

**A** Is the partnership a withholding foreign partnership?  
 Yes  No If "Yes," enter your WP-EIN ▶ \_\_\_\_\_

**B** Is the partnership (including the home office or any branch) a qualified derivatives dealer?  
 Yes  No If "Yes," enter your QI-EIN ▶ \_\_\_\_\_

**C** Check to indicate the parts of Schedule K-2 that apply.

	Yes	No		Yes	No
1 Does Part I apply? If "Yes," complete and attach Part I . . . . .	1	x	7 Does Part VII apply? If "Yes," complete and attach Part VII . . . . .	7	x
2 Does Part II apply? If "Yes," complete and attach Part II . . . . .	2	x	8 Does Part VIII apply? If "Yes," complete and attach Part VIII . . . . .	8	x
3 Does Part III apply? If "Yes," complete and attach Part III . . . . .	3	x	9 Does Part IX apply? If "Yes," complete and attach Part IX . . . . .	9	x
4 Does Part IV apply? If "Yes," complete and attach Part IV . . . . .	4	x	10 Does Part X apply? If "Yes," complete and attach Part X . . . . .	10	x
5 Does Part V apply? If "Yes," complete and attach Part V . . . . .	5	x	11 Does Part XI apply? If "Yes," complete and attach Part XI . . . . .	11	x
6 Does Part VI apply? If "Yes," complete and attach Part VI . . . . .	6	x	12 Reserved for future use . . . . .	12	

#### Part I Partnership's Other Current Year International Information

Check box(es) for additional specified attachments. See instructions.

- |  |   |   |  |
|--|---|---|--|
| <input type="checkbox"/> 1. Gain on personal property sale | <input type="checkbox"/> 4. Foreign tax translation           | <input type="checkbox"/> 7. Form 8858 information | <input type="checkbox"/> 10. Partner loan transactions                                       |
| <input type="checkbox"/> 2. Foreign oil and gas taxes      | <input type="checkbox"/> 5. High-taxed income                 | <input type="checkbox"/> 8. Form 5471 information | <input type="checkbox"/> 11. Dual consolidated loss  |
| <input type="checkbox"/> 3. Splitter arrangements          | <input type="checkbox"/> 6. Section 267A disallowed deduction | <input type="checkbox"/> 9. Other forms           | <input type="checkbox"/> 12. Other international items<br>(attach description and statement) |

#### Part II Foreign Tax Credit Limitation

##### Section 1—Gross Income

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)		
1 Sales							
A							
B							
C							
2 Gross income from performance of services							
A							
B							
C							
3 Gross rental real estate income							
A <b>US</b>	<b>36,000</b>					<b>36,000</b>	
B							
C							
4 Other gross rental income							
A							
B							
C							

For Paperwork Reduction Act Notice, see the Instructions for Form 1065.

Cat. No. 73927C

Schedule K-2 (Form 1065) 2021

Schedule K-2 (Form 1065) 2021

Page **3**

Name of partnership: **Tor, LLC** EIN: **88-9876543**

#### Part II Foreign Tax Credit Limitation (continued)

##### Section 1—Gross Income (continued)

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)		
24 <b>Total gross income</b> (combine lines 1 through 23) . . . . . ▶	<b>36,000</b>					<b>36,000</b>	
A <b>US</b>	<b>36,000</b>					<b>36,000</b>	
B							
C							

Schedule K-2 (Form 1065) 2021

Additionally, Tor has depreciation expense that must be allocated to the U.S. source income. Miscellaneous other rental expenses associated with the property appear on line 34 beneath the depreciation. Both of these expenses are shown on lines 33 and 34 in the following portion of Tor's Schedule K-2.

## For Example 5

Page 4

Schedule K-2 (Form 1065) 2021

Name of partnership <b>Tor, LLC</b>						EIN <b>88-9876543</b>	
<b>Part II Foreign Tax Credit Limitation (continued)</b>							
<b>Section 2—Deductions</b>							
Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
Allocable to sales income							
<b>C SIC code</b>							
<b>33</b> Allocable rental expenses—depreciation, depletion, and amortization	<b>20,512</b>					<b>20,512</b>	
<b>34</b> Allocable rental expenses—other than depreciation, depletion, and amortization	<b>4,000</b>					<b>4,000</b>	

Expenses are totaled on line 54, as shown in the following portion of part II. Immediately beneath it, Tor, LLC shows its net income.

Page 5

Schedule K-2 (Form 1065) 2021

Name of partnership <b>Tor, LLC</b>						EIN <b>88-9876543</b>	
<b>Part II Foreign Tax Credit Limitation (continued)</b>							
<b>Section 2—Deductions (continued)</b>							
Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
Loss							
<b>53</b> Reserved for future							
<b>54</b> Total deductions (combine lines 25 through 53)	<b>24,512</b>					<b>24,512</b>	
<b>55</b> Net income (loss) (subtract line 54 from line 24)	<b>11,488</b>					<b>11,488</b>	

**Other Information for Preparation of Form 1116 or 1118**

## SPECIAL TOPICS

### Qualified Nonrecourse Debt

Generally, interest expense is allocated among partners according to their proportionate ownership of assets.<sup>85</sup> An exception exists for interest expense associated with loans that can be treated as qualified nonrecourse financing.<sup>86</sup> The instructions for Schedules K-2 and K-3 state that lines 39 and 40 of part II allow interest expense that is “directly allocable” to income from specific partnership property, subject to the provisions of Treas. Reg. §1.861-10T. This temporary regulation first appeared in 1988 and now permits exceptions to the allocation rules of Treas. Reg. §1.861-9T, which require allocation by partner or shareholder. In general, qualified nonrecourse indebtedness satisfies the requirements of Treas. Reg. §1.861-10T, allowing interest expense to be placed on line 40.

