Surgent's S Corporation, Partnership, and LLC Tax Update

BCP4/25/V1-X1

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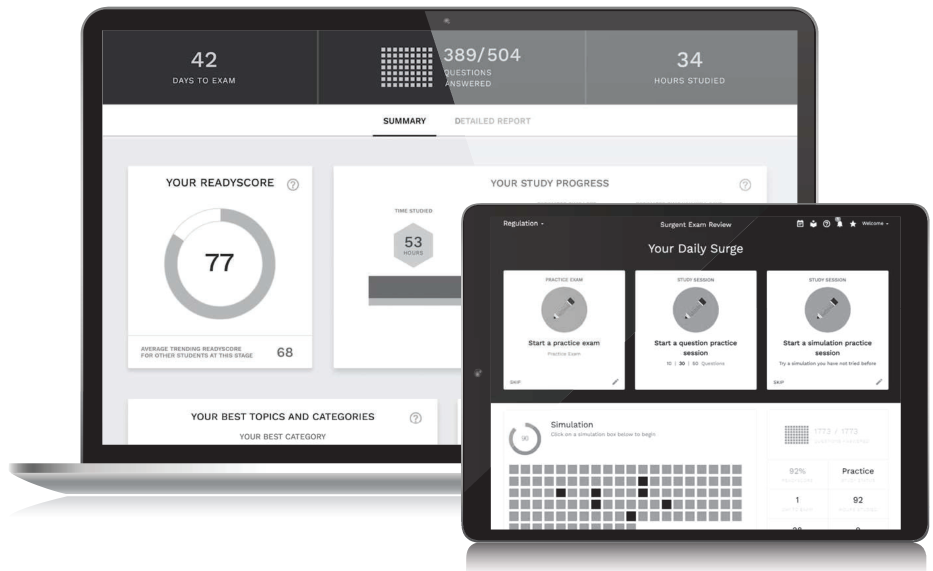

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Revised July 2025

NOTES

Supplement: The One Big Beautiful Bill Act

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Learning objective

Upon reviewing this material, the reader will be able to discuss the major provisions of The One Big Beautiful Bill Act.

I. Overview

On July 4, 2025, President Trump officially signed the "**One Big Beautiful Bill Act**" (OBBBA) into law. This followed a narrow 51–50 vote in the Senate on July 1, where Vice President JD Vance cast the tie-breaking vote in favor of the bill. The bill was passed under budget reconciliation procedures, allowing it to move forward with a simple majority vote. The legislation permanently extends, with certain modifications, key individual, business, and international tax measures that were originally enacted under the 2017 Tax Cuts and Jobs Act (TCJA). Many of these TCJA provisions were set to expire at the end of 2025.

A. Extension and enhancement of TCJA provisions – Individual taxation

1. Individual income tax rates

The OBBBA permanently extends the lower individual income tax rates and brackets originally enacted by the TCJA, effective for tax years beginning after December 31, 2025. These brackets will continue to be adjusted for inflation. The expanded income thresholds and marriage penalty relief introduced by the TCJA are retained. For individuals, the permanent rates will remain at 10%, 12%, 22%, 24%, 32%, 35%, and 37%, rather than reverting to the pre-TCJA structure that topped out at 39.6%.

2. Standard deduction

The OBBBA makes permanent the TCJA's expanded standard deduction and further increases the base amounts beginning in 2025. The new 2025 standard deduction amounts are increased an additional $750 for single filers and $1,500 for joint filers over the 2025 inflation-adjusted TCJA amounts:

- $15,750 for single filers and married individuals filing separately;
- $23,625 for heads of households; and
- $31,500 for married couples filing jointly and surviving spouses.

The standard deduction will continue to be indexed for inflation, and the additional standard deduction for individuals aged 65 or older and/or blind remains unchanged.

3. Pease limitation

The OBBBA permanently repeals the §68 Pease limitation, which previously reduced itemized deductions by up to 3% of AGI over certain thresholds, capped at 80% of total deductions. In its place, the OBBBA introduces a new cap on the value of itemized deductions for higher-income taxpayers. Under the new rule, allowable itemized deductions are reduced by 2/37 of the lesser of:

- The total itemized deductions; or
- The amount by which the taxpayer's taxable income exceeds the threshold for the 37% tax bracket.

This new limitation does not apply to the §199A deduction for qualified business income. This change is in effect for tax years beginning after December 31, 2025.

4. *Miscellaneous itemized deductions*

The OBBBA permanently extends the TCJA's suspension of miscellaneous itemized deductions under §67(g). As a result, it effectively eliminates deductions for items such as unreimbursed employee expenses, tax prep fees, and investment expenses.

The OBBBA creates an exception that allows qualified educators to deduct unreimbursed employee expenses as a permitted itemized deduction under §67(b). Qualified educators include K–12 teachers, instructors, counselors, principals, aides, and interscholastic sports coaches or administrators who work at least 900 hours in a school year. Deductible expenses include classroom equipment and supplemental instructional materials.

This provision is effective for tax years beginning after December 31, 2025.

5. *Personal exemptions*

Under pre-TCJA law, taxpayers could deduct a fixed amount for themselves, their spouse, and dependents, which reduced taxable income. The TCJA set the personal exemption amount to zero from 2018–2025; however, it left the structure intact for a possible return.

The OBBBA amends §151(d)(5) to formally set the personal exemption amount to zero on a permanent basis, preventing its automatic reinstatement after 2025. This change is effective for tax years beginning after December 31, 2024.

6. *Temporary senior deduction*

The OBBBA introduces a temporary deduction for taxpayers age 65 and older, effective for 2025 through 2028. Qualified individuals can deduct $6,000 per eligible senior (including a spouse if filing jointly). The deduction is phased out by 6% of the amount by which modified AGI exceeds:

- $75,000 for single filers; and
- $150,000 for married filing jointly.

A valid SSN must be provided to claim the deduction. Failure to provide such information is treated as a mathematical or clerical error, allowing the IRS to disallow the deduction without a formal audit. This provision is not permanent and is set to sunset after tax year 2028.

7. *State and local tax cap*

Prior to the TCJA, taxpayers could deduct the full amount of their state and local taxes paid. The TCJA imposed the current $10,000 cap beginning in 2018, which created significant limitations for taxpayers in high-tax states.

The OBBBA temporarily increases the SALT deduction cap from $10,000 to $40,000 for most filers (or $20,000 for married individuals filing separately) beginning in 2025. The cap will be adjusted for inflation, rising to $40,400 in 2026 and increasing by 1% annually through 2029.

Beginning in 2030, the SALT cap will revert to its current level of $10,000 ($5,000 for married separate filers), which was established by the TCJA and is currently set to expire after 2025.

A phaseout of the increased SALT cap applies to taxpayers with MAGI over $500,000 in 2025. The phaseout threshold increases to $505,000 in 2026 and continues to rise by 1% annually through 2029. For affected taxpayers, the SALT deduction is reduced by 30% of the amount by which their MAGI exceeds the threshold. However, the deduction will not be reduced below $10,000. This phaseout applies only through 2029, after which the cap reverts to its original level.

8. Child Tax Credit (CTC)

The OBBBA makes several key changes to the CTC, many of which make permanent or expand provisions originally introduced under the TCJA. Beginning in 2025, the nonrefundable portion of the CTC increases by $200, bringing the maximum credit to $2,200 per qualifying child. This amount will be adjusted annually for inflation starting in 2026. This increase applies only to the nonrefundable portion of the credit, meaning it primarily benefits taxpayers with sufficient tax liability to fully utilize the credit.

The bill makes permanent the refundable portion of the credit, currently $1,700 in 2025, with inflation adjustments in future years. The OBBBA retains and makes permanent the higher income phaseout thresholds introduced under the TCJA ($200,000 for single filers and $400,000 for joint filers), as well as the $500 nonrefundable credit (not indexed for inflation) for other dependents who do not qualify for the CTC.

Finally, the OBBBA tightens identification requirements. Under OBBBA, not only must the qualifying child have a Social Security Number (SSN), but also the taxpayer (or spouse, if filing jointly) must have a valid SSN to claim the credit. The omission of a valid SSN for either the child or taxpayer will now be treated as a mathematical or clerical error, allowing the IRS to deny the credit without a full audit.

9. Child and dependent care credit

Prior to the OBBBA, taxpayers with one or more qualifying individuals, such as children or other dependents could claim a credit for employment-related expenses incurred for child and dependent care. Employment-related expenses include costs for household services and care expenses for qualifying individuals.

The credit is calculated by multiplying qualifying expenses up to $3,000 for one qualifying individual or $6,000 for two or more by a credit rate based on the taxpayer’s AGI. Before the OBBBA was enacted, the maximum credit rate was 35%, which phased down to 20% for taxpayers with AGI exceeding $43,000.

The OBBBA permanently increases the maximum credit rate to 50%, effective for tax years after December 31, 2025. The 50% credit rate is gradually reduced by one percentage point for every $2,000 (or fraction thereof) by which the taxpayer’s AGI exceeds $15,000, but this reduction cannot lower the rate below 35%.

For taxpayers with AGI between $43,001 and $75,000 ($86,001 to $150,000 for joint filers), the credit rate is fixed at 35%. For AGI between $75,001 and $105,000 ($150,001 to $210,000 for joint filers), the credit rate is further phased down to a minimum of 20%.

In other words, the credit rate phases down in two stages: first from 50% to a minimum of 35% as AGI exceeds $15,000, then from 35% to a minimum of 20% as AGI surpasses $75,000 (or $150,000 for joint filers).

10. Dependent care assistance programs

Prior to the OBBBA, the maximum amount excludable from income under a dependent care assistance program was $5,000 annually ($2,500 for married individuals filing separately). The OBBBA increases the annual exclusion for employer-provided dependent care assistance to $7,500 ($3,750 for married individuals filing separately).

These amounts continue to apply only to assistance furnished under a qualified employer-sponsored program. The exclusion applies to payments made for the care of a qualifying dependent to enable the employee (and spouse, if married) to work or look for work. This provision is effective for tax years beginning after December 31, 2025.

11. Charitable contribution deduction

For itemizing taxpayers, the OBBBA introduces a new 0.5% AGI floor on itemized charitable deductions. Only the portion of charitable contributions exceeding 0.5% of AGI will be deductible.

Any amount disallowed under this rule may be carried forward, provided the taxpayer has other existing charitable contribution carryforwards. The OBBBA makes permanent the existing 60% AGI limitation for cash contributions to public charities, a provision that was originally set to expire after 2025 under the TCJA.

Beginning in 2026, the OBBBA allows non-itemizers to deduct up to $1,000 ($2,000 for joint filers) for qualified charitable contributions. To qualify, contributions must be cash donations made to public charities under §170(p). Itemizing is not required to take this deduction. This provision creates a permanent charitable deduction for taxpayers who claim the standard deduction.

12. Tip income deduction

The OBBBA introduces a temporary deduction for qualified tip income, available for tax years 2025 through 2028. Under this provision, individuals in occupations that customarily receive tips may deduct up to $25,000 in qualified tip income annually.

The deduction is available to both employees (who receive Form W-2) and independent contractors who report tips on Form 1099-K, Form 1099-NEC, or Form 4317 (used to report unreported tip income).

Itemizing is not required to take this deduction.

The deduction is reduced by $100 for taxpayers with MAGI exceeding $150,000 (or $300,000 for joint filers).

To qualify as "tips," tips must be:

- Voluntary (not negotiated) and properly reported on IRS forms (W-2, 1099, etc.);
- Earned in occupations listed by the IRS as customarily tipped as of December 31, 2024; and
- Not received in "specified service trades or businesses" (as defined under Code §199A(d)(2)).

If the individual operates a business receiving tips, the deduction applies only if gross income (including tips) exceeds deductible expenses. Further, amounts deducted under this provision are excluded from Qualified Business Income (QBI) for purposes of the 20% §199A deduction.

For 2025 only, employers may use any reasonable method to estimate tip amounts for reporting. The IRS will publish a list of eligible tipped occupations within 90 days of enactment, based on tipping practices before 2025.

The IRS is also required to update withholding procedures starting in 2026 to reflect the new deduction. Reporting entities (employers, platforms, third-party payers) must:

- Separately report designated cash tips and recipient occupations; and
- Update Forms W-2, 1099, 1099-K, and related filings.

The FICA tip credit under §45B is expanded to include beauty services industries, such as barbering, hair care, nail care, esthetics, and spa services.

13. Overtime pay deduction

The OBBBA introduces a temporary deduction for qualified overtime compensation, available for tax years 2025 through 2028. Taxpayers may deduct up to $12,500 per year ($25,000 for MFJ filers) in qualified overtime compensation. The deduction phases out by $100 for every $1,000 of MAGI above $150,000 (single filers) or $300,000 (joint filers).

Per the bill, "qualified overtime compensation" is defined as overtime pay received under Section 7 of the Fair Labor Standards Act of 1938, specifically, wages paid at a rate above the employee's regular rate of pay for overtime hours. The deduction does not apply to any amounts already deducted as qualified tips under new §224.

The deduction is available to both employees and non-employees, provided the compensation is properly reported on Form W-2 or applicable 1099. To qualify, taxpayers must provide a valid SSN on the return. Additionally, married taxpayers must file jointly to claim the deduction. Any omission of an SSN is treated as a mathematical or clerical error under §6213(g)(2). Non-itemizers are eligible to claim the deduction, and it applies in addition to the standard deduction. Similar to qualified tips, overtime is subject to payroll taxes and state tax.

14. Trump Accounts

The OBBBA creates a new type of tax-deferred investment account for children under age 18, known as a Trump Account. These accounts are structured as non-Roth IRAs for the exclusive benefit of minors. A child must be a U.S. citizen with a valid SSN to qualify.

Contributions to a Trump Account must be made before the child turns 18, and distributions may begin in the year the child turns 18. Trump Account funds must be invested in mutual funds or indexed ETFs that track U.S. equity markets.

The annual contribution limit is $5,000 per beneficiary, adjusted for inflation beginning in 2028. Contributions may come from parents, relatives, employers, charitable organizations, and government entities. Employer contributions are not included in the employee's income. General funding contributions from charities or government bodies are exempt from the $5,000 limit, as long as they benefit a defined group (e.g., a specific birth year or geographic region). Additionally, contributions cannot be made to the account after the beneficiary turns 18.

Distributions from Trump Accounts may not occur until the beneficiary turns 18, except in limited qualifying cases (e.g., death or disability). Once eligible, funds may be withdrawn for education expenses, first-time home purchases, or small business investments. Distributions for nonqualified purposes may be subject to tax and penalties, similar to traditional IRA rules.

Trump Accounts must be clearly designated as such at setup and managed in compliance with §530A and related provisions. The IRS is authorized to issue guidance and enforce rules to prevent abuse, including regulations addressing contribution misclassification or improper withdrawals.

A $1,000 one-time federal contribution will be made to Trump Accounts for eligible children born between January 1, 2025, and December 31, 2028. The OBBBA also provides a $1,000 tax credit to individuals who open accounts for eligible newborns during this period.

If a qualifying child does not have an account by the time they are claimed on a tax return, the IRS will automatically open one, unless parents opt out. Contributions to Trump Accounts may not begin until 12 months after the bill's enactment, and the entire provision is effective for tax years beginning after December 31, 2025.

15. Basic exclusion amount

The OBBBA permanently increases the federal estate, gift, and generation-skipping transfer (GST) tax exclusion amount to $15 million per person (or $30 million for married couples filing jointly) as of January 1, 2026.

This provision replaces the temporary $10 million (inflation-adjusted) exclusion enacted under the TCJA, which was set to revert to approximately $7 million per person in 2026 absent legislative changes.

The new $15 million exclusion is adjusted annually for inflation, beginning in 2026. This expanded exemption applies to lifetime transfers and transfers at death. Lastly, portability rules remain in place, so an unused exclusion from a deceased spouse can still transfer to the surviving spouse.

16. Alternative Minimum Tax (AMT)

The OBBBA permanently increases the individual AMT exemption amounts, which were previously set to expire after 2025 under the TCJA. Beginning in 2026, the phaseout thresholds are:

- $500,000 for single filers; and
- $1,000,000 for joint filers.
- Note: Both thresholds are indexed for inflation.

The phaseout rate doubles from 25% to 50%, causing higher-income taxpayers to lose the exemption faster as income increases. The AMT still applies only if it results in more tax than under the regular system, ensuring high-income taxpayers pay a minimum amount of tax, regardless of deductions or credits claimed under the regular system.

17. New car loan interest deduction

The OBBBA introduces a temporary tax deduction for interest paid on loans used to purchase new personal-use passenger vehicles, effective for tax years 2025 through 2028. Taxpayers may deduct up to $10,000 of car loan interest per year, regardless of whether they itemize deductions or claim the standard deduction.

This deduction excludes qualified vehicle loan interest from the definition of “personal interest” under §163(h). This provision applies only to qualified indebtedness incurred after December 31, 2024.
To qualify for the deduction, the loan must be incurred after December 31, 2024, and must be secured by a first lien on the vehicle. The vehicle must be new, intended for personal use, and originally placed in service by the taxpayer.

Eligible vehicles include cars, SUVs, pickup trucks, vans, minivans, and motorcycles with a gross vehicle weight rating under 14,000 pounds. Additionally, the vehicle must have had its final assembly in the United States.

Taxpayers are required to report the vehicle identification number (VIN) on their tax return to claim the deduction. Lastly, lenders are required to file information returns with the IRS reporting interest received on qualified personal auto loans.

The deduction phases out beginning at $100,000 of modified adjusted gross income (MAGI) for single filers and $200,000 for married taxpayers filing jointly. For every $1,000 of MAGI above these thresholds, the deduction is reduced by $200 until fully phased out. The deduction does not apply to loans for ATVs, trailers, campers, or used vehicles.

This provision provides new tax planning opportunities for taxpayers financing new vehicles assembled in the U.S. during the effective period.

18. Scholarship credit

Beginning in tax years ending after December 31, 2026, individuals who are U.S. citizens or residents may claim a nonrefundable federal income tax credit for qualified cash contributions made to scholarship-granting organizations (SGOs). The credit is limited to $1,700 per taxpayer per year and applies only in states that elect to participate and provide the IRS with a list of qualified SGOs.

Contributions qualifying for this credit must be used to fund scholarships for eligible students attending elementary or secondary schools within the state in which the SGO is registered.

A qualifying SGO must be a public charity under §501(c)(3) and must maintain segregated accounts for qualified contributions. Qualified contributions must be in cash only and are not eligible for a charitable deduction under §170 if used to claim the credit. The credit amount is reduced by any state tax credit received for the same contribution.

If a taxpayer’s federal credit exceeds the limit on nonrefundable personal credits under §26(a), the excess may be carried forward up to five years. Contributions are subject to a national $4 billion annual cap, with credits allocated on a first-come, first-served basis.

Under new §139K, scholarship amounts received by a taxpayer or a dependent from an SGO are excluded from gross income if used for qualified elementary or secondary education expenses. An "eligible student" must be from a household with income not exceeding 300% of area median gross income, as defined under §42, and be eligible to enroll in a public elementary or secondary school. These scholarships can be used for tuition, fees, books, supplies, and other qualified K–12 educational costs.

19. Learning credits

Beginning in 2026, the OBBBA imposes stricter identification rules for claiming education credits, tightening eligibility and compliance verification. To claim either the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Credit (LLC), taxpayers must include:

- Their own Social Security Number (SSN) (or spouse's, if applicable); and
- The SSN of each student for whom the credit is claimed.

Additionally, taxpayers must report the Employer Identification Number (EIN) of each institution that received qualifying tuition payments used to compute the AOTC or LLC. Missing or incorrect SSNs or EINs are treated as mathematical or clerical errors under §6213, enabling automatic IRS disallowance or correction. This provision applies to tax years beginning after December 31, 2025.

