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NEWSLINE

IRS Releases Tax Inflation Adjustments For Tax Year 2025

The IRS has announced the annual inflation adjustments for tax year 2025. (Rev. Proc. 2024-40; IR-2024-273, 10/22/2024) Rev. Proc. 2024-40 provides detailed information on adjustments and changes to more than 60 tax provisions that will impact taxpayers when they file their returns in 2026.

The tax year 2025 adjustments described below generally apply to income tax returns to be filed starting tax season 2026. The tax items for tax year 2025 of greatest interest to many taxpayers include the following dollar amounts:

Standard deductions. For single taxpayers and married individuals filing separately for tax year 2025, the standard deduction rises to $15,000 for 2025, an increase of $400 from 2024. For married couples filing jointly, the standard deduction rises to $30,000, an increase of $800 from tax year 2024. For heads of households, the standard deduction will be $22,500 for tax year 2025, an increase of $600 from the amount for tax year 2024.

Marginal rates. For tax year 2025, the top tax rate remains 37% for individual single taxpayers with incomes greater than $626,350 ($751,600 for married couples filing jointly). The other rates are:

- 35% for incomes over $250,525 ($501,050 for married couples filing jointly).
- 32% for incomes over $197,300 ($394,600 for married couples filing jointly).
- 24% for incomes over $103,350 ($206,700 for married couples filing jointly).
- 22% for incomes over $48,475 ($96,950 for married couples filing jointly).
- 12% for incomes over $11,925 ($23,850 for married couples filing jointly).
- 10% for incomes $11,925 or less ($23,850 or less for married couples filing jointly).

Alternative minimum tax exemption amounts. For tax year 2025, the exemption amount for unmarried individuals increases to $88,100 ($68,650 for married individuals filing separately) and begins to phase out at $626,350. For married couples filing jointly, the exemption amount increases to $137,000 and begins to phase out at $1,252,700.

Earned Income Tax Credits. For qualifying taxpayers who have three or more qualifying children, the tax year 2025 maximum Earned Income Tax Credit (EITC) amount is $8,046, an increase from $7,830 for tax year 2024. Rev. Proc. 2024-40 contains a table providing maximum EITC amounts for other categories, income thresholds, and phase-outs.

Qualified transportation fringe benefit. For tax year 2025, the monthly limitation for the qualified transportation fringe benefit and the monthly limitation for qualified parking rises to $325, increasing from $315 in tax year 2024.

Health flexible spending cafeteria plans. For the taxable years beginning in 2025, the dollar limitation for employee salary reductions for contributions to health flexible spending arrangements rises to $3,300, increasing from $3,200 in tax year 2024. For cafeteria plans that permit the carryover of

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unused amounts, the maximum carryover amount rises to $660, increasing from $640 in tax year 2024.

Medical savings accounts. For tax year 2025, participants who have self-only coverage the plan must have an annual deductible that is not less than $2,850 (a $50 increase from the previous tax year), but not more than $4,300 (an increase of $150 from the previous tax year). The maximum out-of-pocket expense amount rises to $5,700, increasing from $5,550 in tax year 2024.

For family coverage in tax year 2025, the annual deductible is not less than $5,700, increasing from $5,550 in tax year 2024; however, the deductible cannot be more than $8,550, an increase of $200 versus the limit for tax year 2024. For family coverage, the out-of-pocket expense limit is $10,500 for tax year 2025, rising from $10,200 in tax year 2024.

Foreign earned income exclusion. For tax year 2025, the foreign earned income exclusion increases to $130,000, from $126,500 in tax year 2024.

Estate tax credits. Estates of decedents who die during 2025 have a basic exclusion amount of $13,990,000, increased from $13,610,000 for estates of decedents who died in 2024.

The annual exclusion for gifts increases to $19,000 for calendar year 2025, rising from $18,000 for calendar year 2024.

Adoption credits. For tax year 2025, the maximum credit allowed for an adoption of a child with special needs is the amount of qualified adoption expenses up to $17,280, increased from $16,810 for tax year 2024.

Unchanged for tax year 2025. By statute, certain items that were indexed for inflation in the past are currently not adjusted.

- **Personal exemptions** for tax year 2025 remain at 0, as in tax year 2024. The elimination of the personal exemption was a provision in the Tax Cuts and Jobs Act of 2017.
- **Itemized deductions.** There is no limitation on itemized deductions for tax year 2025, as in tax year 2024 and preceding years, to tax year 2018. The limitation on itemized deductions was eliminated by the Tax Cuts and Jobs Act of 2017.
- **Lifetime learning credits.** The modified adjusted gross income amount used by taxpayers to determine the reduction in the Lifetime Learning Credit provided in Code Section 25A(d)(1) is not adjusted for inflation for taxable years beginning after 12/31/2020. The Lifetime Learning Credit is phased out for taxpayers with modified adjusted gross income in excess of $80,000 ($160,000 for joint returns). ■

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Turning States' Evidence: Disclosing Hidden Secrets for Multistate Voluntary Disclosures

Neill Edwards

Multistate tax voluntary disclosure agreements (VDAs) have become more commonplace lately, particularly sales tax VDAs in the wake of the U.S. Supreme Court's bombshell Wayfair decision in 2018. This article discusses several "dirty little secrets" about multistate tax VDAs, and lessons learned from the author's years of helping business clients bring themselves into better multistate tax compliance.

"We dance round in a ring and suppose, but the secret sits in the middle and knows."

Robert Frost, *The Secret Sits* (1942)

INTRODUCTION

This article concerns several "dirty little secrets" about multistate tax voluntary disclosures, and lessons learned from years of helping business clients bring themselves into better multistate tax compliance. It is also a cautionary tale: state tax voluntary disclosures can have unintended, even dire, consequences for those that "step forward" and disclose without careful planning and consideration. Good deeds seldom go unpunished for those in a hurry.

State tax voluntary disclosure is a pragmatic process through which a secretly noncompliant business (often noncompliant due to tax law complexities), typically acting on an unnamed basis through a tax professional, discloses its "secret" to state tax agencies. In exchange for the unknown business stepping into the disclosure circle, the state enters into a voluntary disclosure agreement (VDA) with the taxpayer, providing it with some form of "grace," such as a waiver of a portion of the potential tax liability.[1] But the secrets which are the focus of this article are those of the state governments and their VDA programs,[2] not the taxpayers' secrets. This article is about what you need to know, before you let the government be in the know, and provides examples from every U.S. state.

Multistate VDAs have become more commonplace lately, particularly sales tax VDAs in the wake of the U.S. Supreme Court's bombshell Wayfair[3] decision in 2018. The business panic incited by *Wayfair* caused many to break ranks and rush headlong into the center of the multistate VDA fray. A boon for state tax coffers, the VDA programs were typically "marketed" by states, and then "purchased" by businesses, on the strength of the promise of tax forgiveness. And make no mistake: VDAs can live up to that promise, delivering deals which provide practical solutions to historical state tax noncompliance. Yet before "stepping into the circle," every business should first be aware of, and carefully consider, the fine print of those bargains.

SECRET #1: YOU DISCLOSE FOR TAX TYPE X, BUT THEN ARE AUDITED FOR TAX TYPE Y

The most common scenario here is posed by a business that decides to "come forward" for a sales tax VDA, but does not consider its compliance with that state's income/franchise (or other non-sales) tax. Later, the company is alarmed to receive a nexus inquiry or audit notice from that state for some other tax, often an income tax. Needless to say, the absolution granted by the company's VDA only extended to the particular type of tax that was actually disclosed.

Many – but certainly not all[4] – states do not expressly require an income tax VDA as a condition to eligibility for a sales tax VDA. Still other states expressly warn that, while a business will still be eligible for a VDA for one tax type even if it fails to conclude a VDA for *all* noncompliant taxes, the VDA itself will impose compliance with *all* taxes as a condition to the deal.[5] But the fine print can get even finer: most states provide no such warning, yet their VDAs do in fact contain an "all taxes" compliance representation or covenant.[6] Still other states' VDAs purport to make compliance with *all state laws* (not just tax laws) a condition to the contract.[7]

Even "loss companies" need to consider this issue. First, there are often taxes other than income and sales tax which might be an issue, such as net worth/capital stock (often called "franchise") taxes, or employment withholding taxes on mobile/"remote" workers. Second, federal income tax returns may later have to be amended for the sales tax VDA period years, which might alter the company's (former) income tax loss position. In fact, in some states, a business is not allowed to take certain loss carryforwards into account for purposes of income tax VDA exposure determinations.[8]

The same concerns apply to a company that claims immunity from income taxation altogether under Public Law 86-272 (as a purely "goods"-based company that strictly limits its activities in the would-be taxing state).[9] Setting aside the fact that most states (incorrectly or not) interpret this income tax safe harbor *extremely* narrowly, 86-272 immunity extends only to state *net income* taxes. So, in addition to the "non-income" taxes

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noted in the preceding paragraph, 86-272 provides no protection against "income-type" taxes not based upon net income, such as Nevada's "commerce tax," New Hampshire's "business enterprise tax," Ohio's and Oregon's "commercial activity taxes," Texas' "net margin (revised franchise) tax," and Washington's "business and occupation tax."[10]

Not-for-profit businesses cannot necessarily rest easy on this point either. It is relatively well known that, in many states, many types of not-for-profits are subject to *sales* tax on various types of purchases, so a sales tax VDA might be advisable for them. However, those organizations may be unaware that the VDA state's tax agency may require advance agency approval for the company to enjoy immunity from that state's *income* tax.[11]

taxability in the first place is uncertain? With the benefit of expert tax guidance, most companies would realize that they would fall into one or both of the above camps: taxability is *often* uncertain.

At this point it is worth noting that there are distinctly different VDA approaches that may be employed. Three conceptually distinct approaches bear mention.

First, many VDA submissions take the form of a very basic request for a VDA, along with a simple offer to sign the VDA once presented and pay all amounts determined to be owing, with few additional details. This type of a VDA approach is "quick and easy" (or at least quicker and easier),[13] but it is not well-suited for any nuanced factual or legal considerations, because it tends to result in overpayment

Many – but certainly not all – states do not expressly require an income tax VDA as a condition to eligibility for a sales tax VDA. Still other states expressly warn that, while a business will still be eligible for a VDA for one tax type even if it fails to conclude a VDA for all noncompliant taxes, the VDA itself will impose compliance with all taxes as a condition to the deal.

It may ultimately be appropriate for a business to limit its VDA to a single tax type; however, the point of Secret #1 is to verify that this is in fact the case, before the business discloses its own secret and irrevocably commits to a single-tax VDA.

SECRET #2: AVOID MISSTEPS — THE SALES TAX ALL-OR-NOTHING "GOTCHA"

The most common scenario here is presented by a business that is uncertain whether to "come forward," because it sells multiple offerings (perhaps through multiple means), the sales taxability of which may be uncertain. An important variation on this scenario is a business that sells a single offering, the taxability of which depends upon how the offering is characterized. Each business is presented by a dilemma that might cause them to forego a VDA altogether:[12] how does a company reach an "agreement" to pay tax on items when their

by the company.[14] Because VDAs are contracts, and are treated by the states as setting the tone and mode for future, ongoing compliance, they have some precedential effect; the "quick and easy" approach may commit the company to overcompliance, which will be difficult to amend later.

As a second approach, some VDA submissions present more detailed *facts*, but little by way of legal argument/advocacy, perhaps beyond arguing that (for one reason or another) the state's presumptive "lookback" period of liability for the company should be truncated.[15]

However, with a bit more careful consideration and strategic development, a VDA submission can be used as a practical and effective substitute for a tax ruling request. This third type of VDA submission details the facts and the law, conceding any conflicting authority, but then argues/demonstrates the applicability of the favorable authority. Such submissions must of course square with the taxpayer's actual facts, but they effectively[16] convert the VDA process into a medium through which the state tax agency makes an evaluative tax compliance *decision.*

To illustrate this third type of VDA submission, consider a company which licenses/provisions Internet-based offerings. Assume that it has developed a proprietary library of clinical trial outcomes. Its customers – mainly pharmaceutical companies – wish to access the library to preliminarily "test the waters" for their own clinical trial prospects. The library content is comprised of interactive charts, photos, and videos of trial subjects, conditions, and medical specimens. For searchability and overall ease of use, the library is encoded in the form of software, which is remotely accessed over the Internet.

Is it sales taxable? Well first, we must know what "it" *is.* Is it software, in the form of SaaS? Is it a digital work, given that it includes digital photos and movies? Is it a medical testing/evaluation service? An information service? Does (should) the form of the medium in which the offering is "encoded" matter? Does (should) the form of the content? The function of the offering? Or the "true object" of the transaction from the customer's perspective? Each of these questions will be relevant in many states.