The key provision is that the proceeds of the loan were used to acquire, construct, or improve the specific property, and the lender’s only security in the loan is the property itself. The lender has no recourse against the borrower or partner should the cash flow from the property not be able to service the loan.<sup>87</sup>

If the partners or shareholders are personally responsible for the servicing of the loan, the partnership agreement or LLC operating agreement likely contains language governing their liability.

<sup>85</sup> Treas. Reg. §1.861-9.

<sup>86</sup> IRC §465(b)(6); Treas. Reg. §1.465-27.

<sup>87</sup> Temp. Treas. Reg. §1.861-10T(b)(2)(iii).

# 2022 Workbook

**Example 6.** Use the same facts as in **Example 5**, except that Tor, LLC acquired the rental real estate with qualified nonrecourse financing. Under the terms of this loan, the members of Tor have no liability for the loan. If the income from the property cannot service the interest and principal of the loan, the only recourse the lender has is to foreclose on the property. In 2021, Tor incurred \$4,300 of interest expense on this loan. Because the loan is qualified nonrecourse indebtedness, it satisfies the requirements of Temp. Treas. Reg. §1.861-10T. The interest on the loan is reported on line 40 of Schedule K-2, part II. Portions of pages 4 and 5 of Tor’s Schedule K-2, showing lines 33, 34, 40, and the totals from lines 54 and 55 follow.

Schedule K-2 (Form 1065) 2021 Page **4**  
 Name of partnership **Tor, LLC** EIN **88-9876543**

**Part II Foreign Tax Credit Limitation (continued)**  
**Section 2—Deductions**

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
33 Allocable rental expenses—depreciation, depletion, and amortization	20,512						20,512
34 Allocable rental expenses—other than depreciation, depletion, and amortization	4,000						4,000
40 Other interest expense specifically allocable under Regulations section 1.861-10T	4,300						4,300

Schedule K-2 (Form 1065) 2021 Page **5**  
 Name of partnership **Tor, LLC** EIN **88-9876543**

**Part II Foreign Tax Credit Limitation (continued)**  
**Section 2—Deductions (continued)**

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
53 Reserved for future							
54 <b>Total deductions</b> (combine lines 25 through 53)	28,812						28,812
55 <b>Net income (loss)</b> (subtract line 54 from line 24)	7,188						7,188

**Other Information for Preparation of Form 1116 or 1118**

**Caution.** Tax practitioners should be alert for changes in the instructions for interest expense. The methods suggested for reporting interest expense may change. In January 2022, the IRS released a document containing substantive changes without updating the instructions, which suggests that major changes in the instructions for Schedules K-2 and K-3 may be expected.<sup>88</sup>

**Note.** If a partner or shareholder had provided a loan to the partnership or S corporation, checkbox 10 in part I should be marked. In addition, this loan is considered a recourse loan to that partner or shareholder.

<sup>88</sup> *Changes to the 2021 Partnership Instructions for Schedule K-2 and K-3 (Form 1065)*. Jan. 18, 2022. IRS. [www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065] Accessed on Jul. 26, 2022.

## Foreign Country Codes

Within each line on Schedules K-2 and K-3, there are three separate sub-lines, each starting with capital “A,” “B,” or “C.” The IRS expects a two-letter country code to be applied on each of these lines. For income sourced in the United States, partnerships and S corporations can use the abbreviation “US.” The permitted abbreviations are listed at [irs.gov/countrycodes](http://irs.gov/countrycodes). However, this list includes “OC” for other country, which is expressly forbidden in the amended instructions, as is use of the word “various.”<sup>89</sup> A separate statement must be attached to Schedule K-2 if income is derived from more than three countries.

However, none of the **expense** lines require a country code, although the particular expenses must be allocated to different categories of income.

**Example 7.** Use the same facts as **Example 6**, except that Tor, LLC also owns an apartment building in San Juan, Puerto Rico. This building produced \$30,000 in rent in 2021, and depreciation expense of \$14,544. In addition, \$2,000 of miscellaneous expenses were incurred, and \$2,100 of mortgage interest was incurred on qualified nonrecourse indebtedness used to acquire the building.

Portions of Schedule K-2, which follow, show two sublines under the heading of line 3, Gross rental real estate income. The first line still shows “US” beside “A”, while the second has country code “RQ” to report to the IRS that Tor, LLC derives rental real estate income from Puerto Rico. While Tor’s income derived from an onshore investment appears in column (a) under U.S. source, the company’s income derived from Puerto Rico appears in column (c), labeled “Passive category income” under “Foreign Source.”