20. Employer payments of student loans

Prior to the OBBBA, employees could exclude up to $5,250 per year of "educational assistance" provided by an employer under a qualified educational assistance program. This exclusion included eligible student loan repayments, including principal or interest paid by the employer for the employee's own qualified education loans, but was set to expire for payments made after December 31, 2025.

The OBBBA makes the student loan repayment exclusion permanent, ensuring employer-paid student loan assistance remains tax-free to employees beyond 2025. The OBBBA also adds an annual inflation adjustment to the $5,250 limit for tax years after December 31, 2026.

21. Casualty loss deductions

The OBBBA permanently extends the TCJA provision limiting itemized deductions for personal casualty losses to losses arising from federally declared disasters. In a significant expansion, the OBBBA now also allows deductions for losses attributable to certain state-declared disasters. Losses from events that are not federally, or state-declared disasters are no longer deductible as personal casualty losses. This provision applies to tax years beginning after December 31, 2025.

The OBBBA also extends and modifies disaster relief rules under the Taxpayer Certainty and Disaster Tax Relief Act of 2020. Taxpayers in qualified disaster areas can claim personal casualty losses without itemizing deductions. The standard deduction is increased by the amount of the net disaster loss, which is the excess of qualified disaster-related personal casualty losses over any casualty gains.

The per-casualty floor for losses has been raised from $100 to $500 under these disaster provisions. To qualify, the loss must arise on or after the first day of the incident period in a qualified disaster area.

22. Moving expenses

The OBBBA permanently disallows the moving expense deduction under §217 and the employer-paid moving expense exclusion under §132(g) for most taxpayers, extending the temporary suspension enacted under the Tax Cuts and Jobs Act (TCJA), which was originally effective from 2018 through 2025.

Limited exceptions remain in place:

- The deduction and exclusion continues to apply to active-duty members of the U.S. Armed Forces who move pursuant to a military order and permanent change of station.
- Further, the OBBBA expands the exception to include employees and appointees of the U.S. intelligence community who relocate due to an official change in assignment.

These changes apply to tax years beginning after December 31, 2025, with expanded eligibility for the intelligence community beginning in tax year 2026.

23. Mortgage interest deduction

The OBBBA permanently extends the limitation on the deduction for qualified residence interest to apply only to the first $750,000 of home acquisition mortgage debt ($375,000 for married individuals filing separately). This change makes permanent the temporary cap introduced by the TCJA, which was originally set to revert to a $1 million limit beginning in 2026. This provision applies to acquisition indebtedness used to purchase, build, or substantially improve a qualified residence, which includes a taxpayer's principal residence and one other residence.

The OBBBA also permanently excludes interest on home equity indebtedness from the definition of qualified residence interest, unless the proceeds are used to acquire or improve the residence.

Lastly, the OBBBA treats certain mortgage insurance premiums paid on acquisition indebtedness as qualified residence interest, thus allowing their deductibility. This provision applies to tax years beginning after December 31, 2025.

24. Adoption credit

The OBBBA enhances the existing adoption credit by making up to $5,000 of the credit refundable beginning in tax year 2025. The $5,000 refundable limit will be adjusted annually for inflation, beginning in 2025. The nonrefundable portion of the credit, which may cover adoption expenses up to $17,280 per child (2025), remains in place. The provision specifies that the refundable portion is not eligible for carryforward to subsequent years. This enhancement applies to tax years beginning after December 31, 2024.

25. 529 plans

The OBBBA significantly expands the list of qualified K–12 education expenses eligible for tax-exempt distributions from 529 savings plans and increases the annual distribution cap for K–12 expenses from $10,000 to $20,000, effective for tax years beginning after December 31, 2025.

Under the OBBBA, newly eligible K–12 expenses include:

- Tuition for public, private, or religious schools;
- Curriculum and curricular materials;
- Books and other instructional materials;
- Online educational resources;
- Tutoring and educational classes outside the home;
- Fees for standardized tests, AP exams, and college admission exams;
- Dual enrollment program fees at higher education institutions; and
- Educational therapies for students with disabilities, provided by licensed professionals.

The expanded list of qualified K–12 expenses is effective for distributions made after the date of enactment. The OBBBA also introduces §529(f), allowing 529 plan funds to be used for qualified postsecondary credentialing expenses.

Postsecondary credentialing expenses include tuition, fees, books, supplies, and equipment required for participation in recognized postsecondary credential programs. Also included are costs for testing and continuing education required to obtain or maintain a recognized credential. This provision applies to distributions made after the date of enactment.

A “recognized postsecondary credential program” includes those that:

- Are listed under the Workforce Innovation and Opportunity Act (WIOA);
- Appear in the VA Web Enabled Approval Management System directory;
- Prepare individuals for exams required for industry credentials; and
- Are deemed industry-recognized by the Secretary of Labor.

Covered credentials include:

- State or federally issued licenses;
- Registered apprenticeship completion certificates;
- Credentials listed in the DoD Credentialing Opportunities On-Line (COOL) directory; and
- Certifications accredited by recognized bodies such as the Institute for Credentialing Excellence.

26. ABLE accounts

The OBBBA permanently extends the TCJA provision allowing additional contributions to ABLE (Achieving a Better Life Experience) accounts for employed individuals with disabilities. These additional contributions are limited to the lesser of:

- The federal poverty level for a one-person household for the preceding year; or
- The beneficiary’s earned income for the year.

The OBBBA also permanently allows for tax-free rollovers from §529 qualified tuition plans to ABLE accounts. These provisions apply to tax years beginning after December 31, 2025.

Further, the OBBBA permanently permits ABLE account contributions to qualify for the Saver’s Credit. The OBBBA increases the maximum Saver’s Credit amount from $2,000 to $2,100 starting in tax years after December 31, 2026.

Beginning in 2027, only ABLE account contributions will be eligible for the Saver’s Credit, meaning retirement plan contributions will no longer qualify. For tax years before 2027, the Act provides a calculation that includes retirement contributions, elective deferrals, and voluntary employee contributions.

27. Limitation on wagering losses

Prior to the enactment of the OBBBA, losses from wagering transactions were deductible only to the extent of gains from such transactions. As a result, between 2018 and 2025, “losses” included all allowable deductions incurred in carrying on any wagering activity.

The OBBBA permanently limits the deductibility of gambling-related losses to 90% of the amount of such losses, still only to the extent of gains from wagering transactions.

As a result, a portion (10%) of losses will remain non-deductible, even when gains and losses are equal. This change is effective for tax years beginning after December 31, 2025.

Example: *A taxpayer has $100,000 in gambling winnings and $100,000 in gambling losses.*

Under pre-OBBBA law, no tax would be due, as losses fully offset winnings.

Under the new OBBBA 90% limitation, only $90,000 of the losses are deductible. The remaining $10,000 becomes taxable income.

Assuming an effective tax rate of 24%, this results in $2,400 in tax owed, despite a break-even year.

This change will particularly impact professional and high-volume bettors, including those in states with legalized sports betting.

The wagering provision is considered one of the more controversial provisions of the OBBBA, particularly due to its disproportionate impact on professional and high-volume sports bettors. Legislative developments, such as the proposed FAIR BET Act, aim to restore full deductibility of wagering losses. It is important to monitor legislative developments, which could potentially be retroactive or future changes.

28. Elimination of energy incentives

The OBBBA eliminates or accelerates the sunset of several clean energy credits that were extended or expanded under prior legislation. These rollbacks will significantly reduce tax incentives for residential and vehicle-based energy initiatives.

Clean Energy Incentives terminated by OBBBA include:

- **Energy Efficient Home Improvement Credit**: Previously available through 2032; now expires for property placed in service after 12/31/2025. This credit covered items like insulation, windows, heat pumps, and audits.
- **Residential Clean Energy Credit**: Previously available through 2032; now expires for expenditures made after 12/31/2025. This credit included items like solar panels, wind turbines, geothermal systems, and battery storage.
- **New Energy Efficient Home Credit**: Previously available through 2032; now ends for homes acquired after 6/30/2026. This credit provided up to $5,000 per unit for ENERGY STAR and Zero Energy Ready Homes.
- **Clean Vehicle Credit**: The OBBBA accelerates phaseout to vehicles acquired after 9/30/2025 (as compared to 2032 under prior law). The OBBBA eliminates future increases in domestic content requirements for battery minerals and components.
- **Previously Owned Clean Vehicles Credit**: This credit was to run through 2032; now terminates for vehicles acquired after 9/30/2025. This credit offered up to $4,000 for qualified used EV purchases.
- **Alternative Fuel Vehicle Refueling Property Credit**: Now expires for EV charging equipment and other property placed in service after 6/30/2026. This credit originally extended through 2032 for rural and low-income areas.

B. Extension and enhancement of TCJA provisions – Business Taxation

1. Section 199A

The OBBBA makes permanent the §199A QBI deduction, originally enacted under the TCJA and scheduled to sunset after 2025. The deduction continues to allow non-corporate taxpayers, including sole proprietors, S corporation shareholders, and partners, to deduct 20% of qualified business income.

The deduction also remains available for qualified REIT dividends and income from publicly traded partnerships. The final legislation does not increase the deduction rate from 20% to 23%, as had been proposed in an earlier House version.

The OBBBA expands the phase-in ranges for the §199A income limitation thresholds:

- For single filers, the phase-in range increases from $50,000 to $75,000.
- For married joint filers, the range increases from $100,000 to $150,000.

These expanded thresholds reduce the impact of wage and capital limitations and broaden access to the full deduction for higher-earning taxpayers. Inflation adjustments will apply to these thresholds for tax years beginning after 2026. This change particularly benefits taxpayers with income near the upper threshold of eligibility, especially those in specified service trades or businesses (SSTBs).

The OBBBA also introduces a minimum QBI deduction of $400 for taxpayers with at least $1,000 of QBI from one or more active qualified trades or businesses. An “active qualified trade or business” requires material participation by the taxpayer, as defined under §469(h).

The minimum deduction ensures that eligible taxpayers with modest QBI amounts are not excluded entirely from the deduction due to income level or complexity. The $400 minimum is adjusted for inflation beginning in tax years after 2026.

2. Bonus depreciation

The OBBBA permanently reinstates 100% bonus depreciation under §168(k) for qualified property acquired and placed in service after Jan. 19, 2025. Under the TCJA, bonus depreciation would have been reduced to 0% over multiple years.

Qualified property continues to include new or used depreciable property with a recovery period of 20 years or less and certain computer software, water utility property, and qualified improvement property (QIP). A limited transitional election allows taxpayers to apply the pre-OBBBA phase-down rates in lieu of full expensing for certain assets.

Specifically, taxpayers may elect to claim a reduced depreciation deduction of 40% (or 60% for certain aircraft or property with a longer production period) for certain qualified property placed in service during the first tax year ending after January 19, 2025.

The OBBBA creates an elective 100% depreciation allowance under §168(n) for Qualified Production Property (QPP), defined as nonresidential real property used as an integral part of a Qualified Production Activity (QPA). The term “Qualified Production Activity” means the manufacturing, production, or refining of a qualified product.

These buildings are now eligible for 100% bonus depreciation, but only if placed in service before January 1, 2031.

The QPP election is irrevocable unless "extraordinary circumstances" exist, and approval is granted by the Treasury Secretary. This is a significant departure from prior law, which excluded real property (other than QIP) from bonus depreciation treatment. The provision is designed to incentivize onshore manufacturing investments and promote U.S.-based industrial activity.

QPP specifically excludes Alternative Depreciation System (ADS) property, property leased to another individual, or offices for sales and research activities. Additionally, QPP must meet an original use requirement; however, certain used property qualifies if:

- It was not previously used by the taxpayer;
- It was not previously used in a QPA by another party; and
- It was not acquired from a related party or through certain non-recognition transactions.

A 10-year recapture rule applies under §1245 if property ceases to be used in a QPA. Coordination with AMT rules and overlapping additional first-year depreciation elections ensures no unintended benefits.

The permanent nature of 100% expensing creates long-term certainty for businesses planning capital expenditures. Strategic timing of acquisitions and construction starts is critical to QPP eligibility. Industries with heavy fixed-asset investments, such as manufacturing, transportation, and logistics, stand to significantly benefit.

However, it is important to note that taxpayers must also consider state conformity, as many states do not follow federal bonus depreciation rules, requiring separate calculations. Further, states may address new §168(n) QPP depreciation separately.

3. Section 179 expensing

Prior to the OBBBA, the inflation-indexed §179 expensing limit for 2025 was $1,250,000, with a phaseout threshold of $3,130,000. The OBBBA increases the statutory maximum amount that a taxpayer may expense under §179 to $2,500,000 and raises the phaseout threshold to $4,000,000. These new limits continue to be subject to annual inflation adjustments.

The deduction continues to phase out dollar-for-dollar when the total cost of qualifying property exceeds the $4,000,000 threshold. These changes apply to property placed in service in tax years beginning after December 31, 2024.

4. Research and experimental expenditures

The OBBBA permanently restores immediate expensing for domestic research or experimental (R&E) expenditures incurred in tax years beginning after December 31, 2024.

This change is implemented through new §174A, which allows taxpayers to either fully deduct domestic R&E costs in the year incurred or elect to capitalize and amortize them ratably over a 60-month period. Foreign R&E expenditures must still be capitalized and amortized over 15 years under the existing provisions of §174.

This change effectively reverses the TCJA's requirement that all R&E expenses be amortized, providing greater flexibility and cash flow benefits for U.S.-based research activities.

The OBBBA provides transitional relief for taxpayers who capitalized domestic R&E costs in 2022 through 2024 under the TCJA rules. Taxpayers may elect to fully deduct the unamortized portion of those expenses in the first tax year beginning after December 31, 2024, or amortize the remaining balance ratably over a two-year period starting in that same year. Additionally, the OBBBA preserves the small business taxpayer election under prior law, which allows eligible taxpayers to retroactively deduct domestic R&E costs incurred after December 31, 2021.

These provisions are intended to ease the administrative and financial burden created by the prior amortization requirement and to support a smoother transition back to full expensing.

Taxpayers should evaluate the need for accounting method changes to conform with the new R&E expensing provisions and take advantage of the available elections. The permanent nature of the provision provides long-term planning certainty and may influence decisions related to capital investment, hiring, and domestic R&E expansion. However, companies with foreign R&E activities will still need to carefully segregate those costs, as foreign expenditures remain subject to 15-year amortization.

5. Advanced Manufacturing Investment Credit (CHIPS Credit)

The OBBBA increases the Advanced Manufacturing Investment Credit under IRC §48D, commonly referred to as the CHIPS Credit, from 25% to 35%. The enhanced 35% credit applies to qualified property placed in service after December 31, 2025.

The credit continues to apply to advanced manufacturing facilities, which are facilities whose primary purpose is the manufacturing of semiconductors or semiconductor manufacturing equipment. This change is designed to further incentivize domestic semiconductor production and aligns with ongoing policy efforts to bolster U.S. supply chains and high-tech manufacturing.

6. Section 163(j) Business Interest

The OBBBA permanently reinstates the more favorable EBITDA-based limitation for business interest deductions under §163(j), effective for tax years beginning after December 31, 2024. This means adjusted taxable income (ATI) will now be calculated before depreciation, amortization, and depletion deductions.

The OBBBA also includes coordination rules for how the §163(j) interest limitation interacts with interest capitalization provisions. These reforms aim to boost investment incentives for capital-intensive and highly leveraged businesses.

The OBBBA creates a new ordering rule in which the business interest deduction limitation under §163(j) is applied before any interest capitalization provisions. After applying the limitation, any allowable interest is allocated first to any amounts that would be capitalized. The remainder (if any) of any allowable interest is allocated to amounts that would be deducted. Interest that is carried forward under 163(j) will not be subject to future capitalization. This provision applies to tax years beginning after December 31, 2025.

The OBBBA also expands the definition of a "motor vehicle" to include any trailer or camper which is designed to provide temporary living quarters for recreational, camping, or seasonal use and is designed to be towed by, or affixed to, a motor vehicle. This means that interest on financing for these items qualifies as floor plan financing interest and can be deductible under §163(j).

The new provisions enacted under the OBBBA are expected to be favorable for domestic capital investment, especially in manufacturing and infrastructure-heavy industries. Further, industries with high leverage, such as real estate, manufacturing, and private equity, are expected to benefit greatly from these changes.

When combined with 100% bonus depreciation, these provisions create a multiplier effect: for every $10 of investment, a company may be able to deduct up to $3 more in interest expense.

7. Qualified Small Business Stock Exclusion

The OBBBA significantly expands the benefits available under §1202, which allows noncorporate taxpayers to exclude gain from the sale of qualified small business stock (QSBS). The changes apply to stock acquired on or after July 4, 2025, and include tiered gain exclusions, increased per-issuer dollar caps, and a higher gross asset test for qualifying corporations.

These reforms are intended to stimulate investment in growing private companies, particularly startups and emerging businesses. Investors in qualified startups and growth-stage businesses will benefit from greater exclusions, longer investment flexibility, and expanded issuer eligibility.

Under prior law, 100% exclusion was available only for QSBS held more than five years (for stock issued after 2010). The OBBBA introduces a tiered structure for QSBS acquired on or after July 4, 2025:

New Tiered Gain Exclusion Structure	
Holding Period	**QSBS Acquired After July 4, 2025**
> 3 years	50% gain exclusion
> 4 years	75% gain exclusion
> 5 years	100% gain exclusion

The percentage of gain excluded increases based on the holding period, incentivizing longer-term investment in small businesses.

The OBBBA raises the lifetime per-issuer cap for QSBS gain exclusion from $10 million to $15 million for stock acquired after July 4, 2025. The new $15 million cap is indexed for inflation beginning in 2027, using 2025 as the base year.

For married taxpayers filing separately, the cap is reduced to $7.5 million, as under prior law. If the taxpayer exceeds the cap in a given year, the exclusion in subsequent years may be reduced to zero, even with inflation indexing.

To qualify for the QSBS exclusion, the issuing corporation must meet an aggregate gross asset limit. The OBBBA raises this limit from $50 million to $75 million, effective for stock issued after July 4, 2025.

The $75 million threshold is also indexed for inflation beginning in 2027, rounded to the nearest $10,000. The change allows larger small businesses to qualify, broadening the reach of §1202 benefits.

Stock that would otherwise be considered acquired before, on, or after the applicable date will instead be treated as acquired on the first day the taxpayer held the stock, in accordance with the holding period rules under §1223. If stock is acquired in multiple tranches or exchanges, the acquisition date is based on the earliest applicable holding period.

As under existing law, excluded gain under §1202 is not treated as a tax preference item for AMT purposes. The new gain exclusion tiers and increased limitations apply to tax years beginning after July 4, 2025.

8. Excess business loss limitation

Under IRC §461(l), noncorporate taxpayers are subject to a limitation on excess business losses, which is the amount by which business deductions exceed business income or gain, plus a statutory threshold. For 2025, the inflation-adjusted EBL thresholds are $313,000 for single filers and $626,000 for joint filers.

Prior to the OBBBA, this limitation was set to expire for tax years beginning after December 31, 2028. The OBBBA makes this limitation permanent, ensuring that EBL rules will continue to apply to future tax years without a sunset provision. The provision applies to tax years beginning after December 31, 2026.

The excess business loss limitation will also permanently apply to farming losses, as the OBBBA makes the inapplicability of the IRC §461(j) farm loss limitation permanent. Lastly, disallowed EBLs may still be carried forward as NOLs, avoiding continued application of the limitation.

9. Charitable contributions

The OBBBA amends §170 to introduce a new 1% floor for corporate charitable contribution deductions. For tax years beginning after December 31, 2025, a corporate taxpayer may deduct charitable contributions only to the extent they exceed 1% of taxable income.

