RIA's 2014

Federal Tax Review Course

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RIA'S 2014 FEDERAL TAX REVIEW COURSE

Subject Category: **Taxes**
Level of Knowledge: **Update**
Prerequisites: **Basic Knowledge of Federal Taxation**
Advanced Preparation: **None**

RIA's 2014 Federal Tax Review Course (revised November 2013) is designed to provide a general refresher course in Federal taxation to both reinforce the basics and keep practitioners up to date on the latest important changes.

The course has three components:

- Module 1: Taxation of Individuals (8 CPE credits);
- Module 2: Taxation of Businesses (10 CPE credits);
- Module 3: Specialized Tax Issues (9 CPE credits).

Course participants may take one, two, or three modules for CPE credit.

Each course module provides a self-study learning experience consisting of:

- Instructional materials;
- Review questions that test for understanding of the material, with evaluative feedback given for incorrect responses and reinforcement for correct responses; and
- A final examination consisting of multiple choice questions, the answers to which should be recorded on the answer sheet.

To obtain CPE credit, please read through the instructional materials that follow and answer the review questions as you go. Check at the end of the course to determine whether your answers to the review questions are correct, and, if not, consider the evaluative feedback included in the Solutions section of the course. When you have finished the instructional material for a module, answer the 50 examination questions for that module, and return your completed answer sheet with your evaluation form to:

Thomson Reuters Tax & Accounting
QZN144, QZN145, or QZN146 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

Each examination answer sheet will be graded, and a CPE certificate of completion will be awarded for achieving a grade of 70% or higher. The certificate will be sent to you within three to five weeks of its submission (somewhat longer during peak periods). Answer sheets CANNOT be returned.

The final examination is valid only through November 30, 2014.

Successful completion of each examination element should qualify you to receive continuing education credit, as outlined below and in conjunction with your CPE governing body's qualifications.

Questions answered:	Processing Fee:
Any 1 Module (50 questions) =	$ 95
Any 2 Modules (100 questions) =	$140
All 3 Modules (150 questions) =	$185

Additional copies of this course are available at $10.00 a copy. Call 1-800-431-9025.

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RIA's must-have Federal Tax Review course is a general refresher in federal taxation that will reinforce basic tax law interpretations and keep you up-to-date on the most important tax changes. Download RIA self-study course materials and use online grading for immediate results on the Checkpoint Learning platform.

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INTRODUCTION

RIA's 2014 Federal Tax Review Course consists of three interactive self-study CPE course modules. There is a charge for grading and processing your answer sheet for each course module. To obtain credit, your **Examination for CPE Credit Answer Sheet(s)** must be submitted for grading by **November 30, 2014**.

Taking the Course

Each course module addresses an aspect of Federal taxation. You are asked to read the material and, during the course, test your comprehension of each of the learning objectives by answering self-study quiz questions. After answering each quiz question, you can evaluate your progress by comparing your answer to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied you understand the material, answer the examination questions which follow each course module. You may either record your answer choices on the printed Examination for CPE Credit Answer Sheet or by logging on to our Online Grading System.

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

After completing each course module, you can receive CPE credit by logging on to our Online Grading System at cl.thomsonreuters.com. Click the purchase link and a list of exams will appear. You may search for the exam using the acronyms QZN144, QZN145, or QZN146. The correct acronym is listed at the top of the answer sheet for each course module. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading System, please refer to the Test Instructions located at the beginning of each course module examination. If you prefer, you may continue to mail your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters Tax & Accounting for grading. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. The examination contains instructions for obtaining CPE credit. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher. Please take a few minutes to complete the **Course Evaluation** and return it to us so that we can provide you with the best possible CPE.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

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RIA's 2014 Federal Tax Review Course

OVERVIEW

COURSE DESCRIPTION: **RIA's 2014 Federal Tax Review Course Module 1** is a general refresher course in Federal taxation of individuals. It is designed to reinforce basic tax law interpretations while keeping practitioners up to date on the latest and most important changes. The course has been updated to reflect the latest in tax legislation through the American Taxpayer Act of 2012.

PUBLICATION/REVISION DATE: November 2013

RECOMMENDED FOR: Users of RIA's Federal Tax Handbook

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of federal taxation

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours.
This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

CTEC CREDIT: 8 Federal Tax Update Hours

EA CREDIT: 8 Federal Tax Law/Tax Related Matters Hours

RTRP CREDIT: 8 Federal Update Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmarked by **November 30, 2014**

KNOWLEDGE LEVEL: Update

LEARNING OBJECTIVES

After completing Course Module 1, you should be able to:

- Identify and compute key tax items, such as gross income, deductions from gross income, itemized deductions, and taxable income; and apply the special rules for determining the tax on unearned income of young individuals.