SCHEDULE K-2 (Form 1065)		Partners’ Distributive Share Items—International				OMB No. 1545-0123	
Department of the Treasury Internal Revenue Service		▶ Attach to Form 1065. ▶ Go to <a href="http://www.irs.gov/Form1065">www.irs.gov/Form1065</a> for instructions and the latest information.				2021	
Name of partnership <b>Tor, LLC</b>						Employer identification number (EIN) <b>88-9876543</b>	
<b>A</b> Is the partnership a withholding foreign partnership?		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No If “Yes,” enter your WP-EIN ▶		<b>B</b> Is the partnership (including the home office or any branch) a qualified derivatives dealer?		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No If “Yes,” enter your QI-EIN ▶	
<b>C</b> Check to indicate the parts of Schedule K-2 that apply.							
		Yes	No		Yes	No	
1	Does Part I apply? If “Yes,” complete and attach Part I . . . . .	1	x		7		x
2	Does Part II apply? If “Yes,” complete and attach Part II . . . . .	2	x		8		x
3	Does Part III apply? If “Yes,” complete and attach Part III . . . . .	3	x		9		x
4	Does Part IV apply? If “Yes,” complete and attach Part IV . . . . .	4	x		10		x
5	Does Part V apply? If “Yes,” complete and attach Part V . . . . .	5	x		11		x
6	Does Part VI apply? If “Yes,” complete and attach Part VI . . . . .	6	x		12		x
7	Does Part VII apply? If “Yes,” complete and attach Part VII . . . . .	7					x
8	Does Part VIII apply? If “Yes,” complete and attach Part VIII . . . . .	8					x
9	Does Part IX apply? If “Yes,” complete and attach Part IX . . . . .	9					x
10	Does Part X apply? If “Yes,” complete and attach Part X . . . . .	10					x
11	Does Part XI apply? If “Yes,” complete and attach Part XI . . . . .	11					x
12	Reserved for future use . . . . .	12					
<b>Part I Partnership’s Other Current Year International Information</b>							
Check box(es) for additional specified attachments. See instructions.							
<input type="checkbox"/> 1. Gain on personal property sale		<input type="checkbox"/> 4. Foreign tax translation		<input type="checkbox"/> 7. Form 8858 information		<input type="checkbox"/> 10. Partner loan transactions	
<input type="checkbox"/> 2. Foreign oil and gas taxes		<input type="checkbox"/> 5. High-taxed income		<input type="checkbox"/> 8. Form 5471 information		<input type="checkbox"/> 11. Dual consolidated loss	
<input type="checkbox"/> 3. Splitter arrangements		<input type="checkbox"/> 6. Section 267A disallowed deduction		<input type="checkbox"/> 9. Other forms		<input type="checkbox"/> 12. Other international items (attach description and statement)	
<b>Part II Foreign Tax Credit Limitation</b>							
<b>Section 1—Gross Income</b>							
Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
1 Sales							
A							
B							
C							
2 Gross income from performance of services							
A							
B							
C							
3 Gross rental real estate income							
A <b>US</b>	36,000						36,000
B <b>RQ</b>			30,000				30,000
C							
4 Other gross rental income							
A							
B							
C							

<sup>89</sup> Ibid.

# 2022 Workbook

Lines 24A and 24B on page 3 show the total gross income earned by Tor by country.

Schedule K-2 (Form 1065) 2021 Page **3**

Name of partnership: **Tor, LLC** EIN: **88-9876543**

**Part II Foreign Tax Credit Limitation (continued)**  
**Section 1—Gross Income (continued)**

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
24 <b>Total gross income</b> (combine lines 1 through 23) ▶	<b>36,000</b>		<b>30,000</b>				<b>66,000</b>
<b>A US</b>	<b>36,000</b>						<b>36,000</b>
<b>B RQ</b>			<b>30,000</b>				<b>30,000</b>
<b>C</b>							

Schedule K-2 (Form 1065) 2021

Deductions are shown on page 4, although they are not broken down by country. The breakdown by category of income is maintained, however.

Schedule K-2 (Form 1065) 2021 Page **4**

Name of partnership: **Tor, LLC** EIN: **88-9876543**

**Part II Foreign Tax Credit Limitation (continued)**  
**Section 2—Deductions**

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
33 Allocable rental expenses—depreciation, depletion, and amortization	<b>20,512</b>		<b>14,544</b>				<b>35,056</b>
34 Allocable rental expenses—other than depreciation, depletion, and amortization	<b>4,000</b>		<b>2,000</b>				<b>6,000</b>
40 Other interest expense specifically allocable under Regulations section 1.861-10T	<b>4,300</b>		<b>2,100</b>				<b>6,400</b>

Lines 54 and 55 on page 5 show the total deductions and the net income. The breakdown of net income by country is not explicit, but the breakdown by category of income is.

Schedule K-2 (Form 1065) 2021 Page **5**

Name of partnership: **Tor, LLC** EIN: **88-9876543**

**Part II Foreign Tax Credit Limitation (continued)**  
**Section 2—Deductions (continued)**

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
54 <b>Total deductions</b> (combine lines 25 through 53) ▶	<b>28,812</b>		<b>18,644</b>				<b>47,456</b>
55 <b>Net income (loss)</b> (subtract line 54 from line 24) ▶	<b>7,188</b>		<b>11,356</b>				<b>18,544</b>

**Other Information for Preparation of Form 1116 or 1118**

**Note.** U.S. territories are considered foreign countries for identifying foreign source income.<sup>90</sup>

<sup>90</sup> IRS Pub. 514, *Foreign Tax Credit for Individuals*.



**FORM 7203 — BACK TO THE BASICS OF BASIS**

To combat concerns that taxpayers are not reporting potentially taxable distributions from S corporations or are deducting losses in excess of their stock or debt basis,<sup>91</sup> the IRS approved Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*. Form 7203 replaces the *Worksheet for Figuring a Shareholder's Stock and Debt Basis* that was previously only in the shareholder's instructions for Schedule K-1 (Form 1120-S).<sup>92</sup>

New for the 2021 tax year, this form must be attached to the S corporation shareholder's tax return, generally Form 1040. The S corporation itself does not file the form.

Form 7203 provides shareholders with a structured method to apply the S corporation basis rules. These rules govern the extent to which stock and debt basis limitations affect allowable losses and carryovers. Form 7203 is the IRS's attempt to make basis reporting more systematic and, therefore, more accurate.

