

Chapter 11: New Developments

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Note. Corrections were made to this workbook through January of 2024. 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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COVID-19 EMPLOYEE RETENTION CREDIT

The employee retention credit (ERC) was modified under the Coronavirus Aid, Relief, and Economic Security (CARES) Act,¹ and covered the period of March 13, 2020, through December 31, 2020.² Under the provisions of the CARES Act, employers who had received Payroll Protection Program (PPP) loans were not eligible for the ERC.³

This program was further expanded by Congress in 2021 through the Consolidated Appropriations Act of 2021.⁴ This act permitted employers that received PPP loans to claim the ERC, and modified and extended the ERC from December 31, 2020, through June 30, 2021.⁵ The American Rescue Plan Act (ARPA), provided an extended and modified ERC for wages paid after June 30, 2021, and before January 1, 2022.⁶

Although ARPA extended the ERC to employers even if those employers had received PPP loans, an employer could not claim ERC for wages that were used to receive forgiveness of their PPP loan. With the Infrastructure Investment and Jobs Act which was signed into law on November 15, 2021, the ERC was retroactively ended as of September 30, 2021, for all businesses except those that qualified as **recovery startup businesses**. Recovery startup businesses are businesses that began operations after February 15, 2020 and are only eligible for the ERC for 3rd and 4th quarters of 2021.⁷

¹. CARES Act, PL 116-136, §2301.

². COVID-19-Related Employee Retention Credits: Overview. Jan. 31, 2023. IRS. [www.irs.gov/newsroom/covid-19-related-employee-retention-credits-overview] Accessed on Aug. 22, 2023.

³. Ibid.

⁴. Consolidated Appropriation Act of 2021, PL 116-260, §276, Div. N.

⁵. Ibid, §§206 and 207.

⁶. IRS Notice 2021-23, 2021-16 IRB 1113.

⁷. Frequently asked questions about the Employee Retention Credit. Jul. 31, 2023. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Sep. 6, 2023.

Caution. Many practitioners do not prepare payroll tax returns and consequently, may not have been engaged by their clients to review and prepare ERC claims. However, as discussed later, some ERC claims may require the taxpayer to file amended income tax returns. Practitioners may have clients ask them to prepare the required amended returns. Practitioners will be well-advised to understand whether the client qualifies for the ERC and the professional responsibility that the practitioner has if the client does not qualify.

Note. For details on computing the ERC, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Due to the perceived popularity of the ERC, a number of firms have popped up promoting the ERC. The **IRS issued an advisory warning** of third parties promoting improper ERC claims to employers who may or may not qualify.⁸ Some of these promoters are claiming large refunds per employee and charging large fees for assisting in claiming the credit.

Note. The IRS also identified ERC fraud as one of its Dirty Dozen that represents the worst tax scams of the year. The Dirty Dozen, including ERC fraud, is covered in the 2023 *University of Illinois Federal Tax Workbook*, Chapter 12: Rulings and Cases.

The IRS identifies the following qualifications that an employer must meet to qualify for the ERC.⁹

1. Sustained a full or partial suspension of operations due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings due to COVID-19 during 2020 or the first three quarters of 2021,
2. Experienced a significant decline in gross receipts during 2020, or a decline in gross receipts in the first three quarters of 2021, or
3. Qualified as a recovery start-up business for the 3rd or 4th quarters of 2021.

As the second qualification states, an employer must have a **significant decline** in gross receipts during 2020 or in the first three quarters of 2021. This is defined under the CARES Act as beginning in the quarter in which the gross receipts declined by more than 50% for the same calendar quarter in 2019.¹⁰ The Taxpayer Certainty and Disaster Relief Act of 2020,¹¹ which expanded the ERC to 2021, defined the eligibility to include decreases in gross receipts in 2021 as **less than 80%** of the gross receipts in 2019 for the same calendar quarter. For businesses which were not in business in 2019, the comparison is made to the same quarter in 2020. Finally, the ARPA made the credit available to “recovery startup businesses” that do not otherwise meet the eligibility criteria.¹² The Infrastructure Investment and Jobs Act modified the ERC to end September 30, 2021, except for recovery start-up businesses which had limited availability and can include 4th quarter 2021.¹³

Note. For more information on the ERC rules and qualifications, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments, and the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments. These chapters can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

⁸. IRS News Rel. IR-2023-105 (May 25, 2023).

⁹. Ibid; IRC §3134(c)(2); *Frequently asked questions about the Employee Retention Credit* Jul. 31, 2023. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Aug. 4, 2023.

¹⁰. CARES Act, PL 116-136, §2301.

¹¹. Consolidated Appropriations Act of 2021, PL 116-260, §§206 and 207.

¹². American Rescue Plan Act of 2021, PL 117-2, §9651.

¹³. Infrastructure Investment and Jobs Act, PL 117-58.

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SUPPLY CHAIN DISRUPTION¹⁴

The IRS is continuing to clarify terms of the ERC. On July 21, 2023, the IRS issued a General Legal Advice Memo (GLAM) that describes five scenarios involving supply chain disruptions where an employer's trade or business was fully or partially suspended in a calendar quarter because of a governmental order limiting commerce, travel, or group meetings due to COVID-19. As mentioned previously, an employer must have experienced a full or partial disruption of their business due to COVID-19 to qualify for the ERC. The general takeaway from these five scenarios is that the IRS is significantly reducing employers who qualify for ERC based on the full or partial disruption qualification.

1. Employer A was not eligible for the ERC because the employer was not subject to a government order that suspended their business. Even though the employer experienced delays from their supplier, the employer could not provide a government order suspending business from the supplier. Additionally, because the employer had a supply of critical goods, they were able to continue operating during the pandemic.
2. Similarly, Employer B also was not eligible for the ERC because they were not subject to any governmental orders suspending their business. Employer B's critical goods were stuck in port, which the employer assumed was due to COVID-19 but could not provide any specific order applicable to their supplier. There was speculation that the delay in supplies could have been attributed to increases in consumer spending, aging infrastructure, or a truck driver shortage (possibly due to COVID-19 illnesses but unconfirmed).
3. Employer C and their supplier **were subject to a government order** that suspended both of their business operations from April 2020 through May 2020. Employer C experienced delays in receiving goods from the supplier for the remainder of 2020 and 2021. The supplier did not provide a reason for the delay, but Employer C assumed the delay was due to COVID-19. Employer C is eligible for the ERC for the **2nd quarter of 2020** because there was a government order in place. However, Employer C is not eligible for the ERC for the remaining quarters of 2020 or any of 2021 because there was no government order in place. The existence of a government order in the 2nd quarter of 2020 does not extend to any future periods.
4. Employer D was not subject to any government orders due to the pandemic at any time. During 2020 and 2021, Employer D could not receive critical supplies from their supplier. However, they were able to obtain the goods from an alternate supplier, but at a 35% increase in costs. Employer D continued their operations, but with a lower profit than in 2019. Employer D is not considered an eligible employer because they continued to operate their business. An increase in the cost of supplies is not the same as having a full or partial suspension of operations.
5. Employer E, a retail business selling a variety of products, was not under a government order, but was unable to stock a limited number of products and had to raise prices on products that were in limited supply because of supply chain disruptions. Despite the product shortage, Employer E was able to continue full operations during 2021. Employer E does not qualify for the ERC because they cannot demonstrate a government order caused the supplier to not be able to provide supplies and that Employer E could not obtain critical goods that resulted in a full or partial suspension of their business.

Caution. The GLAM may not be used or cited as precedent. However, it does show that the number of businesses that are eligible to claim to ERC is significantly limited.

¹⁴ Generic Legal Advice Memorandum (GLAM) AM 2023-005. Jul. 21, 2023. IRS. [www.irs.gov/pub/iranoa/am-2023-005-508v.pdf] Accessed on Aug. 23, 2023.

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AMENDING PAYROLL TAX RETURNS

The window for amending payroll tax returns claiming COVID-19 ERC is beginning to close. For 2020 tax periods, the deadline to claim the ERC is April 15, 2024. For 2021 tax periods, the deadline to claim the ERC is April 15, 2025. The following table outlines the deadlines.¹⁵

Year	Quarter Ending	General Amended Due Date	Due Date for Amending ERC
2020	Jun. 30	Jul. 31, 2023	Apr. 15, 2024
2020	Sep. 30	Oct. 31, 2023	Apr. 15, 2024
2020	Dec. 31	Jan. 31, 2024	Apr. 15, 2024
2021	Mar. 31	Apr. 30, 2024	Apr. 15, 2025
2021	Jun. 30	Jul. 31, 2024	Apr. 15, 2025
2021	Sep. 30	Oct. 31, 2024	Apr. 15, 2025
2021	Dec. 31	Jan. 31, 2025	Apr. 15, 2025

Before a tax practitioner (in this case, CPA, attorney, or EA) claims an ERC for a client, they should be aware of their professional obligations under the Office of Professional Responsibility (OPR). Under Circular 230, practitioners are required to exercise due diligence in the accuracy of any written or oral representations to clients and the IRS. This includes preparing and filing tax returns (income, employment, or other) or other documents on behalf of a client. Therefore, practitioners must acquire sufficient details from their client to determine whether the client qualifies for the ERC and claim the accurate amount. A practitioner may rely in good faith on a client's responses to questions about eligibility if the responses appear to be **reasonable**. A practitioner who learns their client did not comply with the ERC requirements in a previous year must promptly inform the client of the noncompliance, error or omission, and any potential penalties.¹⁶

A practitioner who discovers that a client previously claimed an excessive ERC (including an ERC that they did not qualify for) must advise the client of the noncompliance as mentioned previously. **The practitioner is not required to prepare an amended ERC claim.** While it is considered a best practice to file an amended return, the client must request it and the practitioner must feel competent to prepare it.¹⁷

If a practitioner believes they meet their professional responsibilities as discussed previously, they may be requested to file the amended returns examined next.

Caution. The statute for assessment under the ERC is extended to five years after the filing of the amended returns. In addition, fraud penalties could be applied if fraud can be established in the claim.¹⁸ Therefore, taxpayers that are in doubt about their eligibility for the credit should be cautious about claiming it.

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¹⁵ *Frequently asked questions about the Employee Retention Credit*. Jul. 27, 2023. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Jul. 28, 2023.

¹⁶ *Professional Responsibility and the Employee Retention Credit*. Mar. 7, 2023. IRS. [www.irs.gov/pub/irs-utl/2023-02-professional-responsibility-and-the-employee-retention-credit-R2-508-compliant.pdf] Accessed on Jul. 28, 2023.

¹⁷ Ibid.

¹⁸ IRC §3134.

Taxpayer Qualified for ERC and Did Not Claim¹⁹

A taxpayer who is eligible to claim the ERC but did not claim the credit when they filed their original employment tax return may file an amended employment tax return to claim the credit. A business that files quarterly employment returns claims the credit for prior 2020 and 2021 quarters on Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*. A business that files annual employment returns use Form 944-X, *Adjusted Employer's ANNUAL Federal Tax Return or Claim for Refund*, to claim the ERC.²⁰

A taxpayer must have filed an original employment tax return to claim the ERC on an amended return. Additionally, a taxpayer must have issued and filed Forms W-2, *Wage and Tax Statement*, to claim the credit.

Note. An amended claim for the ERC will result in an employer also filing an amended income tax return to reduce the deduction for wages by the amount of the credit for the same period.

Taxpayer Claimed ERC and Did Not Qualify²¹

Anyone who claimed the ERC and did not qualify must return the funds (including interest received) to the IRS. In addition, they may be assessed additional penalties and interest. The steps to return an erroneous refund depends on the method the refund was issued.²²

- **Refunds on paper Treasury checks that have not been cashed.** The taxpayer must write “void” in the endorsement section on the back of the check. They should submit the paper check immediately to the proper IRS location, which is based on the city listed on the refund check on the bottom text line in front of the words TAX REFUND. The IRS mailing address can be found at www.irs.gov/taxtopics/tc161.
- **Refunds on paper Treasury checks that have been cashed.** The taxpayer must submit a personal check, money order, etc. immediately, but no later than 21 days after cashing, to the appropriate IRS mailing address. As mentioned in the previous bullet point, the mailing address depends on the city listed on the check. Additionally, the taxpayer must write on the check/money order: Payment of Erroneous Refund, plus the tax period for which the refund was issued, and the taxpayer's identification number. Lastly, the taxpayer must include a brief explanation of why the taxpayer is returning the refund. Interest may also be due to the IRS.
- **Refund was direct deposited.** The taxpayer must contact the automated clearing house department of the bank or financial institution where the direct deposit was received and have them return the refund to the IRS. The taxpayer must also call the IRS (800-829-1040 for individual returns and 800-829-4933 for business returns) and provide an explanation of why the taxpayer is returning the refund. Interest may also be due to the IRS.

Taxpayers may receive a notice from the IRS if the IRS calculated an amount different than what was claimed on the return. Taxpayers should review the notice and call the number listed if they require additional assistance.²³

¹⁹ *Frequently asked questions about the Employee Retention Credit*. Jul. 27, 2023. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Jul. 28, 2023.

²⁰ *Employee Retention Credit*. Jul. 27, 2023. IRS. [www.irs.gov/coronavirus/employee-retention-credit] Accessed on Jul. 28, 2023.

²¹ *Frequently asked questions about the Employee Retention Credit*. Jul. 27, 2023. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Jul. 28, 2023.

²² *Topic No. 161, Returning an Erroneous Refund – Paper Check or Direct Deposit*. May 12, 2023. IRS. [www.irs.gov/taxtopics/tc161] Accessed on Jul. 28, 2023.

²³ *Ibid.*

Fraudulently Filed Return. If the IRS determines that fraud exists, fraud penalties could be applied to the additional assessed tax. The fraud penalty is an additional tax of **75% of the portion of the underpayment attributable to fraud.**²⁴ Filing Forms 941-X or 944-X will not necessarily alleviate penalties; however, this action would be a positive step should the IRS pursue a fraud penalty. The employer may, however, still be subject to a **negligence penalty of 20% of the underpayment under IRC §6662.**

Example 1. Briar Company filed an amended Form 941-X for the 2nd quarter of 2021 in December 2022, knowing that they had not been affected by government shutdowns or experienced a decline in gross receipts. They received a refund check of \$63,000 (\$60,000 ERC and \$3,000 interest) in June 2023. The IRS could impose a fraud penalty of \$45,000 ($\$60,000 \times 75\%$) in addition to repaying the \$63,000 of tax.

Example 2. Use the same facts as **Example 1.** Briar decides the potential penalty of \$45,000 is not worth the \$60,000 credit. Briar files another amended Form 941-X (2nd quarter of 2021) return in 2023 and returns the \$63,000 (\$60,000 ERC + \$3,000 interest). Briar may still be liable for interest and penalties on the erroneously filed Form 941-X, but it may avoid the \$45,000 fraud penalty. It may also be liable for the 20% negligence penalty of \$12,000 ($\$60,000 \times 20\%$).

AMENDING AN ENTITY'S INCOME TAX RETURN

The ERC reduces wage expense for the tax year to which the payroll tax quarter relates. Thus, refunds received in later years require the previous income tax returns filed to be amended. This applies to both cash-basis and accrual-basis taxpayers. The following business entities are subject to amending their returns, including corporations, pass-through entities, sole proprietors, and exempt organizations that file Form 990-T, *Exempt Organization Business Income Tax Return* (and proxy statement under section 6033(e)).

S corporations, partnerships, and sole proprietorships must modify their taxable income. As their qualified business income (QBI) **increases** and the corresponding QBI-qualifying wages decrease, the QBI deduction (QBID) may be affected.

After pass-through entities amend their income tax returns, their shareholders or partners must amend their individual income tax returns. In many situations, income tax liabilities may increase, and as a result, shareholders and partners may incur interest and penalties because they paid income tax late.



Practitioner Planning Tip

Given the large number of amended returns this generates depending on the number of partners or shareholders in the entity, a practitioner may consider a cost-benefit analysis of claiming an ERC that was not claimed in the previous year. An incorrectly claimed ERC, however, likely requires amended returns, regardless of the cost-benefit.

²⁴ IRC §6663.

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STATUTE OF LIMITATIONS ISSUES

The following are three different statutes which apply to federal tax issues.

- Refund Statute Expiration Date (RSED)
- Assessment Statute Expiration Date (ASED)
- Collection Statute Expiration Date (CSED)

RSED²⁵

The RSED is the date after which refunds are barred from being made by the IRS. Generally, the RSED is the later of three years from the date the return was filed, or two years from the date paid. There is usually no need to file an amended return once the RSED expires because the taxpayer is likely no longer entitled to the credit or refund.

Note. Because the ERC requests a refund and/or a credit for the taxes paid in 2020 or 2021, the RSED has either already expired or is imminent.