Consider that a given VDA state might tax SaaS, tax digital works, not tax medical testing/evaluation, and not tax information services. Or play with these assumptions – a 4x4 matrix of taxability scenarios quickly emerges. Taxability issues can (and should) be effectively resolved via the VDA process. Just because a company may need to go to a state (anonymously, through a tax professional)[17] with its "hat in hand," does not mean that it should also be seen as carrying a blank check, and thereby forced to agree that everything is taxable.

Secret #2 reveals that, with appropriate advocacy that reliably captures the relevant business facts, ambiguous/conflicting legal authority can be vetted, and a practical tax resolution reached as part of a VDA.

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SECRET #3: COME FORWARD AND DISCLOSE, BUT AVOID TAX "CROSS-CONTAMINATION"

This is a corollary to Secrets #1 and #2. Secret #1 warns that other VDA state taxes should be carefully considered (such as income tax, when the focal issue is sales tax), not just the "disclosure" tax that raised VDA concerns in the first place. Secret #2 illustrates how factual and legal development of the VDA narrative can be critical to a proper and cost-effective VDA resolution, particularly for sales taxes. Secret #3 builds upon these points: those *other* taxes should be kept in mind when establishing the narrative for the "disclosure" taxes.

What does this mean? Consider a company that never filed any sales tax returns, and is accordingly in sore need of a *sales* tax VDA. To date, the company has taken the *income* tax position that it is protected by 86-272. 86-272 immunity from income taxation requires, among various other things, that the taxpayer not provide services within the taxing state.[18] Returning to our example of a clinical trials medical evaluative software offering containing digital goods content, it is hopefully obvious by now that heightened care must be taken before launching that sales tax VDA: what does the VDA state's interpretive guidance say about whether remotely accessed software is a service or a tangible product, for income tax purposes? If there is no income tax authority, what about for sales tax purposes? Does the VDA state have a fictive income tax "doing business" rule that would source services to the customer state, even when not actually performed within that state? What do its general services sourcing rules say for income tax apportionment purposes? Each of these may be relevant considerations for a business claiming 86-272 immunity from state income taxes.

To fully appreciate the dilemma that may be presented for the company, now assume that under the VDA state's sales tax laws, the offering is clearly taxable *unless* it is characterized as a *service* (e.g., an information service, evaluative service, or an unenumerated service under a "true object" analysis). Such a characterization could present an income tax cross-contamination risk; even though presented in a sales tax VDA, this characterization could cause the state to question immunity under 86-272. The risk might very well be worth taking, but before the VDA is submitted, the potential income tax exposure should be recognized, and compared against the sales tax exposure associated with not securing a sales tax VDA.

> As a standard condition to participation in state VDA programs, and as a standard provision of state VDAs themselves, failure to disclose a material fact renders the VDA voidable. This means that the negotiated deal may be rescinded by the state if the business failed to adequately disclose.

Moreover, tax cross-contamination can result not only from what the company is about to say in its VDA, but also by what it has already publicly said. For example, websites are a resource of first resort for tax administrators. How are the company's offerings portrayed (as services? goods? a mix?) online, and is that portrayal consistent with the tax positions the company hopes to take? Does the website suggest that the company has business locations through third-party distributors, and/or affiliates? If so, this could undermine a "*Wayfair*" (economic nexus only) position the company was planning to take in its sales tax VDA. The same result could follow from having a website that attributes a *de facto* "office" to the residences of work-at-home employees, whom the company merely lists as "remote" for payroll tax purposes.[19]

After learning Secret #3, one should be careful what they disclose, and be mindful of what they have disclosed already.

SECRET #4: COME FORWARD AND DISCLOSE, AND DO NOT OVERSTEP (GET GREEDY)

Just as disclosure needs to be measured to avoid missteps, it also needs to be adequate to avoid severe injury from overstepping too boldly. As previously stated, VDAs routinely reserve the state's audit rights.[20] More important, as a standard condition to participation in state VDA programs, and as a standard provision of state VDAs themselves, failure to disclose a material fact renders the VDA voidable.[21] This means that the negotiated deal may be rescinded by the state if the business failed to adequately disclose.

To illustrate, consider a company in *dire* need of a sales tax VDA. The company operated for decades (years before *Wayfair*'s "no physical presence" ruling was decided) with sizeable multistate revenues. The company's arguments for exemptions on its sales are weak. For most of its history, the company has allowed its few out-of-state employees to work "remotely" from their residences, thus making it "physically present" in these "remote" states. Despite strong sales for decades, its sales in these (few) remote states were just low enough to avoid triggering *Wayfair* nexus there; however, this past year's sales in those states were huge.

Like many others, this company has never considered "remote" work to be true "physical presence," and as remote workers are standard in its industry, the company is disinclined to mention its remote workers in the VDA submission. Mentioning that fact would signal tax owed in the remote worker states for each year during the (say, four-year) lookback period.[22] However, omitting this (industry standard, *right?*) fact would limit the VDA exposure to a single year of sales tax in those same states. After all, who would opt to pay 4x instead of just x?

This would of course be a business decision, but it would be important not to lose sight of the major tax objectives, and to handicap risks to the achievement of those objectives. The company's

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biggest issue is its potential sales tax liability for all operational years, based upon physical presence (however arguable the industry view on that may be). This very large risk would be eliminated if a VDA were concluded. While nondisclosure of the physical presence risk might secure a settlement for only a single year's tax liability, it would run the risk of jeopardizing the entire VDA, for all years, for nondisclosure of a material fact.[23] If the VDA were voided, the company would face the prospect of potentially unlimited tax liability. Under the circumstances, many might conclude that not disclosing the physical presence risk would be a risky overreach.

A more recent variation on this problem is presented in the growing number of jurisdictions which have attempted to "fully integrate and automate" their VDA programs. In attempting to systematize VDA processing, these jurisdictions often limit the "discussion" of key facts to forced "yes" or "no" questionnaire responses. As previously stated, it is rare for a VDA situation to be devoid of any nuanced facts, and yet a material omission presents the risk of a voidable agreement. In such situations, the applicant should take the time to find creative opportunities to attempt to explain the answers more fully. As ridiculous as it seems, often this can only be done by repurposing otherwise inapplicable data entry fields.

Thus, Secret #4 is a warning to be sure to disclose those facts – even, and perhaps particularly, those uncomfortable facts – which would be appropriately relevant to a state agency's tax decisions. An overly bold *non*disclosure can undercut one of the main benefits of a VDA, namely the ability to rest easy.

SECRET #5: SIDESTEPPING THE "WHO'S THE REAL TAXPAYER?" TRAP

This VDA scenario arises frequently in the post-M&A context: Buyer purchases Seller's business, through merger, stock purchase, or asset purchase,[24] either ignorant or aware of the Seller's complete historical failure to file various tax returns in various states. The general rule in most states, and for most taxes, is that the failure to file required tax returns in a given state yields an unlimited exposure period (no statute of limitations).[25] The net of this is that Buyer has either knowingly or unknowingly[26] purchased one or more[27] ticking tax time bomb(s), the fuse(s) of which have an indeterminate length: the explosion(s) could come at any time in the future.

Sounds like a perfect situation for a VDA, right? But *which company* can/must be a party to the VDA? Buyer? Seller? Both? Does it matter? Yes, it can.

Assume that Buyer is fully tax-compliant (or as nearly so as is feasible under the current state of multistate taxation). That means that Buyer is likely registered and filing for various tax types in various states. In contrast, prior to the sale, Seller was not registered and not filing – hence the detonation risk for now and the foreseeable future. Seller wants to tackle the situation immediately after closing.

strategy. During that transition year, out of concern for customers who were accustomed to *not* being billed sales tax on Seller's offerings, Buyer continued to sell those offerings to those customers without charging tax – the theory being that, *once VDAs were finalized*, Buyer would be able to tell those customers that Buyer had been forced to remit taxes on transactions for which they were not charged. Going forward, taxes *would* have to be collected from the customers.

How does Buyer address the liabilities for the sales it made in its name during that "stub period" transition year? As previously mentioned, Buyer may be out of luck in VDA states for which registered companies are *not* VDA-eligible.[30] But *even if* we assume that Buyer only sold

> A VDA scenario arises frequently in the post-M&A context: Buyer purchases Seller's business, through merger, stock purchase, or asset purchase, either ignorant or aware of the Seller's complete historical failure to file various tax returns in various states.

If Buyer purchased Seller's assets, Buyer might be inclined to focus on itself as the VDA applicant, not Seller as the historical scofflaw – after all, Buyer did not purchase a controlling interest in Seller.

But applying for VDAs in Buyer's name (even in the name of "Buyer as successor") could be disastrous. Many states limit VDA eligibility to unregistered taxpayers, or at least to taxpayers who are not registered for the particular tax type(s) being disclosed.[28] So in attempting a VDA in its own name in one of these states, Buyer would alert the would-be VDA state to audit Buyer, for taxes for which Buyer would be automatically liable as a successor, and as to which Buyer would have no recourse other than (hopefully strong and solvent) contractual protection against Seller. So Buyer would instead need to use *Seller's* name for the VDAs.[29]

So this time, assume the same facts, but make them more realistic: in this scenario, it has taken Buyer a year to fully implement the transition of the purchased business to Buyer, and to develop a state-by-state exposure analysis and approach

to customers in states in which registered companies *are* VDA-eligible, should the VDA take the form of a "joint" VDA application, to address Seller's pre-closing liabilities, and Buyer's post-closing liabilities?

The answer in this situation is "ideally, yes." But this can be difficult to accomplish.

Some might try to file a single VDA application mentioning both companies, perhaps naming Buyer as "f/k/a [Seller]" or "as successor to [Seller]." This can work in some states, but in many it cannot, and for varying reasons.

New York, for example, does not allow joint applications. In fact, the mere mention of a second company has often forced the VDA discussions into a mandatory "separate application" status, resulting in no action for either company until separate VDA applications are filed. Filing separate applications makes it difficult for Buyer to limit its own factual disclosures to the business at issue (Seller's business). Worse, states requiring separate applications often have (or claim to have) difficulty matching up the two named applicants at the back end of

the process, when the agreement is to be signed, the apparent theory/logistical issue being that once "two files" are opened, they have to be separately closed.

In states that do not automatically force VDA prospects into a separate application status at the mere mention of another company, an alternative approach is to introduce the successorship *idea* in the VDA application narrative but save any actual mention of the second company until the end, at VDA signature time. Alternatively, one might attempt to expand the "forgiveness" provision to include the second company as a third-party beneficiary. In either case, the VDA officer may be a bit more flexible at the contract execution stage.

The most difficult situations seem to arise in the growing number of jurisdictions which have attempted to "fully integrate and automate" their VDA programs through online software. The District of Columbia's VDA system is a particularly inflexible example. One of the many noted drawbacks to such a system is that there cannot be the slightest variation between the name of the (lone) VDA applicant on the one hand, and the name of the ultimate taxpayer/signatory to the VDA on the other. In jurisdictions like this, VDA personnel often say (and act) as if they have no administrative discretionary authority whatsoever. This can be particularly frustrating if the VDA is all but completed when these complications arise.[31]

So Secret #5 shows that care must be taken not only deciding whether to step forward at all, but also which foot one should lead with.

SECRET #6: MIND YOUR STEPS EVEN AFTER THE VDA IS SIGNED

This warning applies in various contexts, the most obvious being the ongoing, post-VDA importance of consistency with the positions taken in the VDA submission. But there are more subtle dangers, and the devil is in the details in the latter parts of the dance.

To illustrate, reconsider our example of Buyer, who is VDA-ineligible in a given state because it is already registered for that tax in the VDA state. Assume that to this point, the business has successfully side-stepped the "who's the real taxpayer" trap discussed in Secret #5: Buyer's tax professional applied for, and entered into, the VDA in Seller's name. The state remains unaware of Buyer's identity or its interest in the VDA outcome, which is important, because Buyer has been selling under its own name during the post-closing transition year, and has decided that it is infeasible or too inconvenient to deal with those tax liabilities. In other words, Buyer has made a business decision to run the risk, and not come forward with a VDA in its own name.

The VDA (in Seller's name) has been negotiated and signed, and it is now time for the business to prove out the base tax liabilities that were claimed as owing for the lookback period. Typically, this involves filing actual returns for income tax VDAs, and monthly spreadsheets (in lieu of actual returns) for sales tax VDAs.[32] The Buyer's tax team has been working on the transaction/return detail, and so they prepare sales tax liability spreadsheets for submission. Unfortunately, the provided spreadsheets contain Buyer's name or other identifying information. While Seller is protected under the signed VDA, Buyer is not (and could not be, under the state's eligibility policy). The state can audit Buyer at any time, and it now has a breadcrumb trail leading straight to Buyer.

Alternatively, assume that Buyer remained unidentified all the way until the eve of the final VDA moment, settlement payment time. The tax liabilities have been finalized, and the company has received its (typically back-billed)[33] final interest calculations. The tax professional now steps back, since it is check-writing time, and the client (Buyer, having bought Seller's business) now steps into the circle. Buyer's CFO asks a few logistical questions of the state, but the email signature indicates his or her status as an officer of Buyer (not Seller). Or the settlement payment is made with a check that is drawn on a bank account bearing Buyer's (not Seller's) name. Either scenario yields the same result – potential Buyer audit risk.[34]

It is therefore very important to keep Secret #6 in mind, so a business can minimize the risk of a last-minute foot fault.

