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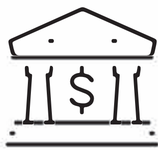

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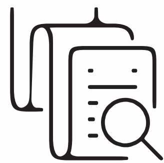

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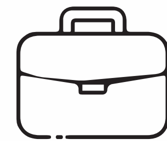

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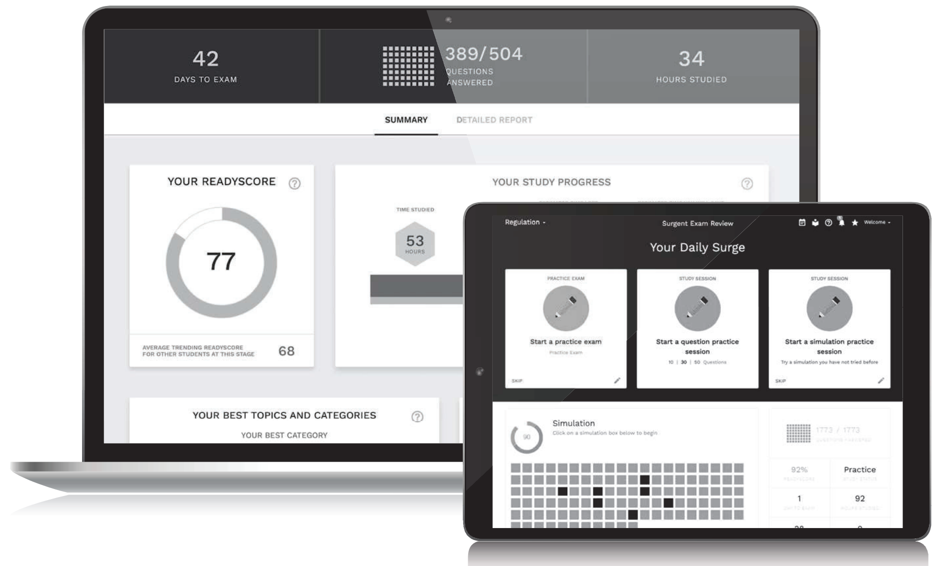

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NOTES

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

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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 or more of three primary regimes to ensure state taxes are collected on the allocable share of PTE income to owners. These three primary regimes are: nonresident withholding, composite return filing, and passthrough entity tax elections.

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

Prior to examining how states collect tax on PTE income, it is essential to understand how a state acquires the authority to tax that income in the first place. Such authority is established through Nexus, which 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

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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. Without nexus, a state cannot impose its income tax on a PTE's activities, and neither the entity nor its owners has a compliance obligation in that state.

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. Physical presence is one of the most traditional nexus-creating factors.
- **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. A PTE may have sales tax nexus in a state, creating a sales tax registration and collection obligation, without having income tax nexus if its only connection to the state is economic sales volume below the income tax threshold. The reverse is also possible: a PTE may have income tax nexus through employee or property presence without meeting the state's economic nexus threshold for sales tax. These are independent analyses that must be conducted separately for each state. 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.

Once nexus is established, the state must determine how much of the PTE's income is subject to its tax. **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.

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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. For PTE purposes, the nexus, apportionment, and allocation analysis is performed at the entity level. The entity determines its taxable income for each state based on that state's specific rules, applies the relevant apportionment formula, and identifies each owner's allocable share of the resulting state taxable income. Those apportioned allocable shares then flow to the owners as the income base on which withholding, composite, or PTET obligations are computed.

At the individual owner level, two competing principles create the potential for double taxation. The owner's resident state taxes all of the owner's income regardless of where it is earned, while the source state (the state in which the income is earned) taxes that income based on its source within the state, regardless of the owner's residency. When an owner has income sourced to a state in which the owner is not a resident, both states may assert a claim to tax that income. To mitigate double taxation, much like the federal system, the resident state may offer a “credit for taxes paid to other states.” The credit is generally computed as the lesser of the tax actually paid to the source state or the resident state's tax on the same income. The credit mechanism prevents double taxation in most cases but does not eliminate it in its entirety, as differences in state tax rates, definitions of taxable income, and the computation of the credit can result in some residual double taxation even when a credit is available.

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

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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

A. Withholding Obligation Directly on the Entity

When a PTE earns income apportioned to a state in which one or more of its owners are not residents, many states impose a withholding obligation directly on the entity. Rather than relying on nonresident owners to voluntarily comply with the source state's filing and payment requirements, with the resulting enforcement burden on the state, these states require the entity to withhold a portion of each nonresident owner's allocable apportioned income and remit it to the state tax authority on the owner's behalf. **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.

The key components of nonresident withholding taxes are:

- **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 a 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. One of the most practically important and overlooked aspects of the withholding analysis is the de minimis threshold question: at what level of in-state activity or income does the withholding obligation actually arise? As of January 1, 2026, 22 states have no meaningful nonresident

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filing threshold, requiring most nonresidents to file an individual income tax return if they spend even a single day working in the state. Meanwhile, 19 states have filing thresholds that relieve nonresidents from filing when they perform limited work in the state, with thresholds based either on days worked or income earned. For PTEs, these thresholds matter because withholding is typically not required, and the owner typically does not have a filing obligation – until the threshold is exceeded. A PTE with de minimis activity in a state where the nonresident owner's allocable apportioned income falls below the state's threshold may have no withholding obligation with respect to that owner in that state. Conversely, in states with no meaningful threshold, any amount of apportioned income may create an obligation regardless of how small.

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	

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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				

Importantly, PTEs with activity in multiple states must verify the withholding threshold for each state and each owner. An owner with a very small allocable share of a PTE's income apportioned to a given state may fall below the withholding threshold and have no withholding or filing obligation in that state, a meaningful compliance simplification that is easy to miss if the analysis focuses only on whether the entity has nexus rather than whether each owner meets the state's individual threshold.

Further, 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 annual SALT limitation.

Lastly, it is important to emphasize that the withholding tax remitted by the PTE on behalf of a nonresident owner is an estimated tax payment, not a final satisfaction of the owner's state tax liability. Unless the state expressly treats withholding as a substitute for a nonresident individual return, the nonresident owner must still file a nonresident individual income tax return in the source state, claim the withheld amount as a prepayment credit, and compute the actual tax liability using the applicable rates and any available deductions. The owner's actual liability may be more or less than the amount withheld, depending on the owner's individual tax circumstances.

This creates a compliance obligation at the individual level that the withholding mechanism does not eliminate, as it only reduces the risk of underpayment at year-end. An owner who receives a K-1 showing

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state withholding on their behalf but who does not file the required nonresident return may be technically delinquent with that state, even though the entity has remitted funds on the owner's behalf.

The PTE must accurately report withholding taxes paid on behalf of each owner on the applicable state K-1 or accompanying schedules. Complete and accurate state K-1 reporting is essential, as owners cannot properly claim withholding credits on their nonresident returns or their resident state credit returns without documentation of what the PTE has paid on their behalf. Incomplete or inaccurate state K-1 reporting can cause reporting errors in multistate individual returns, often resulting in missed credits at the nonresident state level or incorrect credit computations at the resident state level.

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.

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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 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. Composite vs. Withholding — Understanding the Distinction

Withholding and composite returns are often confused, but they operate on fundamentally different mechanics. Withholding is typically mandatory, as the state requires the PTE to remit a percentage of each nonresident owner's allocable income regardless of whether the entity is also filing a composite return. A composite return, by contrast, is generally elective, as the entity chooses whether to file, and owners choose whether to participate.

From the individual owner's perspective, the most significant distinction is the effect on individual filing requirements. Withholding taxes generally do not eliminate the nonresident filing requirement, rather they are prepayments against that obligation. Whereas composite taxes generally do eliminate the nonresident filing requirement for participating owners with no other state-source income, as the composite return is the filing.

V. Passthrough entity taxes

The passthrough entity tax regime was born as a direct response to the TCJA's $10,000 SALT deduction cap. Prior to 2018, individual PTE owners could generally deduct state income taxes attributable to their passthrough income without limit on Schedule A, provided they itemized. The TCJA's cap eliminated the deductibility of most state income taxes above $10,000, effectively increasing the federal tax cost of operating in high-tax states for passthrough owners who itemized.

States and taxpayers recognized that if state income tax could be imposed at the entity level and deducted as a business expense on the entity's return, then the individual SALT cap would not apply to that deduction. The mechanism required federal confirmation that such entity-level state tax payments would be respected as deductible business expenses.

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

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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. As discussed, in response to the SALT deduction cap introduced by TCJA, many states have adopted Pass-Through Entity Tax (PTET) regimes.

Treasury Notice 2020-75 confirmed that the IRS would recognize and respect these PTET elections for federal tax purposes, allowing the entity to deduct the taxes paid without limitation. However, the continued validity of PTET regimes hinges entirely on Treasury Notice 2020-75, and thus remains vulnerable to change through future Treasury guidance.

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 SALT deduction limitation.

The PTET mechanism is relatively straightforward in structure. Rather than the entity withholding on behalf of owners or filing a composite return for them, the PTET regime imposes a tax directly on the entity, which pays that tax to the state and deducts it as a business expense in computing ordinary income that flows to its owners. The individual owners in turn receive a corresponding state tax credit on their returns for their allocable share of the PTET paid, ensuring the same income is not taxed twice at the entity level and again at the individual level.

The PTET deduction reduces ordinary income, and as a result, all owners receive proportionally reduced K-1 income. In other words, the PTET payment effectively reduces each owner's federal taxable income through a reduction in the income allocated to them, rather than through an itemized deduction that might be capped or unavailable. This is the core mechanism by which PTET converts a capped individual SALT deduction into an uncapped entity-level business expense. It is important to note that PTET also reduces the QBI flowing to owners for §199A purposes. This offset must be quantified in any PTET benefit analysis.

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.

The operational mechanics can vary between states with elective regimes. States often have varied deadlines, and missing them can even cause an election to be entirely forfeited for that year. In some states elections are irrevocable for the year of election and in other states, elections can be revoked. Finally, in some states elections bind all owners while other states allow selective participation.

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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 had 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.

VI. Other items of consideration

While PTETs are designed to streamline state tax compliance, their interaction with traditional withholding and composite returns is not uniform across states and often requires parallel tracking. In states where a PTET election is made, the entity-level PTET payment may satisfy or replace the nonresident withholding obligation for participating owners. However, this is not automatic, and the specific mechanics must be verified under each state's law. Other states may require withholding remittances to continue alongside PTET payments, creating a double-payment situation that must be reconciled.

Additionally, when a PTET election is made, composite returns may no longer be necessary in certain states for nonresident owners, as the PTET payment effectively satisfies the entity's obligation to ensure nonresident income is taxed at the state level. However, this treatment varies by state. In some states the PTET and composite return serve different populations. For example, the PTET may address resident and nonresident owners collectively while the composite return may specifically address nonresident individual owners, and both may be relevant.

Lastly, the choice of regime affects how individual PTE owner filing obligations are managed. The withholding regime generally preserves the individual nonresident filing requirement, while the composite regime generally eliminates it for eligible owners. PTET also typically eliminates the filing requirement, but the owner must still claim the credit on their return through some mechanism.

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 the following:

- Is the PTET elective or mandatory?
- Are estimated payments required?

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- 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 generally be accomplished in one of two 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. This approach is straightforward when all owners have equal withholding obligations, as the distributions are proportional to ownership, and no inequity results.

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:

	Debit	Credit
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.

However, this approach becomes problematic when withholding obligations differ across owners, which is a common case in a PTE with a mix of resident and nonresident owners or resident owners in states with different withholding requirements.

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In an S corporation, all distributions must be made on a pro-rata, per-share, per-day basis. A distribution to one shareholder that is not matched by a proportional distribution to all other shareholders constitutes a disproportionate distribution and can violate the single-class-of-stock requirement, potentially triggering an inadvertent termination of the S election. When nonresident withholding obligations apply to some shareholders but not others (for example, because some shareholders are residents of the source state or of states with no income tax), the distribution approach will produce disproportionate distributions unless a corresponding distribution is simultaneously declared to all shareholders in proportion to their ownership.

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 rather than a distribution. 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. For S corporations, it preserves the pro-rata character of those distributions.

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

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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

In both approaches, the withholding or composite taxes paid by the entity are not deductible by the PTE. They are deductible by the individual owner on Schedule A as state taxes paid, subject to the SALT limitation. 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. The accounting entry is relatively straightforward: a debit to state tax expense and a credit to cash (for payments) or accounts payable (for accruals).

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 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. When a state permits its own residents to participate in a PTET election, the election converts what would otherwise be a personal SALT-capped deduction into an entity-level business expense, producing a net federal tax benefit that can be substantial even for single-state PTEs.

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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.

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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 magnitude of these benefits is highly context-specific. The optimal approach varies with the owner's marginal rate, filing status, itemized deduction profile, SALT exposure, §199A zone, and the specific credits available in the resident state.

VII. 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.

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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

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		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.

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VIII. The OBBBA and Its Impact on State Tax Planning for PTEs

As discussed, the OBBBA increases the SALT deduction cap from $10,000 to $40,000 for tax years 2025 through 2029, with the cap increasing by 1% annually. After 2029, the SALT cap reverts to $10,000 unless Congress acts to extend or modify it. For 2026, the SALT cap is $40,400 for Married Filing Jointly taxpayers and $20,200 for Married Filing Separately taxpayers.

Further, as discussed, the SALT cap is subject to a phase-down for high-income taxpayers. Specifically, the cap is reduced by 30 cents for every dollar of MAGI exceeding $500,000 for MFJ filers (and $505,000 for 2026, increasing by 1% annually through 2029), with the deduction floor set at $10,000 regardless of income. For MFJ filers with MAGI at or above $600,000 in 2025 ($605,000 in 2026), the expanded cap provides no benefit, and their effective SALT deduction remains $10,000.

SALT Deduction Cap Phaseout – All Filers Except MFS			
Tax Year	MAGI Limit	SALT Cap	MAGI at Full Phaseout
2026	$505,000	$40,400	$606,333
2027	$510,050	$40,804	$612,730
2028	$515,151	$41,212	$619,191
2029	$520,302	$41,624	$625,716
2030 and beyond	N/A	$10,000	N/A

SALT Deduction Cap Phaseout – Married Filing Separately (MFS)			
Tax Year	MAGI Limit	SALT Cap	MAGI at Full Phaseout
2026	$252,500	$20,200	$303,167
2027	$255,025	$20,402	$306,365
2028	$257,575	$20,606	$309,595
2029	$260,151	$20,812	$312,858
2030 and beyond	N/A	$5,000	N/A

The OBBBA's increased SALT cap is a meaningful benefit for middle-income PTE owners whose total state tax burden falls below the new cap. However, for profitable businesses with owners earning well above $500,000, the expanded SALT cap provides little or no relief, and the PTET regime remains the primary tool for converting state income taxes into a fully deductible federal business expense.