ASED²⁶

The ASED is the date the IRS is allowed to assess additional tax with respect to a tax year. Generally, the rule is within three years of the date the original return was received, or three years from the due date of the return, whichever is later.

Example 3. Alex files his 2020 Form 1040 before April 15th, 2021. The IRS has until April 15th, 2024, to assess additional tax.

Example 4. Bryson failed to file his 2020 Form 1040. The IRS assesses tax due based on information reported to the IRS by third-party reporters, (i.e., employers, banks, etc.). There is no ASED in effect because no tax return has been submitted by the taxpayer. Bryson should prepare and file these returns to start the ASED clock to prevent the IRS from making any further assessments.

Example 5. Carson and Sons, Co., timely filed Forms 941 for 2020 and 2021. Carson and Sons did not take the ERC. The normal ASED applies, and the IRS can assess additional payroll tax against Carson and Sons up to three years after the Forms 941 were filed or they were due, whichever is later.

The ARPA extended the statute of limitations for an IRS audit to five years for ERC claims for the second half of 2021.²⁷ However, the Infrastructure Investment and Jobs Act repealed the ERC as of the end of the 3rd quarter.²⁸ As such, the 5-year statute of limitations **only** applies to the 3rd quarter of 2021.

Example 6. Use the same facts as **Example 5**, except Carson and Sons took the ERC for the first three quarters of 2021. The statute of limitations for the first two quarters is the usual three years. However, the IRS has five years to audit Carson and Sons's 3rd quarter ERC.

²⁵ *Time You Can Claim a Credit or a Refund*. Aug. 7, 2023. IRS. [www.irs.gov/filing/time-you-can-claim-a-credit-or-refund] Accessed on Aug. 28, 2023; *Taxpayer Claims Refund*. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/tax-terms/refund-statute-expiration-date-rsed] Accessed on Aug. 28, 2023.

²⁶ *Time IRS Can Assess Tax*. Jun. 15, 2023. IRS. [www.irs.gov/filing/time-irs-can-assess-tax] Accessed on Aug. 28, 2023; *Assessment Statute Expiration Date (ASED)*. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/tax-terms/assessment-statute-expiration-date-ased] Accessed on Aug. 28, 2023.

²⁷ *American Rescue Plan Act of 2021*, PL 117-2, §6432(f).

²⁸ *Infrastructure Investment and Jobs Act*, PL 117-58, §80604.

CSED²⁹

The CSED establishes the length of time the IRS has to collect taxes. Generally, this is 10 years from the date of the assessment. There are certain circumstances when the IRS can suspend or extend the 10-year period, such as the following.

- The IRS is prohibited from collecting tax (suspended during the period the IRS cannot collect the tax, but the 10-year limit still applies).
- The IRS is legally authorized a specific amount of time to **extend** the initial 10-year period.

There are several common events that a taxpayer can do that can impact the CSED, such as the following.

- Requests an installment agreement
- Files for bankruptcy
- Submits an offer in compromise
- Requests a collection due process hearing
- Files an innocent spouse claim



Practitioner Planning Tip

Practitioners should research the statutes of limitations for the states in which their clients file to determine if the state has a different statute of limitations than the federal statute of limitations.

INFLATION REDUCTION ACT OF 2022

The Inflation Reduction Act of 2022 was signed into law on August 16, 2022.³⁰ This Act includes provisions that introduce new corporate taxes including the corporate alternative minimum tax (AMT), expand clean energy credits, and adjust healthcare and payroll tax provisions. Both individual and corporate taxpayers should understand the alterations made under the Inflation Reduction Act to maximize tax savings, with many of the provisions already in effect.

INDIVIDUAL ENERGY CREDITS

To motivate taxpayers to purchase energy-efficient home improvements and vehicles, numerous individual energy-efficient credits were passed in the Inflation Reduction Act. This section focuses on the energy efficient home improvement credit, the residential clean energy credit, the clean energy credit for new vehicles, and the clean energy credit for used vehicles.

²⁹ *Time IRS Can Collect Tax*. Jun. 20, 2023. IRS. [www.irs.gov/filing/time-irs-can-collect-tax] Accessed on Aug. 28, 2023; *Collection Statute Expiration Date (CSED)*. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/tax-terms/collection-statute-expiration-date-csed] Accessed on Aug. 28, 2023.

³⁰ *Inflation Reduction Act of 2022*, PL 117-169.

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Energy Efficient Home Improvement Credit³¹

The Inflation Reduction Act changed the name applied to IRC §25C from “nonbusiness energy property credit” to the “energy efficient home improvement credit.”³² Beginning with 2023, there is a \$1,200 maximum aggregate yearly tax credit for all building envelope components, home energy audits, and energy property. Electric or natural gas heat pump water heaters, electric or natural gas heat pumps, and biomass stoves and biomass boilers have a separate aggregate yearly credit limit of \$2,000. Thus, the maximum total yearly energy efficient home improvement credit amount may be up to \$3,200. This replaces the old \$500 lifetime limit for nonbusiness energy property.³³

The energy efficient home improvement credit applies to the following types of improvements, which are classified into two groups.

Qualified Energy Efficient Improvements. For an improvement to be eligible for the energy efficient home improvement credit, it must be to a building envelope component that satisfies the energy efficiency requirements. Such improvements include the following.

- Exterior doors (30% of costs up to \$250 per door, up to a total of \$500)
- Exterior windows and skylights (30% of costs up to \$600)
- Insulation materials or systems and air sealing materials or systems (30% of costs)
- Home energy audits (30% of costs up to \$150)

The improvement must also satisfy the following requirements.

- Be installed in the United States
- Taxpayer must be the original user of the improvement
- Taxpayer must reasonably expect to use the improvement for at least five years, and the improvement must be to a principal residence as defined in IRC §121

Residential Energy Property Expenditures. The term “qualified energy property” means any of the following.

- Residential energy property (30% of costs, including labor, up to \$600 for each item) that satisfy the energy efficiency requirements.
 - ♦ Natural gas, propane, or oil water heaters
 - ♦ Central air conditioners
 - ♦ Natural gas, propane, or oil furnaces and hot water boilers
- Improvements to or replacements of panelboards, sub-panelboards, branch circuits, or feeders that are installed along with building envelope components or other energy property and enable its installation and use.
- Heat pumps, biomass stoves, and biomass boilers (30% of costs, including labor) satisfying the energy efficiency requirements include the following.
 - ♦ Electric or natural gas heat pump water heaters
 - ♦ Electric or natural gas heat pumps
 - ♦ Biomass stoves and biomass boilers

³¹ IRC §25C as implemented by *Inflation Reduction Act of 2022*, PL 117-169, §13302.

³² *Inflation Reduction Act of 2022*, PL 117-169, §13301(h)(2).

³³ IRC §25C(b) before amended by *Inflation Reduction Act of 2022*, PL 117-169.

In addition, the residential energy property expenditures must satisfy the following requirements.

- Installed in the United States
- Taxpayer is the original user of the property
- Installed on or in connection with a dwelling unit used as a residence (not necessarily a principal residence)

Rebates are subtracted from qualified expenses if **all** the following apply.³⁴

- The rebate is based on the cost of the property
- The rebate comes from someone connected to the sale such as the manufacturer, distributor, seller, or installer
- The rebate is not given as payment for services the taxpayer provides

State energy efficiency incentives are generally **not** subtracted from qualified costs unless they qualify as a rebate or purchase-price adjustment under federal income tax law. Many states label energy efficiency incentives as rebates, even though they do not qualify under that definition. Those incentives could be included in the taxpayer's gross income for federal income tax purposes.³⁵

Beginning after December 31, 2024, the taxpayer must meet the following qualifications to claim the residential energy property credit.³⁶

1. The item is produced by a **qualified manufacturer**
2. The taxpayer includes the **qualified product identification number** of the item on their tax return for the tax year

For this purpose, the term **qualified product identification number** means the product identification number assigned to the item by the qualified manufacturer (e.g., a unique alphanumeric identification number).³⁷

Home Energy Audits.³⁸ A home energy audit for a taxpayer's main home may qualify for a tax credit of up to \$150. To qualify, the home energy audit must meet the following guidelines.

- Include a written report and inspection that identifies the most significant and cost-effective energy efficiency improvements with respect to the home, including an estimate of the energy and cost savings with respect to such improvement
- Be conducted and prepared by a home energy auditor

^{34.} *Energy Efficient Home Improvement Credit*. Aug. 4, 2023. IRS. [www.irs.gov/credits-deductions/energy-efficient-home-improvement-credit] Accessed on Aug. 6, 2023.

^{35.} Ibid; IRS Notice 2013-70, 2013-47 IRB 528.

^{36.} IRS Notice 2022-48, 2022-43 IRB 316.

^{37.} Ibid.

^{38.} IRC §25C(e); *Energy Efficient Home Improvement Credit*. Aug. 4, 2023. IRS. [www.irs.gov/credits-deductions/energy-efficient-home-improvement-credit] Accessed on Aug. 6, 2023.

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Starting in 2024, the following additional requirements must be met.

- The inspection must be conducted by a **qualified home energy auditor** (an individual certified by one of the qualified certification programs listed on the Department of Energy certification programs for the Energy Efficient Home Improvement Credit (Section 25C) at the time of the audit), or under the supervision of a qualified home energy auditor.
- The written report must be prepared and signed by a qualified home energy auditor, be consistent with industry best practices, and include the following.
 - ♦ The qualified home energy auditor's name and relevant employer identification number (EIN) or other type of appropriate taxpayer identifying number, if the auditor does not have an EIN
 - ♦ An attestation that the qualified home energy auditor is certified by a qualified certification program
 - ♦ The name of such qualified certification program

Residential Clean Energy Credit

Under IRC §25D, taxpayers who make clean energy improvements to their homes may be able to take the residential clean energy credit.³⁹ This credit replaces the residential energy efficient property credit for years prior to January 1, 2023. The residential clean energy credit is a 30% credit based on the cost of new, qualified clean energy property placed in service between January 1, 2023, and December 31, 2032. The credit extends into 2033 and 2034 but at a reduced rate. This credit is non-refundable but can be carried forward to future years.⁴⁰ This credit is different from the energy efficient home improvement credit (discussed previously),⁴¹ formerly known as the nonbusiness energy property credit.

To qualify, the home must be located in the United States and the improvements must be made to the taxpayer's residence, whether owned or rented, but fuel cell property must be installed at the taxpayer's principal residence.⁴² Landlords and other property owners who do not reside in the home are excluded from taking the credit. Qualifying expenses include the following.⁴³

- Qualified solar electric property
- Qualified solar water heating property
- Qualified fuel cell property (only if installed at taxpayer's principal residence⁴⁴)
- Qualified small wind energy property expenditures
- Qualified geothermal heat pump property
- Qualified battery storage technology

Taxpayers who use their homes for business purposes face limitations on the credit. If business use in the home is up to 20%, taxpayers can claim the full credit. For taxpayers with business use greater than 20%, the credit is based on the share of expenses allocable to nonbusiness use.⁴⁵

³⁹ *Inflation Reduction Act of 2022*, PL 117-169, §13302, amending IRC §25D.

⁴⁰ *Residential Clean Energy Credit*. Apr. 27, 2023. IRS. [www.irs.gov/credits-deductions/residential-clean-energy-credit] Accessed on Jun. 28, 2023.

⁴¹ IRC §25C. See *Inflation Reduction Act of 2022*, PL 117-169, §13301(h)(2) for the renaming of this credit.

⁴² IRC §25D(d).

⁴³ IRC §25D(a).

⁴⁴ IRC §25D(d)(3).

⁴⁵ IRC §25D(e)(7).

Clean Energy Credit for New Vehicles⁴⁶

This credit allows taxpayers to claim a \$3,750 credit for purchasing vehicles that meet a mineral content requirement, and another \$3,750 credit for vehicles with battery components manufactured or assembled in the United States, Canada, or Mexico, provided the vehicle was placed in service after April 17, 2023.⁴⁷

Note. Although there is a maximum credit of \$7,500 per vehicle, the amount of the credit for each component was subject to a phase-in and was dependent on guidance from the IRS. On April 17, 2023, the IRS published proposed regulations related to the critical minerals and battery components requirements.⁴⁸ These proposed regulations are effective for vehicles placed in service on or after April 18, 2023. For vehicles placed in service from January 1 to April 17, 2023, the amount of the credit is determined without reference to the critical minerals and battery components test. Rather, IRC §30D(b) provides a base amount of credit of \$2,500 which can be increased based on battery capacity up to a minimum of \$3,751, up to a maximum credit of \$7,500.

This credit is nonrefundable, and the excess cannot be carried forward to future years.⁴⁹ It applies to vehicles purchased through December 31, 2032.⁵⁰ After January 1, 2024, the purchaser may elect to transfer the credit to the dealer to reduce the purchase price under provisions of §30D(g), but not under the conditions of IRC §6418.⁵¹ Taxpayers should consider the trade-off between claiming the credit on Form 8936, *Qualified Plug-in Electric Drive Motor Vehicle Credit*, or taking a reduction of the vehicle's purchase price.⁵²

Qualifications. Qualifying vehicles must have a battery capacity of at least seven kilowatt-hours, have a gross weight under 14,000 pounds, be manufactured by a qualified company, have final assembly in North America, and meet the mineral and battery component tests, assuming they were placed in service after April 18, 2023.⁵³ Dealerships should provide taxpayers with information on eligible vehicles.



Practitioner Planning Tip

Practitioners are required to provide the vehicle identification number (VIN) for the qualified new or used vehicle to be entered on taxpayer's Form 8936. To see the potential credit amount, practitioner can search by year, make, and model at **uofi.tax/23x11x1** [www.fueleconomy.gov/feg/taxcenter.shtml].

Practitioners can verify the vehicle meets the manufacturing requirements for the clean energy credit by entering the VIN at **uofi.tax/23x11x2** [afdc.energy.gov/laws/electric-vehicles-for-tax-credit#vin-decoder].

These websites are just **tools** to assist the tax practitioner and are not definitive tax guidance.

⁴⁶ *Inflation Reduction Act of 2022*, PL 117-169, §13401, amending IRC §30D.

⁴⁷ Prop. Treas. Reg. §§1.30D-3(a)(2) and (b)(2).

⁴⁸ Ibid.

⁴⁹ IRC §30D(c)(2), referring to IRC subtitle A, part IV, subpart A, *Nonrefundable Personal Credits*.

⁵⁰ *Inflation Reduction Act of 2022*, PL 117-169, §13401(a).

⁵¹ Ibid, §13401(g).

⁵² Form 8936, *Qualified Plug-in Electric Drive Motor Vehicle Credit*.

⁵³ *Credits for New Clean Vehicles Purchased in 2023 or After*. Jun. 22, 2023. IRS. [www.irs.gov/credits-deductions/credits-for-new-clean-vehicles-purchased-in-2023-or-after] Accessed on Jun. 28, 2023.

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In addition, the vehicle must be purchased new,⁵⁴ and the seller must furnish the information to the IRS at the time of purchase.⁵⁵ Vans, trucks, and sport utility vehicles with a manufacturer-suggested retail price (MSRP) over \$80,000 do not qualify for the credit.⁵⁶ The MSRP of other vehicles, including passenger automobiles, must be \$55,000 or less.⁵⁷

The vehicle may be for personal use, business use, or both. If electing to transfer the credit to a registered dealer, the purchaser must provide to the dealer their attestation that the vehicle's predominant use is personal.⁵⁸ Taxpayers claiming the credit on Form 8936 calculate their business portion of the credit in Part II, which flows to Form 3800, *General Business Credit*.⁵⁹ The personal portion of the credit is calculated in Part III on Form 8936, which flows to Schedule 3, *Additional Credits and Payments*.⁶⁰ If a business uses the clean vehicle credit under IRC §30D, they cannot also use the credit for qualified commercial clean vehicles under IRC §40W for the business use of the same vehicle.⁶¹

Modified Adjusted Gross Income (MAGI) Limitations. The MAGI limit is set at \$300,000 for married filing jointly (MFJ) taxpayers, \$225,000 for head of household (HoH) taxpayers, and \$150,000 for all other filing statuses. Taxpayers can use MAGI either in the year of delivery or the prior year, whichever is less.⁶²



Practitioner Planning Tip

Inquiring about the purchase of new vehicles is now an essential part of the tax preparation process. As many car manufacturers begin to implement green initiatives, the vehicle qualification range is expanded, and taxpayers may qualify without even knowing.

Additionally, because of the difference in MAGI limitations, practitioners should consider using the married filing separately filing status to maximize the clean energy credit.