CONCLUSION

Having "turned states' evidence" on the states' various VDA programs, we hope that disclosing these secrets to the business community will debunk the myth that VDAs are a "ready-to-wear" option for all noncompliance situations. VDAs should always be considered, but they have their time, place, and manner: whether, and how, to implement the VDA process can heavily influence the outcome, and there are various possible outcomes.

With this inside information in mind, companies should be better-equipped to assess their historical tax noncompliance, to evaluate state VDAs as a remediation option, and to optimize their ultimate tax compliance business decisions and net implementation costs. A business no longer need merely *suppose* how to approach known tax noncompliance: a more informed decision can now be made whether to stay in the periphery, continuing the circle dance, or whether (and if so, how) to come forward and confront the tax agencies, secrets and all.[35]

End Notes

1 The details of the states' VDA programs vary significantly from state to state, and present a complex matrix of considerations. These legal and practical details are vitally important to the business decision whether, and if so, how, to disclose to a given state. Some of these factors are well-known, and much commentary has been written about them. This article attempts to reveal and discuss some of the lesser-known considerations.

2 Local taxes are beyond the scope of this article. VDA programs may or may not formally exist for many local taxes. In certain states in which they do exist, local VDAs are either highly advisable or mandatory, particularly when sales taxes are owed to "home rule" localities. This can be particularly true for Alaska (yes, Alaska has *local* sales taxes), and for Arizona, Colorado, and Louisiana, in which local taxes are often administered quite differently than their state counterparts. Chicago, New York City, and Philadelphia are also localities of frequent concern.

3 *South Dakota v. Wayfair Inc.*, 585 U.S. 162, 138 S. Ct. 2080 (2018). *Wayfair* overturned 50 years of constitutional jurisprudence, ruling that an out-of-state vendor could be

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constitutionally compelled to collect and remit sales tax to a state based merely upon the business' in-state sales, and without any in-state "physical presence." After *Wayfair*, a business can have sales tax collection and remittance obligations in every state in which its sales exceed the relevant (state-specific) gross receipts thresholds.

[4] Hawaii presents a particularly onerous counter-example. Hawaii requires VDA participants to disclose "all applicable Hawaii taxes and an estimate of the amounts owed for these tax types for all outstanding periods." Worse, Hawaii's presumptive "lookback period" – the period before which, the taxpayer's disclosed taxes are "forgiven" – is a draconian *10 years*. Tax Info. Release No. 2020-03, Hawaii Dept. of Taxation (8/3/2020).

[5] West Virginia provides this type of warning in its VDA publication, noting that a VDA participant will have to "[a]gree to disclose all applicable taxes administered by the West Virginia Tax Division." TSD 412, "Voluntary Disclosure Agreements," West Virginia Tax Div. (revised July 2024). Idaho's VDA application template asks that applications for a sales tax or income tax VDA (but not both taxes) explain why the other tax is not included. "Form VDA Voluntary Disclosure Agreement Application," Q13, Idaho State Tax Comm'n., *https://tax.idaho.gov/wp-content/uploads/forms/EFO00308/EFO00308_08-14-2020.pdf* (9/27/2024).

[6] For example, the Georgia Department of Revenue's VDA has historically required that the taxpayer remain "current" for "all tax types." (Note that most states do not publish their VDA templates.) Some states make the issue more difficult in a different way, with balkanized administration, such that separate applications must be made to separate divisions for each proposed disclosure tax. Ohio is a good example. "CAT 2008-01 - Commercial Activity Tax: Voluntary Disclosure Agreements," Ohio Dept. of Revenue (Revised Sept. 2010); "Voluntary Disclosure Program - Sales/Use," Ohio Dept. of Revenue, *https://tax.ohio.gov/business/resources/voluntary-disclosure-sales-use* (9/23/2024).

[7] Washington is a rare example of a state which publishes its form VDA online. That VDA provides that the taxpayer must "endeavor in good faith to comply with all provisions of the Revised Code of Washington (RCW)." Section 3, Washington Dept. of Revenue VDA (template), found at *https://dor.wa.gov/sites/default/files/2022-02/VDAAgreementFINAL.pdf* (9/20/2024). The "negotiability" of a VDA varies from state to state and, in the author's experience, from situation to situation; nevertheless, legal compliance covenants are seldom negotiable.

[8] See New Hampshire Admin. Code Sec. Rev 2910.07(b)(4) (prohibiting offsets for pre-lookback period losses for "business profits tax" VDA purposes).

[9] The Interstate Income Act of 1959, P.L. 86-272, 15 U.S.C. sections 381-384, or "86-272," for shorthand.

[10] As a practical matter, Washington's "B&O" tax is administered as part-and-parcel with the sales tax, so it is difficult to overlook or dismiss it in the context of sales tax compliance; however, the same cannot be said of these other states' "income-type" taxes.

[11] For example, Arkansas, Indiana, and Utah condition state not-for-profit income tax treatment in this manner. Arkansas Reg. 1.26-51-303; Info. Bulletin #17, Indiana Dept. of Revenue (7/1/2022); Utah Rule R865-6F-18.B.

[12] For these purposes, assume (as is often the case) that there are timing, anonymity, or other practical considerations that would prevent the company from seeking a definitive tax ruling.

[13] States vary in the customary speed with which they resolve VDAs. Factual complications aside, a VDA can take a month or two on the speedy end of the spectrum, or in extreme cases the process can take almost a year.

[14] As one example, the Multistate Tax Commission (MTC) promotes its voluntary disclosure process as a one-stop-shopping VDA option for dealing with multiple states simultaneously, in a short-form manner. It is the author's opinion that, while there can be situations in which the MTC route can make the most sense, that process is less flexible than many businesses would need in order to appropriately minimize the settlement payments to the states. For more about the MTC program, see *https://www.mtc.gov/nexus/multistate-voluntary-disclosure-program/*.

[15] These "advocacy-lite" VDAs may, for example, argue for/offer up a lookback period that does not commence until the publication date of a particular bit of adverse state tax authority, the theory being that the company had no realistic notice that its offerings should/could be taxable prior to that publication date. There are countless variations on this "middle-road" theme, and many states will accept such offers if they are carefully and properly framed.

[16] VDAs routinely reserve the state's right to audit the taxpayer. See, e.g., "Voluntary Disclosure – Continuation of Agreement," Connecticut Dept. of Revenue Services, *https://portal.ct.gov/drs/voluntary-disclosure/voluntary-disclosure-program#continuation* (9/23/2024); "Voluntary Disclosure Program," Missouri Dept. of Revenue, *https://dor.mo.gov/taxation/business/voluntary-disclosure-program/* (9/23/2024). While such a VDA technically may not have the same legal force and effect of a letter ruling, this issue rarely if ever arises, on audit or otherwise. In practice, state tax agencies should have difficulty arguing that they can retain the benefits of the VDA bargain they struck, but renege on the tax methodology proposed by the taxpayer as the basis of that bargain. The only consistent limit to this is the requirement that all material facts be disclosed.

[17] A few states – anecdotally, these are states for which VDAs are seldom concluded – require VDAs to be submitted on a "named taxpayer" basis. Illinois and Nevada generally fall into this camp. "Voluntary Disclosure Program," Illinois Dept. of Revenue, *https://tax.illinois.gov/programs/voluntarydislosure.html* (9/20/2024); Nevada Admin. Code Sec. 360.440. California affords anonymity only to out-of-state VDA applicants, and even then, only for purposes of determining whether they might be *eligible* for the VDA program (the VDA process itself must proceed on a taxpayer-disclosed basis). "Out-of-State Voluntary Disclosure Program," California Dept. of Tax and Fee Administration, *https://www.cdtfa.ca.gov/taxes-and-fees/out-of-state.htm* (9/20/2024). Washington only permits taxpayers anonymity for the first 15 days of the VDA process. "Voluntary Disclosure Program," Washington Dept. of Revenue, *https://dor.wa.gov/open-business/apply-business-license/voluntary-disclosure-program#benefits* (9/20/2024). New Mexico requires a "managed audit," which also requires disclosure of taxpayer identity from the outset. FYI 404, New Mexico Revenue and Taxation Dept. (Revised May 2021). Although doable, the District of Columbia's automated online VDA system can make an anonymous VDA very difficult. Note that the identity of the "true" taxpayer is also key to understanding Secret #5, discussed further below.

[18] Unless those services were "entirely ancillary" to protected solicitation, or were "*de minimis*"; these issues and 86-272 compliance generally are beyond the scope of this article. See footnote 9 and accompanying text. Note that just because a business is not asserting 86-272 immunity (e.g., because it views itself as a services business) does not mean that its self-description in the VDA is a simple matter. For example, exemptions from Hawaii's general excise (dual-layer sales) tax may depend upon whether the company styles itself as a "[regular] services" or "[services] retailer" business. As another example, in many states, such as Georgia and North Carolina, the business' future entitlement to various exemptions and tax incentives may be impacted by the NAICS (industry) code(s) claimed by the company.

[19] Obviously, this would likely have state payroll tax consequences, as well as sales/income tax nexus consequences.

[20] In many states, this right is reserved by statute and/or regulation. See, e.g., Iowa Admin. Code Sec. I.A.C. 701-3.1(7)d; Nevada Admin. Code Sec. 360.448. Wyoming is an extreme outlier, permitting the right to audit to be waived in the VDA, but only after heightened agency review and approval. Wyoming Stat. Sec. 39-15-107.2.

[21] See, e.g., "Violation of the Agreement" discussion in "Application for Voluntary Disclosure," California Franchise Tax Board, *https://eformrs.com/Forms09/States09/CA/CA4925R.pdf* (9/20/2024).

[22] Although there are outlier VDA states, most states have a presumptive VDA lookback period of 36 or 48 months for sales taxes. See, e.g., "Guide to Colorado's Voluntary Disclosure Program," Colorado Dept. of Revenue *https://tax.colorado.gov/sites/tax/files/documents/Guide_to_Colorado_Voluntary_Disclosure_Program 06-2021.pdf* (9/20/2024) (three years); Florida Stat. Sec. 213.21(7)

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(a) (three years); "The Comptroller of Maryland's Voluntary Disclosure Agreement Program," Maryland Comptroller, *https://www.marylandtaxes.gov/business/docs/VDA-Program.pdf* (9/20/2024) (four years); Michigan Laws Sec. 205.30c(15)(a)(1) (four years); "Voluntary Disclosure for Businesses," Virginia Dept. of Taxation, *https://www.tax.virginia.gov/voluntary-disclosure-businesses* (9/20/2024) (three years).

[23] While materiality is often debatable, nexus-creating events are usually critical to a VDA determination, and generally are nothing to be "danced around." For example, many states' VDA programs *require* disclosure of in-state employees. See, e.g., "Guideline – Voluntary Disclosure Program," North Dakota Office of State Tax Comm'r, *https://www.tax.nd.gov/sites/www/files/documents/guidelines/individual/voluntary-disclosure-program-guideline.pdf* (9/27/2024); "Businesses – Sales and Use Tax - Sales & Use Tax Voluntary Disclosure Program," South Dakota Dept. of Revenue, *https://dor.sd.gov/businesses/taxes/sales-use-tax/#voluntary* (9/27/2024).

[24] Contrary to persistent popular belief, which is presumably based upon general *federal* income tax principles, an asset purchaser *can* automatically inherit historical *state* tax liabilities from the seller. Compare Internal Revenue Code Section 6901 with, e.g., South Carolina Code Sec. 12-54-124. This is in fact a nearly universal state tax rule.

[25] See, e.g., Kentucky Revised Stat. Sec. 141.210(2)(a)2.; Louisiana Revised Stat. Sec. 47:1580(C)(1); North Carolina Gen. Stat. Sec. 105-248(b)(2); Minnesota Stat. Sec. 289A.38, Subd. (5); 68 Oklahoma Stat. Sec. 223(E).

[26] The critical need for careful diligence, and for negotiating various contractual protections and remedies (including VDA covenants), cannot be overstated; however, these topics are beyond the scope of this article. The (highly-debated) use of "tax clearance certificates" and "bulk sale" notifications are also well beyond the scope.

[27] Another dangerously persistent misconception is that successor liability cannot apply to state *income* taxes, or that, even if income tax liabilities *were* inheritable, this result would not apply in the case of businesses purchased as pass-through entities. Both thoughts go too far. Many – and perhaps most – states have multiple laws imposing successor liability, some of which do so for *any* tax administered by their main tax agency, or for income taxes specifically. See, e.g., 35 Illinois Stat. Sec. 5/902; Massachusetts Gen. Laws Ch. 62C, Sec. 5172; Pennsylvania Stat. Sec. 1403. Some states also impose *mandatory*, direct taxes upon so-called "pass-through entities" (PTEs), in addition to the recent proliferation of *elective* PTE taxes. And almost all states that *do not* impose mandatory entity-level PTE taxes instead require a different type of entity-level taxation, in the form of withholding at the source on a non-resident owner's share of entity income. So by hook or crook, income tax liabilities are often quite contagious.