Early drafts of the OBBBA had contemplated limiting or modifying PTET regimes; however, the final legislation made no such changes. Partnerships and S corporations operating in states with PTET regimes may continue to deduct state-level taxes at the entity level, and owners may continue to claim corresponding credits on their state returns. The IRS's position under Notice 2020-75 remains in effect and unmodified. However, this is cold comfort from a long-term planning perspective. The deductibility of PTET payments at the federal level rests entirely on Notice 2020-75, administrative guidance that can be modified or revoked by the Treasury Department without Congressional action. The OBBBA's silence on PTETs means the mechanism has not been codified into the statute. Any future Treasury guidance narrowing the definition of "specified income tax payments" under Notice 2020-75 would immediately affect the federal deductibility of PTET payments in all participating states.

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Lastly, it is important to note that the 2/37 Rule was introduced by the OBBBA and permanently replaces the Pease limitation beginning in the 2026 tax year. The 2/37 Rule essentially creates a “tax benefit ceiling” for high-income taxpayers, ensuring that their itemized deductions do not provide more than 35% tax benefit, even if the taxpayers are in the top 37% bracket. Specifically, 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.

Standard itemized deductions (like mortgage interest or charitable gifts) occur on Schedule A after AGI is calculated. These are directly subject to the 2/37 Rule’s "haircut". However, when an entity makes a PTET election, the state tax is paid and deducted at the entity level, reducing the PTE owner’s net business income on their K-1 before it even reaches their return. Since the PTET reduces business income directly, it is not treated as an itemized deduction, and therefore, avoids both the SALT cap and the new 2/37 haircut under the OBBBA, allowing the PTE owner to receive the full 37% benefit on every dollar of state tax paid. For high-income earners, this 2% difference leads to additional savings that are often missed in basic tax models.

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Compensation for Passthrough Entity Owners

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Compensation for Passthrough Entity Owners

Learning objectives

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

- Understand reasonable compensation and guaranteed payments in the context of S corporations and partnerships;
- Recognize how compensation for passthrough entity owners interacts with the OBBBA; and
- Understand IRS scrutiny of S corporation reasonable compensation.

I. Introduction

Compensation planning is a fundamental annual requirement for every S corporation and partnership. The risks of inadequate planning are significant, including the retroactive reclassification of distributions, employment tax assessments, and accuracy-related penalties under §6662. In recent years, the IRS has increased enforcement efforts targeting passthrough entities, with reasonable compensation becoming one of the most scrutinized, high-risk areas in small business tax planning.

This chapter focuses on the reasonable compensation framework for S corporations and the guaranteed payment framework for partnerships, as well as the IRS enforcement environment, and the OBBBA's new interactions that affect compensation decisions.

II. Reasonable Compensation

A. The Root of the Problem

Business owners generally contribute both capital and labor to their business. Capital contributions such as money, property, or other assets invested in the business, generate a return in the form of distributions of profit and capital gains. On the other hand, labor contributions, including any work the owner performs, whether producing goods or providing services or managerial oversight to the business, generate compensation in the form of wages/salary. These two types of income are economically distinct and treated differently under tax law, notably for the Federal Insurance Contributions Act (FICA) tax.

FICA is inherently designed to apply to labor income, such as wages and salaries that compensate employees for work they perform. FICA does not apply to capital income, such as distributions of business profits. For S corporations, this distinction creates an incentive to characterize owner compensation as a distribution rather than wages. Both wages and distributions flow from the S corporation to the same owner, so there is a direct financial incentive for S corporation owners to minimize the wage component, since wages are subject to FICA while distributions are not. This strategy is generally employed in one of two ways:

1) **Paying No Compensation** -- The owner takes only distributions and reports no wages; or
2) **Paying Below-Market Compensation** -- The owner receives some wages but at a level that materially understates the market rate for services performed, with the balance taken as distributions.

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Both strategies produce the same economic result of labor income being recharacterized as capital income, with FICA avoided on the recharacterized amount. The reasonable compensation requirement is the legal mechanism designed to counteract both strategies.

B. The Statutory and Regulatory Foundation

S corporations are “flow-through entities” meaning that they pass income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations subsequently report the allocable share of flow-through income and losses on their personal tax returns and are assessed tax at their individual income tax rates. Unlike C corporations, S corporations avoid double taxation on the corporate income. S corporation shareholder-employees essentially occupy two roles simultaneously: as shareholders they receive distributions of profit, and as employees they receive wages for services rendered. The reasonable compensation requirement governs the division between those two categories.

The reasonable compensation requirement for S corporation shareholder-employees does not arise from a single dedicated statute. Rather, it is the product of several converging legal authorities that, taken together, establish both the obligation and its enforcement mechanism.

Under IRC §3121(d)(1) and (2), an employee for FICA tax purposes means any officer of a corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. IRC §3111 and §3121 impose the employer's share of FICA taxes on wages paid to employees. Treas. Reg. §31.3121(d)-1(b) provides that an officer of a corporation is an employee of that corporation. When analyzed together, these provisions establish that a shareholder who performs services for an S corporation and holds an officer position is an employee of that corporation and is therefore subject to FICA withholding and employer matching on compensation received. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees, and thus their compensation is subject to FICA taxes.

IRC §162(a)(1) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Lastly, the Form 1120-S Instructions directly state that "distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

C. IRS Fact Sheet 2008-25

IRS Fact Sheet 2008-25, "Wage Compensation for S Corporation Officers," remains the IRS's clearest and arguably most frequently cited statement of its position on reasonable compensation and the factors it considers in evaluating whether an S corporation owner's compensation is reasonable. Despite its 2008 issuance date, FS-2008-25 accurately reflects the current enforcement framework and is often cited in IRS examination reports and Tax Court opinions.

The fact sheet reiterates that corporate officers are specifically included within the definition of employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code. As such, reasonable compensation is subject

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to 15.3% self-employment taxes (combined employee/employer portion of Social Security and Medicare tax), whereas distributions from an S corporation are not subject to these taxes.

FS-2008-25 further states that when corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages. It asserts that Subchapter S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders. An S corporation must pay reasonable compensation to a shareholder-employee in return for the services provided before a distribution may be given to the shareholder-employee. The Treasury Regulations provide an exception for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee, and the reasonable compensation requirement would not apply.

FS 2008-25 is explicit about the avoidance strategies the IRS targets, stating: "corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages."

FS-2008-25 outlines the following factors considered by the courts in determining reasonable compensation. No single factor is determinative, and the analysis requires weighing all facts and circumstances **–**

1. **Training and Experience:** Specialized training, advanced credentials, or a depth of technical expertise likely justifies an above-market compensation compared to a more generalized peer. For example, a shareholder-employee with 25 years of surgical experience commands different compensation than a newly licensed practitioner performing the same procedures. The analysis should consider specific credentials, years of practice, and any specialized expertise that differentiates the shareholder-employee from a typical market-rate employee in the same role.
2. **Duties and Responsibilities:** This factor considers the depth and scope of the shareholder-employee's role in the business. If gross receipts are generated primarily by the shareholder's personal services, a larger portion of payments should be classified as wages. Similarly, even if a shareholder does not directly produce revenue, they must still be paid for administrative work that supports other income-producing employees or assets. A manager who does not directly generate gross receipts but oversees employees who do is still performing compensable services.
3. **Time and Effort Devoted to the Business:** Part-time involvement often justifies lower compensation than a full-time counterpart, but the analysis hinges on what the market would pay for the actual hours and level of engagement, not on an arbitrary hourly proration. A shareholder-employee who works 20 hours per week likely would not receive the same compensation as one working 60 hours per week in the same role.
4. **Dividend History:** A history of substantial distributions relative to compensation is itself a red flag indicator of potential unreasonableness to the IRS. Similarly, a sudden shift from paying a regular salary to taking only distributions is a red flag indicator.
5. **Payments to Non-Shareholder Employees:** When non-shareholder employees performing less complex or less senior roles are paid more than a shareholder-employee, the corporation's own compensation practices become evidence against the reasonableness of the shareholder-employee's wages. In other words, the IRS can use the corporation's own payroll data as a benchmark.

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6. **Timing and Manner of Paying Bonuses to Key People:** Lump-sum year-end payments characterized as wages, especially when regular periodic payroll was not maintained, raise questions about whether the amounts truly reflect ongoing compensation for services or a retroactive adjustment motivated by tax considerations. The IRS views regular periodic payroll as evidence of genuine employment, whereas year-end lump sums may raise red flags.
7. **What Comparable Businesses Pay for Similar Services:** The market-rate standard is arguably the most objective and most defensible element of any reasonable compensation analysis. The IRS defines reasonable compensation as the amount that would ordinarily be paid for like services by like enterprises under similar circumstances. Compensation data sources include the U.S. Bureau of Labor Statistics Occupational Employment and Wage Statistics (OEWS) database, industry compensation surveys published by trade associations, the Robert Half Salary Guide, the Management of an Accounting Practice survey published by the AICPA, and comparable W-2 data from similarly situated employees in the client's geographic market. The IRS uses BLS data in examinations, making it a primary reference point in any reasonable compensation dispute.
8. **Compensation Agreements and Formula-Based Approaches:** The existence of a formally adopted compensation policy, approved by the board or shareholders, documented in minutes, and consistently applied, often supports the reasonableness of the compensation determination regardless of the specific amount. However, this is only true if the formula itself produces a market-rate result. A formula that produces below-market compensation is not protected simply by its formal adoption.

FS-2008-25 states that the amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate. There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

D. The Case Law Landscape

The Tax Court and circuit courts have consistently supported the IRS in reasonable compensation disputes. Notable cases follow.

1. Zero Compensation Cases

A corporation cannot avoid employment taxes by characterizing payments to an active officer-shareholder as distributions rather than wages. This foundational principle has been established across multiple Courts and has never been successfully challenged on its merits.

a. ***Veterinary Surgical Consultants v. Commissioner***, 117 T.C. 141 (2001): In 2001, in a Tax Court case against a Veterinary Clinic, the Tax Court ruled that an employer cannot avoid federal taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income rather than wages. *Veterinary Surgical Consultants* involved a sole shareholder-veterinarian who paid himself minimal wages. The Tax Court found that a specialist veterinarian in his position would command substantially higher compensation in the open market and recharacterized the payments accordingly.

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b. ***Joly v. Commissioner***, T.C. Memo. 1998-361 aff'd by unpub. op., 211 F.3d 1269 (6th Cir. 2000): J. Michael Joly operated J. Michael Joly, Inc., an S corporation engaged in custom home construction, serving as the president and the primary reason for the corporation's success in attracting customers. His son Jody later joined as vice president and operations manager. The corporation paid no wages but made funds available to Michael and Jody by allowing them to use the company bank account for personal use, drawing on corporate funds as their personal needs arose. The Tax Court found that the amounts drawn from the corporate account constituted taxable wages for FICA purposes, rejecting the argument that the payments were loans because no loan documents existed and the corporation's balance sheets showed no loans outstanding. The Sixth Circuit affirmed this decision that the shareholder-employee of a company used the company bank account for personal use. As such, the Court ruled that the shareholder was an employee and owed employment tax.

c. ***Joseph M. Grey Public Accountant, P.C. vs. Commissioner,*** 119 T.C. 121 (2002): An accountant who was the sole officer and shareholder of his professional corporation took all payments in the form of dividends while performing ongoing accounting services for the corporation's clients. The Tax Court ruled the dividends were actually wages, subject to employment taxes. This decision reiterated the principle that the form of payment is immaterial, rather the relevant question is whether the amounts received were in substance remuneration for services rendered.

d. ***Nu-Look Design, Inc. v. Commissioner***, T.C. Memo. 2003-52: Ronald Stark was the sole shareholder and president of Nu-Look Design, a residential home improvement company. During the years at issue, Stark managed the company, solicited business, handled finances, hired workers, and supervised the work, performing the full range of operational functions. Nu-Look paid Stark no wages and instead distributed net income to him as his personal needs arose. The Tax Court recharacterized the distributions as wages in full, applying the market-rate standard and finding that the corporation provided no credible evidence that the zero-wage position reflected what an unrelated party would accept for the same services. The Court relied on the economic substance of the payments, concluding that the distributions were, in fact, remuneration for services performed.

2. Personal Expense Payments Treated as Wages

Payments of an officer's personal expenses made with compensatory intent are wages for employment tax purposes.

a. ***Ghosn v. Commissioner,*** T.C. Memo. 1995-192*:* The corporation paid the shareholder's personal expenses for insurance and utilities. The Tax Court found that the corporation's payments of the shareholder's personal expenses for insurance and utilities were made with the intent to compensate the shareholder for services rendered. As such, the corporation was entitled to a deduction as additional compensation. The amounts when combined with small amounts of "management expenses" paid by the corporation were not unreasonable. While the IRS most commonly argues that payments are wages rather than distributions, courts also recognize that non-wage payments made with compensatory intent constitute wages for employment tax purposes.

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3. Purported Loans Recharacterized as Wages

One of the most sophisticated avoidance structures litigated in the reasonable compensation context involves characterizing transfers from a corporation to a shareholder-employee as loans rather than wages or distributions. This structure attempts to avoid both employment taxes (applicable to wages) and the reasonable compensation analysis that applies to distributions. To qualify as a genuine loan, the transaction must meet several formal requirements, including:

- **Documentation:** A genuine loan requires documentation, including promissory notes or loan agreements executed at the time of the advance, specifying the principal amount, interest rate, maturity date, and repayment terms.
- **Interest Terms:** Interest must be charged at a rate at least equal to the applicable federal rate and repayment according to a specified schedule, not merely when corporate cash is available or at the shareholder's discretion.
- **Accounting:** The advance must be recorded as a liability on the corporate balance sheet and as a receivable on the shareholder's personal records.
- **Contingency:** Repayment of the advance cannot be dependent entirely on the success of the corporation's business. When a transfer's repayment depends solely on whether the corporation generates sufficient profits, it has the attributes of a capital contribution, not a loan.

When an S corporation borrows from the shareholder and repays that borrowing through distributions, the repayment of a legitimate loan obligation is not characterized as wages. However, when the corporation advances money to the shareholder and claims repayment was accomplished by crediting the advance against future income or distributions, the transaction often lacks economic substance, particularly when no independent economic obligation constrains the timing or amount of repayment. Courts have consistently rejected the loan characterization where the essential attributes of a genuine debt obligation are absent.

a. ***Gale W. Greenlee, Inc. v. U.S.,*** 661 F. Supp. 642 (D. Colo. 1985): Purported "loans" from the S corporation to its sole shareholder, officer, and director, were considered wages for purposes of FICA and FUTA taxes. The loans were unsecured demand notes bearing no interest, the loans were made entirely at the discretion of shareholder, and the shareholder regularly performed substantial, valuable services for the S corporation. The Court found that repayment of loan was "simply a paper transaction" in which the outstanding loan balance was credited against undistributed income and rental payments owed by the corporation to the shareholder.

b. ***Glass Blocks Unlimited v. Commissioner,*** T.C. Memo. 2013-180: Glass Blocks Unlimited manufactured and sold glass blocks for the North American real estate market. Its president, Mr. Blodgett, was the only full-time worker, responsible for all operational and financial decisions, and his services generated all of the corporation's income. The corporation paid Blodgett no salary or wages, distributing money to him as cash was available and as he requested it. During the dispute, the corporation contended that a portion of the distributions represented repayment of loans. Specifically, they argued that Blodgett had transferred funds to the corporation during an economic downturn and that subsequent distributions were merely returning those funds to him. Further, there were no promissory notes documenting the alleged loans; there were no loan terms establishing interest, maturity, or repayment schedules; the transfers were not treated as loans on the corporate balance sheet; and repayment depended entirely on the corporation's available cash and the shareholder's requests rather than on any fixed

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obligation. The Court found that payments made by the S corporation to its president and sole shareholder were wages subject to employment taxes, not distributions or loan repayments. Prior transfers by the shareholder to the corporation were capital contributions and not loans. The Court rejected the argument that the distributions would represent unreasonable compensation to its president.