The existing rule allowing deductions up to 10% of taxable income remains unchanged, as the new 1% floor applies in addition to the 10% ceiling. Qualified conservation contributions are exempt from the 1% floor and continue to follow prior treatment. Contributions that are disallowed either for exceeding the 10% limit or for failing to exceed the 1% floor may be carried forward for up to five years.

10. Paid family and medical leave credit

The OBBBA makes the §45S paid family and medical leave credit permanent, effective for tax years beginning after December 31, 2025. Employers may now elect between a credit based on wages paid to qualifying employees or premiums paid for qualifying insurance policies that provide paid family and medical leave.

The wage-based credit equals 12.5% to 25% of paid leave, depending on the wage replacement rate, for up to 12 weeks per employee per year. Paid leave mandated or funded by state or local governments counts toward meeting the eligibility threshold but does not generate a credit.

The OBBBA lowers the employment duration requirement to as little as six months at the employer's election (previously one year). Further, the definition of eligible employees is expanded to include those working at least 20 hours per week. Lastly, aggregation rules are clarified to treat employers under §§414(a) and 414(b) as a single employer for credit purposes.

11. Employer-provided child care credit

Under the OBBBA, beginning in 2026, the credit percentage for qualified child care expenditures under §45F increases from 25% to 40% for regular businesses and to 50% for eligible small businesses. The maximum annual credit increases from $150,000 to $500,000 for regular businesses and $600,000 for eligible small businesses, with both limits indexed for inflation beginning in 2027.

Under the OBBBA, an eligible small business is defined using a 5-year gross receipts test, instead of the standard 3-year lookback, broadening eligibility. The credit is also expanded to cover third-party intermediary arrangements and jointly owned or operated child care facilities, offering additional flexibility in structuring child care support. These enhancements are effective for amounts paid or incurred after December 31, 2025.

12. Payments from partnerships to partners for property or services

Prior to the OBBBA, §702(a)(2) permitted the IRS to recharacterize certain allocations and distributions to a partner as transactions with an outsider, but only under regulations issued by the IRS. These rules applied where the facts indicated that a partner providing services or property was acting in a capacity other than as a partner, and the related allocation or distribution resembled a disguised sale or compensation arrangement.

The OBBBA removes the requirement that recharacterization must occur pursuant to IRS regulations, thereby allowing the IRS to recharacterize qualifying transactions even in the absence of formal guidance. The change does not apply retroactively and is effective for services performed or property transferred after July 4, 2025.

This amendment is significant for partnerships and their partners, as it provides the IRS with greater flexibility to challenge partner-level transactions that resemble arm's-length compensation or property sales.

13. Form 1099 reporting thresholds

The OBBBA raises the longstanding $600 threshold for reporting payments to nonemployees, providing long-sought relief for businesses and simplifying compliance. For payments made after December 31, 2025, the general reporting threshold increases from $600 to $2,000. This change applies to common payments such as nonemployee compensation, rents, prizes, awards, and other reportable income types made in the course of business.

Beginning in 2027, the $2,000 threshold will be adjusted annually for inflation.
The backup withholding rules under §3406 are also updated to reflect the inflation-adjusted threshold, aligning reporting and withholding compliance.

Further, the OBBBA reverses the American Rescue Plan Act of 2021 (ARPA) provision that lowered the Form 1099-K de minimis threshold to $600. Under the OBBBA, the pre-ARPA thresholds are restored, meaning that Form 1099-K is only required when both of the following are true:

- The total gross payments to a payee exceed $20,000; and
- The total number of transactions exceeds 200 in the calendar year.

This rollback eliminates the requirement to issue 1099-Ks to many casual sellers and gig economy participants, addressing industry concerns about over-reporting.

The OBBBA also clarifies that both the dollar threshold and transaction count must be exceeded before backup withholding applies. The reversion to the higher 1099-K threshold is retroactive and applies as if it were included in the original ARPA legislation. The updated backup withholding clarification is effective for calendar years beginning after December 31, 2024.

14. Qualified bicycle commuting reimbursement exclusion

Effective 2026, the OBBBA permanently repeals the qualified bicycle commuting reimbursement exclusion previously available under §132(f). Prior to the OBBBA, employers could reimburse employees up to $20/month for qualified bicycle commuting expenses as a tax-free fringe benefit. This benefit was suspended from 2018–2025 but was scheduled to return in 2026.

The OBBBA permanently removes the bicycle commuting reimbursement from the list of qualified transportation fringe benefits. Starting in 2026, any employer reimbursement for bicycle commuting is treated as taxable compensation to the employee. This provision applies to tax years beginning after December 31, 2025.

15. Opportunity Zones

The OBBBA permanently extends and modernizes the Opportunity Zone program, beginning with a new round of OZ designations starting January 1, 2027. To qualify, census tracts must have a poverty rate of at least 20% or have a median family income of no more than 70% of the area's median income. The bill excludes any tract where the median family income is 125% or more of the area's median, tightening eligibility standards. At least 33% of newly designated OZs must be entirely rural; if fewer rural tracts qualify, then all eligible rural areas must be designated.

The OBBBA eliminates the ability to designate contiguous tracts that are not themselves low-income communities (LICs), closing a prior loophole. OZ investors may defer capital gain recognition for up to five years and receive basis increases after a five-year holding period, enhancing tax benefits. The second round of OZs will begin on January 1, 2027 and end on December 31, 2033.

16. Employee Retention Tax Credit (ERTC)

The ERTC was created under the CARES Act to provide a refundable payroll tax credit for eligible employers who retained employees during COVID-19 disruptions.

For 2020, the ERTC equaled 50% of qualified wages (up to $5,000 per employee). In 2021, the ERTC increased to 70% of qualified wages per quarter (up to $7,000 per employee, per quarter).

The ERTC ended for most employers after Q3 2021, but recovery startup businesses remained eligible through December 31, 2021. Claim deadlines were as follows:

- 2020 wages → April 15, 2024; and
- 2021 wages → April 15, 2025.

The IRS paused processing new ERTC claims on September 14, 2023, due to widespread abuse by aggressive ERTC "mills."

The OBBBA imposes a $1,000 penalty per violation on COVID-ERTC promoters who fail to meet due diligence standards in assisting with ERTC claims. A COVID-ERTC promoter is defined as someone advising on ERTC who:

- Charges fees based on the credit/refund amount, and in the current or prior tax year, more than 20% of their total gross receipts came from ERTC-related services; or
- In the current or prior year, earns more than 50% of gross receipts from ERTC work; or
- Has ERTC work comprising more than 20% of total gross receipts and has receipts totaling over $500,000.
- Note: Certified Professional Employer Organizations (CPEOs) are excluded from the promoter definition.

The OBBBA bars new ERTC claims filed after January 31, 2024 and extends the IRS assessment window for ERTC-related issues to six years. Businesses must also adjust improperly deducted ERTC wages within the extended timeframe. Penalties for erroneous refund claims now apply to employment taxes, expanding beyond just income tax.

17. Elimination of energy incentives

Similar to the termination of clean energy tax benefits for individuals, the OBBBA eliminates several energy-related tax incentives for businesses. Notable Business Energy Incentives eliminated include:

- **Energy Efficient Commercial Buildings Deduction (§179D)**: Construction of qualifying energy efficient commercial building property beginning after June 30, 2026, will no longer be eligible for the §179D deduction. This provision had no prior sunset and was widely used in the real estate and construction sectors. Code §179D(i), added by the OBBBA, officially terminates this deduction.
- **Qualified Commercial Clean Vehicles Credit (§45W)**: The credit for the purchase of qualified commercial clean vehicles is terminated for vehicles acquired after September 30, 2025. This credit had previously applied through 2032 and provided up to $40,000 per vehicle, depending on size and propulsion system. The repeal eliminates a key incentive for fleet electrification by commercial and logistics companies.

Principles and Considerations for Nonresident Withholding, Composite Payments, and Passthrough Entity Taxes

Principles and Considerations for Nonresident Withholding, Composite Payments, and Passthrough Entity Taxes

Learning objective

Upon reviewing this material, the reader will be able to:

- Understand, discuss, and explain the differences in nonresident withholding, composite, and passthrough entity taxes and the possible advantages of a PTET election.

I. Background

For a number of reasons partnerships and S corporations, collectively referred to as passthrough entities, (PTEs), are the preferred vehicle for the majority of businesses here in the United States. To name a few benefits:

- PTE owners avoid double taxation through the "passthrough regime".
- Depending on registration, owners receive liability protection.
- The §199A QBI deduction is accessible for managing tax liabilities.
- For S corporations, the opportunity to manage self-employment taxes arises.
- The formal entities and their agreements can provide ease of transferability and opportunities for succession planning.

In contrast to these benefits, the state implications of passthrough entities can serve as a significant source of difficulty as it relates to PTEs with activities in multiple states or an ownership pool that is a nonresident with respect to the primary state of a PTE's activities.

While PTEs are often thought of as nontaxable entities, the passthrough nature remains consistent moving from the federal system to most state systems, and as states implement systems to ensure income taxes are collected for PTE economic activity within, regardless of the state of residency, the result is significant complexity for PTEs. Most states adopt one regime or a mix of regimes to ensure state taxes are collected on the allocable share of PTE income to owners. The regimes are usually thought of as withholding taxes, composite taxes, and passthrough entity taxes.

Note:

This chapter material does not, in any way, represent the full breadth and depth of any particular state for income/franchise tax purposes. The scenarios and examples of this chapter serve as tools to frame the various items of consideration and concern that should be addressed in working with multistate PTEs. Further, the items noted should not be considered all encompassing.

A. What drives tax reporting and obligations within a state?

1. Nexus and apportionment

Nexus in multistate taxation refers to the connection or presence that a business has in a particular state that subjects it to that state's tax laws and regulations. When a business has nexus in a state, it is typically required to register with the state's tax authorities and collect and remit various state taxes, such as sales tax, income tax, or franchise tax. Nexus is a crucial concept in the realm of state taxation because it determines a business's tax obligations in multiple states.

Nexus can be established in various ways, and the specific criteria may vary from state to state. Some common factors that can create nexus include:

- **Physical Presence:** A physical presence in a state, such as a storefront, office, warehouse, or manufacturing facility, can create nexus.
- **Sales Activity:** Conducting sales within a state, either through in-person sales representatives, e-commerce, or other means, can establish nexus.
- **Employee Activity:** Having employees working within a state can create nexus. This can include remote workers or sales representatives.
- **Property Ownership:** Owning or leasing property in a state may trigger nexus.
- **Economic Thresholds:** Some states have economic nexus thresholds, where a business may establish nexus if it reaches a certain level of sales or transactions within the state, even without a physical presence.
- **Affiliate or Related Entity Relationships:** Nexus can be established if a business has related entities or affiliates that operate within a state.

It's important to understand the nexus rules of each state in which a business operates to ensure compliance with state tax laws. Non-compliance with nexus requirements can result in penalties, fines, and legal consequences. Additionally, the United States Supreme Court's decision in the *South Dakota v. Wayfair* case in 2018 has led to changes in the rules for collecting sales tax in different states, making it even more important for businesses to stay informed about nexus issues.

Allocation and apportionment are additional essential concepts in multistate taxation, especially for businesses that operate in multiple states. These concepts help determine how a business's income, sales, or other factors are divided among different states for tax purposes. This is important because each state may have its own rules and methods for taxing businesses that have nexus within their jurisdiction.

- **Allocation:** Allocation refers to the process of assigning a specific portion of a business's income, expenses, or other tax-related factors to a particular state. This is typically necessary when certain income or expenses are directly attributable to a specific state. For example, if a business has a manufacturing facility in one state and a sales office in another, it may need to allocate a portion of its income and expenses to each state based on where those activities occur.

  Allocation is straightforward when it's clear-cut and can be directly traced to a single state. However, not all income and expenses can be easily allocated in this manner, which is where apportionment comes into play.
- **Apportionment:** Apportionment is the process of dividing a business's income, expenses, or other relevant factors among multiple states when they cannot be directly allocated. It's a method for fairly distributing these factors among states based on specific formulas or ratios.

  The most common factor used in apportionment is typically the sales factor. States often use a formula that considers the ratio of a business's sales in a particular state to its total sales across all states in which it operates. However, states may also consider factors like payroll, property, or a combination of these factors in their apportionment formulas. For example, if a business's total sales are $1,000,000, and $200,000 of those sales occur in state A while $800,000 occur in state B, the sales factor for state A would be 20%, and for state B, it would be 80%. The business would then allocate a portion of its income and expenses to each state based on these percentages.

Apportionment formulas and rules can vary significantly from state to state, which can make multistate tax compliance complex for businesses.

The goal of allocation and apportionment is to prevent double taxation and ensure that each state taxes a fair share of a business's income based on its economic activity within that state. But these nexus, allocation, and apportionment determinations are made at the PTE level.

At the individual level, it is important to remember the PTE owner’s resident state will take a similar approach as the federal tax system does for US citizens and residents: all income is taxable to the resident taxpayer no matter which state the income is derived in. To mitigate double taxation, much like the federal system, the resident state may offer a “credit for taxes paid to other states.”

2. What do these taxpayer scenarios look like: Setting the stage

In framing this material, consider the following scenario:

Scenario: AB Partnership, a 60/40 partnership, is a 60/40 partnership formed by Brian and Bob. Brian is a resident of North Dakota, and Bob is a resident of Indiana. AB drop ships tangible personal property across the US utilizing Amazon fulfillment from North Dakota and California. These are the only states where there is property, rent, or employees, and as such PL 86-272 protects the sales apportionment of the goods to the states where there is physical presence nexus ties, and in this case, California and North Dakota are the states with nexus ties.

Issues to Consider:

California

With respect to California, what are the tax consequences to AB Partnership?
How does California treat the allocable share of apportioned income to nonresident partners Brian and Bob?
Are there any specific elections available to AB, Brian, and/or Bob?

North Dakota

With respect to North Dakota, what are the tax consequences to AB Partnership?
How does North Dakota treat the allocable share of apportioned income to resident partner Brian?
How does North Dakota treat the allocable share of apportioned income to nonresident partner Bob?
Are there any specific elections available to AB, Brian, and/or Bob?

Indiana

What implications are there for AB Partnership with respect to Indiana?
What are the taxes and/or reporting requirements, if any, for the nonresident Indiana partner Brian?
What are the taxes and/or reporting requirements, if any, for the resident Indiana partner Bob?

II. Nonresident withholding taxes

Nonresident withholding taxes are state-level taxes imposed on income earned within a state by individuals or entities that are not residents of that state. These taxes are often applicable to multistate passthrough entities because they receive income from multiple jurisdictions. Here are the key components of nonresident withholding taxes:

- **Income Source:** Nonresident withholding taxes come into play when income is generated within a specific state. This can include allocable share of business income, rental income, interest, dividends, and more.
- **Withholding Tax:** When a multistate PTE has income sourced to a state where a PTE owner lacks residency, the state may impose tax obligation to withhold a portion of the PTE owner's apportioned allocable income and remit it to the state's tax authority. This withholding is typically a percentage of the income, oftentimes the highest marginal individual tax rate in the state.

Withholding obligations oftentimes do not satisfy a nonresident PTE owner's individual filing requirement at the state level. The withholding taxes merely serve as the PTE making what is essentially an estimated tax payment on behalf of the PTE owner. When the nonresident PTE owner files their nonresident return with the state, the PTE owner may be able to claim a payment/credit to offset the taxes calculated on the nonresident individual tax return. Further, the individual taxpayer may be able to use the withholding taxes toward a credit for taxes paid to other states on the resident individual return, as applicable.

Withholding taxes paid by the PTE should be indicated to the PTE owner for the applicable states on the state K-1s to be provided to shareholders. As an example, California requires income subject to withholding and to be reported by the PTE to the PTE owner on Form 592-B and also reported on the California Schedule K-1. For a partnership, this would include the following reporting:

Resident and Nonresident Withholding Tax Statement

CALIFORNIA FORM

592-B

☐ Amended

Part I Withholding Agent Information

Name of withholding agent (from Form 592, 592-PTE, or 592-F)				SSN or ITIN
Address (apt./ste., room, PO box, or PMB no.)			☐FEIN ☐CA Corp no. ☐CA SOS file no.	
City (If you have a foreign address, see instructions.)	State	ZIP code	Daytime telephone number	

Part II Payee Information

Name of payee			SSN or ITIN
Address (apt./ste., room, PO box, or PMB no.)		☐FEIN ☐CA Corp no. ☐CA SOS file no.	
City (If you have a foreign address, see instructions.)	State	ZIP code	

Part III Type of Income Subject to Withholding. Check the applicable box(es)

A ☐ Payments to Independent Contractors
B ☐ Trust Distributions
C ☐ Rents or Royalties
D ☐ Distributions to Domestic (U.S.) Nonresident Partners/Members/ Beneficiaries/S Corporation Shareholders
E ☐ Estate Distributions
F ☐ Elective Withholding
G ☐ Elective Withholding/Indian Tribe
H ☐ Allocations to Foreign (non-U.S.) Nonresident Partners/Members
I ☐ Other ____________________

Part IV Tax Withheld

1 Total income subject to withholding	1	
2 Total resident and/or nonresident tax withheld (excluding backup withholding)	2	
3 Total backup withholding	3	

Partner's name | **Partner's identifying number**

	(a) Distributive share items	(b) Amounts from federal Schedule K-1 (Form 1065)	(c) California adjustments	(d) Total amounts using California law. Combine col. (b) and col. (c)	(e) California source amounts and credits
Deductions	12 Expense deduction for recovery property (IRC Section 179)				
	13 a Charitable contributions				
	b Investment interest expense				
	c 1 Total expenditures to which an IRC Section 59(e) election may apply				
	2 Type of expenditures ________________				
	d Deductions related to portfolio income				
	e Other deductions. Attach schedule				
Credits	15 a Total withholding (equals amount on Form 592-B if calendar year partnership)			●	▶
	b Low-income housing credit				
	c Credits other than line 15b related to rental real estate activities				
	d Credits related to other rental activities				
	e Nonconsenting nonresident members' tax allocated to partner				
	f Other credits – Attach required schedules or statements				

Lastly, it is important to distinguish that this tax is paid by the PTE on behalf of the PTE owner but is not ultimately imposed on the PTE. As such, withholding taxes are usually treated as either a PTE distribution to the PTE owner, or alternatively for cash flow tight organizations, a "Loan to/Receivable from PTE

Owner" for the amount of the withholding tax paid. The loan/receivable can either be offset by future declared and paid distributions from the PTE or require contributions to the PTE to satisfy the PTE owner's obligation to the PTE. Withholding taxes paid should not be deducted by the PTE in determining PTE taxable income. The withholding taxes would be deductible by the individual PTE owner on Schedule A (1040) and subject to the $10,000 annual SALT limitation.

III. Composite taxes

Nonresident composite taxes are a tax method used by certain states in the United States to simplify the tax compliance process for multistate passthrough entities. These taxes are typically imposed on nonresident partners or shareholders who earn income from the entity's operations within the state. Instead of requiring each nonresident owner to file an individual state tax return, some states allow multistate passthrough entities to calculate and remit a composite tax on behalf of these nonresident owners, which can in many cases serve as the filing requirement of the nonresident and remove the filing requirement of the nonresident individual income tax return. The composite taxes do not apply to residents of the applicable state.

- **Income Source:** Nonresident composite taxes apply to owners or shareholders of multistate passthrough entities who do not reside within the state but receive an allocable share of apportioned/allocated income from the entity's activities within that state.
- **Composite Tax Rate:** The composite tax rate is typically a flat percentage of the nonresident PTE owner's allocable apportioned income sourced within the state. The rate may vary depending on the state's tax laws, but it is often the highest individual marginal tax rate.