Form 7203 divides the reporting into three parts. The first part determines a shareholder's stock basis at year-end. The second part examines the shareholder's basis in the corporation's debt. The shareholder must report a gain if an amount appears on line 34, Reportable gain. This gain is considered long-term capital gain income if the corporation's debt to its shareholder is documented in a formal written promissory note and has existed for at least one year.<sup>93</sup> If there is no note documenting the existence of the loan, the associated repayment is considered ordinary income.<sup>94</sup> The third section substantiates any losses taken on the current year's Form 1040 for the shareholder, and it documents any carryforwards.

**REQUIRED FILING<sup>95</sup>**

The IRS **requires** S corporation shareholders to file Form 7203 in the following circumstances.

- The shareholder claimed a deduction for a loss from an S corporation. The disallowance of the loss in a previous year is irrelevant.
- The shareholder received a distribution from the S corporation that was not a dividend of earnings before the S corporation election.
- The shareholder disposed of their stock in an S corporation.
- The shareholder received a loan repayment from the S corporation.

In other circumstances, the IRS **recommends** filing Form 7203 to provide consistency in maintaining the basis.

**Note.** For more information on S corporation requirements and filings, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: S Corporation Issues. This can be found at [uofi.tax/arc \[taxschool.illinois.edu/taxbookarchive\]](https://uofi.tax/arc/taxschool.illinois.edu/taxbookarchive).

Taxpayers filing Form 7203 must identify their **stock block** at the top of the form. The stock block area allows the S corporation shareholder to distinguish the basis associated with distinct purchases of the corporation's common stock. Although S corporations can have only one class of stock, shareholders do not necessarily purchase it all simultaneously. **Purchase of a second block of stock at a later time necessitates filing a second Form 7203.**

<sup>91</sup> *TAX GAP: Actions Needed to Address Noncompliance with S Corporation Tax Rules*, p. 16. Dec. 2009. United States Government Accountability Office [www.gao.gov/assets/gao-10-195.pdf] Accessed on Feb. 2, 2022; and 5 CFR §1320.13.

<sup>92</sup> Instructions for Form 7203.

<sup>93</sup> Rev. Rul. 64-162, 1964-1 CB 304.

<sup>94</sup> Rev. Rul. 68-537, 1968-2 CB 372. See Treas. Reg. §1.1367-2 for details on the treatment.

<sup>95</sup> Instructions for Form 7203.

# 2022 Workbook

## REPORTING SHAREHOLDER STOCK BASIS<sup>96</sup>

Part I of Form 7203 guides S corporation shareholders on how to correctly report the tax basis of their S corporation stock. Beginning basis is adjusted for items that increase basis, including income,<sup>97</sup> capital contributions,<sup>98</sup> and capital stock purchased.<sup>99</sup>

**Note.** Only positive amounts from Schedule K-1 (Form 1120-S) should be entered into Form 7203, line 3. If any of the related boxes in Schedule K-1 contain negative numbers, they should be entered in part III. However, some of these quantities cannot be negative, including separately stated amounts for dividends, interest, and royalties.

Shareholders also report the following items, which decrease the basis.<sup>100</sup>

- Nondeductible expenses
- Business credits
- Oil and gas depletion
- Distributions
- Restoration of **debt basis**
- Suspended losses from prior years are applied to the current year's stock basis

Most of the data in part I is reported as separately stated information appearing on Schedule K-1 (Form 1120-S).<sup>101</sup> The income items appear on Schedule K-1, part III, in boxes 1 through 9, although the basis does not consider whether dividends are qualified or not.<sup>102</sup> There is no explicit place to report collectible income on Form 7203, as there is no line on Form 7203 corresponding to box 8b on Schedule K-1, although line 3m on Form 7203 could be used for this purpose.<sup>103</sup>

## SHAREHOLDER DEBT BASIS<sup>104</sup>

If they have personally loaned money to the corporation, taxpayers complete part II of Form 7203, which reports the S corporation's debt basis. Section A deals with loan activity, such as the amount outstanding and any additional amounts the shareholder lent to the company. Section B calculates the adjustments to debt basis. The result is Section C, in which a reportable gain is determined for loan repayments. The shareholder must then determine whether the gain is ordinary or capital. Repayments of open account debt not supported by a written instrument produce ordinary income for the taxpayer. This is reported on Form 4797, *Sales of Business Property*. This is also the case of debt evidenced by a separate written instrument that has existed less than the period for long-term capital gains.<sup>105</sup> If a formal note has existed for at least a year, repayments of loan principal can generally be considered capital gain. Capital gains are reported on Schedule D and Form 8949.

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<sup>96</sup> Ibid.

<sup>97</sup> IRC §1367(a)(1).

<sup>98</sup> IRC §118(a).

<sup>99</sup> Treas. Reg. §1.118-1.

<sup>100</sup> IRC §1367(a)(2).

<sup>101</sup> Treas. Reg. §1-1366-1(a)(2).

<sup>102</sup> Shareholder's Instructions for Schedule K-1 (Form 1120-S).

<sup>103</sup> Ibid.

<sup>104</sup> Instructions for Form 7203.

<sup>105</sup> IRC §1368(b)(2).

## SHAREHOLDER ALLOWABLE LOSS AND DEDUCTION ITEMS

Part III of Form 7203 summarizes the results of the basis calculations in terms of losses allowed, deductions permitted, and carryovers. It incorporates carryover amounts from prior years and subsequently allocates them to either stock basis or debt basis if permitted. When allocation to either basis is not permitted, the amounts are carried over to future years.<sup>106</sup>

### Loss Limitation Order

The following three forms address corporation loss deductibility.