- Describe the tax treatment of compensation and investment income and identify when employee benefits are included in income and when they are excluded.

- Recognize income from other sources, including self-employment, insurance and annuities, gifts and inheritances, prizes and awards, insurance and damages, debt discharges, and expense reimbursements.

- Determine the basis of property and when gain or loss is recognized if the property is sold or exchanged.

- Discuss capital gains and losses and the netting process.

- Discuss standard and itemized deductions, the limitations associated with deductions, and exemptions and dependents under the current tax Code.

- Determine the tax benefits related to retirement contributions, medical and health savings accounts, and education expenses.

- Distinguish between refundable and nonrefundable credits.

- Apply the eligibility requirements for, and limitations on, personal tax credits.

- Demonstrate an understanding of tax withholding requirements.

- Compute required installments of estimated taxes.

- Determine a taxpayer's tax filing status and tax filing and payment responsibilities.

- List the special liability rules and relief provisions for joint return filers.

- Identify basic structural and computational elements of the alternative minimum tax.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet(s), Course Evaluation(s), and payment to:

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See the test instructions for more information.

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For information regarding refunds and compliant resolutions, dial (800) 323-8724, select the option for Customer Service, and your questions or concerns will be promptly addressed.

RIA’S 2014 FEDERAL TAX REVIEW COURSE

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MODULE 1: TAXATION OF INDIVIDUALS

I. Overview of Individual Income Tax

Learning Objective

After completing this section, you should be able to:

- Identify and compute key tax items, such as gross income, deductions from gross income, itemized deductions, and taxable income; and apply the special rules for determining the tax on unearned income of young individuals.

The Internal Revenue Code (IRC) imposes a tax liability on the taxable income of individuals. (Code Sec. 1). This income tax liability is increased for some individuals by other taxes (e.g., the self-employment tax and the alternative minimum tax), and is reduced by certain credits.

A. How Income Tax on Individuals Is Computed

To compute taxable income, an individual taxpayer first must compute gross income—generally all income from all sources. (Code Sec. 61) From gross income, the taxpayer subtracts certain deductions to reach adjusted gross income (AGI). (Code Sec. 62)

Finally, taxpayers reduce their AGI by either (1) itemizing certain deductions and claiming personal exemptions or (2) claiming the standard deduction and personal exemptions. (Code Sec. 63(a); Code Sec. 63(b)) The result is a taxpayer's taxable income.

The following items can be deducted from gross income to arrive at AGI: (Code Sec. 62)

- Trade or business expenses (other than unreimbursed employee business expenses);
- Self-employed medical insurance premiums;
- Moving expenses;
- 50% of self-employment tax;
- Amortization of reforestation expenditures;
- Amounts forfeited to a bank or savings institution for premature withdrawal of funds from a deposit account;
- Alimony and separate maintenance payments;
- Employee expenses that are reimbursed by the employer or a third party under an accountable reimbursement arrangement;
- Employee business expenses of certain performing artists and of state and local government employees compensated on a fee basis;
- Jury duty pay remitted to an employer;
- Contributions to Keogh or Simplified Employee Pension (SEP) plans for the self-employed;
- Contributions to individual retirement accounts (IRAs);
- Contributions to health savings accounts (HSAs);
- Contributions to Archer medical savings accounts (MSAs);
- The "total taxable amount" of a lump-sum distribution from a retirement plan to a participant who reached age 50 before 1986;
- Deductions in connection with property held for the production of rents or royalties;

- Depreciation and depletion deductions of a life tenant or an income beneficiary of a trust, or of an heir, legatee or devisee of an estate;
- Losses from the sale or exchange of property;
- Repayment of supplemental unemployment compensation benefits;
- Certain foreign housing costs by individuals having income earned abroad;
- Deduction for interest on qualified education loans;
- Payments for deductible higher education expenses (before 2014);
- Up to $250 of qualifying expenses of educators (before 2014);
- Certain unreimbursed travel expenses of National Guard and Reserve members; and
- Attorney fees and court costs of civil rights suits and whistleblower awards.

Caution: Expired or expiring provisions may be extended by Congress.