Similar to nonresident withholding taxes, composite taxes are paid on behalf of PTE owners in satisfaction of the PTE owner's nonresident activity within a given state for the specific PTE. Assuming all allocable apportioned share of PTE income for a PTE owner is included on composite tax returns for all PTE activities, the composite usually mitigates any need to file a nonresident tax return within a given state, thereby simplifying state tax return filing requirements with respect to the individual PTE owner.

Example: ***Facts***
John, a FL resident, is a PTE owner in Partnership 1, Partnership 2, and 3 S Corporation. Partnership 1, Partnership 2, and 3 S Corporation all operate in multiple states with income taxes. John is included on PTE composite returns within all states where the three PTEs operate.

Conclusion
Because John is included on PTE composite returns in all states where the three PTEs operate and all applicable states treat composite tax returns as substitutes for nonresident individual returns absent any other state sourced income, John will have no state filing obligations with respect to the multistate activities of his PTE ownership interests.

Further, because John is a resident of FL, which does not have an income tax, John will have no resident state return.

Thus, John will file his federal return for all relevant income and deductions, including those related to his allocable share from the PTE ownership interest, and will have no resulting state tax filing obligations.

Again, similar to nonresident withholding, it is important to distinguish that the composite tax is paid by the PTE on behalf of the PTE owner but is not ultimately imposed on the PTE. As such, composite taxes are usually treated as either a PTE distribution to the PTE owner, or alternatively for cash flow tight organizations, a “Loan to/Receivable from PTE Owner” for the amount of the composite tax paid. The loan/receivable can either be offset by future declared and paid distributions from the PTE or require contributions to the PTE to satisfy the PTE owner’s obligation to the PTE. Composite taxes paid should not be deducted by the PTE in determining PTE taxable income. The composite taxes would be deductible by the individual PTE owner on Schedule A (1040) and subject to the $10,000 annual SALT limitation.

The amount of composite taxes paid should be indicated by the PTE to the PTE owner on the related state schedules K-1 or related schedules and/or statements provided to the PTE owner.

IV. Passthrough entity taxes

On November 9, 2020, the IRS issued Notice 2020-75, stating that the Treasury Department and IRS intend to issue proposed regulations clarifying SALT deduction limitations. Per the guidance, any “specified income tax payments” are deductible by partnerships and S corporations in computing their non-separately stated income or loss for the tax year of the payment. Specified income tax payments are any amount imposed on and paid by a partnership or S corporation to a state to satisfy its income tax liability. As such, these payments are not subject to the SALT deduction limitation for partners and shareholders who itemize their deductions and are fully deductible. Notice 2020-75 states that the proposed regulations described in the notice apply to payments made on or after November 9, 2020. Additionally, Notice 2020-75 allows taxpayers to apply the rules to payments made in a taxable year of the partnership or S corporation ending after December 31, 2017 and before November 9, 2020. These “specified income tax payments” became known as Passthrough Entity Taxes (PTETs) and represent an alternative in states that may otherwise impose a mandatory withholding or composite tax regime subject to the SALT limitation on itemized deductions on Schedule A.

Example: Partnership ABC has two equal partners, A and B. Partnership ABC pays state X income tax of $50,000. State X allows partners A and B to each claim a $25,000 credit against their own personal income tax liability owed to state X. Per Notice 2020-75, the $25,000 that each partner receives is **not** subject to the $10,000 SALT deduction limitation.

As demonstrated, the PTE-level tax largely resembles a corporate income tax on PTEs. Most regimes are currently elective and are not mandatory on PTEs. Currently, Connecticut is the only *mandatory* PTE tax state. The Connecticut PTE tax is assessed on the passthrough entity’s taxable income or alternative tax base. In return, each individual shareholder, partner, or member is eligible for a refundable credit equal to their portion of the PTE tax, multiplied by 87.5%. Each passthrough entity reports the amount of the PTE tax credit allocated to each partner on Schedule CT K-1. Any credit in excess of the individual partner’s tax liability is refundable.

A resident state credit may exist for taxes paid to other states, where states allow credits for resident individuals paying taxes to other states. In the distributive share/composite regime, many states allow credits and exclusions to mitigate double taxation. Some states provide a percentage limitation on available credits, while other states provide subtraction modifications for income subject to tax at the PTE-level.

Practice Note: Beware of incomplete or incorrect guidance

> Because these taxes are in a rapidly changing environment, it is important to be aware of what applicable state guidance is being released. For example, prior to the passage of the Indiana PTET, the instructions to the Indiana Individual Income Tax Return (IT-40), which have a most recent revised date of September 2022, specifically permit a credit for taxes paid to other states for both withholding and composite taxes but explicitly disallow the credit for those related to PTETs. However, Indiana later signed into law the PTET retroactive to January 1, 2022, which also permitted the PTET to become a creditable tax, while most state forms and instructions relevant to tax year 2022 remained outdated. This is a simple example of why vigilance is necessary to arrive at the correct answer for the PTEs with multistate activities.

SALT cap workarounds occur when states impose tax on passthrough entities (PTEs) at the entity level, in exchange for offsetting state tax credits or reductions for the entity's members. Certain states allow PTE members to take a credit to offset their taxable income, but the PTE member still reports such income on their tax return. Other states allow PTE members to reduce their AGI by their pro rata share of income from the PTE, provided the PTE elects to be taxed at the entity level. Some PTE elections are irrevocable, so it is important to weigh this consideration when determining whether to make a PTE election.

V. Other items of consideration

Not only should the optimization of taxes be considered but a whole host of other issues must be considered. Some passthrough entity tax (PTET) items to consider include following:

- Is the PTET elective or mandatory?
- Are estimated payments required?
- What voting procedure and percentage of ownership is required to make the election?
- Is the election binding for the current year or future years? Is revocation possible?
- What forms are used to make the election?
- Does the operating agreement or corporate charter permit the PTET election?
- Are all partners/shareholders included in the PTET election?
- Are guaranteed payments reduced by the partner's share of the PTET tax expense?
- How are excess PTE tax credits/refunds addressed for federal income tax purposes?
- Is self-employment income reduced by the PTET?
- Are loss carryforwards allowed for PTET purposes? Would any ASC740/Deferred Tax Accounting be required by an audit team given their materiality thresholds?
- For state purposes, what deductions will be included in the taxable income base for PTET purposes (e.g., charitable contributions, gains for changes in ownership structured as either an asset sale or stock sale)?
- Because most states disallow deductions for state purposes, will there be a different basis in partnership interest/S corporation stock that must be accounted for on the state return when the PTE owner sells their interest?
- How should owners be notified of which states filed withholding, composite, or the PTE tax was executed?
- And many, many more questions could be relevant…

A. Bookkeeping for nonresident withholding and composite taxes

Because nonresident withholding/composite taxes ultimately are imposed on the PTE owner, these payments do not represent deductions to the PTE and should be recorded as what is essentially balance sheet only transactions. This can be done in two separate ways:

1. **Distribution Approach:** When the withholding/composite tax payment is made, the reduction in cash and the reduction in equity is via a PTE owner distribution.

Example: ***Facts – Standard Distribution Approach***

AB S corporation has two 50/50 shareholders, Shareholder A and Shareholder B. AB S corporation is required to make a total $30,000 of nonresident state composite payments on behalf of Shareholders A and B. AB S corporation records the composite tax payment utilizing the distribution approach as follows:

DR Distributions – Shareholder A	$15,000	
DR Distributions – Shareholder B	$15,000	
CR Cash		$30,000

Conclusion

Because the payments made were with regard to withholding taxes, AB S Corporation will record a distribution for the state withholding payments. These payments are not deductible as PTETs for AB S corporation.

With this approach, if the only distributions paid for the year are related to withholding/composite taxes, the result would appear to be a disproportionate distribution.

Example: ***Facts – Distribution Approach/Disproportionate Distributions***

AB S corporation has two 50/50 shareholders, Shareholder A and Shareholder B. AB S corporation is required to make $25,000 of nonresident state composite payments on behalf of Shareholder A, and no withholding or composite taxes are made on behalf of Shareholder B. AB S corporation records the state composite tax payment utilizing the distribution approach as follows:

DR Distributions – Shareholder A	$25,000	
CR Cash		$25,000

Conclusion

Absent any other distributions, the result is a disproportionate distribution in favor of Shareholder A over Shareholder B, which violates the required per-share, per-day S corporation requirements and could result in an involuntary termination of the S election. Oftentimes, a work-around for this would be the entity recording a distribution payable to shareholder B as follows:

DR Distributions – Shareholder B	$25,000	
CR Distribution Payable – Shareholder B		$25,000

While this would serve as a work-around, Shareholder B will be receiving a basis reduction without the cash, and to the extent the distribution would be in excess of basis, the shareholder would be subject to capital gain. As such, these sorts of work-arounds should be considered only under extreme advisement.

2. **PTE Owner Receivable Approach:** Under the shareholder receivable approach, the payment of withholding/composite taxes creates a receivable from the PTE owner. This receivable then can be offset by future distributions, or if the entity is in liquidation proceedings, require the owner to satisfy the PTE owner contribution with a capital contribution.

Example: ***Facts – PTE Owner Receivable Approach***

CD Partnership is a 50/50 partnership with two partners, Partner C and Partner D. Partner C is subject to state withholding taxes in the amount of $20,000. CD Partnership is not required to make any state withholding/composite payments on behalf of Partner D. Utilizing the PTE owner receivable approach, CD records the following entry for the payment of Partner C's state withholding taxes:

DR	Partner C Rcvbl-State W/H/Composite Taxes	$20,000	
CR	Cash		$20,000

Conclusion

As provided by the partnership agreement, any future distributions declared to Partner C will be offset by the receivable before any cash is paid to Partner C. The next distribution declared was $100,000 split 50/50 between Partners C and D. In considering partner receivables, the distribution would be recorded as follows:

DR	Distribution – Partner C	$50,000	
DR	Distribution – Partner D	$50,000	
CR	Partner C Rcvbl-State W/H/Composite Taxes		$20,000
CR	Cash – Partner C		$30,000
CR	Cash – Partner D		$50,000

It is important to think very analytically when discussing complex multistate income tax issues in the passthrough entity context. The simple illustrations provided thus far serve as a springboard for the thinking about and understanding these issues, and it is important to understand that each state is going to be different regarding their requirements for withholding taxes, composite taxes, and PTETs, so an ongoing dialog with the client is essential to understand what additional states the PTE client is engaging in to be able to provide the best advice and planning.

B. Bookkeeping for PTETs

When dealing with PTETs the bookkeeping is still simple enough as the payment/accrual will generally serve as the deductible expense.

Example: ***Facts***

Partnership ABC has two equal partners, A and B. Partnership ABC pays State X PTE income tax of $50,000. The payment is recorded as follows:

DR	*State Tax Expense* **–** *State X*	*$50,000*	
CR	*Cash*		*$50,000*

Conclusion

State X allows partners A and B to each claim a $25,000 credit against their own personal income tax liability owed to State X. Per Notice 2020-75, the $25,000 that each partner receives is ***not*** *subject to the $10,000 SALT deduction limitation as it is deducted in arriving at ordinary taxable income for Partnership ABC.*

Though the above is simple enough, it is essential that taxpayers still receive the information necessary to determine any applicable adjustments or credits on their individual state tax returns.

C. Tax planning with regard to resident state PTE owners

When a partnership or S corporation operates in only one state, most practitioners would forego the notion of electing the PTET regime for resident PTE owners, which wasn't often available in the withholding/composite regimes. However, if the resident state allows, the benefit may be significant to avoid the SALT cap limitation.

Example:

Facts

Mark and John are 50/50 shareholders in MJ S corporation, which operates only in state Y. Mark and John have no other states with income tax nexus. State Y permits S corporations to elect PTETs for PTE owners resident to state Y. State Y has an individual tax rate of 4.5%. MJ S corporation is planning $67,500 cash flow related to taxes structured as either: (1) a distribution to owners to pay their personal estimated taxes, or (2) estimated tax payments made prior to year end and claimed as a deduction.

Prior to the deduction, MJ S corporation has $1,500,000 estimated ordinary taxable income prior to PTET tax deductions.

Mark and John both file Form 1040 with married filing jointly and with total itemized deductions of $40,000 and $50,000, respectively. Both claim a $200,000 salary from MJ S corporation, and both are subject to the SALT limitation prior to the consideration for PTET. Assume each shareholder claims a §199A QBI deduction of $143,250 if the PTETs are deducted and $150,000 if PTETs are filed.

Conclusion

In working through the facts as follows, we arrive at a net tax benefit of $23,160 from claiming the PTET in the resident state as available.

PTETs Elected	Mark	John	Total
Wages	200,000	200,000	
S Corporation *	716,250	716,250	
Itemized Deductions	(40,000)	(50,000)	
QBI	(143,250)	(143,250)	
Taxable Income	733,000	723,000	
Income Taxes	**235,243**	**231,743**	**466,986**

No PTETs Elected	Mark	John	Total
Wages	200,000	200,000	
S Corporation	750,000	750,000	
Itemized Deductions	(40,000)	(50,000)	
QBI	(150,000)	(150,000)	
Taxable Income	760,000	750,000	
Income Taxes	**246,590**	**243,556**	**490,146**
Total Tax Savings	11,347	11,813	**23,160**

** $1,500,000 - $67,500 of PTETs = $1,432,500 * 50% = $716,250*

In the context of a partnership where self-employment taxes apply to a partner's entire allocable share of partnership profit and loss, there may be even greater opportunity for planning assuming the taxpayer does not exceed the SE income taxable base.

Example:

Facts

BA Attorneys, LLC has two 50/50 partners, Barb and Brenda. They each claim an $80,000 guaranteed payment from the LLC. After the consideration of the guaranteed payments, the BA Attorneys, LLC reports $160,000 of ordinary taxable income. Both are resident to state X and have no nexus in any other state. State X permits resident partners to claim the PTETs. State X maintains a flat individual tax rate of 4%. As such, BA Attorneys, LLC has planned cash flow of $7,000 for taxes to be reported as distributions or paid as estimated tax payments for purposes of claiming the PTETs.

Barb and Brenda both file as single taxpayers. They claimed itemized deductions in the amount of $22,000 and $25,000, respectively, and both are subject to the SALT limitation. Because this activity is an SSTB, assume the taxpayers each claim an estimated §199A QBI deduction of $14,875.

Conclusion

In working through the facts as follows, we arrive at a net tax benefit of $2,590 from claiming the PTET in the resident state as available.

PTETs Elected	Barb	Brenda	Total
Guaranteed Payments	80,000	80,000	
LLC Income	76,500	76,500	
SE Taxes	(11,056)	(11,056)	
Itemized Deductions	(22,000)	(25,000)	
QBI	(14,875)	(14,875)	
Taxable Income	108,569	105,569	
Income Taxes	19,456	18,736	
SE Taxes	22,113	22,113	
Total Taxes	41,569	40,849	82,418

No PTETs Elected	Barb	Brenda	Total
Guaranteed Payments	80,000	80,000	
LLC Income	80,000	80,000	
SE Taxes	(11,304)	(11,304)	
Itemized Deductions	(22,000)	(25,000)	
QBI	(14,875)	(14,875)	
Taxable Income	111,821	108,821	
Income Taxes	20,237	19,517	
SE Taxes	22,647	22,607	
Total Taxes	42,884	42,124	85,008
Total Tax Savings	1,315	1,275	**2,590**

The most important thing to remember is that these calculations are going to be extremely context specific, and if a client cares to optimize their taxes and minimize their effective tax rates, this is certainly an area where practitioners can look to do that for a client.

VI. Example

Example 1:

- Two partners: Bob (60%) and Brian (40%); both are Florida residents.
  - Bob itemizes his deduction: $10,000 real estate taxes, $100,000 charity.
  - Brian claims the standard deduction.
  - Assume SE taxes do not apply to either taxpayer and the QBI deduction is unavailable/phased out.
- Taxable in 2 states: California 50% and North Dakota 50%.
- California:
  - AB Partnership elects the PTET tax at 9.3% in 2024.
  - 2023 PTET paid in 2024 was $150,000.
- North Dakota:
  - ND applies nonresident withholding at a rate of 2.5% in 2024.
  - 2023 withholding tax paid in 2024 was $47,000.

Partnership - Tax Year 2024	
Gross Profit	3,150,000
CA 2023 PTET Paid 2024	(150,000)*
Ordinary Taxable Income	3,000,000

***Note:** No deduction for 2023 withholding tax paid as that is an expense of the partner rather than the partnership.

California Taxable Income	
Federal Taxable Income	3,000,000
Addback - State Taxes Deducted	150,000
California Taxable Income	3,150,000
Income Apportioned to California (50%)	1,575,000
PTE Tax 2024 paid in 2025	146,475

California Notes:

- Absent other filing obligations, Bob and Brian have no California filing obligations. The partners will still receive California state K-1s.
- PTET will be deductible by the partnership in determining ordinary taxable income in the year paid.

North Dakota Taxable Income	
Federal Taxable Income	3,000,000
Addback - State Taxes Deducted	150,000
North Dakota Taxable Income	3,150,000
Income Apportioned to North Dakota (50%)	1,575,000

	Allocable ND Income	**ND Withholding Taxes (2.9%)**
Bob Allocable Share of Apportioned ND Income	945,000	27,405
Brian Allocable Share of Apportioned ND Income	630,000	18,270
Total	1,575,000	45,675

		60% Itemized Deductions Bob - Federal 1040	40% Standard Deduction Brian - Federal 1040
AGI (60% to of AB Partnership)		1,800,000	1,200,000
Itemized Deductions			
Real Estate Taxes	10,000		
Withholding	27,405		
Deductible state taxes (max $10,000)	10,000		
Charitable	100,000		
Total Itemized or Standard Deduction		(110,000)	(13,850)
Taxable Income		1,690,000	1,186,150
Income Tax		585,632	399,208
NIIT		60,800	38,000
Total Tax		**646,432**	**437,208**

Note the California PTET taxes were deducted in determining the partner's allocable share of AB partnership income.

Partnership Distributions, Form 7217, and S Corporation Redemptions

Partnership Distributions, Form 7217, and S Corporation Redemptions

Learning objectives

Upon reviewing this material, the reader will be able to:

- Understand that distributions are typically a non-taxable return of the partner's investment, and taxation is deferred until the partner sells the property or their partnership interest;
- Identify some of the basis limitations that can impact partnership distribution taxation; and
- Understand when an S corporation redemption of stock qualifies as an exchange under §302(a).

I. Fundamentals of Partnership Basis

A primary goal of subchapter K is that when a partnership distributes assets, no gain or loss is recognized by either the partner or the partnership, except in specific circumstances. The idea is that distributions are typically a non-taxable return of the partner's investment, and taxation is deferred until the partner sells the property or their partnership interest. However, this deferral is constrained by anti-abuse rules and basis limitations.

Understanding partnership distribution taxation requires a solid grasp of basis concepts. There are two key "bases" in partnership taxation:

i. **Outside basis:** The partner's basis in their partnership interest. This is initially the amount of money and adjusted basis of property contributed, increased by any share of partnership income and liabilities, and decreased by distributions, losses, and liability reductions. If interests in partnership interest were purchased rather than original issue in exchange for contributed capital, the basis is the amount paid to exiting partner. Outside basis represents the amount a partner has invested (and retained) in the partnership for tax purposes. It's crucial because it limits the tax-free return of capital – a partner cannot receive distributions tax-free beyond their outside basis without recognizing gain.

ii. **Inside basis:** The partnership's basis in its own assets. This reflects the asset's original cost (or carryover basis if contributed) adjusted for depreciation, etc. Inside basis for any distributed property becomes relevant because generally the partner takes a carryover of that basis (subject to limitations) when property is distributed.