- Form 6198, *At-Risk Limitations*, limits losses of S corporation shareholders
- Form 8582, *Passive Activity Loss Limitations*, limits losses from passive activities, as prescribed by IRC §469
- Form 461, *Limitation on Business Losses*, applies the EBL limitation of §461(l) to S corporations

### COMPREHENSIVE EXAMPLE

**Example 8.** Richard Dana formed Mast Cleaning, Inc. on January 1, 2020, and immediately filed an S corporation election. He owns all 1,000 shares of Mast’s stock. In addition to purchasing the stock for \$1,000, Mr. Dana loaned the company \$20,000 when he incorporated it. The loan was supported with a formal promissory note drafted by the company’s attorney. Given the COVID-19 pandemic, the company lost \$21,000 in 2020, depleting both stock and debt basis. The terms of the promissory note required no principal payments in 2020.

Mr. Dana perceived a market opportunity for renting specialized vacuum cleaning equipment, and on February 15, 2021, his company put a new rental vacuum into service for \$5,000. Because the company was still in a growth phase, he elected to depreciate it over seven years rather than receive the benefit immediately as special depreciation or IRC §179 expense. Mr. Dana purchased the equipment on credit, which did not increase his debt basis in the S corporation. With the money generated by the vacuum rental in October 2021, he repays \$2,000 of the loan that he extended to the company in 2020.

**Observation.** The decision to elect out of bonus depreciation or elect §179 treatment was likely a good decision as losses created by these accelerated depreciation elections may have been lost due to Mr. Dana’s lack of stock and debt basis. Practitioners are encouraged to consider issues of basis in addition to mainly concentrating on minimizing the net income of a taxpayer’s activity.

The rental business realized \$6,000 in income while incurring depreciation expense of \$715 during 2021. During the year, Mast earned interest income of \$65, mostly generated by a new account promotion at its bank.

The improving economy enabled Mast’s cleaning operations to break even in 2021. The profitability of the vacuum rental business triggered a partial restoration of Mast’s debt basis of \$5,350 (\$6,000 revenue – \$715 depreciation + \$65 interest income), which is shown on line 23 in part II on Form 7203. Mr. Dana still reports \$1,465 of capital gain income on his 2021 Form 1040, as shown in the following calculation.

Debt outstanding	\$20,000
Less: debt basis restoration	<u>(5,350)</u>
	\$14,650
Debt outstanding at beginning of year	÷ <u>20,000</u>
	0.7325
Loan repayment	× <u>2,000</u>
Capital gain income	<u>\$ 1,465</u>

The reportable capital gain appears on line 34 of Form 7203. However, this gain did not appear on the Schedule K-1 (Form 1120-S) he received.

Mr. Dana received the following Form 7203 from Mast’s accountant, although Mast itself does not include the form in its Form 1120-S. The form should appear in Mr. Dana’s individual income tax return.

<sup>106</sup> Ibid.

# 2022 Workbook

## For Example 8

Form **7203**  
(December 2021)  
Department of the Treasury  
Internal Revenue Service

### S Corporation Shareholder Stock and Debt Basis Limitations

▶ Attach to your tax return.  
▶ Go to [www.irs.gov/Form7203](http://www.irs.gov/Form7203) for instructions and the latest information.

OMB No. 1545-2302

Attachment  
Sequence No. **203**

Name(s) shown on return <b>Richard Dana</b>	Identifying number <b>234-56-4321</b>
Name of S corporation <b>Mast Cleaning Inc</b>	Employer identification number <b>77-7777777</b>
Stock block (see instructions) ▶ <b>1</b>	

#### Part I Shareholder Stock Basis

1 Stock basis at the beginning of the corporation's tax year . . . . .					0
2 Basis from any capital contributions made or additional stock acquired during the tax year . . . . .					
3a Ordinary business income (enter losses in Part III) . . . . .	3a				
b Net rental real estate income (enter losses in Part III) . . . . .	3b				
c Other net rental income (enter losses in Part III) . . . . .	3c	5,285			
d Interest income . . . . .	3d	65			
e Ordinary dividends . . . . .	3e				
f Royalties . . . . .	3f				
g Net capital gains (enter losses in Part III) . . . . .	3g				
h Net section 1231 gain (enter losses in Part III) . . . . .	3h				
i Other income (enter losses in Part III) . . . . .	3i				
j Excess depletion adjustment . . . . .	3j				
k Tax-exempt income . . . . .	3k				
l Recapture of business credits . . . . .	3l				
m Other items that increase stock basis . . . . .	3m				
4 Add lines 3a through 3m . . . . .				4	5,350
5 Stock basis before distributions. Add lines 1, 2, and 4 . . . . .				5	5,350
6 Distributions (excluding dividend distributions) . . . . .				6	
<b>Note:</b> If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.					
7 Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15 . . . . .				7	5,350
8a Nondeductible expenses . . . . .	8a				
b Depletion for oil and gas . . . . .	8b				
c Business credits (sections 50(c)(1) and (5)) . . . . .	8c				
9 Add lines 8a through 8c . . . . .				9	0
10 Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15 . . . . .				10	5,350
11 Allowable loss and deduction items. Enter the amount from line 47, column (c) . . . . .				11	
12 Debt basis restoration (see net increase in instructions for line 23) . . . . .				12	5,350
13 Other items that decrease stock basis . . . . .				13	
14 Add lines 11, 12, and 13 . . . . .				14	5,350
15 <b>Stock basis at the end of the corporation's tax year.</b> Subtract line 14 from line 10. If the result is zero or less, enter -0- . . . . .				15	0