4. Below-Market Compensation with Distributions

If an owner receives some wages but at a level substantially below the market rate, with the balance taken as distributions, it is a red flag to the IRS.

a. ***Watson v. Commissioner*, 668 F.3d 1008 (8th Cir. 2012)**: *Watson* is arguably one of the most important and most frequently cited reasonable compensation cases in practice. David Watson (Watson) was a Certified Public Accountant who obtained a 25% interest in an accounting firm, Larson, Watson, Bartling & Juffer, LLP (LWBJ). In 1996, Watson incorporated a business entity known as David E. Watson, P.C. (DEWPC). Watson transferred his individual 25% interest in LWBJ to DEWPC, and thereafter DEWPC replaced Watson as a partner in LWBJ. Watson served as DEWPC's sole officer, shareholder, director, and employee. Through an employment agreement, DEWPC employed Watson, but Watson exclusively provided his accounting services to LWBJ for the period relevant to this dispute. From its inception, DEWPC elected to be taxed as an S Corporation. For the years at issue, Watson paid himself $24,000 per year (a fraction of the market rate) while receiving approximately $200,000 in distributions per year for the years at issue (2002 and 2003). Thus, in the years in question, after DEWPC paid Watson's salary and other expenses, it distributed all remaining cash to Watson as dividends. The IRS determined that DEWPC underpaid employment taxes pursuant to FICA for the years at issue. At trial, the government's expert, Igor Ostrovsky, stated that the market value of Watson's accounting services was approximately $91,044 per year for the years at issue. Ostrovsky relied on several compensation surveys and studies particular to accountants. Primarily, Ostrovsky focused on the Management of an Accounting Practice (MAP) survey conducted by the American Institute of Certified Public Accountants, which contained adjustments for specific regions. Ostrovsky discovered that an owner—defined as an investor and an employee—in a firm the size of LWBJ would receive approximately $176,000 annually, which reflected both compensation and return on investment. Ostrovsky also discovered that a director (an employee with no investment interest) would receive approximately $70,000 in compensation alone. Since owners billed at rates 33% higher than directors, and because Ostrovsky viewed Watson as a de facto partner of LWBJ, Ostrovsky increased the director compensation by 33% to arrive at owner compensation or $93,000. Ostrovsky then made a downward adjustment to $91,044, accounting for untaxable fringe benefits. In reaching his conclusion, Ostrovsky used average billing rates rather than Watson's actual billing rates.

   In resolving this FICA tax dispute, the main issue was whether, based on the statutes and unusual facts involved, the payments at issue made to Watson were remuneration for services performed. Watson's primary argument was that there was no statute, regulation, or rule requiring an employer to pay minimum compensation. Additionally, by requiring proof of reasonable compensation, DEWPC argued that the district court imposed a minimum compensation requirement. Courts have historically addressed

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similar FICA characterization issues by evaluating the economic substance of the transaction rather than the form chosen by the taxpayer.

The Court ultimately rejected Watson's characterization and held that the payments Watson received were, in economic substance, remuneration for services performed. They concluded that the characterization of those payments of distributions did not change their underlying character. Ultimately, the Eighth Circuit affirmed the Tax Court's determination that the distributions should be recharacterized as wages, resulting in additional FICA taxes, penalties, and interest. The case is significant not only for its outcome but for the court's methodology, as it explicitly compared Watson's compensation to that of similarly qualified CPAs in similar positions, using industry compensation data as the benchmark.

The consistent theme amongst these cases is that S corporations are required to pay their owner-employees reasonable compensation for services rendered prior to making any distributions. An owner who contributes both capital and labor to a business earns both capital income and labor income. As a result, characterizing all of the businesses' returns as distributions misrepresents the economic substance of the owner's services. Overall, courts favor a "market approach" when determining reasonable compensation.

E. Reasonable Compensation Analysis

Ultimately, the foundation of any reasonable compensation analysis is the market-rate determination. In other words, what would the corporation pay an unrelated party to perform the same services under similar circumstances? Ideally, the determination of the reasonableness of an employee's compensation is made by comparing the employee's compensation to that of an employee performing similar duties at a similar company of the same size/industry. This determination requires understanding both what the role of the shareholder-employee is and what the market pays for those specific services. S corporation shareholder-employees frequently perform multiple roles simultaneously, for example, CEO, chief revenue officer, operations manager, and perhaps even a professional practitioner. Each role has a separate market value. The reasonable compensation analysis should identify each role, estimate the time allocation across roles, and apply market-rate compensation for each.

Compensation data sources that practitioners and clients can use to support the analysis include the U.S. Bureau of Labor Statistics Occupational Employment and Wage Statistics (OEWS) database, industry compensation surveys published by trade associations, the Robert Half Salary Guide and similar commercial compensation references, and comparable W-2 data from similarly situated employees in the client's geographic market. As discussed, the IRS often uses BLS data in examinations, making it a pivotal reference point in the analysis. No single source is authoritative, and the analysis is stronger when multiple independent sources produce consistent results.

F. IRS Enforcement

The IRS uses various approaches for S corporation compliance. Examiners within the Small Business/Self-Employed (SB/SE) Division may review officer's compensation as part of examinations of Form 1120-S, *U.S. Income Tax Return for an S corporation*. The Forms 1120-S, when examined in the field, could be analyzed for any number of issues that are reported on the return, but it is not mandatory for the revenue agent responsible for the examination to review the officer's compensation issue. Additionally, Exam Case Selection within the SB/SE Division's Specialty Examination function reviews the

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officer compensation issue by using the Form 1120-S along with a set of criteria to identify returns with potential employment tax noncompliance. Finally, the IRS has also used Compliance Initiative Projects (CIP) to focus resources on the issue. CIPs are authorized activities, outside of the planned strategies, with the intended purpose of correcting noncompliance around particular issues or areas of concern.

In 2009, the IRS created a CIP to address the officer's compensation issue associated with S corporations by developing and using filters to identify high-risk cases. The CIP was eventually transitioned into the Employment Tax program workstream within the IRS's Specialty Examination function. Filters applied by Exam Case Selection identify S corporations with no officer compensation reported. Ultimately, these cases can result in an assessment to the S corporation's employment tax returns.

In August 2020, the IRS began its newest CIP associated with the lack of officer's compensation associated with S corporations. The CIP is again focused on improving compliance of S corporations that appear to have not compensated shareholders.

Single-shareholder S corporation owners not providing compensation to themselves, and thus avoiding employment taxes, is a highly scrutinized area in which the IRS has continued to pursue. IRS revenue agents may assess the issue when examining Forms 1120-S in the field or addressing the issue more directly by examining it via the Employment Tax program or CIPs. Additionally, the IRS has a workstream within its Employment Tax Program that is focused on the issue of officer's compensation in S corporations. Per a TIGTA report, this employment tax workstream has realized average results of approximately $17,726 per return when examining employment tax returns associated with S corporation taxpayers. [1]

III. Guaranteed Payments to Partners

A. The Legal Framework

For partnerships, the closest compensation equivalent to S corporation wages is the guaranteed payment under IRC §707(c). Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership’s income. In other words, it is guaranteed in the sense that it is paid regardless of whether the partnership is profitable. A partnership treats guaranteed payments for services or for the use of capital as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner’s distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding. Guaranteed payments are deductible by the partnership as a business expense under §162 and are includible in the recipient partner's ordinary income, subject to SE tax. Guaranteed payments are included in income in the partner’s tax year in which the partnership’s tax year ends. If guaranteed payments to a partner result in a partnership loss in which the partner shares, the partner must report the full amount of the guaranteed payments as ordinary income. The partner separately takes into account their distributive share of the partnership loss, to the extent of the adjusted basis of the partner’s partnership interest.

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[1] TIGTA Report, *Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken.*

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If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

Example. Under a partnership agreement, John is to receive 30% of the partnership income, but not less than $8,000. The partnership has net income of $20,000. John's share, without regard to the minimum guarantee, is $6,000 (30% × $20,000). The guaranteed payment that can be deducted by the partnership is $2,000 ($8,000 − $6,000). John's income from the partnership is $8,000, and the remaining $12,000 of partnership income will be reported by the other partners in proportion to their shares under the partnership agreement. If the partnership net income had been $30,000, there would have been no guaranteed payment because his share, without regard to the guarantee, would have been greater than the guarantee.

B. Key Distinctions form S Corporations

The guaranteed payment framework differs significantly from the S corporation reasonable compensation framework in several important respects. First, there is no statutory requirement that partners receive guaranteed payments. Unlike S corporation shareholder-employees, who are required to receive wages as employees because they are classified as such, general partners and LLC members taxed as partnerships are not subject to the mandatory wage requirement. As a result, the reasonable compensation requirement applicable to S corporations has no direct equivalent in the partnership context. Second, the absence of a guaranteed payment does not automatically create the same employment tax reclassification risk that drives the S corporation reasonable compensation issue. Partnership distributive shares are already subject to SE tax for general partners and active LLC members. The FICA avoidance opportunity that exists in S corporations, where only wages are subject to FICA and distributions are not, does not exist in partnerships in the same form. For general partners and active LLC members, the entire distributive share of ordinary income, whether labeled as a guaranteed payment or an income allocation, is subject to SE tax. There is no tax benefit to converting ordinary income into distributions within the partnership structure for SE tax purposes. Further, guaranteed payments are deductible before the computation of partnership income, while distributive shares are allocations of already computed income. This timing difference affects the computation of each partner's allocable share and can have significant consequences for partners whose economic arrangements are structured around specific income levels.

Additionally, guaranteed payments serve important planning functions in the partnership context, as they establish a defined compensation floor for active partners regardless of partnership profitability. This is critical in professional service partnerships where individual partners want compensation certainty independent of the partnership's overall results. Guaranteed payments also establish a compensation record for partners who may face scrutiny about the adequacy of their compensation from minority partners, lenders, or estate valuators. It is important to note that for limited partners and passive LLC members, guaranteed payments for services are not appropriate as they would convert passive income (not subject to SE tax) into ordinary income subject to SE tax.

C. SE Tax Distinction Between S Corporations and Partnerships

For general partners and active members of LLCs taxed as partnerships, the entire distributive share of trade or business income, including both guaranteed payments and ordinary income allocations, is subject to self-employment tax at 15.3% (on the first $184,500 of net SE income for 2026, and 2.9% Medicare-only above that threshold). As discussed, there is no mechanism within the partnership

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structure to convert active business income into a non-SE-tax item simply by characterizing it as a distribution rather than a guaranteed payment. The IRS generally views active partners as self-employed, so typically every dollar of profit is subject to the SE tax.

On the other hand, for S corporation shareholder-employees, the structure is fundamentally different. In an S Corporation, the shareholder-employee wears two hats as both an employee and shareholder. As an employee, the owner must be paid a reasonable salary. As a shareholder, remaining profit can be taken as a distribution. Only wages paid through W-2 compensation are subject to FICA tax (the equivalent of SE tax at the corporate level). Distributions of S corporation income to shareholders are not subject to FICA or SE tax. As discussed, this creates the incentive for the below-market compensation and/or distributions, as every dollar shifted from wages to distributions saves approximately 15.3% in employment taxes up to the Social Security wage base and 2.9% thereafter, subject to the Additional Medicare Tax at 0.9% above $200,000 ($250,000 MFJ).

IV. Multi-Entity and Multi-Role Compensation Issues

A. The Multiple-Entity Owner

Some S corporation owners own interests in multiple entities simultaneously. Each entity in which the owner performs services as an employee is independently subject to the reasonable compensation requirement. The compensation analysis must be performed separately for each entity based on the services performed for that specific entity, not on the owner's total compensation across all entities.

A common error in multi-entity situations is treating the owner's total compensation as a single number that is then allocated arbitrarily across entities. An allocation of compensation should reflect where the owner's time and services are actually directed. For example, an owner who spends 80% of their working time in Entity A and 20% in Entity B should receive approximately 80% of their total compensation from Entity A and 20% from Entity B. An allocation that heavily weights compensation toward a loss entity (to absorb losses) or away from a profitable entity (to minimize wages subject to FICA) is a red flag to the IRS, especially in multi-entity audits.

1. The Spouse-Employee

Closely held S corporations often employ a spouse in the business. The IRS applies the same reasonable compensation standard to non-shareholder employees as to shareholder-employees, and payments to a related party that exceed the market rate for services actually performed may be challenged under §162(a)(1) as unreasonable compensation or disallowed under §267 as payments between related parties that do not reflect arm's-length bargaining.

For estate planning purposes, compensating a spouse who genuinely contributes to the business at a reasonable market rate serves the legitimate purpose of building the spouse's Social Security earnings record and enabling contributions to the spouse's retirement accounts. It is only appropriate when the spouse’s compensation genuinely reflects services rendered and when the amount of compensation reflects the market rate for those services.

2. The Part-Time and Passive Shareholder

Not all S corporation shareholders are employee-shareholders. A shareholder who does not perform services for the corporation, or only performs minor services, is not required to receive wages and is thus not subject to the reasonable compensation requirement with respect to that entity. The key factual

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question is whether the shareholder provides services. If services are provided, wages are required regardless of the shareholder's characterization of their role.

This issue arises most commonly in family S corporations where younger-generation shareholders have been given equity interests but are not yet active in the business, or in investment holding companies where the shareholder's involvement is limited to oversight and governance. The distinction between governance involvement (which does not create an employment relationship) and active participants (which creates an employment relationship) requires a facts-and-circumstances analysis for each shareholder.

V. Compensation Planning in Light of the OBBBA

A. The Qualified Tips Deduction – New Interaction for Service Industry PTEs

The OBBBA's new §224 qualified tip income deduction creates new compensation considerations for S corporations and partnerships operating in tipping-eligible industries. The deduction is available to both employees and self-employed individuals in occupations that customarily receive tips, subject to a $25,000 annual cap and a MAGI phaseout beginning at $150,000 (single) and $300,000 (MFJ).

For an S corporation shareholder-employee in a qualifying tipped occupation, the deduction under §224 is available individually for any tips received. However, qualified tips deducted under §224 are excluded from QBI for §199A purposes, meaning that the tip deduction reduces QBI at the individual level in addition to reducing taxable income. This double reduction should be explicitly modeled for S corporation taxpayers in a tipping-eligible occupation.