Clean Energy Credit for Used Vehicles⁶³

Beginning January 1, 2023, individual taxpayers who purchase used electric vehicles (EV) or fuel cell vehicles (FCV) from a **licensed dealer** may qualify for the used clean vehicle credit. This credit equates to 30% of the sale price, with a maximum non-refundable credit of \$4,000.⁶⁴

This credit is subject to MAGI limits of \$150,000 for MFJ taxpayers, \$112,500 for HoH taxpayers, and \$75,000 for all other taxpayers. MAGI can either be applied to the year the vehicle was purchased or the preceding year.⁶⁵

⁵⁴ IRC §30D(a).

⁵⁵ IRC §30D(g)(2); *Clean Vehicle Credit Seller or Dealer Requirements*. Jun. 22, 2023. IRS. [www.irs.gov/credits-deductions/clean-vehicle-credit-seller-or-dealer-requirements] Accessed on Jul. 20, 2023.

⁵⁶ IRC §§30D(f)(11)(B)(i)–(iii).

⁵⁷ IRC §30D(f)(11)(B)(iv).

⁵⁸ *Topic H — Transfer of New Clean Vehicle Credit and Previously-Owned Clean Vehicles Credit*. Oct. 6, 2023. IRS. [www.irs.gov/newsroom/topic-h-transfer-of-new-clean-vehicle-credit-and-previously-owned-clean-vehicles-credit] Accessed on Oct. 25, 2023.

⁵⁹ Instructions for Form 8936.

⁶⁰ Ibid.

⁶¹ Prop. Treas. Reg. §1.30D-4(a)(3).

⁶² IRC §30D(f)(10).

⁶³ *Inflation Reduction Act of 2022*, PL 117-169, §13402, creating IRC §25E.

⁶⁴ IRC §25E(a).

⁶⁵ *Inflation Reduction Act of 2022*, PL 117-169, §13402(b); IRC §25E(b)(1).

Previously Owned Clean Vehicles.⁶⁶ To qualify for the credit, the taxpayer must have acquired the used vehicle in a **qualified sale**. A qualified sale requires that the vehicle was purchased through a dealer, and the dealer furnishes sale information to the IRS. Additionally, the sale price must be less than \$25,000, have a vehicle model year at least two years earlier than the purchase year, weigh less than 14,000 pounds, be eligible for FCV or plug-in EV with fewer than seven kilowatt-hours, and be used in the United States. The taxpayer is required to report the VIN with their tax return, and the dealer must report this VIN to the IRS. In addition, the vehicle is allowed only one clean energy credit during its existence.

Qualified Buyer.⁶⁷ A taxpayer may only claim this credit once every three years.⁶⁸ The taxpayer is ineligible for this credit if they purchase the vehicle from a spouse or a dependent.⁶⁹

Taxpayers purchasing vehicles through avenues outside of dealerships are unable to take advantage of this tax incentive.⁷⁰ This credit only applies to vehicles purchased before the end of 2032.⁷¹



Practitioner Planning Tip

Tax practitioners will need to be aware of the specificities surrounding used vehicle purchases, especially the dealer requirements.

BUSINESS ENERGY INCENTIVES

One of the main components of the Inflation Reduction Act provides for business energy credits, deductions, and other incentives. The statutes provide incentives to use clean, renewable energy sources. Businesses that are looking to add improvements to existing structures or construct new premises should consider adopting energy-efficient equipment to leverage tax credits and deductions. This section focuses on the following incentives.

- Renewable electricity production credit
- Commercial clean vehicle credit
- Energy credit modifications
- Federal solar energy tax credit
- Commercial building energy deduction
- Contractor energy-efficient home credits
- Clean fuel credits
- Clean energy manufacturing and security investment incentives

⁶⁶ IRC §25E.

⁶⁷ IRC §25E(c).

⁶⁸ IRC §25E(c)(3)(D).

⁶⁹ IRC §25E(c)(3)(C).

⁷⁰ IRC §25E(c)(2)(A), referring to IRC §30D(g)(8).

⁷¹ IRC §25E(g).

Renewable Electricity Production Credit⁷²

Under IRC §45, businesses that **produce renewable energy** can claim a credit based on kilowatt-hours produced at a qualified facility or sold to an unrelated party.⁷³ Qualified facilities are those that are used for the generation of electricity, placed in service after December 31, 2024, and emit a greenhouse gas emission rate of less than zero. The credit covers facilities producing electricity using wind, closed-loop biomass, and landfill gas, among others.⁷⁴ Construction on the facility must have begun before January 1, 2025.⁷⁵

Once the qualified facility is placed in service, the taxpayer can claim the **renewable electricity production tax credit for 10 years**.⁷⁶ The 2022 tax credit is calculated at a rate of 0.75 cents per kilowatt-hour for electricity generated from landfill gas, municipal solid waste, small irrigation power facilities, and open-loop biomass.⁷⁷ Wind and closed-loop biomass facilities can claim a 2.75 cents per kilowatt-hour credit if the facility was placed in service after 2021.⁷⁸ This credit is claimed on Form 8835, *Renewable Electricity Production Credit*. However, if wage and apprenticeship requirements are not met, the credit is 0.30 cents per kilowatt-hour.⁷⁹

The Inflation Reduction Act modified many of the current provisions relating to renewable energy credits, including labor requirements. Facilities now must meet wage and apprenticeship requirements to qualify for the full tax credit. These requirements include paying all employees and contractors union wage rates, known as the **prevailing wage**. Additionally, qualified apprentices must complete 12.5% of the labor hours for facility construction in 2023 and 15% for construction beginning after 2023.⁸⁰



Practitioner Planning Tip

The new labor requirements place a burden on business owners to ensure proper labor distribution between apprentices and prevailing market wages are present. The inability to meet these requirements can hinder credit-claiming ability and increase taxable income. Tax practitioners and business owners also have expanded tax planning opportunities based on the facility production dates. Credit computation and requirements vary, potentially resulting in tax advantages of speeding up or delaying tentative project start dates.

⁷² *Inflation Reduction Act of 2022*, PL 117-169, §13101(e), amending IRC §§45(b)(5), (d)(1), and 48(a)(5)(E).

⁷³ IRC §45(a).

⁷⁴ *Renewable Electricity Production Tax Credit Information*. Feb. 22, 2023. U.S. Environmental Protection Agency. [www.epa.gov/lmop/renewable-electricity-production-tax-credit-information] Accessed on Jul. 22, 2023.

⁷⁵ IRC §45(d).

⁷⁶ Instructions for Form 8835.

⁷⁷ IRS Ann. 2022-23, 2022-48 IRB 499; Instructions for Form 8835.

⁷⁸ *Ibid.*

⁷⁹ *Ibid.*

⁸⁰ Instructions for Form 8835.

Commercial Clean Vehicle Credit⁸¹

Businesses that purchase a qualified clean commercial vehicle may qualify for the commercial clean vehicle credit. This nonrefundable credit is calculated based on the lesser of 15% of the vehicle's basis or the incremental cost of the vehicle over a comparable vehicle that uses an internal combustion engine. Vehicles that are not powered by gas or diesel can increase the vehicle basis percentage to 30%.⁸²

The credit is capped at \$7,500 for vehicles under 14,000 pounds, and \$40,000 for all other vehicles.⁸³ Qualifying vehicles must be made through a qualified manufacturer, be used primarily for business purposes in the United States, be classified as a motor vehicle under the Clean Air Act, have a qualifying fuel cell motor, and have a plug-in battery capacity of seven kilowatt-hours for vehicles under 14,000 pounds and 15 kilowatt-hours for all other vehicles.⁸⁴

Note. IRC §45W(d)(3) precludes the commercial clean vehicle credit on any vehicle where the clean energy vehicle credit under §30D.

Businesses that frequently purchase vehicles should consider clean alternatives to leverage tax credits up to \$40,000. However, business taxpayers claiming this credit must follow a number of requirements. Additionally, the statute specifically allows **tax-exempt organizations** to claim this credit, which may offset unrelated business income tax. The IRS is still in the process of finalizing forms and regulations.⁸⁵

Energy Credit Modifications to Include Storage Technology⁸⁶

The Inflation Reduction Act modifies the application of IRC §48 to include energy storage technology. Energy storage property is defined as thermal energy property or other property that receives, stores, or delivers energy for conversion to electricity, with a capacity of five kilowatt-hours or more.⁸⁷

To qualify for the energy credit, construction on the facility must begin on or before December 31, 2024.⁸⁸

Federal Solar Energy Tax Credit for Business

Before the enactment of the Inflation Reduction Act, the investment tax credit (ITC) under §48 applied to solar energy generation projects. Solar generation facilities were eligible for an ITC claim and subject to the standard phase-out of that credit. The Inflation Reduction Act retains the §48 credit for solar generation projects and reestablishes an opportunity to claim a 30% tax credit. There are two tax credits available for businesses, including not-for-profit entities, purchasing solar energy systems.

- The ITC⁸⁹ reduces the federal income tax liability based on a percentage of the cost of a solar system installed during the tax year.
- The production tax credit (PTC)⁹⁰ is a per kilowatt-hour tax credit for electricity generated by solar and other qualifying systems during the first 10 years of a system's operation. It reduces the federal income tax liability.

⁸¹ *Inflation Reduction Act of 2022*, PL 117-169, §13403, creating IRC §45W.

⁸² IRC §45W(b)(1)(A).

⁸³ IRC §45W(b)(4).

⁸⁴ IRC §45W(c)(3)(A).

⁸⁵ *Commercial Clean Vehicle Credit*. Jun. 22, 2023. IRS. [www.irs.gov/credits-deductions/commercial-clean-vehicle-credit] Accessed on Jun. 28, 2023.

⁸⁶ *Inflation Reduction Act of 2022*, PL 117-169, §13102(f), amending various paragraphs under IRC §48(a).

⁸⁷ IRC §48(c)(6)(A).

⁸⁸ IRC §48(c)(6)(D).

⁸⁹ IRC §§48 and 48E.

⁹⁰ IRC §§45 and 45Y.

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Generally, business owners cannot claim both the ITC and the PTC for the same property, although they could claim different credits for co-located systems, like solar and storage, depending on further guidance issued by the IRS.

Solar systems that are placed in service in 2022 or later and begin construction before 2033 are eligible for a 30% ITC or a 2.75 cents per kilowatt-hour PTC if they meet labor requirements issued by the Treasury Department or are under one megawatt in size.

Note. For a summary of the ITC and PTC from 2006 through 2036, see **uofi.tax/23x11x3** [www.energy.gov/sites/default/files/2023-05/Summary-ITC-and-PTC-Values-Chart-2023.png].

Commercial Building Energy Deduction⁹¹

This provision of the Act provides for owners of qualified commercial buildings and designers of certain energy-efficient commercial building property to claim this deduction.⁹² This deduction is also available for retrofit buildings.⁹³

Qualified commercial buildings must be:

- Located in the United States;
- For commercial use (includes apartment buildings over three stories);⁹⁴
- Built with qualified property;
- Certified to produce required minimum energy savings; and
- Subject to the American Society of Heating, Refrigerating and Air-Conditioning Engineers Standard 90.1.⁹⁵

Interior lighting systems, heating, cooling, ventilation, and hot water systems are included in the qualified property. The deduction is calculated based on the lesser of the cost of the installed property or square footage. Buildings with 25% energy savings can claim \$0.50 per square foot. An additional \$0.02 deduction per square foot is added for each energy savings percentage point above 25. The deduction caps out at \$1.00 per square foot.⁹⁶

Note. Businesses can claim up to \$5.00 per square foot if compliance with prevailing wage and apprenticeship requirements are met. The applicable deduction is calculated at a rate of \$2.50 per square foot, with a cap of \$5.00 per square foot.⁹⁷

Prior to the Inflation Reduction Act, businesses needed to meet a 50% reduction in the baseline energy use intensity of the building. Lowering the credit threshold to 25% allows more architects and owners of commercial property to leverage additional deductions outside of depreciation. Additionally, exempt organizations can also take advantage of IRC §179D to reduce taxable income. Commercial business owners and architects may benefit from this deduction when planning energy-efficient additions and expansion projects.⁹⁸

⁹¹ *Inflation Reduction Act of 2022*, PL 117-169, §13303, amending IRC §179D.

⁹² *Energy-efficient Commercial Building Deduction*. Jun. 30, 2023. IRS. [www.irs.gov/credits-deductions/energy-efficient-commercial-building-deduction] Accessed on Jun. 30, 2023.

⁹³ IRC §179D(f).

⁹⁴ *Energy Efficient Commercial Building Deduction*. Aug. 2, 2023. IRS. [www.irs.gov/credits-deductions/energy-efficient-commercial-building-deduction#building] Accessed on Aug. 3, 2023.

⁹⁵ *Ibid.*

⁹⁶ IRC §179D(b)(2).

⁹⁷ IRC §§179D(b)(3) and (4).

⁹⁸ *Ibid.*

Contractor Energy-Efficient Home Credits⁹⁹

The energy-efficient home credit was set to expire on December 31, 2021; however, the Inflation Reduction Act extends this credit through 2032. This tax credit allows eligible contractors to claim a credit for qualified energy-efficient homes sold or leased to another person. An **eligible contractor** is a person that constructs a qualified energy-efficient home and has basis in the home.¹⁰⁰

The credit is based on the energy efficiency of the home. Single-family homes that are **certified** under the Zero Energy Ready Home (ZERH) Program¹⁰¹ requirements are eligible for a \$5,000 per dwelling-unit credit. Single-family homes that do not meet the ZERH Program, but participate in the Energy Star Residential New Construction Program,¹⁰² can receive a \$2,500 credit per dwelling unit. The credit for multi-family homes is lower at \$1,000 and \$500 per dwelling unit, respectively.¹⁰³

Note. The requirements for the ZERH Program depend on “the requirements of the applicable version based on building type, the builder/developer/plant must be registered as a ZERH program partner, and the project must be approved by an approved third-party verifier.” For more information on the requirements by building type, see **uofi.tax/23x11x4** [www.energy.gov/eere/buildings/doe-zero-energy-ready-home-zerh-program-requirements].

A contractor set up as an S corporation or partnership claims this credit on Form 8908, *Energy Efficient Home Credit*. The credit then flows through to partners or shareholders, who in turn file Form 3800, *General Business Credit*.¹⁰⁴ The energy-efficient home credit is designed to motivate contractors to install energy-efficient equipment during the construction or remodeling process.



Practitioner Planning Tip

Contractors frequently install energy-efficient items in the normal course of their business that qualify for this credit, potentially creating a tax-saving opportunity. It is important to ask contractors about the products they use in the event the contractors do not know they qualify.

Caution. This credit does not reduce AMT.¹⁰⁵

^{99.} *Inflation Reduction Act of 2022*, PL 117-169, §13304, amending IRC §45L(a)(2), (c), and (g).

^{100.} Instructions for Form 8908.

^{101.} IRC §45L(c)(1)(B).

^{102.} IRC §45L(c)(2)(A).

^{103.} *Inflation Reduction Act of 2022*, PL 117-169, §13201(a); IRC §45L(c)(3)

^{104.} Instructions for Form 8908; Partner’s Instructions for Schedule K-1 (Form 1065); Shareholder’s Instructions for Schedule K-1 (Form 1120-S).

^{105.} See IRC §§45L, 38, and 55(c).

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Clean Fuel Credits

Many fuel credits were extended and modified under the Inflation Reduction Act. These provisions affect fuel transportation, biodiesel, renewable diesel, aviation fuel, and alternative fuel industries.

Extension of Incentives to Biodiesel, Renewable Diesel, and Alternative Fuel Providers.¹⁰⁶ The clean fuel production credit now extends to biodiesel, renewable diesel, and alternative fuel providers. Inflation Reduction Act, §13201 also extends the end date to December 31, 2024.¹⁰⁷ This credit provides taxpayers with the ability to claim \$1.00 for each gallon of biodiesel used and \$0.10 for each gallon of qualified agro-biodiesel production.¹⁰⁸

Many businesses in fuel transportation industries will now be able to reduce taxable income through this credit. This tax credit only applies to fuel used for transportation. Transportation can include aviation and other types of fuel.¹⁰⁹

Note. Inflation Reduction Act, §13701 creates IRC §45Y, the clean electricity production credit, while §13704 of the Inflation Reduction Act creates IRC §45Z, which establishes the clean fuel production credit. The clean **electricity** production credit provides a credit for producing electricity to limit production of carbon dioxide.¹¹⁰ The clean energy **fuel** production credit provides a credit for fuel that is used for transportation. Use of the fuel must meet certain emissions requirements that are listed in §45Z(b).