A. Gain Recognition

Under IRC §731(a), a **partner generally does not recognize gain on a distribution**, **unless** the partner receives **money (including certain deemed cash) in excess of their outside basis** immediately before the distribution. "Money" in this context includes not only cash but also *marketable securities* (treated as cash under §731(c)) and reductions in the partner's share of liabilities (treated as a deemed cash distribution under §752(b)). If the cash (and deemed cash) received exceeds the partner's outside basis, the excess is treated as a gain (usually a capital gain) recognized at the time of distribution.
Conversely, **no gain is recognized for distributions of property (other than money)** – the receipt of property itself is not a taxable event; instead, the partner will take a basis in the property and defer any gain until a later disposition.

Example **_No Gain on Property Distribution:_**
Suppose Partner A has an outside basis of $50,000 in her partnership interest. The partnership distributes to her a parcel of land (property) worth $70,000 with a basis of $60,000. No gain is recognized by A on this distribution because she did not receive money and the distribution is within her basis. Her outside basis will be reduced, and she'll take over the land with a basis as determined under §732 (discussed below).

Example **_Gain Recognized (Cash < Basis):_**
Partner B has an outside basis of $10,000. He receives a distribution of $8,000 cash (with no other property). Because the cash distributed is less than his outside basis, no gain is recognized under §731.

Example **_Gain Recognized (Cash > Basis):_**
Partner C has an outside basis of $10,000. He receives a distribution of $11,000 cash (with no other property). Because the cash exceeds his outside basis by $1,000, B must recognize a $1,000 capital gain under §731. After the distribution, B's outside basis is reduced to zero (but not below zero). If this represented a distribution in liquidation of his interest, he is then no longer a partner.

B. Loss Recognition

Generally, losses are **not recognized** on partnership distributions except in a very limited scenario for **liquidating distributions**. Specifically, a partner may recognize a capital loss if a liquidating distribution consists **only of cash, unrealized receivables, and/or inventory**, and the sum of those distributed amounts is **less** than the partner's outside basis. In that narrow case, the remaining unused outside basis is lost and can be taken as a capital loss. However, if **any other property** (e.g. a capital asset or §1231 property) is received in the liquidating distribution, then no loss is recognized – instead, any excess basis is simply allocated to those other properties (often giving them a higher basis than the partnership had).

II. Non-Liquidating Distributions (Current Distributions)

A **non-liquidating distribution** (also called a current distribution) is one where the partner **continues their partnership interest** after the distribution. In other words, it's not a final settlement – the partner remains a partner. Common examples include periodic distributions of profits or specific property distributions during the partnership's life.

In a non-liquidating distribution, **no gain or loss is recognized** by the partner or partnership except potentially for the cash-exceeds-basis rule discussed above. The critical tax impact is **basis adjustments**: the partner's outside basis will decrease, and the partner must determine their **basis in any property received**.

A. Basis of Property Received (§732(a))

For a current distribution, the **partner's basis in the distributed property** is generally **the partnership's adjusted basis in that property** immediately before distribution (i.e. a carryover basis) **limited to the amount of the partner's remaining outside basis**. The logic is that you can only take as much basis in the property as you have "basis to give." If the partnership's basis in the asset is less than or equal to the partner's outside basis, the partner takes that full carryover basis. However, if the partnership's basis in the property **exceeds** the partner's outside basis (after accounting for any cash received), then the partner's basis in the property is **capped at the amount of outside basis available** (and the remainder of the partnership's basis is lost). This cap ensures the partner's outside basis doesn't drop below zero.

B. Reduction of Outside Basis (§733)

The partner's outside basis is reduced (but not below zero) by: (1) **Money** received (cash or deemed cash), and (2) the **basis of any property** received (as determined under §732). After these adjustments, any remaining outside basis represents the partner's basis in their continuing partnership interest. If the distribution was substantial, this remaining outside basis could be significantly lower, reflecting the smaller stake the partner now has in the partnership's remaining assets.

Example 1 **– Current Distribution – Sufficient Outside Basis (Carryover Basis):** Partner X has an outside basis of $15,000 in the XYZ partnership. She receives a current distribution of a piece of equipment. The equipment's basis on the partnership's books (inside basis) is $4,000 (FMV might be higher, say $7,000, but FMV is generally irrelevant for the distribution tax basis). She also receives $2,000 cash.

No Gain Recognized: First, check the cash against X's outside basis. She received $2,000 in cash which is well under her $15,000 basis, so no gain under §731.

Basis in Distributed Property: After the cash, X's remaining outside basis is $13,000 ($15k – $2k). The partnership's basis in the equipment is $4,000, which is less than X's remaining basis. Therefore, X can take the full carryover basis of $4,000 in the equipment.

Remaining Outside Basis: X's outside basis is then further reduced by $4,000 (the basis of the equipment under §732). Her new outside basis in her partnership interest after the distribution is $9,000 ($13k – $4k). She will use this $9,000 as her basis for her now-reduced partnership interest going forward.

In summary, X recognizes no gain, takes the equipment at a $4,000 basis, and continues as a partner with a $9,000 basis in her partnership interest.

	Amounts	***Notes***
Bgn Basis	15,000	
Less Cash	(2,000)	*cash received in excess of bgn basis is cap. gain*
Rmng Basis	13,000	
Equip. Rcvd	(4,000)	*lesser of inside basis and outside basis*
Rmng Basis	9,000	*carryforward basis*

Example 2 **– Current Distribution – Insufficient Outside Basis (Basis Limitation):** Partner Y has an outside basis of $10,000. Y receives a distribution of $8,000 cash and a parcel of land. The land's basis to the partnership is $5,000 (and FMV $12,000, for reference).

Cash vs. Basis: Y's $8,000 cash is below his $10,000 outside basis, so no immediate gain (cash does not exceed basis). Y's outside basis before property is then $2,000 remaining ($10k – $8k).

Property Basis Limitation: The partnership's basis in the land is $5,000, but Y only has $2,000 of outside basis left to allocate. Under §732(a)(2), Y's basis in the land is limited to $2,000, the amount of outside basis he has left. He cannot carry over the full $5,000 because he simply doesn't have enough outside basis to support it. The distribution fully uses up Y's remaining basis.

Outcome: Y takes the land with a $2,000 basis (which is notably lower than the partnership's $5,000 basis and much lower than FMV). Y's outside basis in the partnership is now $0 ($2k – $2k), meaning if he receives any additional distributions before acquiring new basis (e.g. through income), they could trigger gain. The $3,000 of partnership basis in the land that Y could not take is not transferred anywhere – it just disappears for tax purposes. Y has a built-in gain in the land: if he sells it for its $12,000 FMV, he would realize a large gain partly reflecting that lost basis.

Note how the partner's basis in the distributed property was the lesser of the partnership's basis in the property or the partner's remaining outside basis. This example mirrors the IRS's guidance: no gain on the distribution, but the partner's basis in the land is capped at $2,000 and his partnership basis is fully reduced to zero.

	Amounts	Notes
Bgn Basis	10,000	
Less Cash	(8,000)	*cash received in excess of bgn basis is capital gain*
Rmng Basis	2,000	
Land Rcvd	(2,000)	*lesser of inside basis and outside basis*
Rmng Basis	-	*carryforward basis*

C. Gain Recognition in Non-Liquidating Distributions

The only time a current distribution results in immediate taxable gain to the partner is if **cash (or deemed cash)** received exceeds the partner's outside basis. We saw an example above with Partner B (cash $11k on $10k basis) causing gain. It's worth emphasizing that **property distributions themselves do not cause gain**; only the cash component can. If both cash and property are received, the cash "soaks up" basis first (reducing outside basis), then property takes whatever basis remains. Any excess cash beyond basis is what triggers gain.

Also, under **§731(c)**, **marketable securities** are treated as cash for this purpose (with some exceptions). For instance, if a partner receives readily tradable stock from a partnership, it might be treated as a cash equivalent distribution, potentially causing gain if the value exceeds the partner's basis. The regulations contain detailed definitions of marketable securities and exceptions where this treatment is eased, but those specifics are beyond our scope. The key takeaway is that not only literal cash, but certain financial assets can count as "money" in applying the cash > basis rule.

In a proportionate current distribution (each partner receiving their share of ordinary-income assets), the partnership itself does not recognize gain or loss, and the remaining partners' bases in the partnership are unaffected (except their share of any liabilities may adjust if the distributing partner's share changed). The distributed asset's inside basis leaves the partnership's books, and the outside basis of the distributee partner decreases accordingly, ideally keeping the total of all outside bases equal to total inside bases of remaining assets (unless a special basis adjustment under §734 is needed, discussed later).

III. Partnership Liquidating Distributions

A **liquidating distribution** occurs when a partner **retires or otherwise leaves the partnership** (or the partnership itself winds down), and they receive a final distribution of assets **in complete redemption of their partnership interest**. The tax outcomes here ensure that the partner's entire outside basis is accounted for – either by assigning it to distributed assets or recognizing loss if permissible.

A. General Rules

In a liquidating distribution, unlike a current one, the partner will use up **their entire outside basis** in the process. The **total basis of assets received** (including cash) will equal the partner's pre-distribution outside basis (after any gain recognition). If the partnership distributes multiple assets, the partner's outside basis must be **allocated** among those assets in a prescribed manner (since the partner's partnership interest is now gone, that basis must "go somewhere"). Section 732(b) provides that the basis of property distributed in liquidation of a partner's interest **shall equal the partner's adjusted basis in the partnership interest** (minus any cash received, effectively). In simpler terms, the partner **substitutes** their outside basis for the carryover bases of the assets, subject to specific allocation rules.

B. Gain or Loss Recognition

The same rule about cash causing gain applies in liquidating distributions. If a partner receives cash (or deemed cash) in excess of their outside basis, gain is recognized to that extent. One difference for liquidations is the possibility of recognizing a **loss**: if the only assets received are cash, unrealized receivables, and inventory (i.e. no capital or §1231 assets) and the total of those have a basis (cash basis = face amount, receivables and inventory basis as carried on partnership books) **less than the partner's outside basis**, then the partner can deduct a capital loss for the remaining outside basis not absorbed by the distribution. However, if even one capital asset or §1231 asset is received, no loss is recognized – instead, any unabsorbed basis must be allocated to that property (which may give it a higher basis than its current value, but no immediate loss). This rule prevents partners from cherry-picking a loss by excluding capital assets; thus, the tax law forces the basis into those assets to defer the loss until a later sale.

C. Carryover Basis Allocation (§732(c))

When multiple assets are distributed in a liquidating distribution, the partner's outside basis (after accounting for any cash and gain) is allocated among the assets using a **two-step approach** to fairly allocate any increase or decrease in basis needed.

- **Step 1 - Carryover Basis Step:** Assign each asset its **inside basis (carryover basis)** as a starting point. This is what the partnership had as basis for the asset. Sum these up (along with any cash, which just uses its face value). Compare this total to the partner's outside basis (after any recognized gain has potentially increased it, because if gain was recognized under §731(a)(1), the partner's outside basis is correspondingly increased by that gain under §705, and if loss is recognized, outside basis is decreased).
    - If the sum of carryover bases **equals** the partner's outside basis, then no further adjustment is needed; the carryover assignment is the final basis allocation.
    - If the sum of carryover bases is **more** than the partner's outside basis (meaning the partner doesn't have enough outside basis to take on all the partnership's bases), a **basis reduction** is required. This situation happens when the partner's outside basis is relatively low compared to the bases of assets distributed. The shortfall must be allocated by reducing the basis of certain assets.
    - If the sum of carryover bases is **less** than the partner's outside basis (meaning the partner has extra basis to give – perhaps because the partner had a high outside basis or the assets are fully depreciated), a **basis increase** is required. The excess basis must be allocated by increasing the basis of certain assets.
- **Step 2 - Allocation of Basis Decrease or Increase:** The tax regulations provide an ordering rule for this allocation (Treas. Reg. §1.732-1(c):
    - **If a basis decrease (deficit) is needed:** The **first** assets to have their bases reduced are **those other than unrealized receivables and inventory** (i.e. the capital gain assets). Within that class, reductions are generally done to the extent of "built-in loss" if any, or proportionally with regard to the adjusted bases of the distributed property. If reducing those to zero isn't enough, then reduce the basis of **unrealized receivables and inventory** as necessary. This prioritization

ensures that any necessary basis reduction comes first out of assets that would produce capital gain (or have loss potential), rather than ordinary income assets, preserving ordinary income potential as a last resort.

- **If a basis increase (excess) is needed:** Conversely, **unrealized receivables and inventory ("hot assets") generally do not get a basis increase above their carryover** – their basis is typically limited to the partnership's basis pre-distribution, which is consistent to preserve the ordinary income tax consequences. The increase is allocated primarily to **capital and §1231 assets** that have **unrealized appreciation** (i.e. their FMV exceeds their carryover basis) in proportion to that appreciation. This effectively reduces potential future capital gain by increasing basis. If after bringing all appreciated assets up to their FMVs there is still excess basis to allocate, any further allocation can be spread among all distributed assets (including those now at FMV) typically in proportion to FMV. This can result in some assets receiving a basis **in excess of their value**, creating a built-in loss for the future. While unusual, it is allowed in order to use up the partner's entire basis.

The outcome of these rules is that the partner's entire outside basis is allocated across the distributed assets. The partner's remaining outside basis becomes zero (since their interest is terminated), and there is no "missing" basis; it's either in the assets or taken as a loss if permitted by the all-cash/hot asset scenario.

***Example 3 – Liquidating Distribution* (Outside Basis > Asset Bases):**
Alex is a 25% partner in PRS Partnership with an outside basis of $750. Alex decides to retire, and PRS liquidates his interest by distributing to him: $50 cash, $50 reduction in liability relief/allocated liabilities, inventory with an inside basis of $100 (FMV $200), Asset X (a capital asset) with an inside basis of $50 (FMV $400), and Asset Y (another capital asset) with an inside basis of $100 (FMV $100). Assume no gain is recognized under §731 (cash $50 + liability relief $50 < basis $750, so no gain).

Initial Assignment: Carryover bases: cash $100; inventory $100; Asset X $50; Asset Y $100.
Total = $350. Alex's outside basis is $750, which is $400 higher than the carryover total.
So, a basis **increase** of $400 is required (Alex has more basis to allocate than the assets' current bases total). No loss is possible here because there are capital assets in the mix (and anyway outside basis > inside basis, not a loss scenario).

Allocate Increase: According to the rules, do not increase hot asset (inventory) beyond $100 (its carryover). Focus on assets with appreciation:

- Inventory: basis $100 vs FMV $200 (appreciation $100, but inventory's basis will remain capped at $100 in this allocation).
- Asset X: basis $50 vs FMV $400 (appreciation $350).
- Asset Y: basis $100 vs FMV $100 (no appreciation).
  Asset X has $350 of unrealized gain, inventory $100. The $400 excess basis is first allocated to **appreciated assets (excluding inventory)**. Here, Asset X is the only appreciated capital asset. We raise Asset X's basis by $350 to $400, eliminating its unrealized gain. Now $50 of excess basis remains (750 – (350 carryover + 350 allocated to X) = 50).
- Now all appreciated assets (X) are at FMV basis. We still have $50 to allocate and the only assets left are inventory and Asset Y. Inventory is hot asset (generally not increased beyond carryover), Asset Y had no gain but can receive basis. At this point, the remaining $50 can be allocated among all assets in proportion to their FMVs as a reasonable method. FMVs: Inventory $200, Asset X $400, Asset Y $100 (Asset X is already at FMV basis but can still partake in remaining allocation). Proportionally: Inventory 40%, Asset X 40%, Asset Y 20% of FMV pool. Allocating $50 by FMV:

Inventory $20, Asset X $20, Asset Y $10. However, since inventory's basis is not increased by rule, we instead give its share to capital assets:

- Asset X gets an additional $40 (it ends up with basis $440, $40 above its $400 FMV).
- Asset Y gets $10 extra (basis becomes $110, $10 above FMV).
  Now all $750 of Alex's basis has been allocated: cash 100 + inventory 100 + Asset X 440 + Asset Y 110 = $750. Alex's outside basis is fully used, and he has no remaining interest. Some assets ended up with basis above FMV (built-in losses of $40 on X and $10 on Y) which Alex could realize if he sells them in the future.

Results: Alex recognizes **no gain or loss** on the distribution itself (cash did not exceed basis, and distribution included capital assets so no loss allowed). His bases in the assets are: $100 for inventory, $440 for Asset X, $110 for Asset Y. These bases are markedly different from the partnership's original bases, reflecting the allocation of his outside basis. The inventory still carries its original $100 basis (Alex will recognize ordinary income on the $100 appreciation if sold, maintaining the character as "hot asset"). Asset X's basis was stepped up significantly, meaning Alex will have less capital gain if he sells it. Asset Y's basis was slightly increased above its value, giving Alex a small potential capital loss if sold at a $100.

	Amounts	***Notes***
Bgn Basis	750	
Less Liab.	(50)	*liability relief = deemed cash distribution*
Less Cash	(50)	
Rmng Basis	650	*negative value would create capital gain*
Inventory Rcvd	(100)	*max carryover basis*
Rmng Basis	550	*basis to be assigned to remaining assets*
Inside Basis	(150)	*$100 + $50 = $150*
Basis Increase	400	*Basis increase to be allocated first to unrealized appreciation followed by pro rata allocation based on FMV*

	Basis	**FMV**	**C/O Basis**	**Unrealized Appreciation**	**Basis Incr. ****	**Final Alloc. Basis *****
Asset X	50	400	50	350	40	**440**
Asset Y	100	100	100	-	10	**110**
	150	**500**	150	350	*50	**550**

** 550 remaining basis – (150 c/o basis + 350 unreal. apprec.) = $50*
*** Basis increase is allocated pro rata based on FMVs*
*Asset X = 400 / 500 * 50 = 40*
*Asset Y = 100 / 500 * 50 = 10*
**** Sum of C/O basis, unrealized appreciation, and basis increase for each asset.*

Example 4 – Liquidating Distribution **(Outside Basis < Asset Bases):**
Beth has an outside basis of $100 in her partnership interest. In a complete liquidation of her interest, she receives two assets: Property C with an inside basis of $80 (FMV $75) and Property D with an inside basis of $40 (FMV $40). Both are capital assets (no inventory or receivables in distribution). No cash is received.

Carryover Sum: $80 + $40 = $120 total inside basis. Beth only has $100 of basis to allocate, which is $20 short of the carryover total. Thus, a **basis decrease** of $20 is needed.
Allocation of Decrease: Since no hot assets are present (both are capital assets), we reduce basis on those assets. The deficit $20 is allocated between Property C and D in proportion to their built-in **loss** or basis amounts. Here, property C has a built-in loss of $5 ($75 - $80), $5 of the $20 basis

decrease is allocated to the unrealized depreciation resulting in $15 of remaining basis decrease to be allocated. The remaining $15 of basis decreased is allocated by relative basis: C was $80 of $120 (66.7%), D $40 of $120 (33.3%). Thus, we reduce C's basis by about $10 and D's by $5 to $65 and $35 respectively.

Result: Beth takes Property C at $65 basis, Property D at $35 basis, totaling $100 which matches her outside basis. She recognizes no gain (no cash, and property distribution doesn't trigger gain), and no loss (because she received assets other than cash/inventory). The partnership's combined inside basis was $120, but Beth could only take $100 of it; effectively $20 of basis disappears, giving Beth built-in gains in those assets (each now has FMV greater than basis).