For partnership clients who are self-employed and receive tips from customers, the net income limitation for the §224 deduction caps the deductible tips at the net income of the specific trade or business. In other words, the partnership's profitability directly affects each eligible partner's available tip deduction.

B. The PTET and SE Tax Interaction

One of the most significant and often overlooked OBBBA-related compensation considerations for partnership clients is the interaction between PTET elections and self-employment tax. When a partnership makes a PTET election and the state imposes the PTET on the partnership's ordinary income, the resulting entity-level tax payment reduces the partnership's ordinary income before allocation to partners. Since SE tax for general partners and active LLC members is computed on the partner's distributive share of ordinary income, and because the PTET payment has reduced that ordinary income, the PTET election effectively reduces the SE tax base for active partners.

The magnitude of this benefit ultimately depends on the state tax rate, the partner's SE income level relative to the Social Security wage base, and whether the reduced ordinary income keeps the partner below or above the additional Medicare tax threshold. For a general partner subject to the full 15.3% SE rate on the first $184,500 of net SE income in 2026, each dollar of PTET payment that reduces ordinary income below that threshold produces a 15.3% SE tax savings, a meaningful amplification of the PTET's federal benefit beyond the SALT cap workaround.

This interaction does not exist for S corporation shareholders in the same form, because S corporation distributions are not subject to FICA, and the PTET payment reduces QBI (not subject to FICA) rather

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than wages (subject to FICA). The SE tax dimension of PTET is therefore specific to active partners and LLC members whose entire distributive share is subject to SE tax.

For partnership taxpayers with significant SE tax exposure, the PTET's SE tax interaction is an important component of the full cost-benefit analysis and should be modeled alongside the SALT cap analysis whenever a PTET election is being evaluated.

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Accounting Method Changes: Practical Considerations

Learning objectives

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

- Understand the fundamentals of tax accounting methods;
- Apply the procedural framework governing accounting method changes, including the Form 3115 filing process and the mechanics of the §481(a) adjustment; and
- Identify common areas where accounting method issues arise in practice.

I. Introduction to Tax Accounting Methods

A. What is a Tax Accounting Method?

A tax accounting method is the overall plan of accounting a taxpayer uses to determine when to report gross income and deductions for U.S. federal income tax purposes. At its core, a method of accounting is fundamentally a question of timing, as it determines in which tax year an item of income or deduction is recognized, not whether it is recognized. Fundamentally, a deduction taken today is worth more than the same deduction taken in the future because of the time value of money. As such, there are two main concepts to consider when identifying an accounting method:

- **Timing:** If an accounting practice for an item does not permanently affect a taxpayer's lifetime income but changes the taxable year in which the taxpayer reports taxable income, the accounting practice for the item involves timing and is a method of accounting. In other words, if taxable income computed using two different methods shifts income or deductions from one year to another but ultimately results in the same lifetime taxable income, it involves timing and is an accounting method.
- **Consistency:** Although a method of accounting may exist without a pattern of consistent treatment of an item, a method of accounting is not established in most instances without consistent treatment.

A taxpayer chooses a method of accounting in the first year it reflects the item on its tax return in computing taxable income.

Methods of accounting may apply to the taxpayer's overall plan (e.g., cash vs. accrual) or to the treatment of any specific material item within that plan (e.g., a sub-method for warranty costs). Section 446(a) generally provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books, provided that method clearly reflects income. Once a taxpayer establishes a method of accounting for an item, it may not change that method without first obtaining IRS consent under §446(e).

B. Permissible vs. Impermissible Methods of Accounting

A permissible method of accounting is one that complies with the Code, regulations, or other published guidance. Therefore, the method is presumed to clearly reflect income. A taxpayer adopts a permissible method of accounting by using it on the first return that reflects the overall method or the material item.

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On the other hand, an impermissible method of accounting is a method that does not comply with the Code, regulations, or other published guidance. Therefore, the method is presumed to not clearly reflect income. A taxpayer adopts an impermissible method of accounting by using it on two or more consecutively filed returns.

It is important to emphasize that once a taxpayer adopts a method of accounting, even an impermissible method, it may not change to a different method of accounting without first obtaining the Commissioner's consent.

C. Elections vs. Accounting Methods

The Internal Revenue Code and accompanying regulations provide numerous elections through which taxpayers may determine the tax treatment of specific items. The procedural requirements for making an election vary depending on the particular provision. In certain cases, an election is made by adopting a prescribed method on a timely filed tax return, while in others, the taxpayer must attach an election statement to the return containing specific language required by the applicable guidance. Such elections represent a different way to adopt a method of accounting for the item elected.

Under the doctrine of election, a taxpayer that properly selects a method of reporting on a filed return is generally precluded from subsequently revoking or modifying that election to adopt an alternative, albeit permissible, method without obtaining the consent of the Commissioner. A valid election is generally irrevocable, but in limited circumstances, a taxpayer may request relief to revoke an election through the issuance of a private letter ruling. A taxpayer cannot revoke or make a valid election by filing a Form 3115 or an amended tax return unless provided for in specific guidance.

D. Overall Methods: Cash vs. Accrual

Cash Method	Accrual Method
• Income recognized when actually or constructively received • Deductions taken when payment is actually made • Simpler recordkeeping; better matches cash flow • Aligns naturally with business economics • Available to most individuals and small businesses • Restricted for business above the §448 gross-receipts threshold (average annual gross receipts of $32 million or less (2026) for the prior three taxable years); "tax shelters" are generally not permitted to use the cash method • Prepaid expenses generally deductible only when the 12-month rule or other exception applies	• Income recognized when all events have occurred to establish the right to receive it and the amount can be determined with reasonable accuracy • Deductions taken when all events fix the liability and economic performance has occurred • Better matching of income and related expenses over time • Required for business with average annual gross receipts of $32 million or more (2026) for the prior three taxable years and most tax-shelters • Revenue recognition rules under §451 and related regulations govern timing • Advance payments may be deferred in limited circumstances under Rev. Proc. 2004-34

Under the cash method, income is recognized when actually or constructively received, and deductions are taken when payment is actually made. Income is constructively received when an amount is credited to the taxpayer's account or made available to the taxpayer without restriction. This method offers simpler recordkeeping and better alignment with cash flow, as well as overall alignment with business economics. The cash method is available to most individuals and small businesses but is restricted for C corporations, tax shelters, and certain businesses with average annual gross receipts above the §448

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threshold ($32 million for 2026). Prepaid expenses are generally deductible only when the 12-month rule or another exception applies. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following:

- 12 months after the right or benefit begins; or
- The end of the tax year after the tax year in which payment is made.

Under the accrual method, income is recognized when the all-events test is met. This test is met when all events have occurred to fix the right to receive it and the amount can be determined with reasonable accuracy. Deductions are taken when all events fix the liability and economic performance has occurred. The accrual method provides better matching of income and related expenses and is required for business with gross receipts exceeding $32 million (2026) and most tax shelters above applicable gross-receipts thresholds. Revenue recognition rules under §451 and related regulations govern the timing of income for accrual-basis taxpayers. Advance payments may be deferred in limited circumstances under Rev. Proc. 2004-34.

It is important to note that under IRC §267, an accrual-basis payer cannot deduct expenses owed to a related cash-basis recipient until the payment is actually made. This rule forces a deferral of deductions to match the timing of income recognition, preventing the deduction of expenses not yet paid to related parties. In other words, §267 enforces matching across related taxpayers.

The consequence is to emphasize matching the tax consequences with the economic outlay. The §267 Rule will supersede or otherwise override the overall method of accounting by imposing a statutory timing delay in related-party situations.

E. Definition of a Tax Accounting Method Change

Per Treasury Regulation §1.446-1(e)(2)(ii)(a), an accounting method change is a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in that overall plan. The term “material item” does not carry the same meaning as financial statement materiality, rather, it refers to any item involving the proper timing of income recognition or deduction. A method change is triggered when the taxpayer moves from one permissible or impermissible method to another method that changes the timing of income or deductions.

The definition of an accounting change is broad and encompasses both voluntary changes a taxpayer wishes to make and corrections of impermissible methods the taxpayer has been inadvertently using. Identifying whether a situation constitutes a method change is the essential threshold question before taking any further procedural steps.

F. What Does NOT Constitute a Method Change?

Treas. Reg. §1.446-1(e)(2)(ii)(b) specifically excludes several categories of changes from the method change definition:

- A **change in underlying facts** does not constitute a method change.
- For example, a **change in the nature of a business activity** that alters how income is earned or characterized is a factual development, not a change in accounting method.
- A change of practice that **permanently adjusts** a taxpayer’s lifetime taxable income.
- The **correction of a mathematical or posting error** is not a method change, as these errors do not reflect a different timing approach and must simply be corrected.

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- An **adjustment to an income or expense item** that does not involve a timing change for inclusion or deduction is not a method change.
- The **adoption of an accounting method for a "new" item**, is not a method change. When a taxpayer first encounters a type of income or expense for which it has no established method, it adopts a method for that item, but the initial adoption is not a change from a prior method.
- A **change in the character of income or deductions** that does not affect the year of recognition (e.g., recharacterizing income from ordinary to capital) is not a method change.

The distinction between a method change and an error or factual adjustment is especially important because the procedures and consequences differ significantly.

G. The IRS Consent Requirement: Section 446(e)

Section 446(e) requires taxpayers to obtain the consent of the Commissioner before changing a method of accounting for federal income tax purposes. This consent requirement applies regardless of whether the taxpayer is changing from one permissible method to another or from an impermissible method to a permissible one.

Consent is formally requested by filing IRS Form 3115, *Application for Change in Accounting Method*, the sole formal mechanism for requesting IRS consent for all accounting method changes. Form 3115 requires the taxpayer to describe the current and new method of accounting, identify the items that will be treated differently under the new method of accounting, and include a computation of any adjustment required by §481(a). The consent requirement exists to ensure consistency in tax reporting, prevent manipulation of the timing of income and deductions, and allow the IRS to impose appropriate conditions on changes. Failure to obtain IRS consent before changing a method constitutes an unauthorized change, which can result in adverse tax consequences including denial of the spread period for §481(a) adjustments.

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II. Key Revenue Procedures

A. Overview

Below is an overview of key Revenue Procedures for accounting method changes.

Revenue Procedure	Details
Rev. Proc. 2026-1	Rev. Proc. 2026-1 is the general ruling procedures revenue procedure, updated annually each January. Section 9 addresses method changes and Section 10 covers IRS conferences.
Rev. Proc. 2025-23	Rev. Proc. 2025-23 is the most recent version of the “mass automatic” revenue procedure, updated annually. It contains the comprehensive list of changes for which consent is automatically deemed granted when the taxpayer satisfies all applicable terms and conditions.
Rev. Proc. 2015-13	Rev. Proc. 2015-13 is the method change “playbook” for taxpayer-initiated changes. It was last updated in 2015, and a revised version is on the IRS Priority Guidance Plan.
Rev. Proc. 2002-18	Rev. Proc. 2002-18 governs IRS-initiated method changes, including examination-imposed changes. It illustrates the adverse consequences of waiting for the IRS to act.
Supplementary Procedures	Supplementary procedures such as Rev. Proc. 2025-28 for OBBBA R&D expenditures) address specific topics between annual updates. Practitioners must track these as they are issued.

B. Rev. Proc. 2026-1: General Ruling Procedures

Rev. Proc. 2026-1 is the annual revenue procedure providing the general framework for letter ruling requests and determinations from the IRS National Office. Section 9 contains procedures specific to method change requests, including guidance on how to properly complete and submit Form 3115 and related statements. Section 10 addresses IRS conferences, including the pre-submission conference that practitioners may request before filing a method change application.

Appendix A sets forth the current user fees. The non-automatic method change user fee is currently $13,225 for a timely filed request, plus $280 per additional applicant on the same Form 3115. This fee is generally not refundable if the request is denied. Practitioners should consult this revenue procedure at the outset of any method change engagement to ensure compliance with all current procedural requirements.

C. Rev. Proc. 2025-23: The Automatic Method Change List

Rev. Proc. 2025-23 is the most recent (2025) version of the mass automatic revenue procedure, providing the comprehensive list of method changes for which IRS consent is deemed automatically granted when the taxpayer satisfies all applicable terms and conditions. Each year, the IRS highlights significant changes from the prior version. For example, the 2025 update includes modifications related to foreign income taxes and interest capitalization.

The 2025 version excludes from automatic treatment changes from the cash to accrual method for foreign income taxes as defined under recently revised regulations at Reg. 1.901-2(a). Taxpayers not capitalizing interest on designated property under §263A may not use automatic procedures to change to proper capitalization under certain current or proposed regulations. Because Rev. Proc. 2025-23 was issued on

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June 9, 2025, and predates the OBBBA (enacted July 4, 2025), supplementary revenue procedures such as Rev. Proc. 2025-28 address OBBBA-related changes pending the 2026 update.

D. Rev. Proc. 2015-13: The Method Change Playbook

Rev. Proc. 2015-13 is the foundational playbook for taxpayer-initiated method changes, providing detailed procedural requirements for both automatic and non-automatic changes. Key topics covered include the discussion of an “item,” cut-off versus §481(a) methods of implementation, the spread period for adjustments, audit protection, and filing deadlines.

This revenue procedure was last updated in 2015 and is subject to a priority guidance project to publish a revised version incorporating changes since its issuance. Notably, the 2015 version predates the Bipartisan Budget Act of 2015 (BBA) centralized partnership audit regime, which means it does not address how that regime interacts with pending method changes. This gap creates practical complications for BBA partnership taxpayers. Until the revised version is published, practitioners must consult other guidance for areas not addressed by the 2015 playbook, including OBBBA-related developments.

III. Automatic vs. Non-Automatic Method Changes

A. Automatic Method Changes: Definition and Key Features

An automatic method change is one for which IRS consent is deemed granted without a formal ruling letter, provided the taxpayer satisfies all terms and conditions in the applicable section of Rev. Proc. 2025-23. The IRS National Office does not generally review automatic method change requests, as the filing of a compliant Form 3115 is itself the operative consent event.

A taxpayer that seeks to make an automatic method change must attach Form 3115 to its timely filed (including extensions) original income tax return for the requested year of change and send a copy of the Form 3115 to the IRS national office no later than the date that the original Form 3115 is filed with the federal income tax return for the year of change. There is no user fee for automatic method change filings, which is a significant practical advantage over non-automatic changes. The IRS retains the right to review automatic filings, request additional information, require corrections, or reject requests that do not satisfy the applicable terms and conditions. If a change is listed in Rev. Proc. 2025-23, it must be filed as an automatic change. Filing it as non-automatic may cause the IRS to require refiling, adding delay and expense, as the $13,225 user fee paid is generally nonrefundable.