[28] Washington will apparently reject, as VDA-ineligible, any company that was *ever* registered, *at any time*, for *any* state tax; in fact, it has been motivated enough to litigate the issue. See Washington Appeals Div., Det. No. 14-0397, 34 WTD 332 (2015). But New Jersey allows VDAs as long as the taxpayer is not registered for the *particular tax being disclosed* (if registered for *that* tax, the taxpayer must pursue a different "closing agreement" process). "Voluntary Disclosure Program," New Jersey Div. of Taxation, *https://www.nj.gov/treasury/taxation/voldisc.shtml* (9/20/2024). As always, there are other variations: *Unofficially*, Arizona has historically allowed taxpayers registered for a given tax type to negotiate a VDA for that particular tax, but only on a taxpayer-named (non-anonymous) basis. Compare, "Voluntary Disclosure and Compliance Program," Arizona Dept. of Revenue, *https://azdor.gov/business/voluntary-disclosure-and-compliance-program* (9/23/2024) (certain eligibility limitations apply ". . . if the agreement period will overlap with the audit period"). Alabama and Mississippi will reject a VDA with a company if they learn that it is already *qualified to do business* (i.e., obtained a certificate of authority from its Secretary of State). "Voluntary Disclosure Program," Alabama Dept. of Revenue, *https://www.revenue.alabama.gov/tax-policy/voluntary-disclosure-program/* (9/20/2024); "Voluntary Disclosure Agreement (VDA) Program," Mississippi Dept. of Revenue, *https://www.dor.ms.gov/sites/default/files/Business/Voluntary%20Disclosure%20(1).pdf* (9/20/2024). South Carolina will not enter into a VDA with a South Carolina-headquartered company. "Nexus in South Carolina – Voluntary Disclosure," South Carolina Dept. of Revenue, *https://dor.sc.gov/about/voluntary-disclosure* (9/20/2024). In complete contrast, Texas permits VDAs regardless of *any* taxpayer registration. "Voluntary Disclosure Program," Texas Comptroller, *https://comptroller.texas.gov/taxes/publications/96-576.php* (9/20/2024).

[29] However, in order for Buyer to force VDAs for pre-closing taxes in *Seller's* name, ordinarily Buyer would have presumably needed to have negotiated purchase agreement tax covenants granting that right to Buyer.

[30] The situation would be even more difficult if Buyer had purchased the stock of Seller. In that situation, any tax collections would *have* to be remitted in the name of Seller, which has never registered, collected, or remitted in the past. The moment Seller (under Buyer's new tax compliance approach) registered, the tax authorities would be alerted to a "new" taxpayer suddenly remitting sizeable amounts of tax, which would likely raise audit suspicion. And wait: there's more. As mentioned in footnotes 5-7 and accompanying text, some states' VDAs require the company to enter into an ongoing compliance covenant. How does this work for Seller, whose business is now concluded? If a caveat such as "as required under law by the circumstance" cannot be negotiated, to qualify the ongoing tax remittance promise, this issue can be a potentially troublesome one.

[31] On the other hand, even submitting the VDA in the first place can be frustrating in some states. New York's online application system has a "character count" limit. Factually complicated submissions may have to be winnowed several times before they satisfy the software's limited character count – which for some reason can register as dramatically more than Microsoft Word's character count for the same content.

[32] See, e.g., "Information Guide – Voluntary Disclosure," Nebraska Dept. of Revenue (April 2024); "CAT 2008-01 - Commercial Activity Tax: Voluntary Disclosure Agreements," Ohio Dept. of Revenue (Revised Sept. 2010); "Voluntary Disclosure Program - Sales/Use," Ohio Dept. of Revenue, *https://tax.ohio.gov/business/resources/voluntary-disclosure-sales-use* (9/23/2024); "Voluntary Disclosures - 2 – Filing Information," Tennessee Dept. of Revenue, *https://revenue.support.tn.gov/hc/en-us/articles/360057987132-Voluntary-Disclosures-2-Filing-Information* (9/23/2024). However, Wisconsin's published policy is that returns are required for any type of VDA. "Voluntary Disclosure," Qs 6-9, Wisconsin Dept. of Revenue, *https://www.revenue.wi.gov/Pages/FAQS/ise-disclose.aspx* (9/23/2024). Note that a few states – notably Hawaii, Idaho, Iowa, New York, and Utah – may require information regarding sales that predate the "lookback period" by many years, even though those pre-lookback period sales are not included in the settlement payment calculation. This can be unnerving, but is part of the deal.

[33] Most states do not worry with finalized interest calculations until after the VDA is signed. Kansas' procedure is typical, in providing for the "back-billing" of interest. "Voluntary Disclosure – Executing the Agreement," Kansas Dept. of Revenue, *https://www.ksrevenue.gov/voluntary.html* (9/23/2024).

[34] Consider another variation, this time without any business having been purchased (no Buyer, no Seller, just a lone company in need of a VDA). The company has successfully concluded a VDA with a state in which it never held a tax registration. Now it has to register in order to comply with the ongoing terms of the VDA. As much care should be taken in correctly (and strategically) answering the registration questions – which are often *very* detailed – as should be taken in the VDA process itself. For example, as previously stated, in many states, the business' future entitlement to various exemptions and tax incentives may be impacted by the NAICS (industry) code(s) claimed by the business – in this case in the registration application. And what does the long-noncompliant, newly-registering business say in response to the standard registration question "when did business commence in the state"? In the absence of specific instruction from the state's VDA officer (who will *usually* direct that the VDA lookback period inception date be used), the safest answer is often to reference the company's VDA reference number – if the registration form/software will permit it. The same issue can arise in the context of an application for a certificate of authority, as part of a qualification registration with the state corporate regulatory agency (e.g., Secretary of State). Note that many

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states' *tax* registration systems in fact require such a qualification registration, even though it is quite common for a business to not have to qualify, legally speaking. For example, merely generating receipts from interstate transactions is not enough to require the vendor to qualify with the customer state's corporate regulatory agency, whereas this activity is quite commonly sufficient to trigger customer-state *tax* problems for the vendor. See, e.g., Delaware Code Tit. 8, Sec. 373(a)(4); Maine Revised Stat. T. 13-C, Sec. 1501(2)(K); Oregon Revised Stats. Sec. 60.701(2)(k); Rhode Island Gen. Laws Sec. 7-1.2-1401(b)(9); Vermont Stat. T. 11A, Sec. 1501(c)(12). These states' statutes, along with those of many others, have an interstate commerce safe harbor. New Jersey and New York are in the clear minority, with legal authority purporting to require qualification based on in-state customers alone, but this position is constitutionally questionable. See New Jersey Stat. Sec. 14A:13-15; *Maro Leather Co. v Aerolineas Argentinas* , 161 Misc. 2d 920, 617 NYS2d 617 (1994), *appeal dismissed* 85 NY2d 837, 624 NYS2d 365, *cert. denied* 514 US 1108; compare *Moyglare Stud Farm, Ltd. v. Due Process Stable, Inc*., 569 F. Supp. 1565 (S.D.N.Y. 1983). When qualification is legally inappropriate, but required as a practical matter, it is best to try to reference the safe harbor statute in the qualification filing. Montana's VDA process blithely highlights the issue: the application must include an explanation why the business was not already qualified with the Secretary of State (to which the applicant might cite the interstate commerce safe harbor), but then requires the applicant to register with the Secretary of State as a condition to the VDA. "Voluntary Disclosure Program," Montana Dept. of Revenue, *https://montana.servicenowservices.com/ citizen?id=kb_article_view&sysparm_article=KB0013225* (9/27/2024). For a dry chuckle, compare this to Alabama's and Mississippi's directly opposite stance on pre-VDA qualification with the Secretary of State, mentioned in note 28.

[35] Sincere but all-too-belated apologies to the late, great poet laureate Robert Frost, who undoubtedly would have objected to having his sublime words recited as an unsanctioned preface to a tax article. Although the intended symbolic scope of his poem *The Secret Sits* may still be debated, taxes were almost certainly not within it. It is commonly believed that Frost lamented that "Poetry is what gets lost in translation." Ironically, his actual words were "I like to say, guardedly, that I could define poetry this way: it is that which gets lost out of both prose and verse in translation."

Tax Advantaged Corporate Acquisition Structures

Robert Misey

Although asset sales are fraught with double taxation, share sales with either a Section 338(h)(10) election or a Section 336(e) election, when available, may be the best way to avoid double taxation while providing the buyer with a stepped-up basis in the assets to their fair market value.

Suppose Individual wants to sell his business that consists of depreciable assets in a C corporation. What form should the transaction take? Buyer's attorney will typically advise Buyer to buy the assets to obtain a stepped-up basis while avoiding any hidden liabilities. However, Individual's tax attorney may suggest a share sale to avoid the double tax regime of a C corporation.

In any transaction, there are three parties that have different tax motivations:

- Individual wants to pay the lowest amount of tax on the sale.
- Buyer wants to obtain the highest basis possible in the depreciable assets.
- Congress wants the IRS to collect the same amount of tax regardless of the form of the transaction.

Assume that Individual seller owns all the shares of Target. Individual has a basis of $20,000 in Target's shares that have a fair market value of $200,000. Target owns assets (cash, inventory, and equipment) with a basis of $120,000 that have a fair market value of $200,000. In essence, Individual's outside gain of $180,000 (the $200,000 fair market value of Target's shares less Individual's basis of $20,000 in those shares) is greater than the inside gain of $80,000 (the $200,000 fair market value of the assets less Target's $120,000 basis in those assets).

Buyer, which is a C corporation, and Individual tentatively agree that the business of Target has a fair market value of $200,000.

SALE OF ASSETS

A sale of assets usually results in a stepped-up basis, but with double taxation.

Asset sales can take one of two forms. The parties can structure an asset sale as either (1) Target's sale of the assets followed by Target liquidating to Individual, or (2) Target liquidating to Individual followed by Individual's sale of the assets. These first two examples show identical tax results — a stepped-up basis with double taxation — under either ordering.

> *Example 1: Target sells its assets to Buyer for $200,000 before Target liquidates by distributing the cash to Individual.* When selling the assets, Target will pay tax of $16,800 on its gain of $80,000 (the $200,000 sales proceeds less Target's $120,000 basis in its assets) at a 21% rate. After paying the tax of $16,800, Target will have $183,200 of cash remaining to distribute in liquidation to Individual. The liquidation[1] will result in Individual having a capital gain of $163,200 (the $183,200 of after-tax cash less her $20,000 basis in Target's shares) for Individual tax of $32,640 ($163,200 at 20%). The double tax total is $49,440 ($16,800 of corporate tax to Target plus $32,640 of capital gains tax to Individual). Buyer takes a stepped-up fair market value basis in the assets.

> *Example 2: Target liquidates by distributing all its assets to Individual before Individual sells the assets to Buyer for $200,000.* When liquidating, Target will pay tax on its gain of $80,000[2] (the $200,000 fair market value of the assets less Target's $120,000 basis in those assets), resulting in corporate tax of $16,800 ($80,000 at 21%). However, Target will have to use $16,800 of its cash to pay the corporate tax, leaving only $183,200 of assets to distribute in the liquidation to Individual. The liquidation results in Individual having a capital gain of $163,200 (the $183,200 of assets received less his $20,000 basis in Target's shares) for Individual tax of $32,640 ($163,200 at 20%). The double tax total is $49,440 ($16,800 of corporate tax to Target plus $32,640 of capital gains tax to Individual). Taking a fair market value basis in the assets, Individual sells the assets to Buyer tax-free. Buyer takes a stepped-up fair market value basis in the assets.

As aforementioned, both examples result in Individual bearing the same total tax of $49,440 due to the double tax regime for a C corporation. Although Individual will dislike the high amount of double tax, the IRS likes both asset sale examples resulting in double tax for the same amount. Buyer will enjoy a stepped-up basis of $200,000. Suppose, however, that Individual wants to avoid the double tax that comes from liquidating Target after Target's asset sale.

> *Example 3: Target sells its assets to Buyer for $200,000 and Target stays in existence.* On Target's sale, Target will have gain of $80,000 (the $200,000 of sales proceeds less Target's basis of $120,000 in its assets) and pays corporate tax at a 21% rate on that gain for $16,800. After paying the tax of $16,800, Target has $183,200 of cash remaining, which Target invests.