#### Part II Shareholder Debt Basis

##### Section A—Amount of Debt (If more than three debts, see instructions.)

Description	Debt 1		Debt 2		Debt 3		Total
	<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account debt		<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt		<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt		
16 Loan balance at the beginning of the corporation's tax year . . . . .	20,000						20,000
17 Additional loans (see instructions) . . . . .							
18 Loan balance before repayment. Combine lines 16 and 17 . . . . .	20,000						20,000
19 Principal portion of debt repayment (this line doesn't include interest) . . . . .	( 2,000 )						( 2,000 )
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19 . . . . .	18,000						18,000

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 56396V

Form **7203** (12-2021)

## For Example 8

Form 7203 (12-2021)

Page **2**

**Part II Shareholder Debt Basis** *(continued)*

**Section B—Adjustments to Debt Basis**

Description	Debt 1	Debt 2	Debt 3	Total
<b>21</b> Debt basis at the beginning of the corporation's tax year . . . . .	0			0
<b>22</b> Enter the amount, if any, from line 17 . . . . .				
<b>23</b> Debt basis restoration (see instructions) . . . . .	5,350			5,350
<b>24</b> Debt basis before repayment. Combine lines 21, 22, and 23 . . . . .	5,350			5,350
<b>25</b> Divide line 24 by line 18 . . . . .	0.26750000			0.26750000
<b>26</b> Nontaxable debt repayment. Multiply line 25 by line 19 . . . . .	535			535
<b>27</b> Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24 . . . . .	4,815			4,815
<b>28</b> Nondeductible expenses and oil and gas depletion deductions in excess of stock basis . . . . .				
<b>29</b> Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0- . . . . .	4,815			4,815
<b>30</b> Allowable losses in excess of stock basis. Enter the amount from line 47, column (d) . . . . .				
<b>31 Debt basis at the end of the corporation's tax year.</b> Subtract line 30 from line 29. If the result is zero or less, enter -0- . . . . .	4,815			4,815

**Section C—Gain on Loan Repayment**

<b>32</b> Repayment. Enter the amount from line 19 . . . . .	2,000			2,000
<b>33</b> Nontaxable repayments. Enter the amount from line 26 . . . . .	535			535
<b>34 Reportable gain.</b> Subtract line 33 from line 32 . . . . .	1,465			1,465

**Part III Shareholder Allowable Loss and Deduction Items**

Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
<b>35</b> Ordinary business loss . . . . .					
<b>36</b> Net rental real estate loss . . . . .					
<b>37</b> Other net rental loss . . . . .					
<b>38</b> Net capital loss . . . . .					
<b>39</b> Net section 1231 loss . . . . .					
<b>40</b> Other loss . . . . .					
<b>41</b> Section 179 deductions . . . . .					
<b>42</b> Charitable contributions . . . . .					
<b>43</b> Investment interest expense . . . . .					
<b>44</b> Section 59(e)(2) expenditures . . . . .					
<b>45</b> Other deductions . . . . .					
<b>46</b> Foreign taxes paid or accrued . . . . .					
<b>47 Total loss.</b> Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30 . . . . .					

Form **7203** (12-2021)

# 2022 Workbook

The income from Mast's rental operations is shown on line 5 of Form 7203. However, this amount restores a portion of Mr. Dana's **debt** basis in the corporation. The debt basis must be fully restored before the stock basis can be restored.<sup>107</sup> For this reason, Mast's income of \$5,350 appears on line 12 and line 23 of the form as a restoration of Mr. Dana's debt basis.

This amount restores slightly more than one-quarter of the debt basis associated with the original \$20,000 Mr. Dana lent to the company. The same fraction of the loan repayment is considered a tax-free return of principal to him. The nontaxable amount of the principal repayment is \$535, as shown in the following calculation.

Debt basis restoration	\$ 5,350
Debt outstanding at beginning of year	÷ 20,000
	0.2675
Loan repayment	× 2,000
Capital gain income	\$ 535

This amount appears on line 33 of Form 7203.

The balance of the principal repayment is considered **capital gain** income for two reasons. First, the loss in 2020 reduced the debt basis to zero. Second, Mr. Dana prepared a written note to document the loan. Because the debt was outstanding for over a year, it is a long-term capital gain.

Part III of the form contains no information because Mast did not have an ordinary business loss for 2021. Nor did it carry forward losses from previous years, which would appear in column (b) of part III. If there had been carried-forward losses, they would have been combined with losses generated in the current year, to be allocated to allowable losses from either stock basis or debt basis or to amounts carried over to future years.

**Note.** Mr. Dana may decide that two years of mediocre financial results warrants purchasing additional shares of stock. That would result in more capital in the business and create stock block number two. However, purchasing the second block of stock requires filing a second Form 7203.<sup>108</sup>

**Note.** For more information about the treatment of repayment of reduced-basis S corporation debt, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: S Corporation Shareholder Issues. This can be found at [uofi.tax/arc](https://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](https://taxschool.illinois.edu/taxbookarchive)].

## Practitioner Planning Tip

Tax practitioners should consider building relationships with licensed attorneys to prepare loan agreements, as their preparation may constitute the practice of law in many states.

<sup>107</sup>. IRC §1367(b)(2)(B).

<sup>108</sup>. Instructions for Form 7203.