Extension of Second-Generation Biofuel Incentives.¹¹¹ The Inflation Reduction Act, §13202, extends second-generation biofuel incentives until December 31, 2024.¹¹²

Sustainable Aviation Fuel Credits.¹¹³ Aviation fuel producers are now eligible for a sustainable aviation fuel credit.¹¹⁴ This credit is calculated at a rate of \$1.25 plus the applicable supplementary amount multiplied by the gallons of sustainable aviation fuel sold.¹¹⁵ The applicable supplementary amount equates to \$0.01 for each percentage point that the lifecycle greenhouse gas emissions exceed 50%, with a max of \$0.50.¹¹⁶ This tax incentive helps alleviate the burden of rising material costs in the aviation fuel industry.

Alternative Fuel Credit Reinstatement.¹¹⁷ The Inflation Reduction Act reinstates the IRC §6426 credit for alcohol, fuel, biodiesel, and alternative fuel mixtures for fuel sold, used, or removed, through December 31, 2024. Liquefied hydrogen is not considered an alternative fuel under the new legislation.¹¹⁸ Taxpayers may need to file Form 720-X, *Amended Quarterly Federal Excise Tax Return*, to claim retrospective fuel credits.¹¹⁹

^{106.} *Inflation Reduction Act of 2022*, PL 117-169, §13704(a), creating IRC §45Z.

^{107.} *Ibid.*, §13704(a).

^{108.} IRC §40A(b).

^{109.} *Ibid.*

^{110.} IRC §45Y(b)(2).

^{111.} IRC §40(b)(6).

^{112.} *Inflation Reduction Act of 2022*, PL 117-169, §13202(a).

^{113.} *Inflation Reduction Act of 2022*, PL 117-169, §13203; IRC §40B.

^{114.} *Sustainable Aviation Fuel (SAF) Tax Credit*. U.S. Department of Energy, Alternative Fuels Data Center. [afdc.energy.gov/laws/13160] Accessed on Jul. 22, 2023.

^{115.} *Inflation Reduction Act of 2022*, PL 117-169, §13203(a).

^{116.} *Ibid.*

^{117.} *Ibid.*, §13201; IRC §§40A and 6426(c).

^{118.} *Ibid.*, §13201(a).

^{119.} Instructions for Form 720-X.

Clean Energy Manufacturing and Security Investment Incentives

The Inflation Reduction Act establishes different incentives for qualified investments in energy programs. These programs prioritize qualified investments in advanced energy projects.

Advanced Energy Project Credit.¹²⁰ The advanced energy project credit was extended and adjusted under the Inflation Reduction Act, §13501. Total funds of \$10 billion have been allocated, with at least \$4 billion allocated to energy communities, which are environmentally and economically challenged areas.¹²¹

The credit equals 30% of the qualified investment costs that meet prevailing wage and apprenticeship requirements, and 6% for investments that do not.¹²² A qualifying project creates or expands a facility that recycles specified advanced energy property, installs technology that reduces greenhouse gas emissions by 20%, or adds the recycling of critical materials. Costs for refining or blending non-renewable transportation fuels are specifically excluded.¹²³

The project eligibility list has been expanded under the Inflation Reduction Act, §13501, providing more businesses with the opportunity to claim additional deductions for energy efficiency modifications to plants and premises.



Practitioner Planning Tip

The stark difference in credit amounts for complying with prevailing wage and apprenticeship requirements makes it important to consider the trade-off between paying higher rates for labor on energy-efficient projects and taking a lower credit. This may require businesses and their tax practitioner to spend more time in the project planning phase to make the most informed decision surrounding labor and tax saving opportunities.

Advanced Manufacturing Production Credit.¹²⁴ The advanced manufacturing production credit provides a tax incentive for producers of solar energy, wind components, alternating current, battery components, critical minerals, and invertors. The credit amount is dependent on the type of component being manufactured. Taxpayers can claim this credit on Form 7207, *Advanced Manufacturing Production Credit*.¹²⁵

Clean Electricity Investment Tax Credit.¹²⁶ Investments in qualified electricity production facilities may also qualify for a tax credit. The credit is computed based on the **applicable percentage time** of the investment amount, which is 30% for facilities with a net output of less than one megawatt and was constructed within 60 days of the Secretary's published guidance. Investments in any other qualified facility warrant a 6% credit.¹²⁷

Additionally, if the generating facilities are built on Indian tribal land, they qualify for a 10% bonus credit. An additional 20% is available for facilities built under housing programs that are federally subsidized, or companies that offer 50% or more of their power to low-income families.¹²⁸

¹²⁰. IRC §48C(e).

¹²¹. *Inflation Reduction Act of 2022*, PL 117-169, §13501(a); IRC §48C(e)(2), referring to IRC §45(b)(1)(B).

¹²². IRC §48C(e)(4).

¹²³. *Ibid.*

¹²⁴. *Inflation Reduction Act of 2022*, PL 117-169, §13502(a), creating IRC §45X.

¹²⁵. Instructions for Form 7207.

¹²⁶. IRC §48E.

¹²⁷. *Inflation Reduction Act of 2022*, PL 117-169, §13702(a).

¹²⁸. *Building a Clean Energy Economy*, p.16. Jan. 2023, Ver. 2. The White House. [www.whitehouse.gov/wp-content/uploads/2022/12/Inflation-Reduction-Act-Guidebook.pdf] Accessed on Jun. 30, 2023.

NEW CORPORATE TAXES

Embedded within the Inflation Reduction Act are two tax provisions that impact corporations: a new AMT and a tax on corporate share repurchases.¹²⁹

15% Corporate AMT

IRC §55(b)(2)(a)(i) imposes a 15% AMT on corporate adjusted financial statement income.¹³⁰ This tax only applies to corporations with average **3-year adjusted financial statement income** that exceeds \$1 billion, or corporations with foreign parents reporting adjusted financial statement income that exceeds \$100 million.¹³¹ Regulated investment companies, real estate investment trusts, and S corporations are specifically excluded from corporate AMT.¹³² The 3-year adjusted financial statement income test looks at any three consecutive tax years that precede the tax year in which the taxpayer is computing the tax. This applies to 3-year periods beginning in which the 3rd year ends after December 31, 2021.¹³³

Example 7. Able Corporation is a calendar-year corporation. It is subject to the corporate AMT for 2023. When calculating the 3-year average, Able looks at the years ending December 31, 2020, December 31, 2021, and December 31, 2022.

Corporations that have not existed for three years substitute the number of years it has been in existence for the 3-year period. Tax years less than 12 months must be annualized.¹³⁴

In addition, corporations that are members of foreign-parented multinational groups must also consider the adjusted financial statement income of U.S.-specific subsidiaries. U.S. subsidiaries that have an adjusted financial statement income above \$100 million for the 3-year testing period are considered applicable corporations. The foreign-parented multinational groups must first satisfy the \$1 billion test before the \$100 million test is applied.¹³⁵

The corporate AMT is designed to prevent large corporate taxpayers from leveraging current tax provisions to create a zero-tax liability. By assessing corporate AMT on adjusted financial statement income, corporations can no longer exploit book-to-tax differences to reduce their tax liability.

Calculating Adjusted Financial Statement Income. Adjusted financial statement income is the net income or loss of the corporation from **applicable financial statements**,¹³⁶ with certain adjustments. Applicable financial statements are those certified as being prepared in accordance with generally accepted accounting principles (GAAP), international statements equivalent to those filed with the U.S. Security and Exchange Commission (SEC), and statements filed with any U.S. federal agency for purposes other than federal income tax.¹³⁷ The following are some general adjustments for calculating adjusted financial statement income.¹³⁸

- Removal of income not related to the current tax year
- Removal of income from certain related entities
- Inclusion of certain amounts from non-consolidated group corporations
- Inclusion of specific foreign income
- Adjustments for foreign taxes paid
- Adjustment for tax depreciation instead of book depreciation

¹²⁹ *Inflation Reduction Act of 2022*, PL 117-169, §§10101 and 10201.

¹³⁰ IRC §55(2)(a)(i).

¹³¹ *Inflation Reduction Act of 2022*, PL 117-169, §10101(a)(2), amending IRC §59 by adding subsection (k); IRC §§59(k)(1)(B)(i) and (B)(ii)(II).

¹³² *Ibid*, §10101(a)(2); IRC §59(k)(1)(A).

¹³³ *Ibid*, §10101.

¹³⁴ *Ibid*.

¹³⁵ *Ibid*, §10101(d)(2).

¹³⁶ IRC §56A(b), referencing IRC §451(b)(3).

¹³⁷ IRC §451(b)(3).

¹³⁸ IRC §56A(c).

Net Operating Loss (NOL).¹³⁹ An NOL is deductible from adjusted financial statement income. The deductible amount is the lesser of:

- The aggregate amount of financial statement NOL carryovers to the taxable year, or
- 80% of adjusted financial statement income computed without regard to the NOL.

Treatment of Credits.¹⁴⁰ The Act makes some modifications to the following three credits.

- **General business credit.**¹⁴¹ General business credits are limited to 75% of the taxpayer's net income tax that exceeds \$25,000. There is no limit on the first \$25,000. Net income tax is the total of the taxpayer's U.S. federal income tax liability, including the **base erosion anti-abuse tax** under IRC §59A. The base erosion anti-abuse tax is a corporate minimum tax imposed on applicable taxpayers that make certain base erosion payments to foreign-related parties. Net income tax also includes AMT under §55 (including the corporate AMT).
- **Prior-year minimum tax credit.** The Act modified IRC §53, the net minimum tax imposed under §55, for all prior tax years beginning after 2022. Generally, the minimum tax credit can be carried forward and used as a credit against the taxpayer's regular tax liability, including any base erosion anti-abuse tax.
- **Foreign tax credit.** A taxpayer that chooses to apply its foreign tax credit against its regular U.S. federal tax reduces its corporate AMT. The foreign tax credit is the sum of:
 - ♦ The lesser of a corporation's (must be U.S. shareholder) pro rata share of income, war profits, and excess profits taxes that are paid or accrued by a controlled foreign corporation and included on the controlled foreign corporation's applicable financial statements, or 15% of the amount determined under IRC §56A(c)(3) (adjustments to certain items of foreign income), and
 - ♦ The amount of foreign income, war profits, and excess profits taxes the taxpayer pays or accrues and takes into account on their applicable financial statement.

Penalty Waiver. The IRS has not issued the promised proposed regulations clarifying the Act, although it has issued a notice¹⁴² addressing some issues. Due to gray areas surrounding the corporate AMT calculation, the IRS has passed a temporary waiver on the underpayment of estimated taxes related to corporate AMT for tax years beginning after December 31, 2022, but before January 1, 2024.¹⁴³

¹³⁹. IRC §56A(d).

¹⁴⁰. *Inflation Reduction Act of 2022*, PL 117-169, §10101.

¹⁴¹. IRC §38(c)(6)(E).

¹⁴². IRS Notice 2023-20, 2023-10 IRB 523.

¹⁴³. IRS Notice 2023-42, 2023-26 IRB 1085.

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1% Excise Tax on Corporate Stock Repurchases

The Inflation Reduction Act, §10201 imposes a 1% excise tax on corporations repurchasing their stock starting after December 31, 2022. The excise tax is non-deductible and cannot reduce the taxable income of the corporation.¹⁴⁴

Corporations affected by this include any domestic corporation whose stock is traded on an established securities market, such as the New York Stock Exchange.¹⁴⁵ The excise tax is calculated as 1% of the fair market value (FMV) of any stock repurchases.¹⁴⁶ There are some exceptions.¹⁴⁷

- The repurchased stock is part of a reorganization plan with no recognized gain or loss.
- The repurchased stock is contributed to an employee pension or stock ownership plan.
- The amount of repurchased stock is less than \$1 million.
- The repurchase is made by a dealer in securities, a real estate investment company, or a regulated investment company.
- The repurchased stock is taxable as a dividend to shareholders.

Note. The IRS is still in the process of creating regulations surrounding value determination, employee stock repurchases, and privately negotiated transactions.



Practitioner Planning Tip

Corporations should consider the tax implications of stock buybacks and stock issuances following the passage of the Inflation Reduction Act. The application of the 1% excise tax is very broad, potentially applying in mergers, acquisitions, the use of derivatives, and preferred stock transactions.¹⁴⁸ As such, taxpayers must evaluate the full impact before engaging in transactions surrounding corporate stock.

HEALTHCARE AND PAYROLL TAX PROVISIONS

The Inflation Reduction Act also provides adjustments for research credits and healthcare provisions.

Research Credit Adjustments¹⁴⁹

Inflation Reduction Act, §13902, increases the research credit against payroll tax to \$250,000.¹⁵⁰ The credit is calculated at 20% of basic research payments, plus 20% of energy research consortium payments, plus 20% of the excess of qualified research expenses and the base amount.¹⁵¹

^{144.} *Inflation Reduction Act of 2022*, PL 117-169, §10201(b), creating IRC §4501(b) and amending IRC §275(a)(6).

^{145.} *Ibid*, §10201(a), creating IRC §4501(b).

^{146.} IRC §4501(a).

^{147.} IRC §4501(e).

^{148.} IRC §4501(f)(2).

^{149.} *Inflation Reduction Act of 2022*, PL 117-169, §13902, amending IRC §§41(h) and 3111(f).

^{150.} *Ibid*, §13902(a).

^{151.} IRC §41(a).

Qualified research expenses include contract research expenses and in-house research expenses, like wages, supplies, and qualified research.¹⁵² The increase in available credit against payroll taxes allows small businesses to offset a portion of payroll taxes associated with research activities.

Part B and Part D Medicare Rebates¹⁵³

The Inflation Reduction Act requires the federal government to negotiate prices with drug manufacturers. These drug companies are liable to pay rebates to Medicare when the prices of those drugs increase faster than the rate of inflation. The rebates are **not** paid to individuals. The law imposes requirements on the drug companies to report the total number of units sold, information on the average sale price, and the rebate amount within six months of the end of each calendar quarter. This regulation goes into effect for calendar quarters beginning in 2023. Companies will see rebate invoices beginning in September 2025.¹⁵⁴

These provisions of the Inflation Reduction Act are intended to discourage unethical pricing by drug manufacturers and lower the out-of-pocket costs for Part B and Part D recipients. In addition, drug manufacturers that do not agree to fair prices are assessed an additional excise tax, further discouraging price gouging.¹⁵⁵

Note. As a result of this section of the Act, taxpayers should have expanded access to affordable drugs when utilizing Medicare Part B and Part D, as drug manufacturers will need to consider the tax implications of increasing prices faster than inflation.

Medicare Out-of-Pocket Caps¹⁵⁶

The Inflation Reduction Act, §11201, imposes Medicare Part D out-of-pocket caps, potentially lowering medical and prescription costs for taxpayers. Beginning in 2025, Part B drugs will be 20% of the inflation-adjusted payment amount, while Part D drugs will be capped at 40% of the inflation-adjusted payment amount.¹⁵⁷ If provided through Medicare and not private insurance, insulin prices are limited to \$35 per month through 2025.¹⁵⁸

Affordable Care Act Subsidies¹⁵⁹

Other healthcare-related provisions extend the refundable credit for qualified healthcare coverage through December 31, 2025. Taxpayers whose household income exceeds 400% of the poverty line can continue to claim a credit based on the percentage of income above the poverty line through 2025.¹⁶⁰

¹⁵². Ibid.

¹⁵³. *Inflation Reduction Act of 2022*, PL 117-169, §11101(a), amending 42 USC 1395w-3a, *Social Security Act*, §1847A. See also *Inflation Reduction Act and Medicare*, Jul. 5, 2023. U.S. Centers for Medicare & Medicaid Services. [www.cms.gov/inflation-reduction-act-and-medicare] Accessed on Aug. 23, 2023.

¹⁵⁴. Ibid.

¹⁵⁵. Ibid, §11103(a).

¹⁵⁶. Ibid, §11101(a), amending 42 USC 1395w-102(b), *Social Security Act*, §1860D-2(b).

¹⁵⁷. Ibid, §11201(b).

¹⁵⁸. Ibid, §11406.

¹⁵⁹. Ibid, §12001(b), amending IRC §36B.

¹⁶⁰. IRC §36B(b).

FORM 1099-K CHANGES

For calendar years prior to 2022, the reporting threshold for a Form 1099-K, *Payment Card and Third Party Network Transactions*, was:

- Gross payments that exceed \$20,000, and
- More than 200 transactions.

For calendar years beginning after December 31, 2021, the ARPA reduced the Form 1099-K reporting threshold to:¹⁶¹

- Gross payments for goods and services that exceed \$600, and
- Any number of transactions.

On December 23, 2022, the IRS delayed the implementation of the reduced thresholds for Form 1099-K until the 2023 tax year.¹⁶² The IRS attributed the delay to, “taxpayer confusion, lack of clear guidance, concerns about the existing backlog, and impact on the upcoming filing season.”¹⁶³ On November 21, 2023, the IRS issued news release IR-2023-221, which further delays implementation of the reduced thresholds for Form 1099-K until the 2024 tax year. Additionally, the IRS plans for a threshold of \$5,000 in tax year 2024 to phase in the reporting requirement. The previous reporting thresholds, as shown above, remain in place for tax year 2023.