As in the first two asset sale examples, Example 3 has Buyer taking a basis stepped-up to the fair market value of the assets. Without the liquidation, Individual only incurs one level of tax to the IRS. Moreover, when Individual dies, Individual's heirs will receive a stepped-up basis[3] in Target's shares to their fair market value that could ultimately result in a tax-free liquidation.[4] However, the IRS may view Target with its investments as a personal holding company of Individual, resulting in Target paying a personal holding company tax on its undistributed income at a 20% rate.[5]

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In all three asset sale examples, Buyer pays $200,000 for the assets. The parties will have to allocate that $200,000 among the assets to determine both Buyer's basis in the assets and the characterization of any gain on the sale by Individual. Assuming that the assets are cash, inventory, and equipment, Buyer will want to allocate as much of the price as possible to the inventory to obtain a cost of goods sold deduction. On the other hand, Individual will want to allocate as much of the price as possible to the equipment, whose sale results in capital gain.[6]

Because of these competing interests, the IRS will respect an agreed upon allocation by Buyer and Individual, if it is reasonable. Buyer and Individual must use the residual method[7] to allocate the purchase price of the assets based on their fair market value, in the following order:

- Class 1: Cash and cash equivalents.
- Class 2: Liquid assets (primarily marketable securities).
- Class 3: Accounts receivable.
- Class 4: Inventory.
- Class 5: Equipment and other fixed assets.
- Class 6: Intangibles.
- Class 7: Goodwill or going concern value (the residual).

> *Example 4: Residual Method.* Target owns assets with the following fair market values: Cash: $20,000; Inventory: $25,000; Equipment: $150,000. Buyer buys the assets from Target for $200,000. Buyer's basis in and Target's sale price for each asset is its fair market value. The $20,000 of cash is a Class 1 asset, the $25,000 of inventory is a Class 4 asset, and the $150,000 of equipment is a Class 5 asset. Because the fair market value of these assets total only $195,000, the residual of $5,000 is the Class 7 asset of goodwill or going concern value.

SALE OF SHARES

A sale of shares results in a single tax, but without a stepped-up basis.

In addition to disposing of any potential liabilities, a sale of shares results in Individual incurring only a single level of tax (to the chagrin of the IRS), while Buyer acquires Target that retains the lower historical basis in its assets and any potential liabilities.

> *Example 5: Individual sells Target's shares to Buyer for $200,000.* On the sale of shares, Individual has $180,000 of gain (the $200,000 of sales proceeds less Individual's basis of $20,000 in the shares), resulting in only a single capital gains tax of $36,000 ($180,000 at 20%).

However, it is unlikely that Buyer will pay $200,000 for Target's shares. First, if Buyer pays $200,000 for Target's shares, the assets of Target will retain the same historical basis of $120,000. Second, if Buyer ever has its newly-acquired Target sell its assets, Buyer's Target will have to pay tax of $16,800 on the gain of $80,000 (the $200,000 fair market value in its assets less Target's $120,000 basis in its assets) at a 21% rate. Accordingly, Buyer and Individual will typically negotiate a price somewhere between $183,200 and $200,000 to account for the $16,800 of the potential future tax on the appreciation.

A sale of assets usually results in a stepped-up basis, but double taxation.

So although Individual may be pleased with the single level of tax, the IRS may be displeased that, unlike an asset sale, there may not be a second level of tax. More importantly, Buyer is displeased with Target's lower historical basis in the assets.[8]

SALE OF SHARES WITH SECTION 338(g) ELECTION

A sale of shares with a Section 338(g) election results in a stepped-up basis at the price of double tax.

A Section 338(g) election would give the purchased Target a stepped-up basis in its assets to their fair market value at the cost of a second level of tax to Individual. More specifically, in addition to the gain on the share sale, a Section 338(g) election by Buyer deems Target to have sold its assets at their fair market value, resulting in gain. Individual is responsible for tax on this additional gain (a second level of tax) while Buyer owns shares of Target, which has a stepped-up basis in its assets equal to their fair market value.[9] The total tax due is similar to an asset sale.

The rules for Buyer to elect Section 338(g) are as follows:

- A corporate Buyer must purchase 80% of Target's shares in 12 months or less.[10]
- Buyer (and only Buyer) elects to deem Target as having sold all its assets for their fair market value by the 15th day of the ninth month after the acquisition date (the date Buyer acquires at least 80% of Target's shares).[11]
- Target recognizes gain on the deemed sale of assets (for which Individual pays the tax – even though Buyer makes the election) and Buyer owns the shares of "new" Target that has a basis in its assets at their fair market value and none of "old" Target's tax attributes (*e.g.*, basis of assets, earnings and profits, net operating losses, etc.).[12]

> *Example 6: Individual sells Target's shares to Buyer for $200,000 and Buyer timely elects Section 338(g).* On the sale of shares, Individual has a capital gain of $180,000 (the $200,000 of sales proceeds less Individual's basis in Target's shares of $20,000), resulting in tax at a capital gains rate of 20% for $36,000. The Section 338(g) election deems Target (now, old Target) to have sold its assets with a basis of $120,000 to new Target for $200,000, resulting in gain of $80,000 and tax of $16,800 ($80,000 at 21%) that Individual pays. The double tax total of $52,800 is similar to (but a little higher than) the double tax total of $49,440 in the asset sales described in Examples 1 and 2.

Although Buyer will enjoy the higher basis that new Target takes in its assets and the IRS will like the amount of double tax similar to that of an asset sale, Individual will not enjoy the additional tax. Accordingly, a share sale agreement will typically prohibit Buyer from electing Section 338(g) without Individual's permission. When negotiating to purchase Target's shares, Buyer will not want to pay more to obtain Individual's permission for a Section 338(g) election. More specifically, because the time value of money theorizes that a dollar

today is worth more than a dollar tomorrow, Buyer will not pay more now for a stepped-up basis to later obtain greater depreciation deductions to reduce tax. Therefore, Section 338(g) elections are relatively rare.

CORPORATE SALE OF SHARES WITH SECTION 338(h)(10) ELECTION

A corporate sale of shares with a Section 338(h)(10) election incurs only one tax and steps-up the basis.

Advantageously, a Section 338(h)(10) election results in a corporate seller ("HoldCo") incurring only a single level of tax, which is similar to a share sale, while Buyer obtains Target's shares that have a fair market value in the assets, which is similar to an asset sale. Accordingly, to understand Section 338(h)(10) elections, this article must revisit asset sales.

A sale of shares results in a single tax, but without a stepped-up basis.

Recall how the total double tax from Individual's asset sale and a liquidation were the same in Examples 1 and 2, regardless of the order of the sale and the liquidation. If Target's owner were a C corporation, acting as a holding company, instead of an Individual, the order of the sale and the liquidation would be similarly tax neutral, but with only one level of tax because the cash stays in C corporation solution.

Suppose that HoldCo, a C corporation, has a basis of $20,000 in Target's shares that have a fair market value of $200,000. Target owns assets (cash, inventory, and equipment) with a basis of $120,000 and a fair market value of $200,000. HoldCo's outside gain of $180,000 (the $200,000 fair market value in Target's shares less HoldCo's basis in Target's shares of $20,000) exceeds Target's inside gain of $80,000 (the $200,000 fair market value in Target's assets less the $120,000 of Target's basis in its assets).

Corporate Buyer and HoldCo tentatively agree that Target's business is worth $200,000.

> *Example 7: Target sells its assets to Buyer for $200,000 before Target liquidates by distributing the cash to HoldCo.* Target sells the assets to Buyer for $200,000, resulting in gain of $80,000 (the $200,000 of sales proceeds less the $120,000 basis in its assets) that incurs tax at a 21% rate for $16,800. When liquidating, Target distributes the remaining after-tax cash of $183,200 to HoldCo tax-free.[13] Buyer takes a basis in the assets stepped-up to their fair market value of $200,000.

> *Example 8: Target liquidates by distributing its assets to HoldCo before HoldCo sells the assets to Buyer for $200,000.* Target's liquidation is tax-free,[14] resulting in HoldCo taking a carryover basis of $120,000 in the assets[15] that HoldCo subsequently sells to Buyer for $200,000. HoldCo incurs gain on the sale of $80,000 (the $200,000 of sales proceeds less its $120,000 basis in the assets) that incurs tax at a 21% rate for $16,800. HoldCo keeps $183,200 of cash and Buyer takes a basis in the assets stepped-up to their fair market value of $200,000.

In both of these asset sale examples, Buyer enjoys assets with a basis stepped-up to their fair market value and HoldCo enjoys only one level of tax. The policy behind only one level of tax (in contrast to the double tax in Examples 1 and 2) is that the cash remains in the C corporation solution. If HoldCo were to liquidate to its individual shareholders, they would incur a second level of tax.[16]

Suppose, however, that Target has an important contract that Target may not assign, rendering an asset sale impractical. Because Target must remain in corporate existence, the parties must conduct a share sale.

> *Example 9: HoldCo sells Target's shares to Buyer for $200,000.* HoldCo has gain of $180,000 (the $200,000 of sales proceeds less HoldCo's $20,000 basis in Target's shares) that incurs tax at a 21% rate for $37,800. Buyer acquires shares of Target that owns assets retaining their lower historical basis of only $120,000.

Although HoldCo is pleased with only one level of tax, because Buyer does not like the lower historical basis of $120,000 that its Target retains, Buyer (but not the selling HoldCo) may want to make a Section 338(g) election.

> *Example 10: HoldCo sells Target's shares to Buyer for $200,000 and Buyer elects Section 338(g).* HoldCo has gain of $180,000 (the sales proceeds of $200,000 less HoldCo's $20,000 basis in Target's shares) that incurs tax at a 21% rate for $37,800. In addition, pursuant to Buyer's election, Section 338(g) deems old Target to have sold its assets to new Target for an additional gain of $80,000 (the $200,000 fair market value of the assets less Target's $120,000 basis in its assets) for additional tax to Target (that HoldCo pays) of $16,800 ($80,000 at 21%). The double tax totals $54,600 ($37,800 to HoldCo plus $16,800 for the Section 338(g) election gain). Buyer owns the shares of new Target that owns assets having a $200,000 stepped-up basis to their fair market value.

Although Buyer likes the stepped-up basis and the IRS likes the second level of tax, HoldCo does not like the second level of tax. Accordingly, the same problems with the Section 338(g) election described in Example 6 (negotiations for the payment of the additional tax due and the time value of money) render a Section 338(g) election impractical in Example 7.

A sale of shares with a Section 338(g) election results in a stepped-up basis at the price of double tax.

Fortunately, a Section 338(h)(10) election advantageously provides a stepped-up basis to fair market value for the assets with only a single level of tax. A Section 338(h)(10) election is available for a share purchase when Buyer is a corporation and Target is part of a consolidated group, which our revised scenario satisfies. A Section 338(h)(10) election, jointly made by Buyer and HoldCo, ignores the outside gain on the share sale and taxes only the inside gain on the legal fiction of an asset sale while providing Buyer a stepped-up basis to the fair market value in Target's assets.

The rules for HoldCo and Buyer to jointly elect Section 338(h)(10) are as follows:

- In 12 months or less, a corporate Buyer must purchase 80% of the shares of a Target that is part of a consolidated group.[17]

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- Buyer and HoldCo jointly elect Section 338(h)(10) by the 15th day of the ninth month after the acquisition date (the date Buyer acquires at least 80% of Target's shares).[18]
- HoldCo ignores the gain on the sale of Target's shares as HoldCo pays tax only on the gain on a legal fiction of a sale of Target's assets.[19]

  Example 11: HoldCo sells Target's shares to corporate Buyer for $200,000 and corporate Buyer and HoldCo jointly elect Section 338(h)(10). HoldCo ignores its outside gain of $180,000 (the $200,000 of sales proceeds less the $20,000 of HoldCo's basis) on the sale of the shares. Instead, HoldCo has inside gain of only $80,000 on the legal fiction of an asset sale (the $200,000 of sales proceeds less Target's basis of $120,000 in the assets) for tax at a 21% rate of only $16,800. Corporate Buyer acquires Target, which has a basis in its assets stepped-up to their fair market value of $200,000.

Corporate Buyer is happy because new Target has a stepped-up basis in its assets to their fair market value and HoldCo is happy due to only one level of tax. The HoldCo tax of $16,800 is the same amount of tax that HoldCo pays in the asset sale/liquidation scenarios in Examples 7 and 8, but, of course, the cash is still in C corporation solution. If HoldCo were to liquidate to its individual shareholders, they would incur a second level of tax.[20]

A Section 338(h)(10) election is usually made when both parties are corporations and the outside gain exceeds the inside gain (as in Example 11).[21]

SECTION 336(e) ELECTION

A Section 336(e) election provides benefits similar to a Section 338(h)(10) election.