## RESEARCH AND DEVELOPMENT TAX CREDIT UPDATE

The research and development (R&D) credit provides companies a credit for increasing their research activities, not just for undertaking them. Generally, companies use this credit to offset their income tax liability, acting as a general business credit.<sup>109</sup> IRC §41 provides a special subsection that allows **qualified small businesses** (typically gross receipts less than \$5 million) to offset **payroll** tax liability with the R&D tax credit.<sup>110</sup> The Inflation Reduction Act of 2022 increases the maximum credit for small businesses from \$250,000 to \$500,000 starting in 2023.<sup>111</sup>

**Note.** As a result of the Inflation Reduction Act, the following forms may need to be updated:

- Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*
- Form 6755, *Credit for Increasing Research Activities*
- Form 941, *Employer's QUARTERLY Federal Tax Return*
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*
- Form 944, *Employer's ANNUAL Federal Tax Return*

Only certain expenses qualify for the credit. Qualified research expenses (QREs) must meet one of the following requirements if the company's employees conduct the research.<sup>112</sup>

- Wage expenses are earned by an employee for **qualified services** (activities that engage in qualified research or that supervise qualified research)<sup>113</sup>
- Supplies acquired to perform research
- Expenses incurred for the use of computers and information technology

The research must be designed to acquire knowledge that is “technological in nature.”<sup>114</sup> For example, the award of a U.S. patent is considered conclusive evidence that research satisfied this requirement, although the award of a patent is not required. The technological component may be satisfied by physical or biological sciences, engineering, or computer science research. This requirement precludes expenses of surveys or marketing research as part of the credit, nor can it relate to style, taste, or cosmetic factors.<sup>115</sup>

The research should focus on creating or improving a business component. A business component is a product, process, technique, formula, or in some cases, software that is either used by the business or licensed, leased, or sold to another entity.<sup>116</sup>

<sup>109</sup> IRC §38(b)(3).

<sup>110</sup> IRC §41(h).

<sup>111</sup> *Inflation Reduction Act*, PL 117-169, §13902.

<sup>112</sup> Treas. Reg. §1.41-4(a).

<sup>113</sup> IRC §41(b)(2)(A)(i).

<sup>114</sup> Treas. Reg. §1.41-4(a)(3)(i).

<sup>115</sup> IRC §41(d)(3)(B).

<sup>116</sup> IRC §41(d)(2)(B).

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Computing the credit itself requires summing the following three factors.

1. 20% of QREs that exceed a base amount<sup>117</sup>
2. 20% of **basic** research payments<sup>118</sup>
3. 20% of amounts paid to an energy research consortium specifically for energy research<sup>119</sup>

These amounts must exceed a base amount defined in §41(c). The base amount is the product of the fixed-base percentage (generally starts at 3% and increases each year, not to exceed 16%), and the average annual gross receipts of the taxpayer for the previous four tax years.

**Note.** For more information about the R&D tax credit, see the 2021 *University of Illinois Tax School Federal Tax Workbook*, Volume B, Chapter 6: Small Business Issues.

## CHANGE IN DOCUMENTATION FOR R&D ADMINISTRATIVE REFUND CLAIMS<sup>120</sup>

The Treasury Inspector General for Tax Administration (TIGTA) performed an audit of R&D tax credits claimed by 1,467 businesses that claimed credits resulting in refunds of \$53.2 million. The audit found 81 businesses with “potentially erroneous” R&D credit claims totaling \$2.8 million. Another 55 businesses claimed the credit on a return “prior to when the credit became available.”

In response, the IRS released a Chief Counsel Memorandum<sup>121</sup> that imposed new requirements for an R&D tax credit **refund** claim. In particular, the memorandum required that each refund claim provides the following information.

1. Identification of all business components to which the R&D tax credit claim applies
2. Identification of all research activities performed for each business component
3. Names of the individuals who performed each research activity for each business component
4. Identification of the information each individual sought to discover for each business component
5. Total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year (may be provided on Form 6765, *Credit for Increasing Research Activities*)
6. Inclusion of a signed declaration under penalties of perjury that the facts submitted are accurate
7. Application of the statute of limitations to the R&D tax credit claim, including the restriction on the refund not exceeding the portion of the tax paid within the two years immediately preceding the claim’s filing<sup>122</sup>

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<sup>117</sup>. IRC §41(a)(1).

<sup>118</sup>. IRC §§41(a)(2) and (e)(1)(A).

<sup>119</sup>. IRC §41(a)(3).

<sup>120</sup>. *Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset*. p. 3. Dec. 19, 2018. TIGTA. [www.treasury.gov/tigta/auditreports/2019reports/201940014fr.pdf] Accessed on Jul. 30, 2022.

<sup>121</sup>. CCM 20214101F (Oct. 15, 2021).

<sup>122</sup>. IRC §6511.



## Signed Declaration Required

The taxpayer's statement requesting the refund must state the grounds for the refund and the facts supporting the grounds. The taxpayer must attest to the truth of this statement under penalties of perjury.<sup>123</sup> This requirement would be fulfilled with a signed amended return but could also be fulfilled with an appropriately signed affirmation that is part of the refund request.

## Substantiation Requirements

To substantiate expenditures supporting the R&D credit claim, the taxpayer must provide both the grounds and sufficient factors that form the basis of the research claim. The chief counsel memorandum refers to this as the "specificity requirement," which originates in treasury regulations.<sup>124</sup> It requires taxpayers to tell the IRS the grounds for their claim to the R&D credit or a related refund, as well as the basis of the claim with some precision.<sup>125</sup> A person claiming the R&D credit must not only make an assertion they are entitled to the R&D credit, but must also provide supporting facts so the IRS understands the specific claim being made. The support must be in a form that facilitates the efficient processing of the claim.

## Deadline Imposed by Statute of Limitations<sup>126</sup>

Typically, taxpayers can make claims for the R&D credit three years from when a return is filed or two years from when the associated tax was paid, whichever period expires later. If a taxpayer files a return without claiming the R&D credit but later files a claim for a refund based on the R&D credit, that refund is limited to the taxes paid within the past **two** years.