Form 1099-K reports payments and transactions from online platforms, apps, and processors.¹⁶⁴ Third-party networks include platforms like Uber, Amazon, eBay, PayPal, Venmo, Cash apps, and Facebook Marketplace.



Practitioner Planning Tip

Most businesses are already accustomed to Forms 1099-K for credit and debit cards. Many individual taxpayers will receive a Form 1099-K for the first time when the lower threshold is implemented. Prior to the upcoming filing season, practitioners should communicate the new law and educate their clients.

Form 1099-K identifies the type of transactions the taxpayer engaged in with the reporting entity. The following are examples of the types of transactions that may appear on a Form 1099-K.

- Error
- Personal items sold
- Hobby
- Business income
- Investment

¹⁶¹. *American Rescue Plan Act of 2021*, PL 117-2, §9674.

¹⁶². IRS News Rel. IR-2022-226 (Dec. 23, 2022).

¹⁶³. *NTA Blog: Heard Loud and Clear: IRS Postpones Implementation of \$600 Form 1099-K Reporting by a Year*: Dec. 27, 2022. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/news/nta-blog-heard-loud-and-clear-irs-postpones-implementation-of-600-form-1099-k-reporting-by-a-year] Accessed on Aug. 4, 2023.

¹⁶⁴. *Understanding Your Form 1099-K*. Jul. 3, 2023. IRS. [www.irs.gov/businesses/understanding-your-form-1099-k] Accessed on Aug. 4, 2023.



Practitioner Planning Tip

Some issuers may not mail physical copies of a Form 1099-K, but rather the taxpayer can download their Form 1099-K from the appropriate website, app, etc. Practitioners should ask their clients to verify they have provided all the Forms 1099-K they received during the year.

ERRORS

The taxpayer should verify that the Form 1099-K they received is correct and accurate. There are a variety of errors that could arise, such as the following.¹⁶⁵

- The individual is listed instead of their business
- The information on the Form 1099-K is incorrect (e.g., payee taxpayer identification number, gross amount of payment card/third party network transactions, number of payment transactions, merchant category code)
- The individual receives a Form 1099-K they should not have received (e.g., reports payments that were gifts or reimbursements from family or friends, does not belong to the taxpayer, or is a duplicate)

A taxpayer should request a corrected Form 1099-K from the issuer in the case of an error. If the taxpayer cannot get a corrected Form 1099-K, they should report the amount from the Form 1099-K on their Form 1040, *U.S. Individual Income Tax Return*, Schedule 1, *Additional Income and Adjustments to Income*. The taxpayer enters the incorrect amount on part I, line 8z, with the text, “Form 1099-K received in error” along with the amount. The erroneous amount is then adjusted out of income by entering the text “Form 1099-K received in error” along with the amount, on part II, line 24z. This results in net \$0 effect on the taxpayer’s adjusted gross income.

CHANGES TO SPECIFIED RESEARCH OR EXPERIMENTAL EXPENDITURES AND THE R&D CREDIT

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.¹⁶⁶ There are two changes to R&D for 2023 and 2024, consisting of requiring the amortization of costs and creating an additional payroll credit.

Note. For information on the expanded reporting requirements for the R&D credit, as well as information on how to calculate the credit, see the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

¹⁶⁵. Ibid.

¹⁶⁶. IRC §38(b)(3).

REQUIRED AMORTIZATION

One of the most notable provisions in the Tax Cuts and Jobs Act (TCJA) relating to deducting R&D costs is the elimination of immediate expenditure expensing. Prior to the enactment of the TCJA, taxpayers could deduct R&D expenditures as qualifying business expenses under IRC §174(a), reducing taxable income.¹⁶⁷ Under the TCJA rules, taxpayers must amortize expenditures over a 5-year period. However, specified R&D expenditures related to foreign research require taxpayers to amortize them over a 15-year period.¹⁶⁸ TCJA, §13206(d) states that alterations to the R&D expenditures are effective for tax years beginning after December 31, 2021.¹⁶⁹



Practitioner Planning Tip

The 5-year amortization period can make it less advantageous for businesses to engage in R&D activities as they must spread the costs over a period of time instead of recognizing them all at once in the year incurred. Consequently, all other things being equal, taxable income would be higher each year for these taxpayers. Tax practitioners must effectively advise their clients on expected taxable income increases to remit proper estimated tax payments and remain in compliance with the IRS.

Note. Taxpayers must amortize research and experimentation expenditures regardless of claiming the credit for increasing research activities under IRC §41.¹⁷⁰

Calculating the Deduction

R&D expenditures must be amortized over five years using the half-year convention, resulting in 10% of the cost being deductible in the first year.¹⁷¹ If a qualifying taxpayer has \$1 million in qualifying research expenditures for the year ended December 31, 2022, they can deduct \$100,000 against taxable income ($\$1 \text{ million} \div 5 \text{ years} \times \frac{1}{2} \text{ year}$). Over the next four years, the taxpayer can deduct \$200,000 each year ($\$1 \text{ million} \div 5 \text{ years}$). In the final year, the taxpayer can deduct the final \$100,000 ($\$1 \text{ million} \div 5 \text{ years} \times \frac{1}{2} \text{ year}$).¹⁷² Tax practitioners should have detailed recordkeeping systems to calculate the proper amortization each year and maintain amortization tables.

Note. Even research projects that are abandoned continue to be amortized over the 5- or 15-year period.¹⁷³

¹⁶⁷. IRC §174(a)(1), prior to enactment of TCJA.

¹⁶⁸. IRC §174(a)(2).

¹⁶⁹. *Tax Cuts and Jobs Act*, PL 115-97, §13206(d)(b)(3).

¹⁷⁰. *Ibid*, §13206(a).

¹⁷¹. *Ibid*; IRC §174(a)(2)(B).

¹⁷². *Ibid*.

¹⁷³. IRC §174(d).

Accounting for Dispositions

Under §174(d), disposed of property included in R&D amortization cannot be immediately written off. Instead, taxpayers must continue amortizing the expense as they had been, disregarding the disposition.

Implementing the Change

Under §13206 of the TCJA, the alterations to §174 are considered a change in accounting method under IRC §481. This change will be treated as initiated by the taxpayer with the consent of the IRS on a cutoff basis with no §481(a) adjustment required.¹⁷⁴ Tax practitioners **will not** need to file Form 3115, *Application for Change in Accounting Method*. However, they must include a footnote or information statement outlining the taxpayer's name, EIN or social security number (SSN), and information regarding amortization adjustments.

CREDIT FOR INCREASING RESEARCH ACTIVITIES¹⁷⁵

IRC §41 permits taxpayers a credit to the extent that research expenditures increase during the year over a base amount. The credit is better known as the R&D credit. The purpose of the credit is to incentivize research and experimentation by providing a tax credit for activities that develop a new component of a taxpayer's business or improve an existing component's performance, functionality, reliability, or quality. For a business with under \$50 million in average annual gross receipts over the preceding three years, the credit offsets both regular tax and AMT.¹⁷⁶

Eligible Recipient¹⁷⁷

Taxpayers qualify for the R&D credit if they invest in developing new products, improving the performance of existing ones, or otherwise improve the quality or reliability of a product or business process. Because the credit is computed based on increased research expenditures, the taxpayer's research expenditures must grow over time to be eligible for the credit.

The research must focus on discovering information that is both technological and intended to aid in developing a new or improved business component for the taxpayer. Research must involve hard sciences (e.g., chemistry, physics, or biology) because research involving social sciences does not count for the credit. Research focusing on the style, taste, cosmetic, or seasonal design of products does not count as qualified research for the credit. Substantially all the activities undertaken under the umbrella of qualified research must be a part of a process of experimentation. The experimentation focuses on new or improved functions, improved performance or reliability, or quality. The qualified research expenditures must also satisfy the requirements of §174 (i.e., paid or incurred in connection with a trade or business and are reasonable¹⁷⁸).

¹⁷⁴. *Tax Cuts and Jobs Act*, PL 115-97, §13206(b); Rev. Proc. 2023-11, 2023-3 IRB 417.

¹⁷⁵. IRC §41.

¹⁷⁶. Instructions for Form 6765.

¹⁷⁷. IRC §41(d).

¹⁷⁸. IRC §§174(a)(1) and (e).

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The following items are not eligible for the R&D credit.¹⁷⁹

1. Research after the recipient has begun commercial production of a business component
2. Adaptation of an existing business component, especially if it adapts an existing business component to a customer's requirements
3. Duplicating an existing business component after examining the product itself, its plans, its specifications, or related public information
4. Surveys or studies
5. Computer software that is developed for internal use by the taxpayer unless it is used in an activity that itself constitutes qualified research
6. Foreign research that is conducted outside the United States, Puerto Rico, or any possession of the United States
7. Social sciences, as any research in social sciences, art, or humanities is specifically prohibited
8. Funded research, to the extent that it is funded by a grant, a contract, or by any other person, including grants from a government entity

Calculating the Credit

The R&D credit is claimed on Form 6765, *Credit for Increasing Research Activities*. The R&D credit is the sum of the following items.

- 20% of the amount that **qualified research expenses** exceed the base amount
- 20% of the **basic research payments**, consisting of the amount that basic research payments exceed the qualified organization base period amount
- 20% of the amount paid to an **energy research consortium** for energy research if paid while conducting a trade or business of the taxpayer

The credit for **qualified research expenses** (type 1) are incurred either through in-house research or through contract research. The **credit for basic research payments** (type 2) are payments for outsourced research, which a qualified organization must perform. Credits for research performed by an **energy research consortium** (type 3) are only available to a taxpayer who carries on a trade or a business, presumably in an energy-related business.

In addition to in-house expenses, the taxpayer can count 65% of contract research expenses paid to another person for research if the person is not an employee of the taxpayer. That percentage is increased to 75% if the payment is to a tax-exempt research consortium. The percentage further increases to 100% if the payment is to an eligible small business, a higher education institution, or a federal laboratory.¹⁸⁰

Type 1: Qualified Research Expenses.¹⁸¹ If the research occurs within the taxpayer's organization, the expense includes wages paid to an employee for services related to research, or the earned income of a sole proprietor. In addition, the expenditures may include supplies consumed in the process of qualified research, but the supplies cannot be improvements to land or depreciable items. Consequently, taxpayers who invest in improving their products, developing new ones, or improving processes are typically those who benefit from this credit.¹⁸²

¹⁷⁹. IRC §41(d)(4).

¹⁸⁰. IRC §41(b)(3).

¹⁸¹. IRC §41(b).

¹⁸². IRC §41(d)(4)(F).

Example 8. The management of Reliable Pump Corporation (Reliable) anticipates a need in their agriculture market to offer an irrigation pump with better reliability. Two engineers based in Texas invested 40% of their time in 2022 to this task, and they were paid \$60,000 in the year. To test the reliability of the pump with water having a higher-than-normal pH, they purchased \$5,000 of sodium bicarbonate during 2022 and bought a vat to hold this water solution for \$10,000. Reliable can count 40% of the wages of the two engineers, or \$48,000 (\$120,000 in total wages (\$60,000 each) $\times$ 40%), toward the credit. The \$5,000 of sodium bicarbonate counts as a supply, but the vat does not count toward the credit because it is depreciable property. Reliable thus has qualified research expenditures of \$53,000 (\$48,000 wages + \$5,000 sodium bicarbonate supplies).

Alternative Simplified Credit.¹⁸³ Taxpayers may elect an alternative simplified credit to reduce the computational complexity of the credit. In this case, the credit is 14% of the amount by which qualified research expenses for the current tax year exceed 50% of the average qualified research expenses for the prior three tax years. Revocation of this election must be by consent of the Secretary of the Treasury.

Example 9. The 4N Fertilizer Corporation (4N), an Illinois C corporation incorporated in 2001, investigates new fertilizer products for corn production. It conducts this research in its facility in Mattoon, Illinois, rather than its office in Windsor, Ontario, so that the R&D credit is available. 4N experiments with using the new fertilizer on half of a 40-acre plot in Coles County while using a commercially available fertilizer on the other half of the plot. 4N elects the simplified method of computing the research expense credit. In 2022, its qualified research expenses consisted of \$30,000 of wages and \$10,000 of supplies. Its qualified research expenses in 2021 totaled \$30,000, \$25,000 in 2020, and \$21,000 in 2019. Its average qualified research expense for the prior three years is \$25,333. The 2022 alternative simplified credit is \$3,827 (14% $\times$ (\$40,000 qualified research expenses – (50% $\times$ \$25,333 average qualified research expenses))). The Form 6765 for 4N follows.

¹⁸³. IRC §41(c)(4).

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For Example 9

Form 6765 (Rev. December 2020) Department of the Treasury Internal Revenue Service		Credit for Increasing Research Activities ► Attach to your tax return. ► Go to www.irs.gov/Form6765 for instructions and the latest information.		OMB No. 1545-0619 Attachment Sequence No. 676	
Name(s) shown on return 4N Fertilizer Corporation			Identifying number 12-3456789		
Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.					
1	Certain amounts paid or incurred to energy consortia (see instructions)			1	
2	Basic research payments to qualified organizations (see instructions)	2			
3	Qualified organization base period amount	3			
4	Subtract line 3 from line 2. If zero or less, enter -0-			4	
5	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	5			
6	Cost of supplies	6			
7	Rental or lease costs of computers (see instructions)	7			
8	Enter the applicable percentage of contract research expenses. See instructions	8			
9	Total qualified research expenses. Add lines 5 through 8	9			
10	Enter fixed-base percentage, but not more than 16% (0.16) (see instructions)	10		%	
11	Enter average annual gross receipts. See instructions	11			
12	Multiply line 11 by the percentage on line 10	12			
13	Subtract line 12 from line 9. If zero or less, enter -0-	13			
14	Multiply line 9 by 50% (0.50)	14			
15	Enter the smaller of line 13 or line 14			15	
16	Add lines 1, 4, and 15			16	
17	Are you electing the reduced credit under section 280C? ► Yes ☐ No ☐ If "Yes," multiply line 16 by 15.8% (0.158). If "No," multiply line 16 by 20% (0.20) and see the instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached			17	
Section B—Alternative Simplified Credit. Skip this section if you are completing Section A.					
18	Certain amounts paid or incurred to energy consortia (see the line 1 instructions)			18	
19	Basic research payments to qualified organizations (see the line 2 instructions)	19			
20	Qualified organization base period amount (see the line 3 instructions)	20			
21	Subtract line 20 from line 19. If zero or less, enter -0-			21	
22	Add lines 18 and 21			22	
23	Multiply line 22 by 20% (0.20)			23	
24	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	24	30,000		
25	Cost of supplies	25	10,000		
26	Rental or lease costs of computers (see the line 7 instructions)	26			
27	Enter the applicable percentage of contract research expenses. See the line 8 instructions	27			
28	Total qualified research expenses. Add lines 24 through 27	28	40,000		
29	Enter your total qualified research expenses for the prior 3 tax years. If you had no qualified research expenses in any one of those years, skip lines 30 and 31	29	76,000		
30	Divide line 29 by 6.0	30	12,667		
31	Subtract line 30 from line 28. If zero or less, enter -0-	31	27,333		
32	Multiply line 31 by 14% (0.14). If you skipped lines 30 and 31, multiply line 28 by 6% (0.06)			32	3,827
33	Add lines 23 and 32			33	3,827
34	Are you electing the reduced credit under section 280C? ► Yes ☐ No ☒ If "Yes," multiply line 33 by 79% (0.79). If "No," enter the amount from line 33 and see the line 17 instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached			34	3,827

For Paperwork Reduction Act Notice, see separate instructions.

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Section C—Current Year Credit

35	Enter the portion of the credit from Form 8932, line 2, that is attributable to wages that were also used to figure the credit on line 17 or line 34 (whichever applies)	35	
36	Subtract line 35 from line 17 or line 34 (whichever applies). If zero or less, enter -0-	36	3,827
37	Credit for increasing research activities from partnerships, S corporations, estates, and trusts	37	
38	Add lines 36 and 37 • Estates and trusts, go to line 39. • Partnerships and S corporations not electing the payroll tax credit, stop here and report this amount on Schedule K. • Partnerships and S corporations electing the payroll tax credit, complete Section D and report on Schedule K the amount on this line reduced by the amount on line 44. • Eligible small businesses, stop here and report the credit on Form 3800, Part III, line 4i. See instructions for the definition of eligible small business. • Filers other than eligible small businesses, stop here and report the credit on Form 3800, Part III, line 1c. Note: Qualified small business filers, other than partnerships and S corporations, electing the payroll tax credit must complete Form 3800 before completing Section D.	38	3,827
39	Amount allocated to beneficiaries of the estate or trust (see instructions)	39	
40	Estates and trusts, subtract line 39 from line 38. For eligible small businesses, report the credit on Form 3800, Part III, line 4i. See instructions. For filers other than eligible small businesses, report the credit on Form 3800, Part III, line 1c	40	

Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section if the payroll tax election does not apply. See instructions.