A Section 336(e) election provides benefits similar to a Section 338(h)(10) election as it ignores the outside gain and taxes only the inside gain, while providing Buyer a stepped-up basis in the assets of Target. In fact, the parties could have received the *same* results in Example 11 by electing Section 336(e) instead of Section 338(h)(10). More specifically, a Section 336(e) election permits a corporate seller to pay tax only on Target's inside gain as long as 80% of the shares are sold, distributed, or exchanged to an unrelated party[22] during a 12-month period.[23] Jointly elected by HoldCo and Target (but not Buyer),[24] Section 336(e) provides for HoldCo to pay the tax on Target's fictitious asset sale while ignoring the gain on the share sale. As with a Section 338(h)(10) election, only a single level of tax results because the sales proceeds remain in C corporation solution.

> A corporate sale of shares with a Section 338(h)(10) election incurs only one tax and steps-up the basis.

A Section 336(e) election is more available than a Section 338(h)(10) election because a Section 336(e) election does *not* require Buyer to be a corporation.[25]

Suppose again that HoldCo, a C corporation has a basis of $20,000 in Target's shares that have a fair market value of $200,000. Target owns assets (cash, inventory, and equipment) with a basis of $120,000 and a fair market value of $200,000. HoldCo's outside gain of $180,000 (the $200,000 fair market value in Target's shares less the $20,000 of HoldCo's basis in Target's shares) exceeds Target's inside gain of $80,000 (the $200,000 of fair market value in Target's assets less Target's $120,000 basis in those assets).

Buyer (now, an individual) and HoldCo tentatively agree that Target's business is worth $200,000.

Example 12: HoldCo sells Target's shares to Buyer (an individual) for $200,000 and HoldCo and Target timely elect Section 336(e). HoldCo ignores its gain of $180,000 (the $200,000 of sales proceeds less the $20,000 basis) on the share sale. Instead, HoldCo recognizes gain on the legal fiction of an asset sale of only $80,000 (the $200,000 of sales proceeds less Target's basis of $120,000 in its assets) for tax at a 21% rate of only $16,800. Buyer acquires the shares of Target, which now has a basis in its assets stepped-up to their $200,000 fair market value.

Buyer is happy because Target has a stepped-up basis in its assets equal to their fair market value and HoldCo is happy due to only one level of tax as the cash remains in C corporation solution.

CONCLUSION

Congress has created a patchwork of rules with respect to share sales vis-à-vis asset sales. However, the key to understanding the various sales is the motivation of each party:

- Seller wants to pay the least amount of tax (preferably only a single level of tax).
- Buyer wants a stepped-up basis in the assets to their fair market value.
- Congress wants the IRS to collect the same amount of tax regardless of the form of the transaction.

Although asset sales are fraught with double taxation, share sales with either a Section 338(h)(10) election or a Section 336(e) election, when available, may be the best way to avoid double taxation while providing Buyer with a stepped-up basis in the assets to their fair market value.

End Notes

1 Code Section 331.

2 Code Section 336(a).

3 Code Section 1014(a).

4 Individual would not have any gain because Individual's basis would equal the fair market value of the shares. Some Section 336(a) gain to Target may result if the fair market value of the investments exceeds their basis of $183,200.

5 Code Section 541.

6 Code Section 1231.

7 Code Section 1060.

8 If the assets have a basis lower than their fair market value, Buyer would prefer to purchase assets.

9 In all these share sale examples, Buyer is currently buying 100% of the shares. However, much more complex examples result from the purchase of less than 100% of the shares, particularly if Buyer previously owned some of the shares of Target.

10 Code Section 338(d)(1) and (3).

11 Code Section 338(g)(1).

12 Code Section 338(a).

13 Code Section 332.

14 Code Sections 332 and 337.

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[15] Code Section 334(b).

[16] Code Section 331.

[17] Code Section 338(d)(1); Treas. Reg. 1.338 (h)(10)-1(c)(1). Target may also be an S corporation. Treas. Reg. 1.338(h)(10)-1(b)(4).

[18] Code Section 338(g)(1); Treas. Reg. 1.338 (h)(10)- 1(c)(2).

[19] Code Section 338(h)(10)(A)(ii); Treas. Reg. 1.338 (h)(10)-1(d).

[20] Code Section 331.

[21] The corporate parties would not elect Section 338(h)(10) when the inside gain exceeds the outside gain.

[22] A related party is a party that owns 50% of HoldCo's shares. Code Section 338(h)(3)(C).

[23] Treas. Reg. 1.336-2(b).

[24] Treas. Reg. 1.336-2(h).

[25] Target may also be an S corporation. Treas. Reg. 1.336-1(b)(3). In addition to applying to sales by HoldCo to Buyer (an individual), a Section 336(e) election can apply to a distribution of shares. So if HoldCo distributes shares of Target to HoldCo's unrelated individual shareholders (shareholders who collectively own at least 80%, but no individual shareholder owns 50%), the Section 311(b) gain on the distribution would be the inside gain on the assets instead of the outside gain on the shares.

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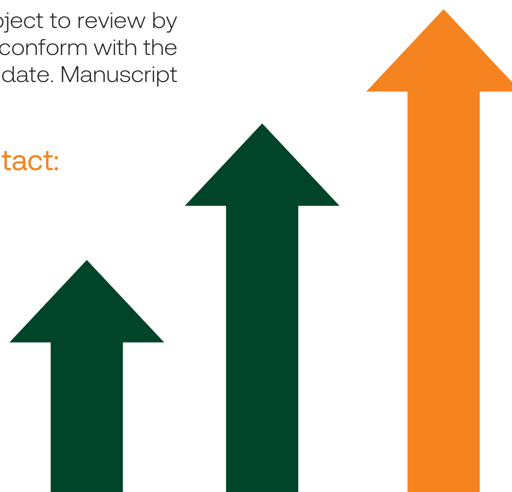

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Employee Retention Credit Refund Suits: Why Taxpayers Are Bringing Tax Refund Suits to Expedite Unprocessed Refund Claims

Mark A. Loyd, Gregory Rhodes, and Helen V. Cooper

This article discusses how to evaluate whether to bring a refund suit for Employee Retention Credit claims.

Originally introduced in 2020 to encourage employers to retain employees during the pandemic, the Employee Retention Credit (ERC) has become a flashpoint federal tax controversy issue. Lately, some taxpayers have begun to take a more active approach to try to expedite the processing of long-awaited ERC refund claims.

Even after the COVID-19 pandemic ended, ERC refund claims made on amended payroll tax returns continued to be filed. The continued filings resulted in a processing backlog at the IRS. In part to address the backlog, but also out of concern about potentially frivolous claims, the IRS introduced a moratorium on processing new claims after September 14, 2023.[1] The moratorium was not lifted until August 8, 2024, and then, only for claims filed before January 31, 2024.[2] Many employers who claimed ERC refunds have still not received the funds. For these taxpayers, there are several options available.

First, the most proactive approach is to file a refund suit in U.S. District Court or the Court of Federal Claims. A refund suit has the advantage of pushing the IRS to engage with employers who claimed the credit. In response to litigation, the IRS would have to address the claim on the merits.

Alternatively, taxpayers waiting on refunds can request assistance from their representative in Congress or from the Taxpayer Advocate Service. This approach is less aggressive, and neither could actually process claims.

Some taxpayers may decide to keep waiting until the IRS processes their claim. The problem with this approach is that while the IRS has ramped up ERC refund claim processing, there is no statutory obligation to process claims quickly. ERC refund claims filed after January 31, 2024 are still not being processed. So, taxpayers playing the waiting game may be in limbo for a long time.

SOME ERC CLAIMS ARE ESPECIALLY IDEAL FOR A TAX REFUND SUIT

The ERC has some facets that make bringing a refund suit ideal in certain circumstances.

The ERC has some facets that make bringing a refund suit ideal in certain circumstances.

First, the taxpayers most in need of ERC refunds are sympathetic. The majority are small or mid-sized businesses. These are employers who did the right thing during the pandemic. They kept their employees on the payroll and faced incredible odds to stay in business. These are the people that Congress was trying to help when the ERC was implemented. The IRS has engaged in a widespread public relations campaign to paint the ERC as rife with fraud, but these allegations have largely not been supported. Instead, the employers that are bringing refund suits now appear to have legitimately claimed the credit.

Second, guidance surrounding how the ERC should be administered is unclear. Congress passed the ERC through waves of legislation. The actual codification of the credit, Section 3134 of the Internal Revenue Code of 1986, as amended (the "Code"), is basic, and the IRS has not promulgated any regulations interpreting eligibility requirements. Instead, most of the guidance surrounding ERC eligibility is contained in frequently asked questions on the IRS website, Chief Counsel Memoranda, and Notice 2021-20. The most comprehensive guidance received to date regarding ERC eligibility is contained in Notice 2021-20.[3]

Since it has not undergone a notice and comment period as required by the Administrative Procedure Act (APA), 5 USC § 553, to be considered a legislative rule, taxpayers can be anticipated to argue that Notice 2021-20 is interpretive and thus lacking the force and effect of law. Under the APA, it "remains the responsibility of the court to decide whether the law means what the agency says," and a court will only be required to give effect to Notice 2021-20 to the extent that the guidance is persuasive in its interpretation of the law.[4]

Many of the alleged requirements contained in Notice 2021-20 are not found in the codification of the ERC in Code Section 3134. It is an open question whether this guidance will be persuasive to a court. This means that some taxpayers who will receive a denial, or no response from the IRS, may have stronger cases than the IRS has acknowledged.

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TAX REFUND SUIT CONSIDERATIONS

Refund suits cannot be initiated until at least six months have passed from the date of filing the claim for refund unless the IRS renders a decision on the claim within that time. And the suit must be brought before two years have passed after a disallowance has been mailed by the IRS.[5]

and still not receive their refund claim. Alternatively, a refund suit may be successful but have high upfront costs.

As an alternative, taxpayers who have not received a letter of disallowance and no longer believe in the strength of their refund claims can also evaluate whether participation in the IRS's claim withdrawal process is a better option.

Taxpayers considering whether to file a tax refund suit should carefully review the claim, starting with documentation supporting eligibility for the credit and the calculation of the amount of the refund.

Unlike a Tax Court petition, the taxpayer must have actually paid the tax to file a refund suit in U.S. District Court or in the Court of Federal Claims. This requirement is generally met by ERC refund claims because the employment taxes have been paid in 2020 or 2021, and the taxpayer is requesting a refund on an amended Form 941X.

The next consideration for the refund suit is where to file. If bringing the case in U.S. District Court, then the taxpayer can file suit in the federal district in which it has its primary place of business.[6] Otherwise, if filing in the Court of Federal Claims, then venue is always Washington, DC, although trials may be held all over the country.[7]

In choosing a forum, it is important to consider jurisdictional requirements. For example, the Court of Federal Claims does not have jurisdiction over constitutional claims where there is no money-mandating provision, because it does not have equity jurisdiction in a tax refund suit. Likewise, the Court of Federal Claims lacks jurisdiction to review an agency's decision under the APA.[8] So, if the employer plans to challenge Notice 2021-20 using constitutional, equity-based arguments or the APA, then the Court of Federal Claims may not be the best forum.

RISKS ASSOCIATED WITH REFUND SUITS

Bringing a refund suit does have some risk. For example, the suit may not be successful. In which case, the taxpayer will be out of pocket for litigation costs

The IRS provides procedures for withdrawing the claim on its website.[9] There is also a second Voluntary Disclosure Program available for taxpayers who have received funds from the IRS related to potentially erroneous refund claims.

EVALUATING WHETHER TO FILE AN ERC REFUND SUIT

Taxpayers considering whether to file a tax refund suit should carefully review the claim, starting with documentation supporting eligibility for the credit and the calculation of the amount of the refund. This documentation should include a narrative explanation for why the employer is eligible for the credit. Additionally, workpapers supporting the calculation of gross receipts to support eligibility for the credit (if based on the gross receipts test) and the calculation of the credit itself should be maintained and reviewed. Careful analysis should be conducted to ensure that wages paid to related individuals, wages related to Paycheck Protection Program forgiveness, and amounts paid to employees providing services (for large eligible employers) were not included in the calculation.

Finally, if credit eligibility was not predicated on gross receipts, then documentation of full or partial suspensions of operations, government orders related to COVID-19 to which the employer was subject, and modifications that had to be made to stay open and their effect on operations should be prepared. As compared to taxpayers with ERC claims based on full or partial suspensions of operations which are fact intensive, taxpayers with brightline gross receipts ERC refund claims may have a more straightforward case.

Next, an employer evaluating whether to bring the claim should consider whether eligibility for the ERC is dependent on challenging IRS guidance, such as the requirements found in Notice 2021-20. Following the Supreme Court's decision in *Loper Bright Enterprises*,[10] challenges to federal agency action are expected to be more well-received than in previous years. However, this is still a tougher argument to make than a showing that the employer checked all the boxes under Notice 2021-20.

Finally, taxpayers should assess their risk tolerance for litigation and the associated costs. Litigation takes time and money. But, waiting entails its own risks, especially as documentary evidence may be more difficult to obtain and the memories of potential witnesses fade or those with knowledge leave the company. For taxpayers that have already waited over a year for much-needed ERC refund proceeds, or employers that filed refund claims after January 31, 2024 – for which there is no end to the moratorium in sight – the risks of inaction may be greater than those associated with litigation.