B. Non-Automatic Method Changes: Definition and Process

A non-automatic change is any method change not listed in Rev. Proc. 2025-23, as well as any change for which the taxpayer has already made a change for the same item within the prior five years. The IRS National Office formally considers non-automatic requests. In processing a request for a change in method of accounting made through the nonautomatic consent process, the IRS National Office considers, among other factors, whether the requested method of accounting is legally permissible for the taxpayer, whether the requested method clearly reflects the taxpayer’s income, and whether the taxpayer has appropriately computed any adjustment required by §481(a). If approved, it issues a written consent letter that constitutes a binding agreement between the taxpayer and the IRS. The taxpayer attaches the Consent Agreement to its timely filed return and implements the new method of accounting according to

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the terms and conditions. The taxpayer must obtain consent before changing its method of accounting on a filed tax return.

The five-year restriction means a change that would ordinarily be automatic becomes non-automatic when the taxpayer made a prior change for the same item within the past five years. Prior changes within the five-year period can include both deliberate Form 3115 changes and also inadvertent method changes. The restriction does not automatically result in denial but invites scrutiny. For a timely filed non-automatic request the user fee is $13,225, plus $280 per additional applicant on the same Form 3115 where eligible.

C. Automatic vs. Non-Automatic: Side-by-Side

Automatic Changes	Non-Automatic Changes
• Listed in Rev. Proc. 2025-23 • Consent deemed granted on compliant filing • No user fee • Due with return, including extensions • No IRS consent letter issued • IRS may still review; rejection is possible • Must be filed as automatic; cannot elect non-automatic • Section 481(a) spread: 4 years (positive) or 1 year (negative)	• Not in Rev. Proc. 2025-23, OR same item changed in prior 5 years • IRS National Office formally reviews; issues consent letter • User fee: $13,225 (timely) plus $280 per additional applicant on the same Form 3115 where eligible • Must be filed by year-end of the year of change • Consent letter is a binding IRS agreement • IRS may request info or deny the request • Conference of right available if IRS is adverse • Section 481(a) spread: 4 years (positive) or 1 year (negative)

D. Identifying the Correct Item or Sub-Method

An “item” is the unit of measurement for determining whether a method of accounting has been established and whether a method change has occurred, as opposed to an error within an existing method. An item is any project or amount that involves the timing of when it is included in income or taken as a deduction. The term “item” is not defined in the statute or Treasury Regulations, making accurate identification a matter of professional judgment requiring thorough factual analysis.

For LIFO inventory changes, sub-method changes may be accomplished at the sub-method level under Rev. Proc. 2015-13, giving practitioners more flexibility in scope. For automatic changes, the applicable section of Rev. Proc. 2025-23 typically describes the item with sufficient specificity to guide identification. For §263A uniform capitalization changes, there is meaningful uncertainty about the level at which sub-methods are determined, particularly when multiple changes are attempted within five years. Misidentifying the item can result in an incorrect §481(a) calculation, use of the wrong procedures, or denial of the change.

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E. Common Areas Where Method Changes Arise

The following chart details common areas in which method changes arise:

Inventory	Revenue & Expenses	Capitalization & Depreciation
• LIFO to/from FIFO changes • Lower of cost or market adjustments • Section 263A UNICAP cost absorption • Retail inventory method changes • Subnormal goods write-downs	• Advance payment deferral (Rev. Proc. 2004-34) • Warranty reserve accruals • Prepaid expense deductibility • Long-term contract percentage completion • Customer loyalty programs	• Tangible property regulations (Reg. 1.263(a)) • Repair vs. capitalization (§263(a)) • Section 168 depreciation methods • Section 174 R&D expenditures • Section 263A interest capitalization

F. Section 263A — Uniform Capitalization Rules

Section 263A (UNICAP) requires certain producers and resellers to capitalize direct and indirect costs allocable to property produced or property acquired for resale. Section 263A method changes often generate large positive or negative §481(a) adjustments because they reach back to all open inventory layers. UNICAP method changes are among the most complex in practice because they involve multiple sub-methods and affect both the balance sheet and taxable income.

Taxpayers frequently seek to change to or from a simplified method (e.g., the simplified production method or simplified resale method) through Form 3115. The appropriate “item” level for §263A method changes is an area of uncertainty. Practitioners must analyze whether a proposed change affects one sub-method or multiple distinct items, especially in the five-year restriction context. The OBBBA may affect §263A by modifying certain cost capitalization rules; practitioners should monitor supplementary IRS guidance and the 2026 automatic procedure update.

IV. The Method Change Process: Step-by-Step

A. Method Change Process: Overview and Timeline

The following steps accurately describe the method change process:

- Step 1: **Preliminary analysis**: Determine whether a method change is needed, identify the item, and classify the change as automatic or non-automatic.
- Step 2 (optional): **Anonymous (no-names) call with the IRS**: Explore IRS receptiveness before committing to the full process, especially for complex or non-automatic changes.
- Step 3 (optional): **Pre-submission conference**: Formal meeting with the IRS Associate office (with taxpayer identity disclosed) for substantive pre-filing discussion.
- Step 4: **Prepare and file Form 3115**: Complete the form with accurate descriptions, legal analysis, and §481(a) adjustment; file by the applicable deadline.
- Step 5: **Respond to IRS inquiries**: If the IRS requests additional information, respond within the 21-day window (extensions available).
- Step 6 (if needed): **Conference of right**: Available if the IRS is tentatively adverse; opportunity to correct misunderstandings and present additional arguments.

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B. Step 1: Preliminary Analysis

Prior to any filing, the practitioner must confirm:

- That the situation involves a genuine method change rather than an error correction, factual change, or character change;
- The specific item or sub-method at issue;
- Whether the five-year restriction applies;
- Whether the change is automatic or non-automatic under Rev. Proc. 2025-23; and
- Whether the taxpayer is under IRS examination and, if so, whether the item is under consideration.

Each of these determinations affects the subsequent steps.

C. Step 2: Optional Taxpayer-Anonymous (No-Names) Call

Before incurring the cost of preparing a formal method change request, practitioners may place a "no-names" call to the IRS to explore the viability of a potential change. During the call, the IRS will know the identity of the calling practitioner but not the underlying taxpayer, enabling candid discussion without triggering examination considerations.

This step is most valuable for complex, unique, or non-automatic changes where there is genuine uncertainty about the IRS's position; for routine automatic changes, it is usually unnecessary. The IRS will not commit to approving any request during a no-names call but may signal willingness to entertain it or clarify whether automatic procedures would apply. Appropriate IRS contacts can be identified via the contact list in Rev. Proc. 2025-23 or the IRS Code Section Subject Matter Directory. If the IRS signals unwillingness to entertain a change, the practitioner has saved the client significant time and expense before the more burdensome steps of the process.

D. Step 3: Optional Pre-Submission Conference with the IRS

A pre-submission conference is an optional, formal meeting with the IRS Associate office before filing a method change request. Requirements include:

- The taxpayer's identity must be disclosed (unlike the no-names call);
- The taxpayer must actually intend to file; and
- The matter must involve an issue on which a letter ruling is ordinarily issued.

The conference is granted at the Associate office's discretion and only as time permits. Historically, the IRS has been accommodating, though staffing fluctuations may affect availability.

A request is submitted to the appropriate contact in Rev. Proc. 2025-1, briefly describing the primary issue. It is then assigned to the relevant IRS branch for scheduling. The pre-submission conference is advisory only and provides no binding commitment from the IRS, but the discussion is more substantive than a no-names call due to the greater factual detail shared. While not binding, it is rare for the IRS to deviate significantly from their stance unless the formal filing has new, contradictory facts. Practitioners use pre-submission conferences to surface IRS concerns in advance so those concerns can be addressed in the Form 3115 filing, reducing the risk of an adverse outcome.

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E. Step 4: Filing Form 3115 — Overview and Key Requirements

Form 3115, *Application for Change in Accounting Method*, is the formal mechanism for requesting IRS consent under §446(e). Key elements of the form include:

- Precise identification of the item;
- A technically accurate description of the old and proposed new methods;
- A legal analysis supporting the change; and
- A computed §481(a) adjustment.

For automatic changes, the description must affirmatively demonstrate that the taxpayer's facts satisfy each term and condition of the applicable section of Rev. Proc. 2025-23. For non-automatic changes, the IRS treats the factual statements in Form 3115 as representations.

Materially misstated facts can void a consent agreement even if the change was formally approved. It is important to note that two copies are generally required: the original filed with the timely filed return, and a copy sent to the IRS Service Center in Ogden, Utah. The Ogden copy should be filed as early as possible, as the earlier it is filed, the earlier the audit protection period begins accumulating for prior years. Filing the Ogden copy late does not invalidate the filing but reduces the back-year audit protection window.

During IRS review, if facts are ambiguous or incomplete, the IRS will most commonly request clarification in writing with a 21-day response window. In rarer cases, it may deny the request outright. The narrative attachments to Form 3115 are the most important element of the filing, as they are the primary basis on which the IRS evaluates the request and become part of the binding consent agreement for non-automatic changes. For automatic changes, the narrative must trace the taxpayer's facts to the specific eligibility requirements of the applicable section of Rev. Proc. 2025-23. Any vague or conclusory narratives invite IRS scrutiny.

For non-automatic changes, because the IRS treats the stated facts as representations, any material inaccuracy, even if unintentional, can void the resulting consent agreement. A well-drafted narrative clearly describes how and when the old method was established, the proposed new method, and the legal and factual basis for the change. Practitioners should describe all exceptions, limitations, and special rules that may apply to the taxpayer's facts, even those that favor the IRS's position, which builds credibility. If facts change after Form 3115 is filed but before consent is granted, the practitioner should promptly notify the IRS to ensure the record accurately reflects the current situation.

A §481(a) adjustment reflects the cumulative timing differences between the old and new methods as of the beginning of the year of change, preventing amounts from being duplicated or omitted when a taxpayer changes its accounting method. The adjustment is necessary because computing income under the new method as if it had always been used would reach back into all prior years. In other words, what would the taxpayer's taxable income have been at the start of this year if it had always used the new method?

> ***Example***: A taxpayer switches from deducting warranties when paid (cash) to deducting them when incurred (accrual); items accrued in prior years but not yet paid would be permanently omitted without an adjustment.

A positive §481(a) adjustment increases income (unfavorable) and reflects that the taxpayer deducted too much or recognized too little income under the old method relative to what the new method would have

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required. On the other hand, a negative §481(a) adjustment decreases income (favorable) and reflects that the taxpayer deducted too little or recognized too much income under the old method. Certain method changes use a cut-off basis, under which only items arising after the year of change are accounted for under the new method, eliminating the need for a §481(a) adjustment. However, most changes in accounting method, whether voluntary or involuntary, require a §481(a) adjustment.

For voluntary (taxpayer-initiated) method changes not under examination, positive §481(a) adjustments are generally recognized ratably over four tax years beginning with the year of change. The ability to spread a positive adjustment over four years is one of the key financial benefits of a timely voluntary method change, deferring the tax impact and allowing for more favorable timing.

For voluntary (taxpayer-initiated) method changes not under examination, negative §481(a) adjustments are generally recognized entirely in the year of change (one year), providing an immediate tax benefit. For IRS-initiated method changes, positive §481(a) adjustments are recognized entirely in the year of change rather than spread over four years.

For voluntary (taxpayer-initiated) method changes under examination, a positive §481(a) adjustment is recognized ratably over two years rather than the standard four. For voluntary (taxpayer-initiated) method changes under examination, a negative §481(a) adjustment is generally recognized entirely in the year of change (one year).

For involuntary (IRS-initiated) method changes, the §481(a) adjustment is taken into income entirely in the year of change, whether positive or negative.

Practitioners should consider the magnitude of the §481(a) adjustment when advising on the timing and year-of-change selection, particularly for changes generating large positive or negative adjustments.

It is important to note that year-of-change selection is a planning opportunity, as a year with losses or lower income can reduce the net impact of a positive 481(a) adjustment. To minimize the impact of a positive §481(a) adjustment, it is recommended to match it to a tax year with a low marginal tax rate (when possible). To maximize the benefit of a negative §481(a) adjustment, it is recommended to match it to a tax year with a high marginal tax rate (when possible).

The §481(a) adjustment is computed as of the beginning of the year of change and must take into account all taxable years for which the statute of limitations has not expired as well as closed years that created a tax effect. For each affected item, determine what the balance would have been under the new method at the beginning of the year of change and compare it to the balance under the old method. Documentation is essential: maintain workpapers showing the source data, assumptions, and mathematical steps for each component of the adjustment so the calculation can be explained to the IRS if questioned. Practitioners should identify whether the adjustment is a single adjustment or the sum of multiple sub-adjustments for different items, as each sub-item may have separate identification and eligibility considerations. For changes involving inventory (LIFO, UNICAP), the 481(a) adjustment can be large and complex; consider engaging a specialist or reviewing prior-year workpapers to ensure completeness.

For automatic method changes, Form 3115 must be filed no later than the due date of the tax return for the year of change, including extensions. For a calendar-year corporate taxpayer, this is September 15

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with extensions. For non-automatic method changes, Form 3115 must be filed by the end of the tax year for which the change is to be effective. For a calendar-year taxpayer, this means December 31 of the year of change.

As discussed, for both types, it is advisable to file the Ogden copy of Form 3115 as early as possible to begin accumulating back-year audit protection as soon as practical. Extensions of time to file Form 3115 may be granted in unusual and compelling circumstances. Extensions are rare for non-automatic changes but more commonly granted for automatic changes where a good-faith effort to file was defective.

F. Step 5: Respond to IRS Inquiries

If the IRS requests additional information during the processing of an accounting method change, the IRS notifies the taxpayer, and the taxpayer is generally permitted 21 days to furnish the necessary information. Such requests for additional information typically occur if the IRS cannot verify the consistency or accuracy of a proposed change from Form 3115 alone. Common reasons for requests include:

- **Section 481(a) Calculations**: The IRS may ask for more detail on how the §481(a) adjustment was computed.
- **Reason for Change**: The IRS may request more detailed information if the description of the current vs. proposed method and the reason for change is unclear.
- **Missing Supporting Statements**: Some method changes, such as depreciation or inventory, may require specific attachments. If such information is missing, the IRS may request it.
- **Eligibility Verification**: For automatic consent changes, the IRS may request additional proof of the taxpayer's eligibility.

G. Step 6: Conference of Right (if needed)

The conference of right is available after the IRS has tentatively determined that it is adverse, in whole or in part, to the taxpayer's non-automatic method change request. As a best practice, always elect the conference of right option on every Form 3115 submission. If the IRS is not tentatively adverse, no conference occurs and the election creates no burden. The conference provides the taxpayer with a structured opportunity to correct factual misunderstandings, clarify ambiguities in the narrative, and present legal arguments that may cause the IRS to reconsider.

Following the conference, the IRS issues its final determination, either a consent letter or a formal denial, which concludes the method change process for that request. If a consent letter is issued and executed by both parties, it constitutes a binding agreement governing the terms and conditions of the method change, including the §481(a) adjustment recognition period. A denial is not necessarily the end of the road, as the taxpayer may consider refiling with revised facts or arguments, or may request reconsideration through appropriate IRS channels.