41	Check this box if you are a qualified small business electing the payroll tax credit. See instructions ☐		
42	Enter the portion of line 36 elected as a payroll tax credit (do not enter more than \$250,000). See instructions	42	
43	General business credit carryforward from the current year (see instructions). Partnerships and S corporations, skip this line and go to line 44	43	
44	Partnerships and S corporations, enter the smaller of line 36 or line 42. All others, enter the smallest of line 36, line 42, or line 43. Enter here and on the applicable line of Form 8974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	44	

Form **6765** (Rev. 12-2020)

Example 10. The Smith family operates a 720-acre farm as a sole proprietorship in McLean County, Illinois. They typically grow soybeans in even years and corn in odd years. The soil at the Smith farm has a relatively high level of calcium, but a relatively low level of magnesium. Fred Smith is interested in the relationship between the temperature of irrigation water and the leaching of these nutrients, particularly magnesium, from the soil to levels at which it would not benefit the soybean plants. To test the effect of water temperature, Fred Smith set aside two 5-acre plots of soybeans in the southwest corner of the farm. The Smiths irrigated one plot with water heated to a temperature of 24°C, and they irrigated the other plot with unheated water. The water heater cost \$5,500, and the propane to run it during April, May, June, and July 2022 cost an additional \$350. The work for the experiment required two hired farmhands, who together worked 250 hours on the project and earned \$12 per hour. They paid \$200 to have the Illinois Farm Research Consortium¹⁸⁴ analyze the soil at the beginning of the study, and another \$200 at the end of the growing season. The Illinois Farm Research Consortium is an IRC §501(c)(3) organization primarily organized to conduct research on behalf of family farms.

Because of the degree of experimentation involved, Fred Smith and his tax preparer believe that this qualifies for the R&D credit. The Smith family has never undertaken a research project of this nature and elects to use the alternative simplified credit.

The Form 6765 for Mr. and Mrs. Smith follows.

¹⁸⁴. This is a fictitious organization used only for the purposes of illustration.

2023 Workbook

For Example 10

Form 6765 (Rev. December 2020) Department of the Treasury Internal Revenue Service		Credit for Increasing Research Activities ► Attach to your tax return. ► Go to www.irs.gov/Form6765 for instructions and the latest information.		OMB No. 1545-0619 Attachment Sequence No. 676
Name(s) shown on return Fred and Gloria Smith			Identifying number ***-**-7891	
Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.				
1	Certain amounts paid or incurred to energy consortia (see instructions)		1	
2	Basic research payments to qualified organizations (see instructions)	2		
3	Qualified organization base period amount	3		
4	Subtract line 3 from line 2. If zero or less, enter -0-		4	
5	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	5		
6	Cost of supplies	6		
7	Rental or lease costs of computers (see instructions)	7		
8	Enter the applicable percentage of contract research expenses. See instructions	8		
9	Total qualified research expenses. Add lines 5 through 8	9		
10	Enter fixed-base percentage, but not more than 16% (0.16) (see instructions)	10	%	
11	Enter average annual gross receipts. See instructions	11		
12	Multiply line 11 by the percentage on line 10	12		
13	Subtract line 12 from line 9. If zero or less, enter -0-	13		
14	Multiply line 9 by 50% (0.50)	14		
15	Enter the smaller of line 13 or line 14		15	
16	Add lines 1, 4, and 15		16	
17	Are you electing the reduced credit under section 280C? ► Yes ☐ No ☐			
If "Yes," multiply line 16 by 15.8% (0.158). If "No," multiply line 16 by 20% (0.20) and see the instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached				17
Section B—Alternative Simplified Credit. Skip this section if you are completing Section A.				
18	Certain amounts paid or incurred to energy consortia (see the line 1 instructions)		18	
19	Basic research payments to qualified organizations (see the line 2 instructions)	19		
20	Qualified organization base period amount (see the line 3 instructions)	20		
21	Subtract line 20 from line 19. If zero or less, enter -0-		21	
22	Add lines 18 and 21		22	
23	Multiply line 22 by 20% (0.20)		23	
24	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	24	3,000	
25	Cost of supplies	25	350	
26	Rental or lease costs of computers (see the line 7 instructions)	26		
27	Enter the applicable percentage of contract research expenses. See the line 8 instructions	27	300	
28	Total qualified research expenses. Add lines 24 through 27	28	3,650	
29	Enter your total qualified research expenses for the prior 3 tax years. If you had no qualified research expenses in any one of those years, skip lines 30 and 31	29		
30	Divide line 29 by 6.0	30		
31	Subtract line 30 from line 28. If zero or less, enter -0-	31		
32	Multiply line 31 by 14% (0.14). If you skipped lines 30 and 31, multiply line 28 by 6% (0.06)		32	219
33	Add lines 23 and 32		33	219
34	Are you electing the reduced credit under section 280C? ► Yes ☐ No ☒			
If "Yes," multiply line 33 by 79% (0.79). If "No," enter the amount from line 33 and see the line 17 instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached				34
				219

For Paperwork Reduction Act Notice, see separate instructions.

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For Example 10

Form 6765 (Rev. 12-2020)

Page **2**

Section C—Current Year Credit

35	Enter the portion of the credit from Form 8932, line 2, that is attributable to wages that were also used to figure the credit on line 17 or line 34 (whichever applies)	35	
36	Subtract line 35 from line 17 or line 34 (whichever applies). If zero or less, enter -0-	36	219
37	Credit for increasing research activities from partnerships, S corporations, estates, and trusts	37	
38	Add lines 36 and 37 • Estates and trusts, go to line 39. • Partnerships and S corporations not electing the payroll tax credit, stop here and report this amount on Schedule K. • Partnerships and S corporations electing the payroll tax credit, complete Section D and report on Schedule K the amount on this line reduced by the amount on line 44. • Eligible small businesses, stop here and report the credit on Form 3800, Part III, line 4i. See instructions for the definition of eligible small business. • Filers other than eligible small businesses, stop here and report the credit on Form 3800, Part III, line 1c. Note: Qualified small business filers, other than partnerships and S corporations, electing the payroll tax credit must complete Form 3800 before completing Section D.	38	219
39	Amount allocated to beneficiaries of the estate or trust (see instructions)	39	
40	Estates and trusts, subtract line 39 from line 38. For eligible small businesses, report the credit on Form 3800, Part III, line 4i. See instructions. For filers other than eligible small businesses, report the credit on Form 3800, Part III, line 1c	40	

Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section if the payroll tax election does not apply. See instructions.

41	Check this box if you are a qualified small business electing the payroll tax credit. See instructions ☐		
42	Enter the portion of line 36 elected as a payroll tax credit (do not enter more than \$250,000). See instructions	42	
43	General business credit carryforward from the current year (see instructions). Partnerships and S corporations, skip this line and go to line 44	43	
44	Partnerships and S corporations, enter the smaller of line 36 or line 42. All others, enter the smallest of line 36, line 42, or line 43. Enter here and on the applicable line of Form 8974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	44	

Form **6765** (Rev. 12-2020)

Information appears in Section B of Form 6765 because Mr. and Mrs. Smith elected to use the alternative simplified credit. The wages paid to farm laborers are shown on line 24, while 75%¹⁸⁵ of the \$400 Mr. Smith paid to the research consortium to analyze soil appears on line 27. Mr. and Mrs. Smith file this form with their Form 1040.

Mr. and Mrs. Smith file the following applicable page of Form 3800 with their Form 1040.

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¹⁸⁵. IRC §41(b)(3)(C)(i).

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For Example 10

Form 3800 (2022)

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Name(s) shown on return

Identifying number

Fred and Gloria Smith

*****-**-7891**

Part III General Business Credits or Eligible Small Business Credits (see instructions)

Complete a separate Part III for each box checked below. See instructions.

- A** ☒ General Business Credit From a Non-Passive Activity **E** ☐ Reserved
B ☐ General Business Credit From a Passive Activity **F** ☐ Reserved
C ☐ General Business Credit Carryforwards **G** ☐ Eligible Small Business Credit Carryforwards
D ☐ General Business Credit Carrybacks **H** ☐ Reserved
I If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III ☐

(a) Description of credit	(b) Enter EIN if claiming the credit from a pass-through entity.	(c) Enter the appropriate amount.
Note: On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.		
1a Investment (Form 3468, Part II only) (attach Form 3468)	1a	
b Advanced manufacturing production (Form 7207)	1b	
c Increasing research activities (Form 6765)	1c	
d Low-income housing (carryforward only) (see instructions)	1d	
e Disabled access (Form 8826)*.	1e	
f Renewable electricity production (Form 8835)	1f	
g Indian employment (Form 8845)	1g	
h Orphan drug (Form 8820)	1h	
i New markets (Form 8874)	1i	
j Small employer pension plan startup costs and auto-enrollment (Form 8881)	1j	
k Employer-provided child care facilities and services (Form 8882)*	1k	
l Biodiesel, renewable diesel, or sustainable aviation fuel (attach Form 8864)	1l	
m Low sulfur diesel fuel production (Form 8896)	1m	
n Distilled spirits (Form 8906)	1n	
o Nonconventional source fuel (carryforward only)	1o	
p Energy efficient home (Form 8908)	1p	
q Energy efficient appliance (carryforward only)	1q	
r Alternative motor vehicle (Form 8910)	1r	
s Alternative fuel vehicle refueling property (Form 8911)	1s	
t Enhanced oil recovery credit (Form 8830)	1t	
u Mine rescue team training (Form 8923)	1u	
v Agricultural chemicals security (carryforward only)	1v	
w Employer differential wage payments (Form 8932)	1w	
x Carbon oxide sequestration (Form 8933)	1x	
y Qualified plug-in electric drive motor vehicle (Form 8936)	1y	
z Qualified plug-in electric vehicle (carryforward only)	1z	
aa Employee retention (Form 5884-A)	1aa	
bb General credits from an electing large partnership (carryforward only)	1bb	
zz Other. Oil and gas production from marginal wells (Form 8904) and certain other credits (see instructions)	1zz	
2 Add lines 1a through 1zz and enter here and on the applicable line of Part I	2	0
3 Enter the amount from Form 8844 here and on the applicable line of Part II	3	
4a Investment (Form 3468, Part III) (attach Form 3468)	4a	
b Work opportunity (Form 5884)	4b	
c Biofuel producer (Form 6478)	4c	
d Low-income housing (Form 8586)	4d	
e Renewable electricity production (Form 8835)	4e	
f Employer social security and Medicare taxes paid on certain employee tips (Form 8846)	4f	
g Qualified railroad track maintenance (Form 8900)	4g	
h Small employer health insurance premiums (Form 8941)	4h	
i Increasing research activities (Form 6765)	4i	219
j Employer credit for paid family and medical leave (Form 8994)	4j	
z Other	4z	
5 Add lines 4a through 4z and enter here and on the applicable line of Part II	5	219
6 Add lines 2, 3, and 5 and enter here and on the applicable line of Part II	6	219

* See instructions for limitation on this credit.

Form **3800** (2022)

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The R&D credit flows from Form 3800 to Form 1040, Schedule 3, *Additional Credits and Payments*.¹⁸⁶

Regular Credit.¹⁸⁷ Suppose the taxpayer does not elect to use the alternative simplified credit. The regular credit is calculated off a **base amount**, which is the product of the fixed-base percentage and the average annual gross receipts for the four preceding tax years prior to the year the taxpayer is calculating the credit. The base amount cannot be less than 50% of the qualified research expenses for the year. The **fixed-based percentage** is the ratio of the aggregate qualified research expenses for the taxpayer between 1984 and 1988 to the aggregate gross receipts for those years. There are exceptions to the fixed-base percentage for start-up companies when their first tax year with both gross receipts and qualified research expenses began after December 31, 1983, or had fewer than three tax years with both gross receipts and qualified research expenses between 1984 and 1988 inclusive. The fixed-base percentages for start-up companies are illustrated in the following table.

Taxable Year	Portion of Gross Receipts Eligible for Regular Credit
Each of the taxpayer's first five taxable years after 1993 during which it had qualified research expenses	3%
Sixth taxable year	0.16667 of the percentage that qualified research expenses bear to gross receipts for the fourth and five taxable years combined
Seventh taxable year	0.33333 of the percentage that qualified research expenses bear to gross receipts for the fifth and sixth taxable years combined
Eighth taxable year	0.5 of the percentage that qualified research expenses bear to gross receipts for the fifth, sixth, and seventh years combined
Ninth taxable year	0.66667 of the percentage that qualified research expenses bear to fifth, sixth, seventh, and eighth years combined
Tenth taxable year	0.83333 of the percentage that qualified research expenses bear to the fifth through tenth years combined
Subsequent taxable years	The percentage from any five years chosen by the taxpayer from among the fifth through the tenth years that qualified research expenses bear to gross receipts

The fixed-base percentage cap is 16%, and the number is rounded to the nearest 0.01%.

¹⁸⁶. See instructions for Form 1040, Schedule 3.

¹⁸⁷. IRC §41(c).

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Type 2: Basic Research Payments.¹⁸⁸ Basic research is any original investigation for the advancement of scientific knowledge that does not have a specific commercial objective. It does not include research conducted outside of the United States or basic research in the social sciences, arts, or humanities.

There are a few hurdles associated with basic research payments. S corporations are not eligible for a credit arising from basic research payments; personal holding companies and service organizations are not eligible, either. IRC §41 imposes the following requirements on payments for basic research.

- The payments must be made in cash during the taxable year.
- The payments must be according to a written agreement.
- The written agreement must be between a corporation and a qualified organization. The qualified organization must perform the research. An exception to this requirement allows tax-exempt scientific organizations or certain grant organizations to perform research. The following requirements are placed on the grant organizations.
 - ♦ Qualified §501(c)(3) organizations
 - ♦ Established before July 10, 1981
 - ♦ Organized and operated exclusively to make grants to educational institutions
 - ♦ Make an election for treatment as a private foundation

Qualified organizations for conducting research include educational institutions and other tax-exempt organizations to perform scientific research, unless they are private foundations. A qualified organization can also be a corporation.

Example 11. Use the same facts as **Example 9**, except that 4N contracts with the University of Illinois College of Agricultural, Consumer, and Environmental Sciences to research university land. The contract between 4N and the University stipulates that the University owns the intellectual property arising from the research, even though the results are to be shared with 4N under the terms of the contract. Payments under the contract are qualified as basic research payments for the R&D credit.

Type 2 payments are calculated as the amount that basic research payments exceed the qualified organization base period amount, which itself is equal to the sum of the following two items.

- Minimum basic research amount
- A maintenance-of-effort amount

The **minimum basic research amount** is the greater of the following.

- 1% of the average of any amounts paid or incurred during the base period for in-house research expenses and contract research expense, **or**
- Contract research expenses during the base period

The **maintenance-of-effort amount** reflects an increase in nondesignated university contributions made by a taxpayer in a current year over nondesignated contributions to a university in a base period, adjusted for inflation.

The base period is the three-year period ending with the tax year immediately before the taxpayer filed its first tax return. For example, the base period for a company formed in 2014 runs from January 1, 2014, to December 31, 2016.

¹⁸⁸. IRC §41(e).

As a result, a portion of contributions to higher learning institutions become research credits under this provision of the R&D credit. They must exceed an inflation-adjusted amount of nondesignated contributions that were not used as a basic research payment but would have been allowable as a deduction under IRC §170. There is a floor under the minimum basic research amount of 50% of the basic research payments made.

Example 12. Use the same facts as **Example 9**, except that in 2022 4N also makes payments to the University of Illinois under a signed agreement for research. It pays \$35,000 to the University because the University conducts technical research that is of interest to 4N but without immediate commercial application. In this case, the minimum research credit is \$850 ($1\% \times (\$40,000 \text{ wages} + \$10,000 \text{ supplies} + \$35,000 \text{ contract research expenses})$). The base period was 2001 through 2003, the first three years of 4N's existence, when it incurred no research expenses.

Type 3: Energy Research Consortium. The R&D credit for Type 3 payments to an energy consortium is beyond the scope of this chapter. For more information, see §41(f)(6).