End Notes

[1] IR-2023-169 (9/14/2023).

[2] IR-2024-203 (8/8/2024).

[3] *See Guidance on the Emp. Retention Credit Under Section 2301 of the Coronavirus Aid, Relief, & Econ. Sec. Act*, 2021-11 I.R.B. 922 (2021).

[4] *Loper Bright Enterprises, et al v. Raimondo*, 144 S. Ct. 2244 (2024), *overruling Chevron, U.S.A., Inc. v. Nat. Resources Def. Council, Inc.*, 467 U.S. 837 (1984) (citing *Perez v. Mortgage Bankers Ass'n*, 575 U.S. 92, 109 (2015)).

[5] Code Section 7422; Treas. Reg. 601.103(c)(3).

[6] 28 USC § 1402(a)(2).

[7] 28 USC § 173.

[8] 28 U.S.C.A. § 1491(a)(1); *Ballard v. United States*, 680 F. App'x 1007, 1008-1009 (Fed. Cir. 2017).

[9] Withdraw an Employee Retention (ERC Claim), IRS.gov.

[10] *Loper Bright Enterprises, et al v. Raimondo*, 144 S. Ct. 2244 (2024), *overruling Chevron, U.S.A., Inc. v. Nat. Resources Def. Council, Inc.*, 467 U.S. 837 (1984).

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Tax Court Holds That FBAR Penalties Are Not Taxes and Therefore Are Not Subject to Collection Due Process Rights

The Tax Court has held that Foreign Bank Account Reporting (FBAR) penalties are not taxes subject to the collection due process (CDP) requirements in Code Section 6320 and Code Section 6330. Thus, the court lacked jurisdiction over the taxpayers' claim that the IRS improperly denied their requested CDP hearing. (*Jenner*, 163 TC No. 7 (2024))

After the IRS assessed FBAR penalties against the taxpayers, the Treasury Department informed them that funds would be withheld from their monthly Social Security benefits to satisfy their FBAR penalties. The taxpayers, a married couple, each requested a CDP hearing for the FBAR penalties. The IRS denied the taxpayers' request for a CDP hearing, claiming that the FBAR penalties assessed against them were not taxes and, therefore, not subject to the requirements of Code Section 6330.

The taxpayers then filed a Tax Court petition claiming that the IRS deprived them of their CDP rights. The IRS moved to dismiss the case for lack of jurisdiction.

The Tax Court, holding in favor of the IRS, held that FBAR penalties are not taxes. The Tax Court explained that FBAR penalties are authorized and imposed by Title 31 of the U.S. Code (not the Internal Revenue Code, which is Title 26). The Tax Court rejected the taxpayers' argument that the letter they received from the IRS denying their requested CDP hearing was enough to invoke the Tax Court's jurisdiction.

The Tax Court found that Title 31 expressly provides the assessment and collection procedures for FBAR penalties, and there is no statutory, regulatory, or judicial authority providing that these penalties are subject to IRC Sections 6320 and 6330. The rights afforded by the CDP statutes apply only to those people subject to IRS actions to collect "tax." The Tax Court held that because FBAR penalties are not taxes, the IRS was under no obligation to provide the taxpayers with a CDP hearing. ■

IRS Issues Final Regulations on Sales of Seized Property

The IRS has issued final regulations designed to modernize the rules governing sales of taxpayer property seized by the IRS by levy. (TD 10011, 11/5/2024) The final regulations amend existing regulations to better allow the IRS to maximize sale proceeds for the benefit of the taxpayer whose property the IRS has seized and the public fisc.

Generally, sales of property the IRS seized through the levy process are governed by Code Section 6335. The rules went without substantial revisions to reflect modern-day technological advancements until the IRS issued proposed regulations in October 2023.

According to the IRS, there was only one response submitted during the open comment period, which was disregarded for not directly addressing the proposed regulations. Thus, the regulations were adopted and finalized in November 2024 with only minor tweaks and no substantive changes.

Modernized amendments to the regulations were necessary, according to the IRS, to support online sales and allow more options with forms of payment and how properties are grouped. This flexibility permits the IRS to consider methods that will produce the highest aggregate amounts from sales of seized property. As the IRS noted, such sales are held at public auctions or under sealed bids. The regulations clarify various aspects of bidding and remittance, such as the form used by bidders, time and consideration of bids, and bid withdrawals.

The regulations also expand on how the IRS makes decisions on assigning employees to conduct sales or related ministerial work.

As the IRS explained in the preamble of the proposed regulations, online sales "can attract a wider range of potential purchasers, and thus potentially higher bids, while conserving IRS resources." The place of an online sale will generally be the county in which the property is seized. If, based on the facts and circumstances, the IRS determines that the place of an online sale is not within the county in which the property is seized, the sale may be conducted online by special order when doing so would be more efficient or would likely result in more competitive bids.

The final regulations apply to all sales of property seized by the IRS, effective 11/5/2024. ■

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401(k) Contribution Limit Increases to $23,500 for 2025, IRA Limit Remains $7,000

The IRS announced that the annual contribution limit for employees who participate in 401(k) plans, 403(b) plans, governmental 457 plans, and the federal government's Thrift Savings Plan is increased to $23,500 for 2025, up from $23,000 for 2024. (IR 2024-285, 11/1/2024) In Notice 2024-80 the IRS also issued technical guidance regarding all cost-of-living adjustments affecting dollar limitations for pension plans and other retirement-related items for tax year 2025.

The limit on annual contributions to an IRA remains $7,000. The IRA catch-up contribution limit for individuals aged 50 and over was amended under the SECURE 2.0 Act of 2022 (SECURE 2.0) to include an annual cost-of-living adjustment, but remains $1,000 for 2025.

The catch-up contribution limit that generally applies for employees aged 50 and over who participate in most 401(k), 403(b), governmental 457 plans, and the federal government's Thrift Savings Plan remains $7,500 for 2025. Therefore, participants in most 401(k), 403(b), governmental 457 plans, and the federal government's Thrift Savings Plan who are 50 and older generally can contribute up to $31,000 each year, starting in 2025. Under a change made in SECURE 2.0, a higher catch-up contribution limit applies for employees aged 60, 61, 62, and 63 who participate in these plans. For 2025, this higher catch-up contribution limit is $11,250 instead of $7,500.

The income ranges for determining eligibility to make deductible contributions to traditional IRAs, to contribute to Roth IRAs, and to claim the Saver's Credit all increased for 2025.

Taxpayers can deduct contributions to a traditional IRA if they meet certain conditions. If during the year either the taxpayer or the taxpayer's spouse was covered by a retirement plan at work, the deduction may be reduced, or phased out, until it is eliminated, depending on filing status and income. (If neither the taxpayer nor the spouse is covered by a retirement plan at work, the phase-outs of the deduction do not apply.)

The following are the phase-out ranges for 2025:

- For single taxpayers covered by a workplace retirement plan, the phase-out range is increased to between $79,000 and $89,000, up from between $77,000 and $87,000.
- For married couples filing jointly, if the spouse making the IRA contribution is covered by a workplace retirement plan, the phase-out range is increased to between $126,000 and $146,000, up from between $123,000 and $143,000.
- For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the phase-out range is increased to between $236,000 and $246,000, up from between $230,000 and $240,000.
- For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains between $0 and $10,000.
- The income phase-out range for taxpayers making contributions to a Roth IRA is increased to between $150,000 and $165,000 for singles and heads of household, up from between $146,000 and $161,000. For married couples filing jointly, the income phase-out range is increased to between $236,000 and $246,000, up from between $230,000 and $240,000. The phase-out range for a married individual filing a separate return who makes contributions to a Roth IRA is not subject to an annual cost-of-living adjustment and remains between $0 and $10,000.
- The income limit for the Saver's Credit (also known as the Retirement Savings Contributions Credit) for low-income and moderate-income workers is $79,000 for married couples filing jointly, up from $76,500; $59,250 for heads of household, up from $57,375; and $39,500 for singles and married individuals filing separately, up from $38,250.

The amount individuals can generally contribute to their SIMPLE retirement accounts is increased to $16,500, up from $16,000. Pursuant to a change made in SECURE 2.0, individuals can contribute a higher amount to certain applicable SIMPLE retirement accounts. For 2025, this higher amount remains $17,600.

The catch-up contribution limit that generally applies for employees aged 50 and over who participate in most SIMPLE plans remains $3,500 for 2025. Under a change made in SECURE 2.0, a different catch-up limit applies for employees aged 50 and over who participate in certain applicable SIMPLE plans. For 2025, this limit remains $3,850.

Under a change made in SECURE 2.0, a higher catch-up contribution limit applies for employees aged 60, 61, 62 and 63 who participate in SIMPLE plans. For 2025, this higher catch-up contribution limit is $5,250. ■

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Social Security Administration Announces Social Security Taxable Wage Base and Benefit Increase for 2025

The Social Security Administration (SSA) has announced the annual cost-of-living adjustment to the maximum amount of earnings subject to Social Security tax (i.e., the taxable wage base). For 2025, that amount will be $176,100 (up from $168,600 for 2024). (SSA News Release, 10/10/2024)

The SSA also announced in the same news release that Social Security benefits and Supplemental Security Income (SSI) payments for more than 72.5 million Americans will increase 2.5% in 2025. On average, Social Security retirement benefits will increase by about $50 per month starting in January 2025.

Social Security beneficiaries will see a 2.5% cost-of-living adjustment (COLA) beginning in January 2025. Increased payments to people receiving SSI will begin on 12/31/2024.

For the first time, Social Security beneficiaries will receive a newly designed and improved COLA notice that makes it easier for customers to find their benefits information. The new simplified COLA notice is only one page, uses plain and personalized language, and provides exact dates and dollar amounts of a person's new benefit amount and any deductions.

Individuals who have a personal "my Social Security" account can view their COLA notice online. Individuals can set up their "my Social Security account" by visiting www.ssa.gov/myaccount.

The Social Security Act ties the annual COLA to the increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) as determined by the Department of Labor's Bureau of Labor Statistics.

Over the last decade the COLA increase has averaged about 2.6%. The COLA was 3.2% in 2024. ■

IRS Issues Final Regulations Regarding Withholding on Section 3405 Distributions

The IRS has issued final regulations under Code Section 3405(a) and Section 3405(b) to amend income tax withholding rules on certain periodic payments and nonperiodic distributions from employer deferred compensation plans, individual retirement plans, and commercial annuities that are not eligible rollover distributions. (TD 10008, 10/21/2024)

In March 2019, the IRS issued proposed regulations generally adopting existing guidance provided in Notice 87-7, released in the wake of withholding changes in the Tax Reform Act of 1986. The Notice applied to taxpayers who make distributions from deferred compensation plans, individual retirement accounts, or commercial annuities and explained their responsibilities to withhold from such distributions for the payee's income tax liability under Code Section 3405.

The 2019 proposed regulations addressed requests for clarifications from stakeholders regarding certain situations, such as when:

- The payee provides the payor with an Army Post Office (APO), Fleet Post Office (FPO), or Diplomatic Post Office (DPO) address.
- The payee provides the payor with a residence address located within the U.S. but provides payment instructions that request delivery of the designated distribution to a financial institution or other person located outside of the U.S.

With respect to payees with a military or diplomatic post, the IRS determined that designated distributions to personnel or their families should not be treated as delivered outside of the U.S. The regulations also require payors to withhold in certain circumstances when a payee provides a residence address located within the U.S. but also provides payment instructions indicating that the funds are to be delivered outside of the U.S. Withholding also applies for those who have not provided a residential address.

In addition, the regulations clarify the withholding rules do not apply to designated distributions that do not include a distribution that is subject to withholding under subchapter A of chapter 3. For example, the withholding rules do not apply to a U.S.-source distribution to a nonresident alien from a trust as described in Code Section 401(a). Instead, treatment would follow Code Section 1441.

The new final regulations adopt the proposed regulations without substantive changes and apply to payments and distributions made on or after 1/1/2026. The IRS specified, however, that taxpayers may follow the regulations for earlier payments and distributions. Notice 87-7 will not apply to payments and distributions made after 12/31/2025. ■

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IRS Issues Final Regulations on Advanced Manufacturing Production Credit

The IRS has issued final regulations to provide guidance for the Code Section 45X Advanced Manufacturing Production Credit established by the Inflation Reduction Act of 2022. (TD 10010; IR 2024-281, 10/24/2024)

The Advanced Manufacturing Production Credit provides a tax credit for the production and sale of statutorily specified eligible components to unrelated persons. Such eligible components include solar and wind energy components, inverters, qualifying battery components, and 50 applicable critical minerals. The eligible components must be produced in the United States or a territory of the United States.