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

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V. Benefits of Voluntary Changes & Consequences of Inaction

A. Audit protection and Ruling Protection: The Primary Incentive

Taxpayers who obtain IRS consent for a method change generally receive audit protection and ruling protection, one of the most significant incentives for pursuing voluntary changes. Audit protection means the IRS will not require the taxpayer to change its accounting method for the same item for any taxable year prior to the year of change. In practical terms, audit protection prevents the IRS from using a forward-looking method change as a mechanism to adjust returns for prior years in which the old method was used. Audit protection effectively allows the taxpayer to move to a permissible method on a prospective basis without exposure to prior-year adjustments for the changed item. It is important to emphasize that protection is item-specific, as it applies only to the particular method and items addressed in the Form 3115 filing, not to the taxpayer's returns generally.

The IRS also will not require the taxpayer to change or modify the new method of accounting except in certain circumstances specifically enumerated in section 8 of Rev. Proc. 2002-9 and, if the IRS does require the taxpayer to change or modify the new method of accounting, the required change or modification to the new method of accounting generally will not be applied retroactively ("ruling protection"). In other words, the taxpayer receives protection with respect to the use of the new method of accounting in future years.

B. Exceptions to Audit Protection: Taxpayers Under Examination

As a default rule, taxpayers currently under IRS examination do not receive audit protection for a method change filed during the examination period. Specifically, audit protection is unavailable when the taxpayer is under examination and the item for which the method change is sought is under consideration by the examination team. An item is under consideration when the taxpayer receives written notification, such as an Information Document Request (IDR), citing the treatment of that item as an issue under consideration. A taxpayer may still file a Form 3115 for an item that is under consideration, but the change will not carry back-year audit protection, and a positive §481(a) adjustment is recognized over two years instead of four.

C. IRS-Initiated Method Changes Under Rev. Proc. 2002-18

An IRS-initiated change is an involuntary method change. The IRS has the authority to change a taxpayer's method of accounting in the following circumstances:

- **Impermissible Method**: The method of accounting a taxpayer used on a tax return is impermissible and is presumed not to clearly reflect income (the IRS has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income) or;
- **Unauthorized Method Change:** The taxpayer made an unauthorized method change and its method is improper due to not properly adopting the method, not requesting consent to change to the method, or not receiving consent to change to the method.

If a taxpayer does not voluntarily correct an impermissible method, the IRS may initiate a method change under Rev. Proc. 2002-18, with materially less favorable terms. Once the IRS determines that a method of accounting does not clearly reflect income (impermissible method), they have broad discretion to select a method of accounting that does properly reflect income (permissible method).The IRS may place the

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taxpayer on the least favorable permissible accounting method, (i.e., one that recognizes income sooner and deductions later) maximizing the taxpayer's near-term tax liability.

The IRS selects the year of change, which will likely be earlier than any year the taxpayer would have chosen for a voluntary change, potentially exposing more prior-year items to adjustment. A positive §481(a) adjustment under an IRS-initiated change is recognized entirely in the year of change (i.e., no four-year spread) creating a potentially large, immediate tax liability. Failure to file Form 3115 does not preclude the imposition of penalties or additions to tax in connection with an IRS-initiated change, adding further financial burden. The combination of an adverse method selection, an earlier year of change, a compressed §481(a) recognition period, and potential penalties makes an IRS-initiated change dramatically more costly than a timely voluntary change.

It is important to note that the IRS does not have discretion to change a taxpayer from one permissible method of accounting to another permissible method of accounting.

D. Unauthorized Method Changes: Risks and Consequences

An unauthorized change occurs when a taxpayer implements a method change by reporting under the new method on a return without obtaining IRS consent through the Form 3115 process.

As with an IRS-initiated change, the taxpayer may be denied the four-year spread period for positive §481(a) adjustments and may be required to recognize all income in the single year of the unauthorized change. If an unauthorized change would generate a favorable negative §481(a) adjustment, the IRS has the authority to deny the attempted change altogether, leaving the taxpayer on the impermissible method.

An unauthorized change provides no audit protection, leaving the taxpayer fully exposed to IRS adjustments for all open prior years during which the impermissible method was used. If the unauthorized change also affects the taxpayer's financial statements or deferred tax positions under ASC 740, the consequences can extend beyond income tax to financial reporting and restatement risk. The lesson is clear: always obtain IRS consent via Form 3115. There is no shortcut that preserves the benefits while avoiding the process.

E. Method Change Outcomes: A Comparison

The following table compares the different method change outcomes:

Voluntary Change	IRS-Initiated Change	Unauthorized Change
• Taxpayer selects year of change • Positive §481(a): 4-year spread • Negative §481(a): 1-year recognition • Audit protection for prior years • No penalties for the change itself • Taxpayer selects most favorable permissible method	• IRS selects year of change (earlier) • Positive §481(a): all in year of change • IRS selects least favorable method • No audit protection • Penalties may apply • Governed by Rev. Proc. 2002-18	• Taxpayer acts without IRS consent • Positive §481(a): all in year of change • Favorable negative §481(a) adjustment may be denied • No audit protection • Penalties may apply • IRS may reverse the change entirely

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VI. Special Topics & Advanced Considerations

A. Method Changes for Consolidated Groups

Members of a consolidated group generally must apply consistent accounting methods across the group, and a method change by one member may have implications for other members. New members joining a consolidated group may be required to change their accounting methods to conform to the group's methods. Such conformity changes are typically available under automatic procedures. When a method change generates a §481(a) adjustment at the subsidiary level, that adjustment must be properly reflected in the consolidated return. Special considerations apply to consolidated groups participating in the IRS Compliance Assurance Process (CAP), including rules governing the availability of audit protection for method changes made by newly acquired or joining members.

B. Method Changes for Partnerships and Passthrough Entities

Partnerships, S corporations, and other pass-through entities may change their accounting methods using the same Form 3115 process, but the resulting §481(a) adjustments flow through to the owners. For BBA partnerships (subject to the centralized audit regime), Rev. Proc. 2015-13 does not fully address the interaction between method changes and the BBA audit rules, and as such, practitioners should consult applicable guidance. Partners and S corporation shareholders may face inconsistent treatment if a method change creates a §481(a) adjustment allocated in a year when ownership has changed, creating potential disputes.

A positive §481(a) adjustment spread over four years will be allocated to whoever owns interests in the entity during those four years, not necessarily to the owners who were in place when the old impermissible method was being used. When a partnership is under IRS examination, the “under consideration” analysis must take into account both entity-level and partner-level examination activity to assess audit protection availability.

C. Tangible Property Regulations and Method Changes

The tangible property regulations under Reg. 1.162-3, 1.162-4, and 1.263(a)-1 through -3, finalized in 2013, created one of the largest waves of method change filings in recent IRS history. These regulations established standards for distinguishing deductible repair and maintenance costs from capital expenditures, including the de minimis safe harbor, the routine maintenance safe harbor, and the betterment/adaptation/restoration standards.

Taxpayers who had not previously adopted methods consistent with these regulations were required to file Forms 3115 to conform to the new rules, and many of these changes were available as automatic changes. Even today, practitioners encounter clients who have not fully conformed their accounting methods to the tangible property regulations; identifying and correcting these impermissible methods remains an important compliance area. Interaction between the tangible property regulations and Section 263A (UNICAP) can create additional complexity when the capitalization of costs for financial purposes differs from the tax treatment required by the regulations.

D. Strategic Planning: Selecting the Year of Change

The year of change is not always fixed. For automatic changes, the taxpayer has flexibility up to the return filing deadline, providing practitioners an opportunity to optimize based on the tax position. A year with a net operating loss (NOL) or other favorable attributes can significantly reduce the net tax impact of

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a positive §481(a) adjustment recognized in that year or spread over the subsequent four years. If the taxpayer anticipates a large negative §481(a) adjustment (favorable), selecting a high-income year can enhance the value of the change.

When multiple method changes are contemplated simultaneously, practitioners should analyze the combined §481(a) adjustment impact and consider whether to file all changes in the same year or stagger them. The year-of-change selection also affects the audit protection period, as an earlier year of change means earlier back-year protection, which can be valuable if IRS scrutiny of the relevant item is imminent. For non-automatic changes, year-of-change flexibility is more limited by the year-end filing deadline, but the analysis remains important when choosing between filing in the current year or rolling forward.

E. Method Changes in Mergers, Acquisitions, and Restructurings

Corporate transactions such as acquisitions, mergers, spin-offs, and restructurings, frequently create method change requirements or opportunities that must be identified during tax due diligence. Tax due diligence checklists for acquisitions should include systematic review of the target's accounting methods as a standard component, both for permissibility and for tax efficiency.

Sophisticated buyers often request representations regarding accounting method compliance as part of the purchase agreement and negotiate for the target to file corrective Form 3115 changes pre-closing where material issues are identified. In an asset acquisition (or a §338(h)(10) deemed asset acquisition), the target's accounting methods generally do not carry over; the acquirer adopts fresh methods and may need to conform to permissible ones. In a stock acquisition, the target's accounting methods carry over, potentially including impermissible methods; the acquirer is responsible for identifying and correcting any such methods through the Form 3115 process.

F. Common Pitfalls and How to Avoid Them

Common pitfalls to be mindful of include:

- **Incorrect classification**: Filing an automatic change as non-automatic (or vice versa) is a common error; the IRS may require refiling, and a user fee paid unnecessarily is typically not refunded.
- **Incorrect item identification**: Filing a method change for too broad or too narrow of an item can invalidate the filing or leave some impermissible treatment uncorrected.
- **Missing deadlines**: Particularly for non-automatic changes (year-end deadline), missing the deadline eliminates the opportunity to make the change for the desired year.
- **Inaccurate §481(a) calculation**: Errors in the adjustment amount can trigger IRS questions and, if material, may affect the validity of the consent agreement.
- **Failure to file the Ogden copy early**: Filing the Ogden copy late reduces the back-year audit protection period; the copy should be filed as early in the year as possible.
- **Overlooking related items**: A method change for one item may reveal impermissible methods for related items; practitioners should perform a broader review when any method change is identified.

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Miscellaneous Business Considerations

Learning objectives

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

- Understand §1244: Small Business Stock Loss Treatment;
- Review Decentralized Autonomous Organizations (DAO) considerations; and
- Review §1202: Qualified Small Business Stock Gain Exclusion considerations.

I. Advanced Practice Issues

A. Section 1244: Small Business Stock Loss Treatment

1. Purpose and Policy Rationale

Congress recognized that small, closely held corporations often face greater financing challenges than public companies. In order to encourage equity investment in these businesses, §1244 allows investors to deduct certain stock losses as ordinary losses rather than capital losses. Ordinarily, capital losses can only offset capital gains plus up to $3,000 of ordinary income per year. This means that if a taxpayer invests $50,000 in stock that becomes worthless, only $3,000 per year can offset ordinary income and the remaining loss may take many years to fully utilize. Section 1244 changes this result by permitting an ordinary loss deduction for qualifying small-business stock, enabling immediate relief up to statutory limits.

The special treatment applies only to original purchasers of stock—transferees cannot benefit—and is limited to stock issued by a qualified small business. It is not intended to provide tax benefits for purely speculative trading or for investors who buy stock from secondary markets. In addition, the corporation must satisfy certain active-business requirements and the amount of stock eligible for §1244 treatment is capped. These rules ensure that the provision is targeted to operating businesses and to initial investors bearing entrepreneurial risk.

2. Mechanics of the Ordinary Loss Deduction

An investor who meets the §1244 requirements may deduct up to $50,000 of loss per year ($100,000 on a joint return) as an ordinary loss. Any additional loss beyond these limits is treated as a capital loss subject to the $3,000 annual offset against ordinary income. The ordinary loss is reported on Form 4797 (Part II, Ordinary Gains and Losses) and flows to Schedule 1 (Form 1040), line 4. Because ordinary losses reduce adjusted gross income, they can also lower income thresholds for other deductions and credits, which can magnify the tax benefit.

Example 1: ***Basic application**.*
An investor buys $50,000 of stock in a qualifying small corporation and the business fails within a year. If the stock does not qualify under §1244, the $50,000 loss is treated as a capital loss and may offset only capital gains plus $3,000 of ordinary income annually. By contrast, if the stock does qualify, the full $50,000 is deducted as an ordinary loss in the current year, resulting in a much larger immediate deduction.

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Example 2: ***Loss exceeding the annual limit.***

Suppose a married couple filing jointly invests $120,000 in §1244 stock that becomes worthless. Under §1244, they may deduct $100,000 of this loss as an ordinary loss in the year the stock becomes worthless. The remaining $20,000 is treated as a capital loss subject to the $3,000 annual ordinary-income offset. If the couple has no capital gains and cannot absorb additional capital losses, it may take several years to fully use the remaining $20,000 loss.

3. Eligible Stock and Eligible Taxpayers

a. **Original issuance.** Only stock issued directly by the corporation to the taxpayer (or through an underwriter) is eligible. Investors must pay money or transfer property to the corporation; stock issued for services does not qualify. Qualifying stock may be either common stock or preferred stock (if issued after July 18, 1984). Stock acquired by a transferee—by purchase from another shareholder or by gift or inheritance—does not qualify. If stock is transferred after acquisition, the new owner cannot claim §1244 benefits; the election does not travel with the stock.

b. **Individual taxpayers and partnerships.** The provision applies to individual taxpayers and to partners in a partnership that purchases §1244 stock. When a partnership holds qualified stock, the §1244 deduction limit applies at the partner level. S corporations, trusts and estates cannot claim §1244 benefits, so stock held through these entities will not qualify.

Example 3: ***Subsequent Owner.***

Jerry Stevens invested $30,000 in a new corporation. On January 1, prior year, he sold one-half of his stock for $15,000 to Bill Myers. On December 1, current year, the corporation declared bankruptcy.

Jerry Stevens could deduct this $15,000 stock loss 100 percent on his Form 1040 for the current year as an ordinary loss.

Bill Myers' stock loss would not qualify for §1244 treatment since he was not an original owner of the stock.

Thus, his stock loss would be a long-term capital loss. The current year, Myers would deduct $3,000 and carryover $12,000 capital loss to subsequent years.

4. Corporate Eligibility Requirements

For stock to qualify for §1244 treatment, the issuing corporation must meet several requirements:

a. **Active business test.** During the five taxable years preceding the year of loss—or for all taxable years if the corporation has existed for fewer than five years—the corporation must be primarily engaged in an active trade or business. At least 50 percent of the corporation's gross receipts during this period must be derived from the active conduct of a business rather than passive activities. Passive sources such as rents, royalties, dividends, interest, annuities, or gains from securities do not count toward this test.

b. **Small business capital limit.** The corporation may issue up to $1,000,000 of §1244 stock (including paid-in capital and surplus). Only the first $1 million of stock issued qualifies for §1244 treatment; subsequent issuances beyond that cap do not. There is no requirement for a written stock plan, but corporations should maintain thorough documentation to substantiate the amount of qualifying stock issued.

c. **Proper issuance.** The stock must be issued for money or property. If stock is issued for services—such as legal or consulting services—it does not qualify.

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5. Interaction with Partnerships and Other Structures

When a partnership purchases §1244 stock, the benefits are allocated to the partners. Each partner applies the $50,000/$100,000 annual loss limit separately on their individual return. If the partnership sells the stock at a loss or if the stock becomes worthless, each partner's share of the loss is treated as an ordinary loss to the extent of the limit, and any excess is a capital loss.