ADDITIONAL PAYROLL CREDIT

Section §41 provides a special subsection that allows **qualified small businesses** to offset **payroll** tax liability with the R&D tax credit.¹⁸⁹ The Inflation Reduction Act of 2022 increases the maximum credit for small businesses from \$250,000 to \$500,000 starting in 2023.¹⁹⁰ A **qualified small business** is a corporation or partnership with gross receipts less than \$5 million that did not have gross receipts for any tax year during the preceding 5-year period. This does not apply to tax-exempt organizations.¹⁹¹

The \$500,000 is a combined credit; \$250,000 applies against an employer's portion of social security tax, and \$250,000 applies to an employer's portion of Medicare tax. Any remaining credit after reducing the employer's social security and Medicare taxes is carried forward to the next quarter. Taxpayers use Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*, to determine the amount of payroll tax credit they can use in the current quarter.¹⁹²

Employers making a new payroll tax election on Form 6765 for tax years beginning after December 31, 2022, a qualified small business can take the payroll tax credit against their social security and Medicare taxes starting with the first calendar quarter beginning after the date the taxpayer filed the income tax return including the election.¹⁹³

Employers with a credit that carried forward from a previous year can apply that credit against the employer's portion of social security tax (up to \$250,000), and then to the Medicare tax.¹⁹⁴

¹⁸⁹. IRC §41(h).

¹⁹⁰. *Inflation Reduction Act of 2022*, PL 117-169, §13902(d); IRC §13902.

¹⁹¹. IRC §41(h)(3).

¹⁹². See *Inflation Reduction Act*, PL 117-179, §13902; IRC §3111(f); *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*. Jun. 27, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/qualified-small-business-payroll-tax-credit-for-increasing-research-activities] Accessed on Jul. 31, 2023.

¹⁹³. Ibid.

¹⁹⁴. Ibid.

RECONTRIBUTED CARES ACT RETIREMENT PLAN DISTRIBUTIONS

The CARES Act, §2202 added special distribution options and rollover rules for retirement plans, individual retirement arrangements (IRA), and permissible loans.¹⁹⁵ Congress implemented many of these provisions to alleviate taxpayers' financial burdens during the COVID-19 pandemic. Tax practitioners must be aware of §2202 specifications to ensure taxpayers receive the most favorable tax treatment of distributions and remit timely repayments.

ALLOWABLE DISTRIBUTION AMOUNTS

Under §2202, taxpayers may take distributions up to \$100,000 without triggering early-withdrawal penalties under IRC §72(t). Distributions may come from eligible retirement plans, including IRC §§401(k), 403(b), and IRAs between January 1, 2020, and December 31, 2020.¹⁹⁶

TAXPAYER QUALIFICATIONS

Taxpayers qualifying for favorable treatment of retirement plan distributions must meet certain criteria.¹⁹⁷

- The taxpayer was diagnosed with COVID-19 by an approved test by the Centers for Disease Control and Prevention (CDC).
- The taxpayer's spouse or dependent was diagnosed with COVID-19 by an approved test by the CDC.
- The taxpayer experienced adverse financial consequences from reduced work hours, layoffs, lack of childcare, or quarantine.

This criterion is a broad set of qualifications. However, if taxpayers cannot substantiate any of these factors, they will not qualify for distribution exclusions under §72(t) and §2202 of the CARES Act. Tax practitioners need to ensure that clients qualify before treating distributions as coronavirus-related. The taxpayer's employer can help furnish information surrounding work hours and layoffs.¹⁹⁸

DISTRIBUTION TAX TREATMENT

Coronavirus-related distributions do not receive non-taxable treatment. Instead, §2202 only eliminates the 10% early withdrawal penalty.¹⁹⁹ 2023 marks the final year for repayment of a coronavirus-related distribution. Tax practitioners should advise their clients on the tax implications of previous taxable distributions.

Income Inclusion

Taxpayers may include qualifying distributions in income in the year of distribution or report them ratably over a 3-year period.²⁰⁰ Before filing 2023 tax returns, tax practitioners should revisit prior year returns to determine the tax treatment of distributions. Form 8915-E, *Qualified 2020 Disaster Retirement Plan Distributions and Repayments*, should have been filed for 2020, and Form 8915-F, *Qualified 2021 Disaster Retirement Plan Distributions and Repayments*, should have been filed for 2021, to indicate distributions and repayments.²⁰¹ The information provided in the form should assist practitioners in assessing the tax treatment of 2023 distributions.

¹⁹⁵. CARES ACT, PL 116-136, §2202(a)(3).

¹⁹⁶. *Coronavirus-related relief for retirement plans and IRAs questions and answers*. Aug. 19, 2022. IRS. [www.irs.gov/newsroom/coronavirus-related-relief-for-retirement-plans-and-iras-questions-and-answers] Accessed on Jul. 17, 2023.

¹⁹⁷. CARES ACT, PL 116-136, §2202(a)(4)(A)(ii).

¹⁹⁸. Ibid, §2202(a)(4)(B).

¹⁹⁹. *Coronavirus-related relief for retirement plans and IRAs questions and answers*. Aug. 19, 2022. IRS. [www.irs.gov/newsroom/coronavirus-related-relief-for-retirement-plans-and-iras-questions-and-answers] Accessed on Jul. 17, 2023.

²⁰⁰. CARES ACT, PL 116-136, §2202(a)(5).

²⁰¹. Instructions for Form 8915-E.

Recontributions

Taxpayers can make repayments on qualifying distributions for three years, beginning on the distribution date. Any amounts taxpayers recontribute to the retirement account receive rollover contribution treatment.

An amended individual tax return is required to claim a refund of any taxable distributions that have been recontributed.

Example 13. Elizabeth receives a distribution of \$90,000 from her IRA on November 15, 2020. Elizabeth is a qualified individual and treats the distribution as a coronavirus distribution. She ratably includes the \$90,000 distribution over a 3-year period.

Without any recontribution, Elizabeth will include \$30,000 in income with respect to the coronavirus distribution on each of the 2020, 2021, and 2022 tax returns. She then recontributes \$45,000 to an IRA on November 10, 2023 (and made no other recontribution in the 3-year period).

Pursuant to Notice 2005-92,²⁰² Elizabeth must amend a tax return. She can choose which return(s) to amend subject to statute of limitations.

REDUCED ESTATE TAX EXCLUSION CONSIDERATIONS

With many provisions of the TCJA²⁰³ set to expire at the end of 2025, one impacted area is the increased estate tax exclusion. After the enactment of the TCJA, taxpayers could make larger taxable gifts without concern of exceeding their lifetime estate tax exclusion. With the decrease in the exclusion back to \$5 million set to occur in 2026, taxpayers and practitioners should familiarize themselves with the treatment of taxable gifts made during the TCJA period and any of its impacts concerning future and uncompleted gifts. This section highlights these estate tax considerations and associated IRS guidance.

BASIC EXCLUSION AMOUNT

The **unified credit** against the estate tax is a tax credit every decedent is entitled to use in offsetting both estate value and gift taxation.²⁰⁴ The credit comprises the estate tax on the **basic exclusion amount** that a taxpayer can reduce the value of their estate subject to the estate tax. The value of **taxable** gifts that a taxpayer makes over their lifetime reduces their basic exclusion amount. When a taxpayer makes taxable gifts (gifts valuing over \$17,000 in 2023²⁰⁵) in a tax year, they report the amount of the taxable gifts on Form 709, *United States Gift Tax (and Generation-Skipping Transfer) Tax Return*. Form 709 includes a schedule with the history of taxable gifts the taxpayer made during their lifetime up until the current tax year. At the end of a taxpayer's life, executors, and tax practitioners must total the basic exclusion amount the taxpayer used for their lifetime taxable gifts to assess how much of the exclusion is available to offset the estate tax. The tax practitioner shows this amount on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*.

²⁰². IRS Notice 2005-92, 2005-51 IRB 1165.

²⁰³. *Tax Cuts and Jobs Act*, PL 115-97.

²⁰⁴. IRC §2010(a).

²⁰⁵. Rev. Proc. 2022-38, 2022-45 IRB 445; *Frequently Asked Questions on Gift Taxes*. Jun. 16, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes] Accessed on Jul. 12, 2023.



Practitioner Planning Tip

The latest Form 709 should be kept in the taxpayer's permanent documents maintained by the practitioner and the taxpayer. A form could get lost in an annual tax return file which may eventually be purged.

The enactment of the TCJA resulted in the basic exclusion amount doubling from \$5 million to \$10 million for taxpayers who die between 2017 and 2026.²⁰⁶ The exclusion is further adjusted each year for inflation, with the resulting exclusion for decedents who die in 2023 being \$12,920,000.²⁰⁷ However, when the provisions of the TCJA sunset at the end of 2025, the basic exclusion amount falls back down to \$5 million²⁰⁸ (this amount is projected to be \$6.4 million adjusting for inflation).

SPECIAL RULE FOR THE BASIC EXCLUSION AMOUNT

Anticipating the basic exclusion amount reduction back down to the pre-TCJA amount, a question arises as to the impact on 2026 and future years' basic exclusion amount for gifts taxpayers made during 2017 through 2025. Historically, the basic exclusion amount increased over time, causing no issue when reconciling taxable gifts to the basic exclusion amount when an individual died. However, with a reduction in the basic exclusion amount after 2025, scenarios will arise where a taxpayer's lifetime taxable gifts exceed the basic exclusion amount at the time of their death post-2025 for gifts they made under the increased basic exclusion amount during 2017 through 2025.

The **clawback** concept refers to a taxpayer who is subject to estate tax because they used more than their basic exclusion amount available at death, even though they made taxable gifts **under** the annual basic exclusion amount at the time they gifted property. This treatment renders the benefits of the higher basic exclusion amount during the TCJA useless for taxpayers making gifts during that time who died after 2025.

To address the clawback issue, the IRS issued regulations providing a special rule for decedents whose basic exclusion amount for gifts in prior years exceeds the basic exclusion amount at the time of their death under Treas. Reg. §20.2010-1. This rule allows the basic exclusion amount at the decedent's date of death to consist of the sum of their allowed basic exclusion amount in calculating gift tax on their lifetime gifts. This special rule **only** applies to taxpayers whose allowable basic exclusion amount for lifetime gifts exceed the basic exclusion amount at their death. The special rule, therefore, prevents the estate being taxed on taxpayer gifts that were free from gift tax in the year the taxpayer made the gift.²⁰⁹

²⁰⁶. IRC §2010(c)(3).

²⁰⁷. IRC §2010(c)(3)(B); Rev. Proc. 2022-38, 2022-45 IRB 445.

²⁰⁸. Ibid.

²⁰⁹. TD 9884, 84 Fed. Reg. 64,995 (Nov. 26, 2019); Treas. Reg. §20.2010-1(c).

Example 14. Marcy, a single taxpayer, made a \$7 million gift in 2019 to her nephew. The transaction was a complete gift when Marcy's nephew received the property title in 2019. In 2019, the basic exclusion amount was \$11.4 million.²¹⁰ Marcy did not make any additional gifts during her lifetime before passing away in 2026. Assuming the basic exclusion amount for taxpayers dying in 2026 is \$6.4 million, Marcy's basic exclusion amount for her lifetime taxable gifts exceeds the basic exclusion amount at the time of her passing. Therefore, the special rule under the basic exclusion amount applies to Marcy's estate.

Marcy's basic exclusion amount that she used for her 2019 gift was \$6,985,000 (\$7 million gift – \$15,000 annual gift exclusion). Consequently, Marcy's basic exclusion amount for estate tax purposes is \$6,985,000 instead of the standard \$6.4 million. Her 2019 gift that was not taxable when she transferred the property to her nephew is still not taxable in 2026 when she died.

Deceased Spousal Unused Exclusion Considerations²¹¹

Relatively few individuals die leaving estates that use all the decedent's unified credit. In most cases, decedents have unused exclusions. The Code permits the transfer of a decedent's unused exclusion to pass to their surviving spouse. This process is referred to as **portability**. The amount available to be "ported" to the estate of the surviving spouse is the **deceased spouse's unused exclusion (DSUE)**.²¹²

Note. For additional information about portability and the DSUE, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets.

The special rule for the basic exclusion amount under Treas. Reg. §20.2010-1 addresses decedents with a DSUE. For those taxpayers, the DSUE must be applied to their lifetime gifts before applying their basic exclusion amount in calculating the allowed basic exclusion amount on lifetime gifts. The sum of the basic exclusion amount and any DSUE is central to the computation of a surviving spouse's estate and gift tax. This sum is defined as the **applicable exclusion amount**.²¹³

The applicable exclusion amount can offset a certain amount of tentative tax that would be imposed on a surviving spouse's estate and their prior gifts. This offset to this tentative tax is defined as the **applicable credit amount**.²¹⁴

Example 15. Use the same facts as **Example 14**, except Marcy had a husband, Charlie, who predeceased her in 2018 and left her with a DSUE of \$5 million. The exclusion amount for Marcy's taxable gift in 2019 is \$7 million, consisting of the \$5 million of DSUE that must apply first to the gift and \$2 million of the basic exclusion amount. Therefore, 28.6% of the exclusion is attributable to the basic exclusion amount (\$2 million ÷ \$7 million). The 2019 estate and gift tax credit equivalent for the \$7 million gift is \$2,745,800 (using the 2019 estate tax table). The gift tax credit equivalent to the basic exclusion amount is \$785,299 (\$2,745,800 × 28.6% = \$785,299).

The estate tax credit equivalent for the 2026 basic exclusion amount of \$6.4 million is \$2,505,800. Because the 2019 gift tax credit equivalent attributable to the basic exclusion amount (\$785,299) is less than the 2026 estate tax credit equivalent attributable to the basic exclusion amount (\$2,505,800), the special rule under Treas. Reg. §20.2010-1 does not apply to Marcy's estate. Therefore, Marcy's allowable applicable exclusion amount is \$11.4 million (\$5 million + \$6.4 million).

²¹⁰ Rev. Proc. 2018-57, 2018-49 IRB 827.

²¹¹ Treas. Reg. §20.2010-1(c).

²¹² IRC §2010(c)(4); Treas. Reg. §20.2010-2.

²¹³ Treas. Reg. §20.2010-1(c)(2).

²¹⁴ Treas. Reg. §20.2010-1(e)(1).

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Treatment of Incomplete Gifts²¹⁵

The IRS issued proposed regulations for treating incomplete gifts taxpayers made during 2017 through 2025, and who die after 2025. The regulations require these incomplete gifts to be included in the taxpayer's gross estate at the gifted property's FMV at the time of the taxpayer's death. Because incomplete gifts are not taxable and do not have the offsetting basic exclusion amount in the year of the gift, the special rule under Treas. Reg. §20.2010-1 would not apply to incomplete gifts. Consequently, taxpayers do not receive an adjustment to their basic exclusion amount at the time of their death for incomplete gifts that exceed the basic exclusion amount at the time of death but did not exceed the basic exclusion amount at the time the taxpayer initiated the gifts.

Example 16. Use the same facts as **Example 14**, except Marcy's 2019 gift to her nephew was incomplete because the property title did not transfer to her nephew until after Marcy's death. Marcy's basic exclusion amount for estate tax purposes is \$6.4 million. If Marcy has no other assets at her death in 2026, \$600,000 of her estate is subject to estate tax (\$7 million – \$6.4 million).



Practitioner Planning Tip

In considering estate tax matters, it may benefit taxpayers to complete taxable gifts that exceed the reduced basic exclusion amount before the end of 2025 to benefit from the increased basic exclusion amount provided by the TCJA.

DIGITAL ASSET TAXATION

Cryptocurrencies and other digital assets continue to rise in popularity among the public for business use, investing, and collecting. In response to this growing trend, the IRS has attempted to clarify the taxation impacts of involvement in digital asset activity and corresponding reporting compliance. As the population gravitates more towards participating in digital asset activity, the likelihood of a practitioner's client base holding digital assets increases. Therefore, practitioners need to follow up with clients and see if there are any changes in their behavior toward digital assets. This section highlights key developments in IRS communication regarding digital assets and how tax practitioners should proceed in aiding their clients in complying with these new developments.

DEFINING DIGITAL ASSETS²¹⁶

Before 2022, the IRS required taxpayers to answer a question on Form 1040 regarding whether the taxpayer engaged in receiving, selling, exchanging, or disposing of any virtual currency financial interest.²¹⁷ The 2022 Form 1040 broadened the scope of this reporting requirement by replacing the term virtual currency with digital asset.²¹⁸ The IRS defines digital assets as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." In addition to virtual currency, the IRS mandates that taxpayers disclose their activity in other virtual assets. These assets can include the following.

1. Virtual currency and cryptocurrency, such as Bitcoin
2. Stablecoins, which are a type of cryptocurrency with values tied to a currency, commodity, or other financial instrument to achieve more value stability compared to traditional cryptocurrencies
3. Non-fungible tokens (NFTs), which comprise unique digital identifiers recorded in a blockchain

²¹⁵. Prop. Treas. Reg. §20.2010-1.