	Amounts	***Notes***
Bgn Basis	100	
Less Liab.	-	*liability relief = deemed cash distribution*
Less Cash	-	*cash received in excess of bgn basis is capital gain*
Rmng Basis	100	
Inventory Rcvd	-	*max carryover basis*
Rmng Basis	100	*basis to be assigned to remaining assets*
Inside Basis	(120)	*$80 + $40 = $120*
Basis Decrease	(20)	*Basis decrease to be allocated first to unrealized depreciation by pro rata allocated based on inside basis*

	Basis	**FMV**	**C/O Basis**	**Unrealized Depreciation**	**Basis Decr.**	**Final Alloc. Basis**
Prop. C	80	75	80	(5)	(10)	**65**
Prop. D	40	40	40	-	(5)	**35**
	120	**115**	120	(5)	(15)	**100**

** 100 remaining basis – (120 c/o basis - 5 unreal. depr.) = 15*

*** Basis increase is allocated pro rata based on FMVs*

*Prop. C = 80 / 120 * 15 = 10*

*Prop. D = 40 / 120 * 15 = 5*

**** Sum of C/O basis, unrealized depreciation decrease, and basis decrease for each asset.*

When a partner leaves, the partnership itself usually does not recognize gain or loss on the distribution. However, a discrepancy can arise between the remaining partners' **total outside bases** and the partnership's **inside basis** in its remaining assets. For instance, in Example 3, Alex's assets left with him, but in Example 4, if there were other partners, the partnership had $20 more inside basis in those assets than Beth could take. This creates a mismatch. **Section 734(b)** provides that if the partnership has a **§754 election** in effect, it will make an adjustment to the bases of the partnership's remaining assets to eliminate the disparity. In Beth's case, the partnership (with a §754 election) would decrease the bases of its remaining assets by $20 to reflect that "excess" basis that disappeared to Beth. Similarly, if a partner recognizes a loss (allowed scenario) or gain on a distribution, a §754 adjustment can increase or decrease remaining asset bases to keep things in line. Even if no §754 election, if the basis reduction exceeds $250,000 (a "substantial basis reduction"), the partnership is **required** to adjust basis under §734(b) even without an election. These adjustments ensure no tax attribute vanishes or is duplicated when partners leave.

IV. Partnership - Special Considerations

The above rules (Sections 731 and 732) cover most **"plain vanilla"** distributions, assuming they are proportionate and cover no special circumstances. However, partnership taxation has several **anti-abuse provisions and special situations** that tax professionals must be aware of when dealing with distributions of property:

A. Disproportionate Distributions (§751(b))

A disproportionate distribution occurs if a partnership distribution (either current or liquidating) results in a partner's share of certain **ordinary income assets** (so-called **"hot assets"**) changing more than their share of other assets. The hot assets are generally **unrealized receivables and substantially appreciated inventory**. Section 751(b) is designed to prevent partners from converting what should be ordinary income into capital gain by means of clever distribution allocations. If, as a result of a distribution, a partner ends up **with an increased share of the partnership's remaining capital assets and a decreased share of hot assets (or vice versa)**, then part of the transaction is recharacterized as a **taxable exchange** between the partner and the partnership. The partner is treated as if they sold a portion of their interest in the hot assets in exchange for other property. This triggers immediate recognition of gain (or loss) to the extent of that deemed sale, usually treating it as ordinary income to keep the character of the hot assets.

For example, if a partner receives a distribution of only capital assets while the other partners keep all the inventory, that partner's share of inventory (hot asset) went to zero from some positive amount – clearly disproportionate. Section 751(b) would require that partner to recognize what their share of gain on that inventory would have been, as if they "exchanged" it for the capital assets received. The rules of 751(b) are quite complex in practice, and it's important to note that **Form 7217 explicitly asks** if any part of the distribution was treated as a sale or exchange under §751(b) (Line 2 on the form). If yes, the partner must attach a statement computing the gain or loss resulting from §751(b). Thus, when preparing Form 7217 or advising on distributions, consider whether the partner's share of hot assets relative to other assets changed disproportionately. If so, a detailed §751(b) calculation is needed (beyond our scope to compute here, but be aware of the requirement).

Example 5: ***Facts***

A member sells his LLC interest when the LLC assets were as follows:

Assets	***Adjusted Basis***	***Market Value***
Cash	12,000	12,000
Inventory	10,000	11,000
Land	13,000	28,000
Total	35,000	51,000

Test -- Does the market value of inventory exceed 100 percent of basis?

Yes. $11,000 is greater than $10,000 [$10,000 x 100 percent]. (Section 751(a)(2) applies here.)

Any distribution of inventory which is not prorata would trigger ordinary income recognition under §751 "as if" the member's share of inventory was sold at market value to the LLC. However, for distributions the value of inventory must exceed 120 percent of basis. [1]

[1] I.R.C. §751(b)(3).

B. Precontribution Gain (§704(c)(1)(B) & §737)

These are often called "mixing bowl" rules, aimed at preventing abuse when partners contribute property to a partnership and then within a short period either that same property is distributed to another partner or different property is distributed to the contributing partner.

- **Section 704(c)(1)(B):** If a partner contributes appreciated property to a partnership, and **within 7 years** that same property is distributed to another partner, the original contributing partner must recognize the remaining **built-in gain** on that property at the time of distribution. It's as if the property had been sold by the partnership at FMV and the gain allocated to the contributing partner. This prevents partners from shifting built-in gain to others via distributions. (Likewise, if the contributed property had a built-in loss, that loss is disallowed and basically stays with the contributing partner). For our course focus (distribution to partners), if you encounter a distribution of property that was contributed by a different partner within the last 7 years, 704(c)(1)(B) will override the nonrecognition rule and force the contributing partner to recognize gain.
- **Section 737:** Alternatively, if a partner contributes property and then **within 7 years receives a distribution of other property**, §737 may trigger gain. Specifically, the contributing partner must recognize gain equal to the **lesser of**: (a) the **excess** of the FMV of the property (other than money) received in the distribution over the partner's adjusted basis in their partnership interest **immediately before** the distribution, or (b) the **net precontribution gain** (the built-in gain on any property they contributed in the past 7 years that still hasn't been recognized). In plainer terms, §737 says: if you put property into a partnership and then soon after, take different property out, you might have to pay tax on the gain you had in the contributed property (to the extent the distribution property's value exceeds your basis). This prevents a partner from effectively swapping assets tax-free through a partnership (contribute appreciated asset A, then shortly thereafter distribute asset B of equal value, avoiding the sale of A). Section 737 does **not** apply if more than 7 years have passed since the contribution.

C. Payments to Retiring Partners (§736)

This section distinguishes between payments for a retiring or deceased partner's **partnership interest in assets (§736(b))** versus other payments such as for unrealized goodwill or as a substitute for income (§736(a)). In a liquidation of a partner's interest, some payments might be treated as **guaranteed payments or distributive share (taxable as ordinary income to the partner and deductible to partnership)** under 736(a), especially for payments that are in the nature of replacing the partner's share of income (or if the partnership agreement says so for goodwill). Other payments are treated as a distribution in exchange for their interest in partnership assets (736(b)), which follow the distribution rules we've been discussing (capital gain or loss, basis allocations, etc.). For purposes of this course, we assumed distributions are under 736(b) (property/cash in exchange for interest) unless noted. Tax professionals should be aware that if a retiring partner's payout is partly for something like unrealized receivables or partnership goodwill without a §754 election, there may be different treatment.

Total payments and related guaranteed payments should be agreed upon amongst the partners prior to any distribution actually being made as well as the number of years across which such payments will be made. After such agreement, there will then need to be an allocation between guaranteed payments under §736(a) and liquidating distributions under §736(b). This is done in the following manner.

- **Fixed Payments across Fixed Years**: If distributions are a fixed amount and are to be received over a fixed number of years, the first dollars are allocated to the §736(b) in the following manner:
  - *Total §736(b) Payments / (Total §736(a) Payments + Total §736(b) Payments) x Payment Received*
    - Any additional amounts will be treated as guaranteed payments under §736(a).[2]
- **Non-Fixed Payments**: If the retiring partner receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under §736(b) to the extent of the value of that interest and thereafter, as payments under §736(a).[3]
- **Payments Agreed Upon by Partners**: The allocation of each annual payment between §736(a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under §736(b) does not exceed the fair market value of such property at the retirement. [4]

Example 6: ***Facts (Fixed Payments)***

Retiring partner A is entitled to an annual payment of $12,000 for 10 years in liquidation of his partnership interest in Too Big LLC, resulting in total payments of $120,000. The total $120,000 to be paid represents $90,000 of §736(b) payments.

Conclusion and Analysis

Each $12,000 payment will be split as follows:
§736(b) Payment → ($90,000 / $120,000) x $12,000 = $9,000
§736(a) Payment → $12,000 total payment - $9,000 §736(b) payment = $3,000.

Example 7: ***Facts (Non-Fixed Payments)***

Retiring partner D is to receive liquidating payments for his partnership interest in Not Worth It LLC, which represents an agreed-upon value of $50,000. D receives the following payments: Year 1: $20,000, Year 2: $28,000, Year 3: $12,000.

Conclusion and Analysis

The payments received in Years 1 and 2 represent a total of $48,000 ($20,000 + $28,000), which is less than the agreed-upon value of the partnership interest. Thus, the entire value of these amounts will be treated as a §736(b) liquidating distribution.

In Year 3, $2,000 ($50,000 total §736(b) payments to be received - $48,000 previously received) will be treated as a §736(b) liquidating distribution, and the remaining $10,000 ($12,000 total payment - $2,000 §736(b) payment) received will be treated as a §736(a) guaranteed payment.

Gain is usually not recognized until the cash received exceeds the retiring partner's adjusted basis in the partnership interest, thus deferring gain to future tax years. Losses are usually deferred until the liquidation is complete.

However, if §736(b) payments are a fixed sum thereby resulting in a known and measurable amount of gain or loss, the retiring partner **may elect to recognize gain or loss ratably** by allocating adjusted basis to each §736(b) payment received using the following formula: [5]

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2 Reg. §1.736-1(b)(5)(i)
3 Reg. §1.736-1(b)(5)(ii)
4 Reg. §1.736-1(b)(5)(iii)
5 Reg. §1.736-1(b)(6)

§736(b) Payments Received x Total adjusted basis of Partnership Interest / Total §736(b) Payments

The ratable recognition is elected by attaching a statement to the partner's tax return in the first taxable year the liquidating distributions are received. Such statement should outline payments received, indicate the election, and show the computation of gain included in gross income.

Because gain deferral is usually preferable, ratable gain recognition is generally not preferable. However, depending on facts and circumstances, it might make sense in managing tax attributes (other loss carryover, excess business losses) and ultimately benefiting in tax rate arbitrage. Additionally, if §754 elections are in effect, these elections might make sense as well to facilitate the step-up in basis, which would generally only be achieved when the retiring partner recognizes gain.

D. Partnership Basis Adjustments (§734/§754)

As touched on earlier, whenever a distribution causes a **difference between the partnership's inside basis and the partners' outside bases**, the partnership can elect under §754 to make a basis adjustment. This often comes into play if:

- A partner **recognizes a gain or loss** on a distribution (which affects their outside basis without a corresponding change in inside basis of remaining assets); or
- In a liquidating distribution, a partner's outside basis was **more or less than the carryover bases** of assets received, causing an increase or decrease in those assets' bases and hence a disparity.

If a §754 election is in place for that year, the partnership will adjust the bases of its **remaining assets**. For example, if a partner recognized a $10,000 gain on a distribution (outside basis went up $10k due to gain), the partnership can **increase the basis** of remaining assets by $10,000 under §734(b)(1) to reflect that corporate tax has been paid on that amount. If a partner took a loss or could not take full inside basis, §734(b)(2) might require a **decrease** in remaining asset basis. Partnerships must make a §734(b) adjustment **even without an election** if the distribution resulted in a "substantial basis reduction" (more than $250,000 aggregate basis decrease or loss). This is a complex area, but for a tax professional, the takeaway is: check if a 754 election is in effect when distributions occur, and if so, account for basis adjustments on the partnership's books. If not, be mindful of mandatory adjustments for large basis disparities.

E. Partnership Distributions Elections under §732(d)

Internal Revenue Code (IRC) §732(d) addresses the determination of the basis of property (other than money) distributed by a partnership to a partner who acquired their partnership interest through a transfer (such as a sale or inheritance) when the partnership has not made a §754 election.

Under normal circumstances, when a partnership distributes property to a partner, the partner's basis in the distributed property is generally the partnership's adjusted basis in that property immediately before the distribution.

However, if a partner acquired their interest by transfer and the partnership did not have a §754 election in effect, §732(d) allows the transferee partner to elect to adjust the basis of the distributed property. This adjustment is made as if the partnership had a §754 election in place at the time of the transfer, thereby applying the rules of §743(b) to the distributed property.

This provision ensures that the transferee partner's basis in the distributed property reflects any built-in gain or loss attributable to their acquired interest, maintaining consistency in basis calculations and preventing potential distortions in income recognition.

F. Certain Distributions to Corporate Partners under §732(f)

IRC §732(f) addresses situations where a corporate partner receives a distribution of stock in another corporation (the "distributed corporation") from a partnership. If, after the distribution, the corporate partner gains control of the distributed corporation, and the partnership's adjusted basis in the stock exceeds the corporate partner's basis in the stock post-distribution, then the excess must be used to reduce the basis of the distributed corporation's assets.

This provision aims to prevent tax avoidance through basis shifting. By reducing the basis of the distributed corporation's assets, it ensures that any built-in gain is preserved and not eliminated through the distribution. If the required basis reduction exceeds the total adjusted basis of the distributed corporation's assets, the excess is recognized as long-term capital gain by the corporate partner, and the basis of the distributed stock is increased accordingly.

While provisions are minorly notable, exception exists for the provisions above.

V. IRS Form 7217 – Partner's Report of Property Distributed

Form 7217 is a new IRS form (released for 2024) specifically designed for partners to report **non-liquidating and liquidating distributions of property**. The form captures the key calculations we've discussed: it reports the bases, values, and any gain related to a partnership property distribution. **Every partner who receives a distribution of property (other than just cash or cash-equivalent securities) in a tax year must complete Form 7217 and attach it to their tax return**. This applies to **both** current and liquidating distributions. If multiple distributions occur on different dates, separate Forms 7217 are required for each date (even if part of the same overall plan). You do **not** file Form 7217 if the distribution consisted solely of cash (or marketable securities treated as cash), or for certain special cases like payments under §707(a) (which are not distributions) or disguised sales.

Form **7217** (December 2024) Department of the Treasury Internal Revenue Service

Partner's Report of Property Distributed by a Partnership

Attach to your tax return.
Go to *www.irs.gov/Form7217* for instructions and the latest information.

OMB No. 1545-0123 Attachment Sequence No. **217**

Partner's name	Partner's TIN
Distributing partnership's name	Distributing partnership's EIN

Date property was distributed to partner

Part I **Aggregate Basis of Distributed Property on Distribution Date.** File a separate form for each date a partner received distributed property.

1	Was this distribution in complete liquidation of the partner's interest in the partnership?		☐ **Yes** ☐ **No**
2	Was any part of the distribution treated as a sale or exchange under section 751(b)?		☐ **Yes** ☐ **No**
3	Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b)		$
4	Adjusted basis of the partner's interest in the partnership immediately before the distribution		$
5a	Cash received in the distribution	$	
b	Fair market value of marketable securities (as defined in section 731(c)) received in the distribution	$	
c	Add lines 5a and 5b		$
6	Enter the smaller of line 4 or line 5c		$
7	Gain recognized. Subtract line 6 from line 5c. If zero, enter -0- and go to line 9		$
8	Is U.S. tax required to be paid on the gain entered on line 7?		☐ **Yes** ☐ **No**
9	Partner's basis in partnership interest reduced by cash received in the distribution. Subtract line 5a from line 4. If zero or less, enter -0-. See instructions if you recognized gain under section 737 as a result of the distribution		$
10	Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e)		$

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Form 7217 Part I – Aggregate Basis of Distributed Property on Distribution Date: This part summarizes the distribution event.

- **Line 1 – Complete Liquidation?** Check "Yes" if this distribution **completely liquidates** the partner's interest (i.e. a final distribution, no further interest in partnership) or "No" if it's a current distribution. This is crucial because later lines (and Part II) treat liquidating vs. non-liquidating differently. For example, in Alex's case (Example 3), this would be "Yes." In Partner Y's case (Example 2, current distribution), "No."
- **Line 2 – Section 751(b) applies?** Indicate if any part of the distribution is treated as a sale or exchange under **§751(b)**. If "Yes," as noted, the partner must attach a separate statement calculating the gain or loss from that deemed transaction. For most straightforward proportionate distributions, the answer will be "No." (All our examples assumed proportionate distributions of assets relative to interest, so we would check "No.")
- **Line 3 – Partnership's aggregate basis in distributed property:** This is the total **inside basis** of all property (not including cash) that the partnership had **immediately before distribution**. Sum up the partnership's basis in each asset distributed. If multiple assets, this corresponds to the total of column (b) in Part II. The partnership is supposed to provide this info –**Schedule K-1 (Form 1065) box 19 code C** will report the partnership's aggregate basis of property distributed to the partner. For Example 2, in Partner Y's case, if the partnership's basis in the land was $5,000, line 3 would be $5,000. In Alex's case (Example 3), the sum of bases (inventory $100 + Asset X $50 + Asset Y $100) was $250.

- **Line 4 – Adjusted basis of partner's interest before distribution:** The partner's **outside basis** in their partnership interest immediately before the distribution. This number is critical as the starting point for all further calculations. For our examples: Y's outside basis was $10,000; Alex's was $750; Beth's $100, etc., as of just before the distribution.
- **Line 5a and 5b – Cash and Marketable Securities:** Line 5a is the amount of **cash** the partner received in this distribution and that was deemed received due to the decreased allocable share of liabilities under §752(b). Line 5b is the **fair market value of any marketable securities** received (that are treated as money under §731(c)). These are added: 5a and 5b are added together on Line 5c. This represents the total "money" received.
- **Line 6 – Basis Limit for Money:** Enter the smaller of line 4 or line 5c. This effectively is the portion of the cash that can be covered by the partner's outside basis. If outside basis is larger than the cash, this will just equal the cash (no gain yet). If outside basis is smaller, this will equal the outside basis (meaning any cash above that will be gain). In Partner Y's case, line 4 was $10k, line 5c $8k, so line 6 = $8k.
- **Line 7 – Gain Recognized:** Subtract line 6 from line 5. Any positive result is **gain the partner must recognize** under §731. If zero or negative, enter 0 (no gain). In Y's example, $8k (line 5c) – $8k (line 6) = $0, so no gain. If a partner had cash > basis, this line would show the excess as taxable gain. Form 7217 also asks on **Line 8** whether U.S. tax is required to be paid on the gain on line (this might be relevant for foreign partners or tax-exempt partners – generally for a U.S. individual it's "Yes" if there is gain).
- **Line 9 – Basis After Cash:** This line computes the partner's remaining outside basis **after cash distributions**. It is the **outside basis (line 4) minus cash received (line 5a)**, but not below zero. (Marketable securities on 5b don't reduce basis since they were treated as money for gain calcs, but basis in them is handled in Part II as property.) If the distribution triggered a §737 gain (precontribution gain) for the partner, the instructions indicate there are special considerations in making this adjustment – if §737 applied, the partner's outside basis would have been increased by the gain recognized before allocating basis to properties. In most cases, line 9 = line 4 – line 5a (with a floor of zero). In Y's case: $10k – $8k = $2k.
- **Line 10 – Basis Allocable to Property:** This is the total basis the partner will assign to the **non-cash property** received. For a **non-liquidating distribution**, line 10 is the smaller of line 3 or line 9. This directly reflects §732(a)(2)'s limitation: you take the lesser of the partnership's basis in the property or your remaining outside basis. For a **liquidating distribution**, line 10 is simply the amount from line 9 (since you allocate all remaining basis to the assets in a liquidation). In Y's non-liquidating case, line 3 was $5k (partner's basis in land from K-1) and line 9 $2k, so line 10 = $2k. In a liquidating scenario like Beth's Example 4, assume no cash, line 9 = line 4 (say $100), line 3 (sum of bases) might be $120, line 10 for liquidating = line 9 = $100 (all outside basis goes to assets).