Example 4: ***Partnership investment and multiple partners.***
Three partners, Alex, Sam and Taylor, form AST Partnership and invest $450,000 in newly issued stock of StartCo, a qualifying §1244 corporation. Each partner's basis is $150,000. After two years, StartCo fails and the stock becomes worthless. On dissolution, the partnership deducts a $450,000 loss. Each partner's $150,000 share of the loss is subject to §1244. Alex, Sam and Taylor may each deduct $50,000 (single filers) or up to $100,000 if filing jointly. Any remaining loss on each partner's share (up to $100,000 if single, $50,000 if joint, depending on filing status) is treated as a capital loss.

6. Planning Considerations and Tips

Section 1244 can provide significant tax savings, but it requires careful planning and documentation. Some key planning points include:

a. **Document the issuance:** Investors should ensure that stock certificates, subscription agreements, minutes and capitalization tables clearly identify the stock as §1244 stock and reflect that it was issued for cash or property. This documentation is vital if the IRS questions the deduction.

b. **Monitor the $1 million cap:** A corporation cannot exceed $1,000,000 of §1244 stock (including initial paid-in capital and surplus). If a corporation grows and issues more stock, subsequent issuances may not qualify. Shareholders should track the issuance amount to determine eligibility.

c. **Satisfy the active business test.** The corporation should derive the majority of its income from operating activities rather than from passive investments. Keeping records of revenue sources helps demonstrate compliance with the 50 percent test.

d. **Spread losses across tax years:** Because the ordinary loss deduction is limited per year, consider timing the recognition of losses or structuring separate entities to maximize the deduction over multiple years. For example, if an investor holds stock in more than one §1244 company, staggering the recognition of losses may allow multiple $50,000 deductions in different years.

B. Section 1202: Small Business Stock Loss Treatment

1. Legislative History and Purpose

Section 1202 was enacted in 1993 as part of the Omnibus Budget Reconciliation Act to foster long-term investment in emerging companies by granting non-corporate shareholders an exclusion from tax on a portion of the gain realized from the sale of qualified small business stock (QSBS). The goal was to channel capital into high-growth sectors, such as technology and manufacturing, by reducing the tax cost of investing. Over time, the provision has evolved, with Congress increasing the exclusion percentage and modifying rules to address perceived inequities.

From 1993 to early 2009, taxpayers could exclude 50 percent of gain on QSBS held more than five years; the remaining 50 percent was taxed at a special 28 percent rate (which still applies for QSBS gains today), resulting in an effective rate of 14 percent. The American Recovery and Reinvestment Act of 2009

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(ARRA) temporarily increased the exclusion to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011. Four later acts, culminating in the Protecting Americans from Tax Hikes (PATH) Act of 2015, raised the exclusion to 100 percent for stock acquired after September 27, 2010 and made the 100 percent exclusion permanent for stock acquired after 2015. Additionally, those acts eliminated the gain from being treated as an AMT preference item.

The One Big Beautiful Bill Act (OBBBA) further expanded §1202 for QSBS issued after July 4, 2025. Under the OBBBA, investors can qualify for partial exclusions even when stock is held fewer than five years, creating a tiered structure. The OBBBA also raises the corporate asset limit and per-issuer exclusion cap.

2. Eligibility Requirements for QSBS

To qualify for the §1202 gain exclusion, several conditions must be satisfied at the time of issuance and during the holding period:

a. **Original issuance and non-corporate shareholder.** The stock must be acquired at original issuance, directly from the corporation or through an underwriter, in exchange for money, property (excluding stock), or as compensation for services (other than underwriting services). The shareholder must be a *non-corporate* taxpayer, such as an individual, partnership or S corporation. If stock is acquired from another shareholder, it does not qualify as QSBS.

b. **Qualified small business.** The issuer must be a C corporation that is a **qualified small business** on the date the stock is issued. A qualified small business is generally defined as a C corporation with aggregate **gross assets** not exceeding **$50 million** at all times before and immediately after issuance (increased to **$75 million** for stock issued after July 4, 2025). When property other than cash is contributed, the basis for the asset test is its fair market value, not its tax basis. If the corporation subsequently exceeds the asset limit, stock issued while the corporation met the limit does not lose its QSBS status.

c. **Active trade or business requirement.** At least **80 percent** (by value) of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses during substantially all of the shareholder's holding period. Qualified trades or businesses generally exclude personal services (such as law, health, accounting and consulting), banking, insurance, finance, leasing, investing, farming, mineral extraction, and hotel and restaurant operations. Reasonable amounts of working capital and assets held for planned expansion may be counted toward the active business requirement.

d. **Holding period.** The shareholder must hold the stock for more than **five years** to qualify for the full exclusion (subject to pre-and post-OBBBA variations described below). Shorter holding periods yield partial exclusions for post-OBBBA issuances. The holding period begins on the day after the stock is acquired and ends on the date of sale.

e. **Exclusion limits.** The amount of gain eligible for exclusion is subject to the greater of: **(i) 10 times the shareholder's basis** in the stock; or **(ii) an aggregate dollar amount** per issuer. Prior to OBBBA, the aggregate exclusion limit was **$10 million**, measured per taxpayer per corporation. H.R. 1 increased the aggregate limit to **$15 million** (indexed for inflation beginning in 2027) for stock issued after July 4, 2025. Gains beyond the greater-of limits remain subject to the 28 percent capital gains tax rate.

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3. Percentage Exclusions Across Time

The percentage of gain that can be excluded depends on when the stock was acquired:

Acquisition Period	Exclusion Percentage	Applicable Tax Rate on Nonexcluded Gain	AMT Preference
Aug. 11, 1993 – Feb. 17, 2009	50 %	Max 28%	42%/28%/7% of Excluded Gain
Feb. 18, 2009 – Sept. 27, 2010	75 %	Max 28%	7% of Excluded Gain
Sept. 28, 2010 – July 3, 2025	100 %	Max 28%	N/A
July 4, 2025 and later (OBBBA)	50 % if held >3 yrs & <4 yrs 75 % if held ≥4 yrs & <5 yrs 100 % if held ≥5 yrs	Max 28%	N/A

These rates apply only to the **excludable** portion of the gain. Any portion of gain not eligible for exclusion is taxed up to a 28% tax rate. For example, a 50-percent exclusion means half of the gain is excluded and the other half is taxed as a long-term capital gain.

4. Practical Examples

Example 1: ***Pre-OBBBA 50 percent exclusion.*** In 1993, Elaine buys 1,000 shares of a qualified small business for $100,000 ($100 per share). She sells the stock in 2026, after holding it for more than 30 years, for $2 million. Because she acquired the stock in 1993, 50 percent of her $1.9 million gain is excluded under §1202. Elaine can exclude $950,000, and the remaining $950,000 is taxed at a 28% rate. Of the $950,000 excluded gain, $66,500 ($950,000 x 7% represents an AMT adjustment item).

Example 2: ***Full exclusion for post-2010 stock.*** Carlos acquires 1,000 shares of QSBS for $50,000 on October 11, 2011. In 2026 he sells the stock for $5 million. Under the 100 percent exclusion applicable to stock acquired after September 27, 2010, Carlos excludes the entire $4.95 million gain, pays no federal income tax on that gain and has no AMT adjustment.

Example 3: ***Tiered exclusion after the OBBBA (3–4 years).*** On August 1, 2026 Lisa invests $200,000 in the original issuance of TechRise Inc. stock, which qualifies as QSBS. TechRise grows rapidly and Lisa sells the stock on September 1, 2029—just over three years later—for $1 million. Because the stock was issued after July 4, 2025, and held for more than three but less than four years, Lisa qualifies for the 50-percent exclusion. Her gain is $800,000 ($1 million minus $200,000 basis). She may exclude $400,000; the remaining $400,000 is taxed at a 28% tax rate and has no AMT adjustment.

Example 4: ***Tiered exclusion after the OBBBA (4–5 years).*** Suppose Lisa had instead sold the stock after four years and one month. Now she is entitled to a 75-percent exclusion. On a $800,000 gain, she may exclude $600,000, leaving $200,000 taxed at a 28% rate and no AMT adjustment.

Example 5: ***Aggregate limit after the OBBBA.*** David invests $3 million in multiple rounds of QSBS issued by ABC Corp. after July 4, 2025. Five years after his last tranche of stock purchase(s), he sells his shares for $20 million, realizing a $17 million gain. Under the OBBBA, the aggregate exclusion limit is $15 million (indexed for inflation). David can exclude the greater of (a) 10 times his basis ($30 million) or (b) the $15 million aggregate limit. Since $30 million is greater, he may exclude up to $30 million of gain. Because the gain of $17 million is less than his exclusion limit of $30 million, the total gain of $17 million is excluded, and there is no modification for AMT.

Example 6: ***Multiple Holding Periods across Tranches.*** David invests $1 million in ABC Corp. stock in three separate tranches after July 4, 2025:

Tranche A: $1 million purchased on July 5 2025.
Tranche B: $1 million purchased on July 5 2026.
Tranche C: $1 million purchased on July 5 2027.

On August 1, 2030, David sells all of his ABC shares for $20 million. The sale proceeds are allocated $8 million to Tranche A, $7 million to Tranche B, and $5 million to Tranche C. His total basis is $3 million, so his total gain is $17 million. Under the One Big Beautiful Bill Act (H.R. 1), QSBS issued after July 4, 2025, is eligible for tiered exclusions: 50 % if held more than 3 years but less than 4 years, 75 % if held at least 4 but less than 5 years, and 100 % if held 5 years or more. David's tranches therefore qualify as follows:

Tranche A (held > 5 years): Gain = $8 M – $1 M = $7 million. Held more than five years, this tranche qualifies for a 100 % exclusion. All $7 million of gain is excluded.

Tranche B (held ≈ 4 years): Gain = $7 M – $1 M = $6 million. Held slightly more than four years, it qualifies for the 75 % exclusion. David can exclude $4.5 million and must include the remaining $1.5 million in income taxed up to a 28% tax rate.

Tranche C (held just over 3 years): Gain = $5 M – $1 M = $4 million. Held more than three but less than four years, it qualifies for the 50 % exclusion. David can exclude $2 million and must include the remaining $2 million to be taxed up to a 28% tax rate.

Altogether, David excludes $13.5 million of his $17 million gain. The remaining $3.5 million is taxed up to a 28% rate. Note that his potential exclusion limit is the greater of 10x basis (10 × $3 M = $30 M) or $15 M; the $13.5 million exclusion falls below the $30 million cap, so the limit does not restrict him.

Example 7: ***Partnership QSBS and pass-through limitation.*** Ron, Sally and Tom form RST Partnership and purchase $150,000 of QSBS ($50,000 per partner). A year later, Ron and Sally buy out Tom's interest. After more than five years from the original purchase date, RST sells the stock for a $180,000 gain. The partnership allocates $90,000 of gain each to Ron and Sally. Under §1202, each partner can exclude only up to the gain they would have realized if they had never bought Tom's interest. Since Ron and Sally originally held one-third of the stock, their excludable gain is $60,000 each; the remaining $30,000 each is taxed up to a 28% tax rate.

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5. Interactions with Other Rules and Planning Strategies

Several additional considerations can affect the availability and usefulness of §1202.

a. **Stacking the basis limit and aggregate limit.** The exclusion is limited to the greater of 10 times basis or a dollar cap per issuer ($10 million or $15 million for post-2025 issuance). Taxpayers with low basis relative to potential gain may rely on the aggregate limit, while those with high basis may be constrained by the 10× basis limit. Planning capital contributions early, rather than later, may increase basis and thereby the 10× limit, but subsequent contributions after stock issuance do not increase the basis for QSBS purposes.

b. **Rollover under §1045.** Investors may defer gain by rolling over sale proceeds from QSBS held more than six months into other QSBS within 60 days. The requirements and benefits of this provision, and its interaction with §1202, are explored in the following section.

c. **State conformity.** Not all states conform to the federal §1202 exclusion. For example, California does not recognize the QSBS exclusion, while many other states do. Investors should consider state implications when planning dispositions.

d. **Alternative minimum tax (AMT) considerations.** For stock issued before September 28, 2010, 7 percent of the excluded gain may be an AMT preference item. Stock acquired on or after that date is not subject to AMT preference, and post-OBBBA gains are also excluded from AMT. Understanding the acquisition date is crucial to avoid unexpected AMT liability.

e. **Other H.R. 1 provisions.** OBBBA introduced numerous tax changes that can influence a taxpayer's overall investment and liquidity strategy. For example, the permanent extension of the qualified business income (QBI) deduction, increased SALT deduction cap, new deductions for tip income and overtime pay, and deductions for auto loan interest and newborn savings contributions all interact with overall tax planning. Although these provisions do not directly alter §1202, they may affect a taxpayer's marginal tax rate and the relative benefit of deferring or accelerating QSBS gains.

6. Section 1045 Rollover: Deferring and Amplifying the §1202 Benefit

While §1202 provides an exclusion for long-term capital gains, **§1045** offers investors a *deferral* mechanism when they sell QSBS before satisfying the five-year holding period or when their gain exceeds the §1202 exclusion cap. Under §1045, a taxpayer who has held **qualified small business stock for more than six months** may elect to defer recognition of gain by **reinvesting the sale proceeds in other QSBS within 60 days**. The key requirements and benefits include:

a. **Eligibility and requirements.** The stock sold must be QSBS as defined in §1202. The taxpayer must have held the stock for **more than six months**, and the replacement stock must be acquired during the **60-day period** beginning on the date of sale. The replacement stock must itself be QSBS, but it only has to meet the active business requirement for the first **six months** after issuance; thereafter it may convert to S corporation status or engage in passive activities. The election is available only to non-corporate shareholders; C corporations cannot defer gain under §1045. An election must be made on the return for the year of sale (Form 8949 and Schedule D) by the due date (including extensions).

b. **Deferral mechanics.** Section 1045 does not eliminate the gain; it merely **defers** it. The gain is deferred to the extent that the taxpayer invests the proceeds in replacement QSBS. The taxpayer's basis in the replacement stock is reduced by the amount of gain

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deferred. If the taxpayer sells the replacement stock, any gain attributable to the deferred gain is recognized at that time. Importantly, **the holding period of the original stock is tacked onto the replacement stock** for purposes of the §1202 five-year requirement. Thus, replacement QSBS may qualify for the §1202 100% exclusion sooner than five years from the replacement investment.

c. **Interaction with §1202.** Section 1045 serves as a bridge to §1202. A taxpayer who sells QSBS before meeting the five-year holding requirement may defer the gain under §1045, invest in replacement QSBS and, once the combined holding period exceeds five years, **permanently exclude** the deferred gain under §1202 if the replacement stock otherwise qualifies. In addition, §1045 can be used to defer gain **above the §1202 exclusion cap**. For example, if a taxpayer sells QSBS after five years with a $15 million gain, only $10 million (or $15 million for post-OBBBA stock) is excludable under §1202; the excess gain can be deferred by reinvesting that amount in replacement QSBS within 60 days. Each block of replacement stock has its own exclusion cap, allowing investors to repeat the process and potentially exclude multiple $10 million or $15 million gains over time. Note though that partial rollover where a nonexcludable gain exists will result in part of the gain being recognized. The mechanics are as follows:

Step 1. Compute the gain realized on the sale of the old QSBS; then

Step 2. Compute recognized gain, which is the realized proceeds less the old QSBS gain excluded under §1202 less the amount reinvested in new QSBS exclusion and the amount reinvested in new QSBS; and

Step 3. Reduce basis in the replacement QSBS by the amount of gain computed in step 1 less the amount recognized in step 2.