²¹⁶. *Digital Assets*. Jun. 15, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/digital-assets] Accessed on Jul. 10, 2023.

²¹⁷. Form 1040, *U.S. Individual Income Tax Return* (2021).

²¹⁸. Form 1040, *U.S. Individual Income Tax Return* (2022).

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While this list is not comprehensive, the IRS specifically identified these items as examples that would meet the definition of digital assets. Therefore, practitioners and their clients must be mindful of participation in any of the above to adhere to reporting requirements while filing their tax returns.

Note. For more information on digital assets, including terms, treatment, etc., see the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments. This topic is also covered in the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Individual Taxpayer Issues.

TREATMENT OF SIGNIFICANT DECLINE IN VALUE²¹⁹

Cryptocurrency market values experienced a significant decline in 2022, with the price of Bitcoin sharply falling and the collapse of the cryptocurrency exchange FTX. In response, the IRS advised taxpayers that they could not take a loss deduction for the decline of a digital asset's market value if they did not dispose of it or attempt to abandon it. While some could argue that a cryptocurrency whose value dropped to a fraction of a penny is worthless, the IRS took the position that as long as the cryptocurrency was traded on at least one exchange, the possibility existed that its value could increase in the future and, therefore, it was not worthless.

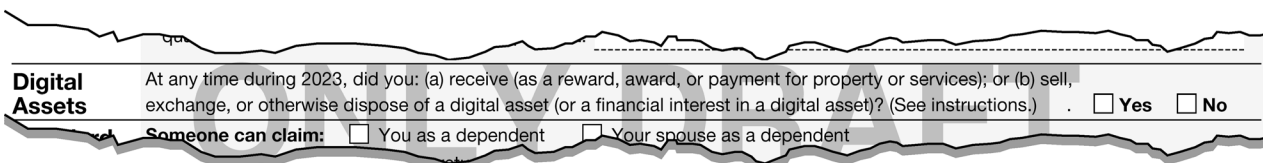
Caution. The IRS memo is not an official ruling or position, and the IRS is not bound to its content and could be subject to change without notice. However, practitioners and their clients should exercise caution in this realm, as digital assets are relatively new territory, especially regarding taxation. There are several unprecedented scenarios in which taxpayers with digital assets may find themselves. Consequently, there is much uncertainty around positions one could take in reporting transactions involving digital assets. Therefore, following guidance issued by the IRS would be a conservative approach.

REPORTING DIGITAL ASSET ACTIVITY

In addition to broadening the subject matter for reporting digital assets, the IRS has further clarified reporting requirements pertaining to digital asset activity.

Form 1040 Disclosure

As mentioned previously, every individual filer must answer the question on the front of Form 1040 whether they received or sold a digital asset in the taxable year. The IRS modified the question and provided more specific instructions to help preparers correctly check the “Yes” or “No” boxes. The question on the draft 2023 Form 1040 (dated June 15, 2023) reads as follows.



Digital Assets At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ Yes ☐ No

Someone can claim: ☐ You as a dependent ☐ Your spouse as a dependent

²¹⁹. CCA 202302011 (Jan. 13, 2023).

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There are minor changes to the detailed list for Yes and No response to the preceding question. In general, a taxpayer should check “Yes” for the following activities.²²⁰

- Received digital assets as payment for property or services provided
- Transferred digital assets for free (without receiving any consideration) as a bona fide gift
- Received digital assets resulting from a reward or award
- Received new digital assets resulting from mining, **staking**, and similar activities
- Received digital assets resulting from a hard fork (a branching of a cryptocurrency’s blockchain that splits a single cryptocurrency into two)
- Disposed of digital assets in exchange for property or services
- Disposed of a digital asset in exchange or trade for another digital asset
- Sold a digital asset
- Otherwise disposed of any other financial interest in a digital asset

In general, a taxpayer should check “No” if their activities were limited to one or more of the following.²²¹

- Holding digital assets in a wallet or account
- Transferring digital assets from one wallet or account they own or control to another wallet or account they own or control
- Purchasing digital assets using U.S. or other real currency, including through electronic platforms such as PayPal and Venmo

Staking Income

The IRS provided guidance in Rev. Rul. 2023-14²²² on the taxability of income from staking. Staking is a way of earning rewards while holding onto certain cryptocurrencies. Staking is similar to mining; it is the method by which a network participant adds the latest batch of transactions to the blockchain and earns some digital assets in exchange. Stakers establish which blocks are valid through complex mathematical equations.²²³ Although a comprehensive understanding of staking is beyond the scope of this chapter, it is important to understand the IRS’ stance on reporting any income earned from staking.

The takeaway from the Revenue Ruling is that if a cash-method taxpayer stakes cryptocurrency native to a **proof-of-stake blockchain** (cryptocurrency transactions that are validated by a consensus mechanism) and receives additional units of cryptocurrency as rewards when validation occurs, the taxpayer includes the FMV of the validation rewards received in their gross income in the tax year in which the taxpayer gains **dominion and control** over the validation rewards. The FMV is determined as of the date and time the taxpayer gains dominion and control over the validation rewards. Dominion and control in this Revenue Ruling was established when the taxpayer was able to sell, exchange, or otherwise dispose of the units of digital assets the taxpayer received as validation rewards.

²²⁰. IRS News Rel. IR-2023-12 (Jan. 24, 2023).

²²¹. Ibid.

²²². Rev. Rul. 2023-14, 2023-33 IRB 1.

²²³. *What is Staking?* Coinbase. [www.coinbase.com/learn/crypto-basics/what-is-staking] Accessed on Aug. 6, 2023.



Practitioner Planning Tip

With the cooling down of mining within the digital asset realm, it appears staking is the direction that digital asset activities are heading toward. Therefore, tax practitioners should have a basic understanding of the process and the reporting obligations.

Reporting Income and Losses

Generally, taxpayers report the receipt of income or realization of losses from digital asset activity based on the source and characteristics of the digital activity. Taxpayers may need to use different tax forms to report the activities correctly.

Wages on Form 1040. Taxpayers who receive wages from an employer that pays them in virtual currency or other digital assets must report the wages on Form 1040, line 1. The reporting requirements for the reporting and taxation of wages remain the same as taxpayers receiving wages in a nondigital currency.

Investments on Schedule D. A taxpayer selling digital assets as an investment activity reports income and losses on Form 1040, Schedule D, *Capital Gains and Losses*. Unless the taxpayer receives Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*, reporting digital asset activity with basis information reported to the IRS and no adjustments, the taxpayer must reconcile and report their activity on Form 8949, *Sales and Other Dispositions of Capital Assets*. The taxpayer receives capital gain and loss treatment for investment in digital asset activities. Accordingly, an individual taxpayer is limited to \$3,000 of capital loss for a tax year.²²⁴

To calculate the gain or loss on the activity, the taxpayer must subtract their adjusted basis in the digital asset from the sales proceeds. The taxpayer's adjusted basis for digital assets follows the same principles as the basis of assets under IRC §1012.²²⁵ If the taxpayer purchased the digital asset, their basis is the purchase cost. If the taxpayer received the digital asset as a payment for goods or services and holds the digital asset for investment purposes, their basis is the asset's FMV at the date of receipt.²²⁶

Example 17. William purchased one Bitcoin in June 2020 for \$9,475. William intended to hold onto the Bitcoin over time and sell it as an investment. He sells the Bitcoin for \$19,207 in October 2022. William does not receive a Form 1099-B reporting this transaction. While preparing his 2022 income tax return, he reports the sale of Bitcoin on Form 8949, calculating a long-term capital gain of \$9,732. William's Schedule D, summarizing the transaction in part II, line 10, along with his Form 8949, are shown on the following pages.

²²⁴. IRC §1211(b).

²²⁵. Rev. Rul. 2019-24, 2019-44 IRB 1004.

²²⁶. IRS Notice 2014-21, 2014-16 IRB 938.

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For Example 17

Form 8949 (2022)

Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side

William Wonka

Social security number or taxpayer identification number

*****-**-8842**

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II Long-Term. Transactions involving capital assets you held more than 1 year are generally long-term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You must check Box D, E, or F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS

☒ **(F)** Long-term transactions not reported to you on Form 1099-B

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the Note below and see <i>Column (e)</i> in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g).
						(f) Code(s) from instructions	(g) Amount of adjustment	
	1 Bitcoin	6/15/20	10/27/22	19,207	9,475			9,732
2 Totals.	Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 8b (if Box D above is checked), line 9 (if Box E above is checked), or line 10 (if Box F above is checked).			19,207	9,475			9,732

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2022)

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For Example 17

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to www.irs.gov/ScheduleD for instructions and the latest information.
Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2022

Attachment
Sequence No. **12**

Name(s) shown on return

William Wonka

Your social security number

*****-**-8842**

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ Yes ☒ No

If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7

Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)

See instructions for how to figure the amounts to enter on the lines below.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked	19,207	9,475		9,732
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then, go to Part III on the back				15 9,732

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2022

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Business Income on Schedule C.²²⁷ If the taxpayer receives payment for services they perform or other business activity, the taxpayer reports the income on Schedule C, *Profit or Loss From Business*. The amount of income for the taxpayer to report for this payment is the FMV of the digital assets on the date of receipt. This value also serves as the taxpayer's basis in the digital asset. If the taxpayer is in the business of selling, exchanging, or transferring digital assets to customers, income arising from this activity is also reported on Schedule C.²²⁸ Income the taxpayer reports on Schedule C is subject to self-employment tax.

Ordinary Income on Schedule 1.²²⁹ If a taxpayer sells or exchanges digital assets they are not holding for investment and would not otherwise meet the definition of a capital asset, the gain or loss on the sale is ordinary.²³⁰ In some cases, this income is reported on Schedule 1, such as when the digital asset is not a capital asset or held in the course of a business.

Donating Digital Assets²³¹

Taxpayers who donate digital assets to a qualified nonprofit organization can itemize the contribution as a charitable deduction. However, taxpayers must submit a qualified appraisal of the digital asset with their filed return to take the deduction for donations over \$5,000.²³² Notably, taxpayers may not use values cryptocurrency exchanges report in lieu of qualified appraisals to support the deduction amount.

Note. Depending on the type of digital asset a taxpayer donates, appraising a digital asset may be more difficult than appraising traditional tangible assets. While cryptocurrencies are regularly traded, NFTs are more complex, as they are unique by nature. Until Congress passes legislation or the IRS issues different guidance, taxpayers should plan on obtaining an appraisal before donating digital assets to claim the deduction.

Digital Asset Treatment for Personal Use

Taxpayers may use digital assets, particularly cryptocurrencies, as a “checkbook” to purchase personal goods. This trend is evident in more businesses accepting cryptocurrencies as forms of payment from their customers. The facts and circumstances surrounding the use of the digital asset drive the classification and associated tax treatment for its associated activities.²³³ While the IRS does not explicitly identify digital assets in this specific context, the agency explains that most personal use items are capital assets.²³⁴ Therefore, if taxpayers use digital assets for the purchase of personal goods, the gain or loss from the change in the digital asset's value from the time of acquisition until the time of disbursement should receive the same tax treatment as a personal use asset. The IRS appeared to reinforce this concept by stating that virtual currency receives treatment as property instead of a currency for federal income tax purposes.²³⁵ Consequently, digital asset transactions would not receive a \$200 de minimis gain exclusion resulting from personal foreign currency transactions.²³⁶

²²⁷ Rev. Rul. 2019-24, 2019-44 IRB 1004.

²²⁸ IRS News Rel. IR-2023-12 (Jan. 24, 2023).

²²⁹ *Frequently Asked Questions on Virtual Currency Transactions*. Jun. 27, 2023. IRS. [www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions] Accessed on Jul. 11, 2023.

²³⁰ IRS Notice 2014-21, 2014-16 IRB 938.

²³¹ CCA 202302012 (Jan. 13, 2023).

²³² IRC §170(f)(11).

²³³ IRS Notice 2014-21, 2014-16 IRB 938.

²³⁴ *Topic Number 409, Capital Gains and Losses*. Apr. 4, 2023. IRS. [www.irs.gov/taxtopics/tc409] Accessed on Jul. 11, 2023.

²³⁵ IRS Notice 2023-34, 2023-19 IRB 837.

²³⁶ IRC §988(e)(2).

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When taxpayers realize a gain from the sale of personal property, the income receives capital gain treatment and is reported on Form 8949 and Schedule D.²³⁷ Losses on the sale of personal-use property, however, are nondeductible.²³⁸ Therefore, if digital asset transactions are considered in the context of personal-use property, taxpayers would recognize capital gains from the exchange of digital assets in a transaction, but would not recognize any losses.

Caution. Practitioners should monitor IRS communications regarding the treatment of digital assets, as this is a relatively new area in the realm of taxation, and the IRS continuously states that it intends to provide further guidance on associated topics at a future date.

Another consideration still requiring guidance is the classification of digital assets, particularly NFTs, as collectibles. The IRS has issued a notice stating that it intends to issue guidance regarding NFTs as IRC §408(m) collectibles subject to a higher tax rate.²³⁹ As with personal-use assets, the facts and circumstances surrounding the nature of its actual and intended use determine the classification of the digital asset.

EXPIRING PROVISIONS

The following are some expiring provisions for which taxpayers may want to plan. Additionally, some provisions that expired in 2022 may impact a taxpayer's 2023 tax return.

DECEMBER 31, 2022

Code Sections	Description
45G(a)	Railroad track maintenance credit of 50%
274(n)(2)(D)	Allowance of full deduction for business meals

SEPTEMBER 30, 2023

Code Sections	Description
4043(d), 4081(d)(2)(B), 4083(b), 4261(j) and (k), 4271(d)	Various airport and airway trust fund excise taxes

²³⁷. Ibid.

²³⁸. Ibid.

²³⁹. IRS Notice 2023-27, 2023-15 IRB 634.

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DECEMBER 31, 2024

Code Sections	Description
40(b)(6)(J)	Second generation biofuel producer credit
40A(g)	Various income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agribiodiesel producers (also renewable diesel)
40B(h)	Credit for sustainable aviation fuel
45(d), 48(a)(5)	Beginning-of-construction date for renewable power facilities eligible to claim the renewable electricity production credit or investment credit in lieu of the production credit
48(a)(2)(A)(i)(II), 48(a)(3)(A)(ii) and (viii), 48(c)(1)(E), 48(c)(2)(D), 48(c)(3)(A)(iv), 48(c)(4)(C)	Beginning-of-construction date for increased credit for business solar energy property and credit for fiber optic solar lighting system property, qualified fuel cell and stationary microturbine power plant property, combined heat and power property, small wind property, and waste energy recovery property
48(a)(3)(A), 168(e)(3)(E)	Five-year recovery period for certain energy property
48(e)(4)(C)	Increase in energy credit for solar and wind facilities placed in service in connection with low-income communities
223(c)(2)(E)	Safe harbor for absence of deductible for telehealth
6426(c)(6)	Excise tax credits and outlay payments for (renewable) diesel fuel mixtures
6426(d)(5)	Excise tax credits and outlay payments for alternative fuel
6426(e)(3)	Excise tax credits for alternative fuel mixtures
6426(k)	Excise tax credits and outlay payments for sustainable aviation fuel
6427(e)(6)(B), (C), and (E)	Excise tax credits and outlay payments for (renewable) diesel fuel mixtures

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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), 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
45S(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 AMT
59A(b)(2)	Rate on modified taxable income and treatment of credits in the calculation of base erosion minimum tax amount
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
168(e)(3)(C)(ii), 168(i)(15)(D)	7-year recovery period for motorsports entertainment complexes
170(b)(1)(G)	Increase in percentage limitation on cash contributions to public charities
181(g)	Special expensing rules for certain film, television, and live theatrical productions
199A(i)	QBI
217(k)	Suspension of deduction for moving expenses
250(a)(3)	Deduction percentages for foreign-derived intangible income and global intangible low-taxed income

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December 31, 2025 (*continued*)

Code Sections	Description
274(o)	Deductibility of employer de minimis meals and related eating facility, and meals for the convenience of the employer
420(b)(4)	Transfer of excess pension assets to retiree health and life insurance accounts
954(c)(6)(C)	Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules
1391(d), (h), 1394, 1396	Empowerment zones: Designation of an empowerment zone, tax-exempt bonds, employment credit
2010(c)(3)(C)	Increased estate and gift tax exemption
4611(f)(2)	Oil Spill Liability Trust Fund financing rate

DECEMBER 31, 2026

Code Sections	Description
25B	Elective deferrals and IRA contributions by certain individuals
48D(e)	Credit for advanced manufacturing investment
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

DECEMBER 31, 2027

Code Sections	Description
45Z(g)	Credit for clean fuel production