At this point, Part I has computed and **ensures the partner and IRS are on the same page regarding taxability and basis moving forward.**

Part II Allocation of Basis of Distributed Property

	(a)	(b)	(c)					(d)	(e)
	Description of distributed property (If applicable, include property code. See Pub. 946, Appendix B.)	Partnership's basis in distributed property immediately before the distribution	Check applicable box(es) below. See instructions.					FMV of distributed property	Partner's basis in distributed property after application of section 732
			(i) 732(d)	(ii) 732(f)	(iii) 734(b)	(iv) 743(b)	(v) Reserved for future use		
1		$	☐	☐	☐	☐		$	$
2		$	☐	☐	☐	☐		$	$
3		$	☐	☐	☐	☐		$	$
4		$	☐	☐	☐	☐		$	$
5		$	☐	☐	☐	☐		$	$
6		$	☐	☐	☐	☐		$	$
7		$	☐	☐	☐	☐		$	$
8		$	☐	☐	☐	☐		$	$
9		$	☐	☐	☐	☐		$	$
10		$	☐	☐	☐	☐		$	$
11		$	☐	☐	☐	☐		$	$
12		$	☐	☐	☐	☐		$	$
13		$	☐	☐	☐	☐		$	$
14		$	☐	☐	☐	☐		$	$
15		$	☐	☐	☐	☐		$	$
16		$	☐	☐	☐	☐		$	$
17		$	☐	☐	☐	☐		$	$
18		$	☐	☐	☐	☐		$	$
19		$	☐	☐	☐	☐		$	$
20		$	☐	☐	☐	☐		$	$
21		$	☐	☐	☐	☐		$	$
22		$	☐	☐	☐	☐		$	$
23		$	☐	☐	☐	☐		$	$
24		$	☐	☐	☐	☐		$	$
25		$	☐	☐	☐	☐		$	$
26		$	☐	☐	☐	☐		$	$
27		$	☐	☐	☐	☐		$	$
28		$	☐	☐	☐	☐		$	$
29		$	☐	☐	☐	☐		$	$
30		$	☐	☐	☐	☐		$	$
A	If applicable, enter any totals from any attached Parts II. See instructions	$						$	$
B	Totals for all items	$						$	$

Form **7217** (12-2024)

Form 7217 Part II – Allocation of Basis of Distributed Property: In Part II, the partner lists each property received (except cash) and details how the basis was allocated. The columns are:

a. **Description of distributed property:** Name or type of asset. If applicable, include a property code (IRS provides codes for various asset types, e.g. depreciable equipment, real estate, etc., referencing Pub. 946 Appendix B for MACRS asset types).

b. **Partnership's basis in distributed property:** The asset's **inside basis** just before distribution (this is part of what was summed in line 3). For example, if an equipment had $4k basis, put $4,000 here.

c. **Check applicable box(es):** These checkboxes identify special basis adjustments or circumstances:

   i. **§732(d)** – Check if the partner made a basis election under §732(d). (This is a special election for certain transferee partners to use an adjusted basis for distributed property if they had purchased their partnership interest).

   ii. **§732(f)** – Check if the distributed property is stock in another corporation and §732(f) (old §732(e)) applies (certain corporate drop-down situations).

   iii. **§734(b)** – Check if a **special basis adjustment under §734(b)** affected this property's basis (i.e. the partnership had a §754 election and adjusted this asset's basis prior to distribution due to a prior distribution or death of partner).

   iv. **§743(b)** – Check if a **§743(b) adjustment** is included in the partnership's basis (i.e. the asset's basis to the partnership included a step-up or step-down from someone buying a partnership interest under a §754 election).

   v. **Reserved** – (No current use; for future regulations).

- These boxes alert the IRS if the basis numbers include any special adjustments beyond the default. In many straightforward cases, none of these boxes will be checked.

d. **FMV of distributed property:** The property's fair market value at distribution. This isn't directly used in basis calculations on the form, but it provides context (and could be relevant for applying the 732(c) allocation rules in complex cases or for identifying if substantially appreciated inventory exists, etc.). Also, listing FMV might help flag if someone is assigning basis wildly in excess of FMV (though allowed, it's a notable outcome).

e. **Partner's basis in distributed property after application of §732:** This is the **resulting basis the partner assigns to the asset**. These values should sum up to the number on line 10 (the form ensures that via the total line). The partner, using the rules discussed, determines how their remaining basis (line 9) gets allocated to each asset. For a single asset, it's often just that remaining basis (or the partnership's basis if lower). For multiple assets, the partner will go through the allocation process (which might be complex for them to do manually – typically the partnership might provide a suggested allocation).

After listing all assets, you total up columns (b) and (e) for all items (line B at the bottom of Part II). Line B, column (b) total should equal Part I, line 3, and line B, column (e) total should equal Part I, line 10. This reconciliation ensures you haven't "created or lost" basis inappropriately: the partnership's total basis (with any adjustments) is accounted for, and the partner's basis allocated matches what's available.

Example 2 Revisited – Current Distribution – Insufficient Outside Basis (Basis Limitation) with Form 7217: Partner Y has an outside basis of $10,000. Y receives a distribution of $8,000 cash and a parcel of land. The land's basis to the partnership is $5,000 (and FMV $12,000, for reference).

Cash vs. Basis: Y's $8,000 cash is below his $10,000 outside basis, so no immediate gain (cash does not exceed basis). Y's outside basis before property is then $2,000 remaining ($10k – $8k).

Property Basis Limitation: The partnership's basis in the land is $5,000, but Y only has $2,000 of outside basis left to allocate. Under §732(a)(2), Y's basis in the land is limited to $2,000, the amount of outside basis he had left. He cannot carry over the full $5,000 because he simply didn't have enough outside basis to support it. The distribution fully uses up Y's remaining basis.

Outcome: Y takes the land with a $2,000 basis (which is notably lower than the partnership's $5,000 basis and much lower than FMV). Y's outside basis in the partnership is now $0 ($2k – $2k), meaning if he receives any additional distributions before acquiring new basis (e.g. through income), they could trigger gain. The $3,000 of partnership basis in the land that Y could not take is not transferred anywhere – it just disappears for tax purposes. Y has a built-in gain in the land: if he sells it for its $12,000 FMV, he would realize a large gain partly reflecting that lost basis.

In Example 2, note how the partner's basis in the distributed property was the lesser of the partnership's basis in the property or the partner's remaining outside basis. This example mirrors the IRS's guidance: no gain on the distribution, but the partner's basis in the land is capped at $2,000 and his partnership basis is fully reduced to zero.

	Amounts	***Notes***
Bgn Basis	10,000	
Less Cash	(8,000)	*cash received in excess of bgn basis is capital gain*
Rmng Basis	2,000	
Land Rcvd	(2,000)	*lesser of inside basis and outside basis*
Rmng Basis	-	*carryforward basis*

Form **7217** (December 2024) Department of the Treasury Internal Revenue Service

Partner's Report of Property Distributed by a Partnership

Attach to your tax return.
Go to *www.irs.gov/Form7217* for instructions and the latest information.

OMB No. 1545-0123
Attachment Sequence No. **217**

Partner's name	Partner's TIN
PARTNER Y	999-99-9999
Distributing partnership's name	Distributing partnership's EIN
PARTNERSHIP	99-9999999

Date property was distributed to partner

Part I **Aggregate Basis of Distributed Property on Distribution Date.** File a separate form for each date a partner received distributed property.

1	Was this distribution in complete liquidation of the partner's interest in the partnership?		☐ Yes ☑ No
2	Was any part of the distribution treated as a sale or exchange under section 751(b)?		☐ Yes ☑ No
3	Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b)		$ 5000
4	Adjusted basis of the partner's interest in the partnership immediately before the distribution		$ 10000
5a	Cash received in the distribution	$ 8000	
b	Fair market value of marketable securities (as defined in section 731(c)) received in the distribution	$ 0	
c	Add lines 5a and 5b		$ 8000
6	Enter the smaller of line 4 or line 5c		$ 2000
7	Gain recognized. Subtract line 6 from line 5c. If zero, enter -0- and go to line 9		$ 0
8	Is U.S. tax required to be paid on the gain entered on line 7?		☐ Yes ☑ No
9	Partner's basis in partnership interest reduced by cash received in the distribution. Subtract line 5a from line 4. If zero or less, enter -0-. See instructions if you recognized gain under section 737 as a result of the distribution		$ 2000
10	Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e)		$ 2000

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Form 7217 (12-2024) Page **2**

Part II **Allocation of Basis of Distributed Property**

	(a) Description of distributed property (If applicable, include property code. See Pub. 946, Appendix B.)	(b) Partnership's basis in distributed property immediately before the distribution	(c) (i) 732(d)	(c) (ii) 732(f)	(c) (iii) 734(b)	(c) (iv) 743(b)	(c) (v) Reserved for future use	(d) FMV of distributed property	(e) Partner's basis in distributed property after application of section 732
1	LAND	$ 5000	☐	☐	☐	☐	☐	$ 12000	$ 2000

Check applicable box(es) below. See instructions.

Example 3 Revisited – Liquidating Distribution (Outside Basis > Asset Bases):
Alex is a 25% partner in PRS Partnership with an outside basis of $750. Alex decides to retire, and PRS liquidates his interest by distributing to him: $50 cash, $50 reduction in liability relief/allocated liabilities, inventory with an inside basis of $100 (FMV $200), Asset X (a capital asset) with an inside basis of $50 (FMV $400), and Asset Y (another capital asset) with an inside basis of $100 (FMV $100). Assume no gain is recognized under §731 (cash $50 + liab.relief $50 < basis $750, so no gain).

Initial Assignment: Carryover bases: cash $100; inventory $100; Asset X $50; Asset Y $100. Total = $350. Alex's outside basis is $750, which is $400 higher than the carryover total. So basis **increase** of $400 is required (Alex has more basis to allocate than the assets' current bases total). No loss is possible here because there are capital assets in the mix (and anyway outside basis > inside basis, not a loss scenario).

Allocate Increase: According to the rules, do not increase hot asset (inventory) beyond $100 (its carryover). Focus on assets with appreciation:

- Inventory: basis $100 vs FMV $200 (appreciation $100, but inventory's basis will remain capped at $100 in this allocation).
- Asset X: basis $50 vs FMV $400 (appreciation $350).
- Asset Y: basis $100 vs FMV $100 (no appreciation).

- Asset X has $350 of unrealized gain, inventory $100. The $400 excess basis is first allocated to **appreciated assets (excluding inventory)**. Here, Asset X is the only appreciated capital asset. We raise Asset X's basis by $350 to $400, eliminating its unrealized gain. Now $50 of excess basis remains (750 – (350 carryover + 350 allocated to X) = 50).
- Now all appreciated assets (X) are at FMV basis. We still have $50 to allocate and the only assets left are inventory and Asset Y. Inventory is hot asset (generally not increased beyond carryover), Asset Y had no gain but can receive basis. At this point, the remaining $50 can be allocated among all assets in proportion to their FMVs as a reasonable method. FMVs: Inventory $200, Asset X $400, Asset Y $100 (Asset X is already at FMV basis but can still partake in remaining allocation). Proportionally: Inventory 40%, Asset X 40%, Asset Y 20% of FMV pool. Allocating $50 by FMV: Inventory $20, Asset X $20, Asset Y $10. However, since inventory's basis is not increased by rule, we instead give its share to capital assets:
    - Asset X gets an additional $40 (it ends up with basis $440, $40 above its $400 FMV).
    - Asset Y gets $10 extra (basis becomes $110, $10 above FMV).

      Now all $750 of Alex's basis has been allocated: cash 100 + inventory 100 + Asset X 440 + Asset Y 110 = $750. Alex's outside basis is fully used, and he has no remaining interest. Some assets ended up with basis above FMV (built-in losses of $40 on X and $10 on Y) which Alex could realize if he sells them in the future.

Results: Alex recognizes **no gain or loss** on the distribution itself (cash did not exceed basis, and distribution included capital assets so no loss allowed). His bases in the assets are: $100 for inventory, $440 for Asset X, $110 for Asset Y. These bases are markedly different from the partnership's original bases, reflecting the allocation of his outside basis. The inventory still carries its original $100 basis (Alex will recognize ordinary income on the $100 appreciation if sold, maintaining the character as "hot asset"). Asset X's basis was stepped up significantly, meaning Alex will have less capital gain if he sells it. Asset Y's basis was slightly increased above its value, giving Alex a small potential capital loss if sold at a $100.

	Amounts	***Notes***
Bgn Basis	750	
Less Liab.	(50)	*liability relief = deemed cash distribution*
Less Cash	(50)	
Rmng Basis	650	*negative value would create capital gain*
Inventory Rcvd	(100)	*max carryover basis*
Rmng Basis	550	*basis to be assigned to remaining assets*
Inside Basis	(150)	*$100 + $50 = $150*
Basis Increase	400	*Basis increase to be allocated first to unrealized appreciation followed by pro rata allocation based on FMV*

	Basis	**FMV**	**C/O Basis**	**Unrealized Appreciation**	**Basis Incr. ****	**Final Alloc. Basis *****
Asset X	50	400	50	350	40	**440**
Asset Y	100	100	100	-	10	**110**
	150	**500**	150	350	*50	**550**

** 550 remaining basis – (150 c/o basis + 350 unreal. apprec.) = $50*

*** Basis increase is allocated pro rata based on FMVs*

*Asset X = 400 / 500 * 50 = 40*

*Asset Y = 100 / 500 * 50 = 10*

**** Sum of C/O basis, unrealized appreciation, and basis increase for each asset.*

Form **7217** (December 2024) Department of the Treasury Internal Revenue Service

Partner's Report of Property Distributed by a Partnership

Attach to your tax return.

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OMB No. 1545-0123

Attachment Sequence No. **217**

Partner's name	Partner's TIN
ALEX	999-99-9999
Distributing partnership's name	Distributing partnership's EIN
PRS PARTNERSHIP	99-9999999

Date property was distributed to partner

Part I **Aggregate Basis of Distributed Property on Distribution Date.** File a separate form for each date a partner received distributed property.

1	Was this distribution in complete liquidation of the partner's interest in the partnership?		☑ Yes ☐ No
2	Was any part of the distribution treated as a sale or exchange under section 751(b)?		☐ Yes ☑ No
3	Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b)		$ 250
4	Adjusted basis of the partner's interest in the partnership immediately before the distribution		$ 750
5a	Cash received in the distribution	$ 100	
b	Fair market value of marketable securities (as defined in section 731(c)) received in the distribution	$ 0	
c	Add lines 5a and 5b		$ 100
6	Enter the smaller of line 4 or line 5c		$ 100
7	Gain recognized. Subtract line 6 from line 5c. If zero, enter -0- and go to line 9		$ 0
8	Is U.S. tax required to be paid on the gain entered on line 7?		☐ Yes ☑ No
9	Partner's basis in partnership interest reduced by cash received in the distribution. Subtract line 5a from line 4. If zero or less, enter -0-. See instructions if you recognized gain under section 737 as a result of the distribution		$ 650
10	Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e)		$ 650

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Part II Allocation of Basis of Distributed Property

	(a)	(b)	(c)					(d)	(e)
	Description of distributed property (If applicable, include property code. See Pub. 946, Appendix B.)	Partnership's basis in distributed property immediately before the distribution	Check applicable box(es) below. See instructions.					FMV of distributed property	Partner's basis in distributed property after application of section 732
			(i) 732(d)	(ii) 732(f)	(iii) 734(b)	(iv) 743(b)	(v) Reserved for future use		
1	INVENTORY	$ 100						$ 100	$ 100
2	ASSET X	$ 50				✔		$ 400	$ 440
3	ASSET Y	$ 100						$ 100	$ 110
4		$						$	$
5		$						$	$
6		$						$	$
7		$						$	$
8		$						$	$
9		$						$	$
10		$						$	$
11		$						$	$
12		$						$	$
13		$						$	$
14		$						$	$
15		$						$	$
16		$						$	$
17		$						$	$
18		$						$	$
19		$						$	$
20		$						$	$
21		$						$	$
22		$						$	$
23		$						$	$
24		$						$	$
25		$						$	$
26		$						$	$
27		$						$	$
28		$						$	$
29		$						$	$
30		$						$	$
A	If applicable, enter any totals from any attached Parts II. See instructions	$						$	$
B	Totals for all items	$ 250						$ 600	$ 650

Form **7217** (12-2024)

VI. Partnership Practical Tips

- **Always Track Outside Basis:** A partner's adjusted outside basis is the most important element for determining taxability of distributions. Ensure you maintain proper basis schedules for clients with partnership interests. This will inform whether a distribution triggers gain and how much basis to assign to distributed assets. Remember that basis is adjusted annually for income, loss, and prior distribution.
- **Distinguish Distribution Types:** Determine early if a distribution is **liquidating** or **non-liquidating**, as the tax outcomes diverge. If liquidating, be prepared to allocate basis among assets and consider if any loss might be recognized (only if no capital assets are received). If non-liquidating, remember the partnership's basis in property might exceed what the partner can take – basis limitations could apply.
- **Watch the Cash (and Debt):** Cash is usually the only item that can cause immediate gain. Don't overlook deemed cash from liability reductions – if a partnership distribution relieves a partner of some share of debt, that's treated as cash received. Compare total cash (actual + deemed) with outside basis before concluding no gain.
- **Hot Asset Considerations:** If the partnership has substantial unrealized receivables or appreciated inventory, be cautious. Disproportionate distributions of these can trigger unexpected ordinary income via §751(b). Check if the partner's share of these hot assets is changing drastically. If so, compute the §751(b) impact and report accordingly (including the statement with Form 7217, line 2).
- **Reconcile with Partnership:** If you're the partnership's tax professional, inform partners of the necessary info: provide the inside basis of distributed assets (K-1 code C) and

indicate any potential §751 or §737 issues. If you're the partner's tax professional, ensure the K-1 includes these details or request a breakdown. This collaboration is important now that partners have to report distributions in detail on Form 7217.

- **Form 7217 Accuracy:** Treat Form 7217 as more than a formality. It's in effect a mini "audit" of the distribution. Fill out all applicable lines, double-check that Part II totals align with Part I, and that the numbers correspond to those on the K-1. The form, once completed, is also a handy record for the client of their new asset bases. Keep a copy in the workpapers for future reference (especially if assets are later sold).

VII. S Corporation Redemptions

A distribution of cash or property by an S corporation in a **redemption** transaction is treated as a distribution under §301 and is thus covered by the distribution rules of Subchapter S[6] unless the redemption qualifies as an exchange under §302(a) or §303.[7]

In general, a redemption of S corporation stock qualifies as an exchange under §302(a) if: [8]

- The redemption is **not essentially equivalent to a dividend** by virtue of a meaningful reduction in the shareholder's proportionate interest of the corporation;
- The redemption is **substantially disproportionate with respect to the shareholder** (after considering the constructive ownership rules);
- The redemption **completely terminates the redeeming shareholder's interest** in an S corporation;
- The **redemption is made in partial liquidation of an S corporation**; **OR**
- In certain circumstances, a **distribution is in redemption of stock from a decedent's estate** to pay death taxes and expenses.