Example 8: ***Early sale and deferral.***
In 2015, John buys QSBS for $1 million. After three years, in 2018, he sells the stock for $3 million. He reinvests the entire $3 million of proceeds in replacement QSBS within 60 days and makes a §1045 election. In 2022, he sells the replacement QSBS for $6 million. John's $2 million gain on the 2018 sale is deferred under §1045. Because the holding period of the original stock (2015–2018) is tacked onto the replacement stock, John is treated as having held the replacement stock for more than five years (2015–2022). Accordingly, he may qualify for the §1202 exclusion on the deferred gain when he sells the replacement stock in 2022.

Example 9: ***Early sale and partial deferral.***
Bethany purchased stock in XYZ Corp (QSBS) in 2020 for $2M. In 2022, she sells the stock in XYZ Corp for $7M (§1202 holding period not met), and within 60 days, reinvests the $4M of proceeds in ABC Corp (QSBS) making a §1045 election on the reinvestment. Bethany's realized gain is $5M ($7M proceeds - $2M basis). Her recognized gain amounts to $3M ($7M proceeds - $0 §1202 excluded gain - $4M replacement cost of ABC Corp). The basis of the replacement QSBS in ABC Corp is reduced by $2M ($5M realized gain less $3M recognized gain) and assumes basis in ABC Corp of $2M ($4M replacement cost – $2M basis reduction) rather than $4M.

Example 10: ***Exceeding the exclusion cap.***
Lisa acquires QSBS in 2016 for $1 million and sells it in 2023 for $15 million, realizing a $14 million gain. Under §1202 (pre-OBBBA), she may exclude **$10 million** of the gain. To defer the remaining $4 million, Lisa reinvests $4 million of the proceeds into new QSBS within 60 days and makes a §1045 election. After holding the replacement stock for two additional years (which, combined with the original holding period, satisfies the five-year requirement),

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she sells it for $6 million. Lisa may exclude the deferred $4 million gain under §1202 because the holding period of her original investment is tacked onto the replacement stock. The replacement investment also provides a new $10 million exclusion cap, allowing her to potentially exclude additional gains if the replacement stock appreciates.

Example 11: ***Partnership Rollover.***
Suppose a partnership holds QSBS, sells it and reinvests the proceeds in replacement QSBS within 60 days. The partnership can elect §1045 at the entity level. Alternatively, if the partnership fails to elect §1045, individual partners may still make the election on their personal returns for their share of the proceeds used to acquire replacement QSBS. However, a partner cannot defer gain when selling his or her partnership interest itself, even if the partnership owned only QSBS.

Investors contemplating a §1045 rollover should plan ahead. The **60-day reinvestment window** is short, and finding suitable replacement QSBS can be challenging. Due diligence is essential to ensure that both the old and replacement stock qualify as QSBS and that the corporation issuing the replacement stock meets the active business requirement for at least six months. Documentation should demonstrate the QSBS status of both investments and substantiate the amount of gain deferred. Section 1045 is not available for gains treated as ordinary income and does not apply to C corporations. When used in conjunction with §1202, it can turn a **temporary tax deferral into a permanent exclusion**, but only if the replacement QSBS is held long enough and continues to qualify through the date of sale.

Although OBBBA did not modify §1045 itself, the Act's enhancements to §1202, such as the increased $15 million per-issuer cap and the tiered 50/75/100 percent exclusions make §1045 even more valuable. Taxpayers can use §1045 to defer gain until they reach the three-, four- or five-year milestones necessary for partial or full exclusion under §1202 and can roll gains exceeding the new $15 million cap into additional QSBS for further exclusions. Thus, §1045 remains an important tool in the tax planner's arsenal when combined with the generous benefits of §1202 under the One Big Beautiful Bill Act.

II. Tax Court Update

A. Denham v. Commissioner, (T.C. Memo 2024-114)

Facts:
The petitioner in this case is the tax matters partner and state law general partner of Denham. Petitioner is a Delaware limited liability company and elected to be treated as a partnership for federal income tax purposes. Denham is organized as a limited partnership under Delaware law and offers investment advisory and management services to affiliated private equity funds that invest in the energy sector. Pursuant to investment advisory agreements between Denham and each fund, Denham was expected to furnish investment advice, negotiate terms of investments, monitor the health of the investments, and complete the day-to-day administrative tasks associated with managing the funds.

In addition to the petitioner, Denham had five limited partners during the years in issue ("The Partners"). The Partners functioned similarly to and were subject to the same general policies and procedures as Denham's employees. Denham's Fifth Amended and Restated Limited Partnership Agreement (LPA), effective May 1, 2014, governed the obligations and authority of Denham's partners for the years in issue. Under the LPA, petitioner, as general partner of Denham, had unlimited liability for Denham's debts. Partners had limited liability and could be held personally liable for the debts and obligations of Denham only to the extent, if any, of capital contributions they made to Denham.

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The LPA vested all management authority exclusively in petitioner. Mr. Porter, one of the five limited partners, owned 100% of the equity of petitioner, but all of the Partners were voting members of petitioner throughout the years in issue. Denham's limited partners had authority to the extent petitioner delegated authority to them. On November 1, 2013, acting in his authority as managing member of petitioner, Mr. Porter authorized via written resolution to The Partners, along with Denham's chief financial officer, director of tax, general counsel, and associate general counsel, to negotiate and execute any type of agreement or document on petitioner's behalf. Denham's LPA also required that each partner, except for Mr. Porter, "devote substantially all of his or her business time and attention to the affairs of Denham and its affiliates."

The Partners' role with Denham was so fundamental to the firm's operation that investors had the right to withdraw their investments early if one or more of the Partners died, became disabled, or could no longer devote substantially all business time to the funds. Each fund's "key person" provision referred to Mr. Porter, but all five Partners were considered a key person by at least one of the funds active during the years in issue.

The CFO led Denham's finance team and handled financial reporting for Denham and its affiliates. Denham worked in conjunction with PwC to have its financial statements audited and to prepare Denham's Forms 1065. PwC's audit report described the Partners as "active limited partners," a term provided by Denham.

Petitioner made no guaranteed payments or distributions to the Partners in 2016 or 2017. In each of those years Denham made guaranteed payments and capital distributions to the Partners and petitioner. The guaranteed payments were intended to represent the Partners' salaries and included the value of a package of typical employment benefits. The distributions to the Partners were tied to their distributive shares of Denham's income and calculated on the basis of their profits interests. There was no guaranteed minimum for the Partners' distributive shares for the year, and they varied from year to year as they were tied to the profits of the firm.

When computing the Partners' Net Earnings from Self-Employment (NESE) for the years in issue, Denham included their guaranteed payments but excluded their distributive shares of Denham's ordinary business income. For tax years 2016 and 2017, the IRS issued Final Partnership Administrative Adjustment (FPAA) notices that increased Denham's NESE by more than $27.4 million and $22.9 million, respectively.

Issues and Analysis:

The Commissioner's determinations in an FPAA are generally presumed correct, though the taxpayer can rebut this presumption. To rebut the presumption, the taxpayer must:

- Provide factual evidence and supporting documentation that contradicts the IRS's position; or
- Offer legal arguments or interpretations that demonstrate the IRS's adjustment is inconsistent with tax law.

Under IRC §1402(a), Net Earnings from Self-Employment (NESE) generally includes:

- Gross income from any trade or business the individual personally carries on;
- (-) Deductions directly attributable to that trade or business; and

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- (+) The individual's distributive share of income or loss under §702(a)(8) from any partnership in which the individual is a member (whether or not the income is actually distributed).

A key exception is the Limited Partner Exclusion. Section 1402(a)(13) excludes from NESE "the distributive share of any item of income or loss of a limited partner, as such, except for guaranteed payments made to that partner for services actually rendered. In other words, limited partners (in the traditional sense) generally do not owe self-employment tax on their distributive share of income, unless:

- They receive guaranteed payments for services; and
- Those payments are compensation-like.

The central issue in this case is whether the distributive share of income received by The Partners was subject to self-employment tax, or whether it qualified for the limited partner exclusion under §1402(a)(13).

Recently, *Soroban Capital Partners v. Commissioner* (161 T.C. No. 12) held “that the limited partner exception does not apply to a partner who is limited in name only” and that “Congress intended section 1402(a)(13) to apply to partners that are passive investors.” Before Soroban, in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), the Court applied a functional analysis test to determine whether the lawyer-partners of a Kansas limited liability partnership were limited partners under §1402(a)(13). Such test typically evaluates whether a partner is functionally passive and excluded from SE tax under §1402(a)(13), or functionally active (i.e., rendering services, managing), and therefore included in NESE. Key criteria in functional analysis include the level of activity in the business, involvement in management or decision-making, whether income received is tied to services rendered, and capital invested vs. income received (investment return vs. compensation).

The Petitioner argued that The Partners were limited partners under state law, and thus, their income was not NESE. The Court disagreed, noting that Denham’s income came from providing investment management services, and The Partners actively managed the firm, funds, and personnel. Further, The Partners were integral to operations, solicited capital, participated in investment and valuation committees, and made strategic and hiring decisions. There were no meaningful capital contributions (except one), yet the Partners received millions in distributions.

As a result, the Court found that The Partners were not passive investors; rather, they were actively engaged and materially participating as self-employed individuals. Therefore, the Court found that The Partners’ income was not excluded from NESE.

Conclusion:

Merely being a “limited partner” by state designation is insufficient for §1402(a)(13). The economic relationship and duties of the partner control, not the label. Further, even if guaranteed payments are made, a partner’s larger profit shares (disguised compensation) may still be fully subject to SE tax.

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III. Legislative updates

A. Depreciation changes

1. Electronic filing requirements for information returns

The Taxpayer First Act (TFA), enacted July 1, 2019, streamlined electronic filing requirements for information returns. Prior to the TFA, any organization filing at least 250 information returns was required to do so electronically. The TFA provided the Secretary of the Treasury with the authority to prescribe regulations that decrease, in accordance with the TFA, the number of returns a filer may file without being required to file returns and other documents electronically.

Under this authority, the Secretary of the Treasury may require any person who must file at least 10 returns during a calendar year to file the returns electronically. This requirement was designed to enhance efficiency, accuracy, and timeliness in tax reporting processes. Additionally, this requirement encouraged the transition to electronic filing to reduce errors and processing delays associated with paper filings. Although initially intended to be gradually implemented over a span of several years, the IRS announced a delay of these requirements until corresponding regulations were formally issued.

On February 23, 2023, the Department of the Treasury and the IRS published T.D. 9972, *Electronic-Filing Requirements for Specified Returns and Other Documents*, making several important changes, including:

- Providing that the new reduced threshold for filing information returns from 250 to 10 was generally effective beginning January 1, 2024 (for tax year 2023 returns);
- Requiring filers to aggregate almost all information return types covered by the regulation (with the exception of Form 940 and 941) to determine whether the filer meets the 10-return threshold and is required to e-file their information returns -- prior to this requirement, the 250-return threshold was applied separately to each type of information return covered by the regulation;
- Eliminating the e-filing exception for income tax returns of corporations that report total assets under $10 million at the end of their taxable year; and
- Requiring partnerships with more than 100 partners to e-file information returns, and requiring partnerships required to file at least 10 returns of any type during the calendar year to e-file their partnership return.

On January 23, 2023, the IRS launched the Information Returns Intake System (IRIS), a free web-based platform to help taxpayers file Form 1099 series information returns electronically. IRIS allows taxpayers to enter data to create forms by either keying in the information or uploading a .csv file. Additionally, taxpayers can use IRIS to create, upload, edit and view information and download completed copies of 1099 series forms for distribution and verification. Any entity with an Employer Identification Number (EIN) can file electronically via IRIS for calendar year 2022 and beyond. Other benefits of IRIS include:

- IRIS e-file security standards to keep information safe and protected;
- IRIS automatically detects filing errors and provides alerts for missing information;
- Filers can submit automatic extensions and make corrections to information returns filed through the IRIS platform;
- Filers can submit up to 100 forms per submission;
- When using the IRIS, the IRS acknowledges receipt of the return in as early as 48 hours; and

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- The IRIS platform retains issuer information from year to year, as well as prior years filed through IRIS.

Example: In 2026, ABC Corporation is required to file seven 2025 Forms 1099-MISC, one 2025 Form 1099-INT, one 2025 Form 1099-DIV, as well as 2025 Form 1120. Since ABC Corporation is required to file 10 tax year 2025 returns during the 2026 calendar year, ABC Corporation must file all of the above forms electronically, including Form 1120.

Notice 2010-13 provided procedures for corporations, electing small business corporations, and other tax-exempt organizations that are required to file returns under §6033, to request a waiver of the requirement to file electronically Form 1120, Form 1120-F, Form 1120-S, Form 990, Form 990-PF, and returns, amended returns, and superseding returns in the Form 1120 series and Form 990 series as required by regulations and IRS publications. Following the release of TD 9972, the IRS issued Notice 2023-60, obsoleting Notice 2010-13.

Notice 2024-18 obsoletes Notice 2023-60 and provides for certain administrative exemptions from the electronic filing requirement. Regulations outlined under TD 9972 provided an exemption for filers for whom using the technology required to file in electronic form conflicts with their religious beliefs (religious exemption). Notice 2023-60 required Form 1120, 1120-S, 1120-F, and 1065 filers to file Form 8508, *Application for a Waiver from Electronic Filing of Information Returns*, to apply for a religious exemption before filing their returns.

Notice 2024-18 modifies this requirement and specifies that most filers claiming the religious exemption have the option to notify the IRS that they qualify for a religious exemption in advance of filing returns and other documents. Such filers are encouraged to notify the IRS in advance that they are claiming a religious exemption by filing a Form 8508, in accordance with the form's instructions.

Notice 2024-18 also specifies that filers of Forms 1120, 1120-F, 1120-S, and 1065 who are claiming the religious exemption must not File Form 8508, but instead, such filers must file returns and other documents in paper form following the paper filing requirements provided by applicable IRS revenue procedures, publications, forms, instructions, or other guidance. Additionally, such filers of the above forms who qualify for the religious exemption must print in bold letters "Religious Exemption" at the top of page 1 of the return they file in paper form.

It is important to note that information return penalties apply to taxpayers who don't file or furnish their required information return or payee statement correctly by the due date of the return. The IRS charges penalties for each information return that was not filed correctly on time.

B. 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.

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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.

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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

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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.

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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.

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