The requirements of the R&D credit complicate the statute of limitations determination. For example, a taxpayer may file a deficient claim before the expiration of the statute of limitations. The IRS may still consider the claim if the taxpayer **perfects** the claim, meaning they correct the deficiencies in it, even if amended after the statute of limitations expires.<sup>127</sup> The subsequent claim perfection is identified as the "informal claim doctrine."

IRS FAQs<sup>128</sup> provide for 45 days to perfect a claim for a refund and state that guidance will be given to IRS employees examining the claims for a refund. However, the FAQs also allow the 45-day perfection period for only a 1-year transition period ending on January 10, 2023.<sup>129</sup> Presumably, any refund claim based on the R&D credit filed after that date must include all information specified in the chief counsel memorandum, although the FAQs did not specifically address this point.

## AMORTIZING CREDIT AMOUNT

TCJA modified IRC §174 so that starting in 2022, taxpayers are not permitted to expense their R&D credit in one year. Rather, the expenses must be **amortized over five years** (15 years for foreign research expenses.)

**Caution.** Several pieces of legislation have been proposed to modify the amortization requirement but have failed. There is a chance changes will be implemented before the end of the year.

<sup>123</sup> Treas. Reg. §301.6402-2(b)(1).

<sup>124</sup> Treas. Reg. §301.6402-2.

<sup>125</sup> *An early 21st century history of IRS efforts to police the R&D credit*. Bertiglia, Rory, et al. Apr. 1, 2022. The Tax Adviser. [www.thetaxadviser.com/issues/2022/apr/history-irs-efforts-to-police-research-development-credit.html] Accessed on Jul. 31, 2022.

<sup>126</sup> IRC §6511.

<sup>127</sup> *Computervision Corporation v. U.S.*, 445 F.3d. 1355, 1364.

<sup>128</sup> *Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions*. Feb. 9, 2022. IRS. [www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions] Accessed on Aug. 1, 2022.

<sup>129</sup> Ibid.

# 2022 Workbook

## EXPIRING PROVISIONS

The following are some expiring provisions for which taxpayers may want to plan. Additionally, some provisions that expired in 2021 may impact a taxpayer's 2022 tax return.

### DECEMBER 31, 2021

Code Sections	Description
21(g)	Refundable and increased child and dependent care credit
24(i) and (j)	Increased amount and availability of child tax credit
129(a)(2)(D)	Increased exclusion for dependent care assistance provided to employees
170(p)	Charitable contribution deduction for taxpayers who do not itemize
6428B	2021 recovery rebates to individual
7527A(f)	Advance payment of child tax credit

### DECEMBER 31, 2022

Code Sections	Description
40A(g)	Various income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agribiodiesel producers (also renewable diesel)
274(n)(2)(D)	Allowance of full deduction for business meals

### DECEMBER 31, 2024

Code Sections	Description
6426(c)(6)	Excise tax credits and outlay payments for (renewable) diesel fuel mixtures
6427(e)(6)(B)	Excise tax credits and outlay payments for (renewable) diesel fuel mixtures

DECEMBER 31, 2025

Code Sections	Description
1(j)	Modification of individual income tax rates
24(h)	Child tax credit amounts
25B(d)(1)(D), 529(c)(3)(C)(i)(III), and 529A(b)(2)(B)	Achieving a Better Life Experience (ABLE) accounts: Contributions eligible for saver's credit; rollovers from qualified tuition plans permitted, and increased contribution amounts
36B	Premium assistance credit enhancements
45D(f)(1)	New markets tax credit
455(i)	Employer credit for paid family and medical leave
51(c)(4)	Work opportunity tax credit
55	Modifications of exemption amount and phaseout threshold of individual alternative minimum tax (AMT)
63(c)(7)	Increase in standard deduction of individuals
67(g)	Suspension of miscellaneous itemized deduction
68(f)	Suspension of limitation on itemized deductions
108(a)(1)(E)	Exclusion from gross income of discharge of indebtedness on principal residence
108(f)(5)	Certain discharges of student loans
127(c)(1)(B)	Exclusion for certain employer payments of student loans
132(f)(8)	Suspension of exclusion for reimbursement of bicycle commuting
132(g)(2)	Suspension of exclusion for moving expense reimbursement
151(d)(5)	Suspension of deduction for personal exemptions
163(h)(3)(F)	Limitation on deduction for qualified residence interest, suspension of deduction for home equity interest
164(b)(6)	Limitation on deduction for state, local, etc., taxes
165(d)	Modification of rules relating to computation of wagering losses
165(h)(5)	Personal casualty losses limited to federally declared disaster areas
170(b)(1)(G)	Increase in percentage limitation on cash contributions to public charities
199A(i)	Qualified business income deduction (QBID)
217(k)	Suspension of deduction for moving expenses
250(a)(3)	Deduction percentages for foreign-derived intangible income and global intangible low-taxed income
274(o)	Deductibility of employer de minimis meals and related eating facility, and meals for the convenience of the employer
1391(d), (h), 1394, and 1396	Empowerment zones: Designation of an empowerment zone, tax-exempt bonds, employment credit
2010(c)(3)(C)	Increased estate and gift tax exemption

# 2022 Workbook

DECEMBER 31, 2026

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<b>Code Sections</b>	<b>Description</b>
168(k) and 460(c)	Various additional first-year depreciation elections
1400Z-2(a)(2)(B)	Election to invest capital gains in an opportunity zone

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