Generally, the final regulations define qualifying production activities, provide rules for the sale of eligible components to unrelated persons, and special rules that apply to sales between related persons. The final regulations also provide rules to address contract manufacturing scenarios.

In addition, the final regulations provide definitions of eligible components, rules related to calculating the credit, including eligible production costs, and specific recordkeeping and reporting requirements. ■

IRS Issues Final Regulations on Advanced Manufacturing Investment Credit

The IRS has issued final regulations to implement the Code Section 48D Advanced Manufacturing Investment Credit, which was established by the CHIPS Act of 2022. (TD 10009; IR 2024-275, 10/22/2024)

The final regulations provide the eligibility requirements for the credit and provide clarity on the amended investment credit recapture provisions.

This credit was enacted to incentivize the manufacturing of semiconductors and semiconductor manufacturing equipment within the United States. The credit is available to taxpayers that meet certain eligibility requirements, and there is the ability for taxpayers to make an elective payment election to be treated as making a refundable payment against the tax equal to the amount of the credit.

A partnership or S corporation can make an elective payment election to receive a payment, instead of claiming the credit.

The Advanced Manufacturing Investment Credit for any taxable year is generally equal to 25% of an eligible taxpayer's qualified investment in an advanced manufacturing facility. An eligible taxpayer's qualified investment equals its basis in any qualified property placed in service during the taxable year. The qualified property must be integral to the operation of the advanced manufacturing facility. The credit is generally available for qualified property placed in service after 12/31/2022. ■

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IRS Issues Guidance on Energy Efficient Home Improvement Credit

The IRS has issued proposed regulations and a Revenue Procedure to guide energy efficient product manufacturers and individual taxpayers on new requirements effective in 2025 for claiming the Energy Efficient Home Improvement Credit under Code Section 25C. (REG-118264-23; Rev. Proc. 2024-31; IR 2024-280, 10/24/2024)

Rev. Proc. 2024-31 provides procedures and requirements that a manufacturer of specified property must follow to be treated as a qualified manufacturer (QM). To become a QM, a manufacturer must:

- Register and enter into an agreement with the IRS.
- Assign a qualified product identification number (PIN) unique to each item of specified property.
- Label such items with PINs.
- Make periodic reports to the IRS of PINs assigned.

Soon manufacturers will be able to use the IRS Energy Credits Online Portal (IRS ECO) to register with the IRS. IRS ECO is a free electronic service that is secure and requires no special software, making it accessible to large and small businesses alike.

Manufacturers of qualifying products can use the IRS ECO platform to register and provide information to the IRS for filing purposes. In addition, IRS ECO incorporates validation checks and other risk-mitigation measures and allows for monitoring in real time of key metrics to include identification of customer-service enhancements and fraudulent activity.

For property placed in service beginning in 2023, a taxpayer may take a credit equal to 30% of the total amount paid for certain energy efficient products or for a home energy audit. The credit is limited to certain amounts, per taxpayer and per tax year. A taxpayer may claim a total credit of up to $3,200, with a general total limit of $1,200, and a separate total limit of $2,000 for electric or natural gas heat pump water heaters, electric or natural gas heat pumps, and biomass stoves or boilers that meet certain requirements.

The $1,200 general limit also includes additional limitations specific to certain types of property that meet the requirements:

- $600 for any item of qualified energy property.
- $600 in total for exterior windows and skylights.
- $250 for an exterior door.
- $600 in total for exterior doors.
- $150 for home energy audits.

Beginning in 2025, for each item of specified property placed in service, no credit will be allowed unless the item was produced by a QM and the taxpayer includes the PIN for the item on the taxpayer's tax return.

The IRS has several publications concerning the Energy Efficient Home Improvement Credit, including:

- Publication 5967, Energy Efficient Home Improvement Credit (25C).
- Publication 5976, How to Claim an Energy Efficient Home Improvement Tax Credit — Residential Energy Property,
- Publication 5978, How to Claim an Energy Efficient Home Improvement Tax Credit — Home Energy Audit.
- Publication 5979, How to Claim an Energy Efficient Home Improvement Tax Credit — Exterior Doors, Windows, Skylights and Insulation Materials. ■

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IRS Announces Launch of New Pass-Through Entity Compliance Unit

The IRS has announced that its new pass-through field operations unit has officially started work in the IRS Large Business and International (LB&I) division to more efficiently conduct audits of pass-through entities. (IR 2024-276, 10/22/2024)

The IRS stated that the creation of a new unit specifically devoted to ensuring compliance of pass-throughs of every size and form — including partnerships, S corporations, and trusts — reflects the IRS's broader efforts to focus more attention and resources on an area that has historically been under-scrutinized.

Previously, pass-through exams were divided between LB&I and the Small Business/Self-Employed (SB/SE) division based on the size of the entity. Going forward, revenue agents in pass-through field operations will be assembled into geographically based teams that are responsible for primary exams of pass-through entity returns. LB&I will be responsible for starting pass-through exams, regardless of entity size. SB/SE will continue to examine pass-through entities as part of a related exam of a tax return.

According to the IRS, consolidating the case-working expertise and removing the entity-size barrier helps the IRS achieve its goal of increased audit rates in this complex area, streamlines workflows, and provides a more consistent experience for taxpayers.

The IRS also announced the following related developments:

- The IRS launched examinations of 76 of the largest partnerships with average assets over $10 billion, including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms, and many other industries. These audits can take years, depending on the size and complexity of the partnerships.
- The IRS Chief Counsel announced the creation of a new associate office that will focus exclusively on partnerships, S corporations, trusts, and estates. The new office will be drawn from the current Passthroughs and Special Industries (PSI) Office. ■

IRS Announces New Associate Chief Counsel to Focus on Partnerships and Other Pass-Through Entities

The IRS announced the selection of the first Associate Chief Counsel for the newly created Passthroughs, Trusts, and Estates office that will focus exclusively on partnerships, S corporations, trusts, and estates. Staffing for this office will be drawn from the current Passthroughs and Special Industries office. (IR 2024-284, 10/29/2024)

The new Associate Chief Counsel, Jeffrey Erickson, was expected to join the IRS in January 2025. Most recently, he served as a Principal in Ernst & Young's National Tax Passthroughs Transaction Group.

As the Associate Chief Counsel for Passthroughs, Trusts, and Estates, Erickson will coordinate and direct the activities of the office and oversee legal advisory services that support the uniform interpretation, application, enforcement, and litigation of tax laws involving partnerships, S corporations, trusts, and estates.

Erickson began his tax career in 1991 as an Attorney Advisor at the IRS Office of Chief Counsel in Passthroughs and Special Industries and left the IRS in 1999 as an Assistant Branch Chief. Erickson has also served as an Adjunct Professor at the Georgetown University Law Center, where he co-taught Taxation of Partnerships for LL.M. and J.D. students, and has authored articles for tax publications. ■

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IRS Grants Filing Exception For Tax-Exempt Organizations from Filing Form 4626, Alternative Minimum Tax—Corporations, for Tax Year 2023

The IRS has granted a filing exception for tax-exempt organizations; they do not have to file Form 4626, Alternative Minimum Tax—Corporations, for tax year 2023. (IR 2024-277, 10/23/2024)

The Inflation Reduction Act created an alternative minimum tax for corporations — a 15% minimum tax on the adjusted financial statement income (AFSI) of corporations that have average annual AFSI greater than $1 billion, beginning in 2023. For tax-exempt organizations, the corporate alternative minimum tax applies only to the AFSI of any unrelated trades or businesses.

The IRS stated that tax-exempt organizations should maintain Form 4626 in their books and records for purposes of documenting whether they are an applicable corporation for purposes of the alternative minimum tax and, if so, for determining any corporate alternative minimum tax liability. In addition, any tax-exempt organization that is liable for the alternative minimum tax must pay the tax and report the amount on Part II, Line 5 of Form 990-T, Exempt Organization Business Income Tax Return.

In Notice 2023-7 and in proposed regulations published in September 2024 (REG-112129-23), the IRS provided a simplified method for determining whether a corporation is an applicable corporation, but this method did not take into account the specific AFSI adjustment provided by the statute for tax-exempt organizations.

To give taxpayers and the IRS time to consider the comments on the proposed regulations, including comments relating to reporting for tax-exempt entities and on the application of the simplified method for tax-exempt entities, tax-exempt organizations are exempted from the obligation to file Form 4626 for tax year 2023.

IRS EXAMINATION QUESTIONS

Israel Blumenfrucht

INTEREST EXPENSE DEDUCTION

How much of the following interest expense is deductible on Schedule A, before limitations? The taxpayer is reporting $1,500 in investment income.

- $1,200 interest paid on a loan used to purchase a vacant lot held for investment.
- $750 interest paid on a qualifying student loan.
- $2,700 credit card interest on an advance used to make a down payment on a new home.
- $625 interest on a loan used to invest in tax-free bonds.

a. $1,200

b. $1,950

c. $4,650

d. $3,900

Solution: The correct choice is "a."

Interest expenses incurred by individual taxpayers are generally categorized as follows:

- Personal interest.
- Home mortgage interest
- Investment interest.
- Student loan interest.
- Business interest.

The tax treatment for each category of interest differs significantly. The interest expense may be not deductible, deductible as an itemized deduction, or fully deductible from gross income as a deduction for adjusted gross income (AGI). The following discussion briefly outlines each category of interest.

Personal interest is not deductible. This includes interest on credit card charges, car loans, revolving charge accounts, and even interest on Federal, state, and local income taxes.

Home mortgage interest on a principal residence and one additional residence is deductible as an itemized deduction provided that it satisfies certain conditions and limitations. For home mortgage interest to be deductible, the mortgage must be considered "acquisition indebtedness." Acquisition indebtedness refers to costs incurred in acquiring, constructing, or substantially improving the taxpayer's residence. Furthermore, the mortgage must be secured by the residence and the person deducting the interest must own the home. Interest expense on acquisition indebtedness is limited to a maximum combined mortgage of $750,000 on two personal residences or $1 million dollars for mortgages incurred before December 15, 2017. The higher $1 million dollar amount will apply to all mortgages after 2025, regardless of the date of borrowing.

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Investment interest is interest expense incurred on funds borrowed to be used for investment purposes. Such interest is deductible as an itemized deduction, but is limited to the net investment income for the year. The amount of investment interest that cannot be deducted currently because of this limitation is carried over to future years and may be deducted in a future year provided that the taxpayer has net investment income in that year (Section 163(d)). The purpose of this limitation is to discourage taxpayers from borrowing funds to invest in relatively high-risk investments under the assumption that the interest expense incurred will be reduced by the savings on taxes resulting from the taxpayer's ability to deduct the interest against other forms of income.

Furthermore, the Code specifically disallows taxpayers to deduct investment interest expense incurred to purchase tax-exempt securities (Section 265). The purpose of this rule is to prevent taxpayers from accumulating tax-free income by purchasing state and local bonds and notes — all interest from which is excluded from federal income tax — while financing these investments from loans whose interest is tax deductible.

Investment income generally includes gross income from interest, annuities, and royalties not derived in the ordinary course of a trade or business. Qualified dividend income and the net capital gain attributable to the disposition of investment property producing these types of income, such as the net capital gain on the sale of stocks and bonds, is generally not included in investment income unless the taxpayer elects to do so. However, there is a price to be paid for this election. Taxpayers who elect to include their qualified dividends and net capital gains as investment income must forego the alternative tax computation for net capital gains by an equivalent amount. That is, they cannot use the lower capital gains rates of 0%/15%/20% on this amount of qualified dividend income and capital gains, but must use the regular tax rates for ordinary income. Taxpayers with little or no investment income and large amounts of investment interest expense may benefit from this election because they would otherwise not be able to deduct the investment interest in the current year.

Student loan interest is interest incurred on loans for higher education. Such interest is deductible above-the-line as a deduction from gross income in arriving at adjusted gross income and is not an itemized deduction. Note that the maximum amount that can be deducted in one year is limited to $2,500 and is not indexed for inflation. Moreover, for 2024 the deduction is phased out for married taxpayers with modified AGI between $165,000 and $195,000 and for unmarried taxpayers with modified AGI between $80,000 and $95,000. These phaseout amounts are indexed for inflation, and for 2025 will be increased for married taxpayers to modified AGI between $170,000 and $200,000 and for unmarried taxpayers to modified AGI between $85,000 and $100,000.

Business interest is fully deductible from gross income as is true for all other business deductions.

Accordingly, of the four items of interest expense stipulated in this problem, only the $1,200 of interest paid on a loan to purchase a vacant lot held for investment qualifies as an itemized deduction on Schedule A, since it does not exceed the taxpayer's investment income of $1,500. The $750 interest paid on a qualifying student loan is deductible as an above-the-line deduction from gross income and not as an itemized deduction. The $2,700 credit card interest is not deductible even though the funds were used as a down payment on a new home, since the loan was not secured by the new home. The $625 interest on a loan used to invest in tax-free bonds is specifically excluded by the Code as an itemized deduction. ■

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