A. S Corporation Consequences

A distribution of cash in redemption of S corporation stock has no effect on the amount of an S corporation's income, loss, deduction, or credit in the year of redemption. Allocations of income, gain, loss, deduction, and credit are still made on a per-share, per-day basis, absent a closing-of-the-books election under §1377(a)(2). Further, the typical ordering rules for adjustments would still generally apply.

A distribution (either cash or property) does affect, however, an S corporation's accumulated adjustments account (AAA) and perhaps its accumulated earnings and profits (AE&P).

With regard to **AAA**, this is done by reducing AAA in proportion to the shares redeemed (§1368(e)(1)(B)).

- If a **redemption** is treated as an exchange **and** an S corporation makes **other distributions** during the year of redemption, **the taxability of the distribution is determined before the adjustment to AAA caused by the redemption**. The adjustment to AAA for a redemption is made after the AAA is adjusted for corporate income or loss.
- When an S corporation **distributes appreciated property** in redemption of its stock and **recognizes gain on the distribution**, the balance of its **AAA increases by the amount**

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6 I.R.C. §1368(a).

7 I.R.C. §§302(a), 303, and 1371(a)(1). See PLRs 9224036, 9116008, 8705014, and 8546059. (I.R.C. §302(a) applied to redemption of stock in S corporation.)

8 §302(b) and §303(a)

of the gain recognized. If an S corporation distributes depreciated property in redemption of its stock, its AAA only decreases if the realized loss is recognized.

- If an **S corporation distributes depreciated property** in redemption of its stock, it **generally may not recognize a loss on the distribution**. Because a shareholder's basis in distributed property is equal to its fair market value and the realized loss is not recognized, an S corporation should consider the alternative of selling the property, recognizing the loss, and distributing the cash proceeds.

Example 8: ***Facts***

S corporation's AAA balance is $150. A and B each own S corporation's outstanding shares in a 40/60 split. S corporation redeems all of A's shares for $500, and the redemption is treated as an exchange.

Conclusion and Analysis

S corporation's AAA balance is reduced from $150 to $90, regardless of the amount paid for the stock.
$150 AAA x 40% redeemed shares = $60 reduction in AAA
$150 AAA - $60 AAA reduction from redemption = $90 new AAA balance.

Subchapter C provides that a redemption of stock to which §302(a) or §303 applies results in a ratable reduction of a corporation's earnings and profits. This ratable reduction adjustment to accumulated earnings and profits for a redemption treated as an exchange is similar in nature to the adjustment to AAA under §312(n)(7).

Example 9: ***Facts***

On January 1, S corporation has AAA of $100 and AE&P of $100 with two shareholders, C and D, who own the shares 70/30 at a 70/30 split. On February 1, a $200 distribution was paid to C and D, which was split $140/$60 between the two shareholders. On December 31, when all of Shareholder C's stock is redeemed for $130 in a redemption qualified under §302(a), S corporation had computed taxable income of $160.

Conclusion and Analysis

To determine the implications of the ordinary distributions in February, S corporation updates AAA to $260 ($100 bgn AAA + $160 taxable income). Because the ordinary distribution does not reduce AAA below zero, the February distribution then reduces AAA to $60, prior to the analysis of the redemption.

The redemption subsequently reduces AAA as follows:
$60 AAA x 70% redeemed shares = $42 reduction in AAA
$60 AAA - $42 reduction for redemption = $18 EOY AAA balance

Finally, S corporation must also reduce AE&P in an amount equal to the ratable share attributable to the redeemed stock as follows:
$100 AE&P x 70% redeemed shares = $70 reduction in AE&P
$100 AE&P - $70 reduction in AE&P = $30 EOY AE&P balance

When an S corporation distributes appreciated property with respect to its stock, an S corporation is treated as though it sold the distributed property to its shareholders at fair market value. The gain recognized by an S corporation generally passes through to its shareholders, along with other items of income and loss, on a per-share, per-day basis and increases their bases in their stock. The character of the recognized gain is determined at the corporate level and depends upon the character of the asset distributed. If the gain is attributable to recapture items, however, it is ordinary. A distribution or sale of appreciated property in connection with a redemption also affects an S corporation's AAA and perhaps its accumulated earnings and profits.

B. Shareholder Consequences

If a redemption of S corporation stock qualifies as an exchange, the amount of gain or loss realized and recognized by the redeeming shareholder is computed under the general provisions of §1001. A redeeming shareholder offsets the shareholder's adjusted basis in the stock redeemed against the cash and fair market value (FMV) of other property received in the taxable year of the redemption and recognizes gain, or to the extent adjusted basis is not offset, loss.

A redeeming shareholder's adjusted basis in the stock redeemed generally equals the shareholder's original basis in the stock decreased by losses, deductions, and nontaxable distributions and increased by income and contributions.

Adjustments to the basis of the redeemed stock for corporate items of income or loss in the year of redemption are generally determined at the end of the year of redemption, and before determining the amount of gain or loss, a shareholder must recognize on the redemption of the shareholder's shares.

1. Closing-of-the-books election

Generally, the adjustment to stock basis is determined by computing an S corporation's tax items for the year of redemption and allocating the tax items to the S corporation stock on a per-share, per-day basis. Thus, a redeeming shareholder who does not completely terminate the shareholder's interest in an S corporation will not be able to ascertain the shareholder's basis in the redeemed stock and the amount of gain or loss recognized on the redemption, until the end of an S corporation's tax year. If a redeeming shareholder completely terminates the shareholder's interest in an S corporation, however, the shareholder can fix the basis of the redeemed shares on the date of redemption by consenting to a §1377(a)(2) election by the S corporation to close its books for allocation purposes on the date of the redemption. **Such an election creates two short taxable years in the year of redemption so that post-redemption income or loss during a taxable year does not adjust a redeemed shareholder's stock basis or the amount of recognized gain or loss.** All affected shareholders must agree to the election.

> ***Example 10:*** X is a calendar-year S corporation. A owns 50 percent of the outstanding shares of X, and B owns the remaining 50 percent. A and B are not related. A has no basis in the stock at the beginning of the year. Assume, for ease of illustration, the year consists of twelve 30-day months. On June 30, A redeems all of the shares for $500. For the period January 1 through June 30, X recognizes $100 of ordinary taxable income. For the period July 1 through December 31, X recognizes $200 of ordinary losses. If A and B do not consent to an election by X under §1377(a)(2), A's basis in his shares immediately before the redemption is $0, and A recognizes capital gain of $500 on the redemption. No portion of X's net $100 ordinary loss passes through to A because A has no basis in the stock. If A and B consent to X's election to close the books of X on June 30, 50 percent of X's taxable income for the period ended June 30 ($50) passes through to A, and the basis in the shares immediately before the redemption is $50 and A recognizes capital gain of $450 on the redemption. A therefore recognizes a total of $500 in income, $450 of capital gain and $50 of ordinary income, which passed through to A. Whether A would prefer the election to close the books be made will depend on whether ordinary income is taxed at a higher rate than capital gain and whether A has capital-loss carryovers that exceed $450.

Miscellaneous Business Developments and Tax Considerations

Miscellaneous Business Developments and Tax Considerations

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Describe recent developments in the legal landscape for DAOs; and
- Understand the requirements to e-file Form 8300, *Report of Cash Payments Over $10,000*.

Note: Line and code references apply to 2024 forms

Within this manual, references to line numbers of forms, including Forms 1040 and Form 8949 are made. All references apply to the 2024 final version of the respective forms.

The IRS generally releases an early draft version of forms in the late summer of each year. The final versions of tax forms are generally released in December or early January.

I. Legislative updates

A. Introduction to Decentralized Autonomous Organizations

1. The rise of DAOs: A new era in organizational structure

The evolution of technology, particularly in the blockchain space, has introduced new ways of structuring organizations, and Decentralized Autonomous Organizations (DAOs) are at the forefront of this movement. These unique entities are revolutionizing how businesses, nonprofits, and even social groups are formed and managed. Over the past five years, more than 10,000 DAOs have come into existence, marking a clear shift in how organizational structures are conceptualized and operated.

In essence, DAOs are organizations that operate primarily through automated algorithms and decentralized governance rather than traditional human-led management. These organizations are powered by smart contracts and protocols that dictate how decisions are made, how resources are allocated, and how the entity is governed. The rise of DAOs aligns closely with the broader push toward decentralization in the digital age, particularly within the context of Web3 and blockchain technologies.

A key feature of DAOs is their ability to reduce human interference in operational decision-making, thereby minimizing the risk of corruption and inefficiency. Traditional organizations—whether businesses, nonprofits, or governments—often suffer from issues like gatekeeping, bureaucracy, and the manipulation of power by those in control. In contrast, DAOs utilize automated, transparent systems to facilitate decision-making, ensuring that every action is recorded and verifiable on a public ledger, often a blockchain.

Interestingly, this concept of transparency contrasts sharply with the origins of cryptocurrency, which was initially rooted in ideals of privacy and autonomy from centralized institutions. DAOs, while decentralized, embrace transparency as a means of ensuring trust and accountability. This has led some to coin the term “transparocurrency” as a more appropriate descriptor for the type of financial and organizational structures DAOs represent.

2. Understanding the legal landscape for DAOs

Initially, DAOs were considered to exist outside traditional legal frameworks, and many early proponents believed that DAOs did not need to conform to the entity classifications used by most legal systems. The decentralized and often anonymous nature of blockchain technology reinforced this belief, as DAOs could operate without a physical presence or centralized leadership.

However, as DAOs have proliferated, legal systems worldwide have begun to recognize their growing influence. In the United States, for example, DAOs that are not registered as formal legal entities are typically treated as general partnerships. This default classification exposes DAO members to significant risks, including unlimited personal liability for the actions of the DAO, which can be a major deterrent for participants. This legal ambiguity has led many DAOs to seek formal recognition through the creation of "legal wrappers" that grant the organization legal standing, liability protection, and clearer tax treatment. These legal wrappers typically involve incorporating the DAO as a traditional legal entity such as a corporation, limited liability company (LLC), or nonprofit. By doing so, DAO founders and members can enjoy the benefits of limited liability, shielding themselves from personal responsibility for the actions of the DAO.

Several U.S. states have developed laws and regulations specifically designed to accommodate DAOs, providing them with the legal certainty needed to operate within the existing legal framework. These state laws allow DAOs to register as formal entities while maintaining their decentralized nature. However, navigating these laws requires a deep understanding of both the legal and technical aspects of DAOs, as well as an awareness of the unique challenges they present.

3. Legal entities for DAOs

Selecting the appropriate legal entity for a DAO is a critical decision that can have far-reaching implications for its governance, tax obligations, and overall operational structure. The choice of entity will largely depend on the DAO's purpose, its level of centralization, and whether it intends to generate taxable income.

Broadly speaking, DAOs can be categorized based on their intended purpose, and each category comes with its own set of legal considerations. There are four primary categories of DAOs and the legal structures commonly used for each:

a. **Charitable and Social Purpose DAOs (Nonprofits)**: DAOs established to pursue charitable, educational, or social missions often seek nonprofit status. Nonprofit DAOs may apply for tax-exempt status under relevant sections of the U.S. Internal Revenue Code, such as §501(c)(3) for charitable organizations or §501(c)(6) for trade associations. These entities must navigate strict regulations regarding their activities, income sources, and how funds are allocated to ensure compliance with their nonprofit tax standing.

b. **Shared Property or Collection DAOs**: Many DAOs are created to manage shared assets, such as intellectual property, digital files, or even physical goods. In these cases, the legal structure must accommodate shared ownership and governance, often through the use of LLCs or cooperatives. This type of DAO allows multiple stakeholders to collaborate on managing assets, with decision-making typically handled through decentralized voting mechanisms.

c. **Governance or Protocol DAOs**: Some DAOs are designed to manage decentralized networks, software protocols, or blockchain ecosystems. These governance-focused

DAOs rely heavily on smart contracts and algorithms to automate decision-making processes. While these DAOs may not generate significant revenue, they still require a legal structure that provides liability protection and a clear governance framework. LLCs are often used in these cases, although some DAOs opt for more innovative legal structures that better reflect their decentralized nature.

d. **Investment DAOs**: DAOs that pool resources for investment purposes operate similarly to traditional venture capital or investment funds. These DAOs may invest in a wide range of assets, including cryptocurrencies, real estate, and startups. Investment DAOs often form as corporations or LLCs, allowing for the distribution of profits to members while providing liability protection. In some cases, these DAOs may also explore international legal structures, depending on the jurisdictions in which they operate.

The selection of the appropriate legal entity for a DAO also depends on its operational structure and goals. For example, a DAO created by multiple for-profit companies to manage shared software protocols might choose to incorporate as a joint venture LLC. This approach allows the DAO to hire employees, manage intellectual property, and allocate profits to members while limiting their liability.

In contrast, a DAO with a mix of commercial, nonprofit, and industry-specific goals might choose to "spin off" multiple DAOs to manage each aspect of its operations separately. This can help avoid the complications that arise when trying to combine diverse objectives within a single legal entity.

4. The legal framework for DAOs in the United States

Several U.S. states have been at the forefront of developing legal frameworks that cater specifically to DAOs. These laws provide DAOs with the legal certainty they need to operate while maintaining their decentralized structure. Notable states include the following.

- **Vermont (2018)**: Vermont was the first state to introduce legislation that allowed LLCs to operate using blockchain technology. The state's Blockchain-Based Limited Liability Company (BBLLC) framework provides DAOs with a way to operate under a decentralized governance model while still enjoying the benefits of limited liability. This framework was an early attempt to provide legal recognition to blockchain-based organizations, and it set the stage for other states to follow suit.
- **Wyoming (2021)**: Wyoming has emerged as a leader in blockchain and DAO regulation. In 2021, the state introduced a law that explicitly recognized DAOs as legal entities, known as DAO LLCs. This legislation allows DAOs to register as limited liability companies while maintaining their decentralized governance structure. Wyoming's DAO law also provides a clear framework for how DAOs can operate within the state's legal system, making it one of the most attractive jurisdictions for DAO founders.
- **Tennessee (2022)**: Following Wyoming's lead, Tennessee passed its own DAO LLC law, which grants legal recognition to DAOs and provides a regulatory framework for their operation. Tennessee's law is similar to Wyoming's, but it includes additional provisions that address some of the unique challenges DAOs face, such as conflicts between smart contracts and traditional legal agreements.
- **Utah (2023)**: Utah's DAO legislation represents a significant step forward in DAO regulation. Unlike other states that have adapted existing LLC statutes for use by DAOs, Utah's law is based on a model developed by the Coalition of Automated Legal Applications (COALA). This model law is specifically designed for DAOs, and it allows them to operate as distinct legal entities with their own set of rules and protections. The

COALA model law provides DAOs with greater flexibility and autonomy while ensuring they remain compliant with state and federal regulations.

These state laws share a common goal: to provide DAOs with the legal certainty needed to operate in compliance with U.S. law. However, these laws are not without their challenges. Some experts argue that the current legal frameworks impose unnecessary burdens on DAOs, such as disclosure requirements that may be difficult for decentralized organizations to meet. Others believe that the laws fail to address the complexities of reconciling smart contracts with traditional legal agreements.

5. Evolution of DAO-specific legal entities

Laws modeled on the COALA framework provide DAOs with a distinct legal personality and offer limited liability protections. Unlike earlier DAO LLC laws, which adapted existing LLC statutes for use by DAOs, the COALA model law is specifically designed for decentralized organizations.

The COALA model law addresses several key issues that have arisen in the context of DAOs, including how to handle contentious hard forks (situations where a blockchain splits into two competing chains) and how to manage cooperative upgrades to the DAO's governance protocols (known as "soft forks"). By providing clear guidelines for these scenarios, the COALA law offers DAOs a level of legal certainty that was previously lacking.

One of the most significant innovations in the COALA model law is its approach to resolving disputes that arise from hard forks. In the event of a contentious fork, the COALA law provides mechanisms for determining which version of the blockchain is the "majority chain," and therefore retains control over the DAO's assets. This is crucial in ensuring that DAOs can navigate complex technical issues without losing their legal standing or facing lawsuits from disgruntled members.

The COALA model law also recognizes that DAOs often engage in a mix of commercial and non-commercial activities. This flexibility allows DAOs to pursue a wide range of objectives, from profit-making ventures to community-driven projects, without being constrained by rigid legal classifications.

6. The future of DAOs and legal entities

As DAOs continue to grow in scope and complexity, the need for robust legal frameworks that accommodate their unique characteristics will only increase. The choice of legal entity is critical for any DAO, as it impacts everything from governance and liability to taxation and compliance. States like Wyoming, Vermont, and Utah are leading the way in developing laws tailored to the needs of DAOs, but these laws are still in their early stages.

In the coming years, DAO-specific legal entities will need to address common legal issues such as fiduciary duties, the business judgment rule, and the application of partnership or corporate tax regimes. As DAOs continue to grow in complexity and scope, the legal frameworks surrounding them will need to evolve in tandem, providing both flexibility and certainty for these innovative new organizational structures.

One of the key challenges for DAOs moving forward will be navigating smart contracts. While smart contracts offer significant advantages in terms of automation and transparency, they can also create legal ambiguities when conflicts arise. DAO-specific legal frameworks will need to address these issues head-on, providing clear guidelines for how smart contracts should be treated in a court of law.

Another major challenge for DAOs is tax compliance. DAO-specific legal entities will need to provide clear guidance on how DAOs should be taxed, whether as partnerships, corporations, or some other legal entity.

Finally, as DAOs continue to push the boundaries of what is possible in terms of decentralized governance, they will need to find new ways to balance innovation with legal compliance. DAO-specific legal frameworks will need to evolve in tandem with the technology, providing DAOs with the flexibility they need to grow while ensuring they remain compliant with state and federal laws.

In conclusion, DAOs represent a new frontier in organizational structure, and their continued growth will depend on the development of robust legal frameworks that can accommodate their unique needs. As more states and countries recognize the potential of DAOs, we can expect to see even more innovative legal structures emerge, providing DAOs with the legal certainty they need to thrive in the digital age.

II. General business tax issues

A. Form 8300 changes

Businesses that receive more than $10,000 in cash must report such transactions to the U.S. government. On August 20, 2023, the IRS announced that beginning January 1, 2024, certain businesses are required to e-file Form 8300, *Report of Cash Payments Over $10,000*. Beginning with calendar year 2024, businesses must e-file all Forms 8300, as well as other certain types of information returns required to be filed in a given calendar year, if they're required to file at least 10 information returns other than Form 8300. The requirement for e-filing Form 8300 applies to businesses that are required to e-file certain other information returns such as Form 1099 series and Form W-2.

A person must file Form 8300 within 15 days after the date the person received the cash. If multiple payments are received toward a single transaction or two or more related transactions, and the total amount paid exceeds $10,000, the person should file Form 8300. Each time payments add up to more than $10,000, the person must file another Form 8300. If filing electronically would cause undue hardship, a business may request a waiver by submitting Form 8508, *Application for a Waiver from Electronic Filing of Information Returns.* If the IRS grants a waiver, such waiver applies to all Forms 8300 for the rest of the calendar year. It is important to note that businesses may not request a waiver from e-filing only Form 8300.

> ***Example 1:*** ABC, LLC files seven Forms W-2 and three Forms 1099-INT. ABC, LLC must e-file all their information returns during the year, including any Forms 8300.

> ***Example 2:*** ABC, LLC files fewer than 10 information returns of any type, other than Forms 8300. ABC, LLC does not have to e-file the information returns and is not required to e-file any Forms 8300. However, while ABC, LLC is not required to e-file, they may still choose to do so.

If filing electronically would cause undue hardship, a business may request a waiver by submitting Form 8508, *Application for a Waiver from Electronic Filing of Information Returns*. If the IRS grants a waiver, such waiver applies to all Form 8300s for the rest of the calendar year. It is important to note that businesses may not request a waiver from e-filing only Form 8300.