Itemized deductions are all allowable deductions except those subtracted from gross income in arriving at adjusted gross income (above), and except the deductions for personal exemptions. (Code Sec. 63(d)) Itemized deductions include nonbusiness deductions, such as those for medical expenses, charitable contributions, state and local income taxes, and home mortgage interest, plus employee business expenses.

Review Question 1

Which of the following is **not** claimed as a deduction from gross income to arrive at AGI?

a. Interest on a qualified education loan.

b. Home mortgage interest.

c. Contribution to an IRA.

The annual income tax liability of an individual on taxable income is computed by using either the tax rate schedules or (when taxable income is less than $100,000) the tax tables issued by the IRS. There are tax rate schedules for:

- Single persons (not married at year's end), including certain marrieds living apart. These rates are more favorable than those for marrieds filing separate returns, but less favorable than head of household and (generally) joint return rates.
- Married couples filing joint returns, and certain widows and widowers who qualify as "surviving spouses." These are often the most favorable rates.
- Heads of household. These rates are more favorable than those for single persons.
- Married persons filing separate returns—the least favorable rates. (Code Sec. 1)

Review Question 2

An individual qualifying as a "surviving spouse" uses the same tax rates as:

a. Single individuals.

b. Married taxpayers filing separately.

c. Married taxpayers filing jointly.

d. Heads of households.

For tax years beginning on or after January 1, 2013, there are seven tax brackets with rates of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.

A taxpayer's tax liability as determined above may be increased by certain taxes (e.g., self-employment tax; see VII.G.) and reduced by certain tax credits (see V.).

B. Tax on Unearned Income of Young Individuals (Kiddie Tax)

A young individual may be required to pay tax at his or her parents' highest marginal rate on the individual's unearned income over $2,000 for 2013 if that tax is higher than what the individual would otherwise pay on it. The parents can instead elect to include on their own return the individual's gross income in excess of $2,000.

This increased tax for younger individuals has traditionally been referred to as the "kiddie" tax. For tax years beginning after May 25, 2007, the kiddie tax applies to an individual who:

(1) is either (a) under age 18 or age 18 at the close of the tax year or (b) age 19 through 23 at the close of the tax year and a full-time student;

(2) has earned income for the tax year that doesn't exceed one-half of his or her support for the tax year;

(3) has at least one parent alive at the close of the year; and

(4) does not file a joint return for the tax year.

The child pays a tax equal to the greater of:

- the sum of (a) the tax that would be imposed if the taxable income of the child for the tax year were reduced by the net unearned income of the child, plus (b) the child's share of the allocable parental tax (see below) (Code Sec. 1(g)(1)(B)), or
- the tax imposed on the child without regard to (1), above (Code Sec. 1(g)(1)(A)), that is, the tax imposed on the child as a single person.

The "allocable parental tax" is the excess of: (1) the tax that would be imposed by these rules on the parent's taxable income if that income included the net unearned income of all children of the parent to whom these rules apply, over (2) the tax imposed on the parent without regard to these rules.

The "child's share" of the allocable parental tax equals the amount that bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the aggregate net unearned income of all children of the parent to whom this tax applies. (Code Sec. 1(g)(3)(B))

Net unearned income is adjusted gross unearned income reduced by the sum of the amounts determined under (1), (2) and (3), below. (Code Sec. 1(g)(4)(A); Reg §1.1(i)-1T, Q&A-6) These are:

- the amount allowable as a standard deduction for dependents, specifically $1,000 in 2013 (RIA estimate);
- the greater of (a) the amount in (1), above, or (b) the amount of the itemized deductions which are directly connected with the production of the unearned income if the child itemizes deductions;
- adjustments to income attributable to the unearned (investment) income, such as the penalty on early withdrawal of savings.

However, net unearned income for any tax year can't exceed the child's taxable income for the year. (Code Sec. 1(g)(4)(B))

As a result of the above rules, for example, the child's first $1,000 of 2013 unearned income isn't taxed at all, the next $1,000 of unearned income is taxed at the child's tax rate, and the remainder of the child's unearned income is taxed at the parent's marginal rate.

Review Question 3

An individual subject to the "kiddie" tax has $2,000 of earned income and $2,600 of unearned income for 2013. The individual is in the 10% tax bracket and the marginal tax rate of the individual's parents is 35% for 2013. The individual must pay tax at the parent's marginal rate on:

a. $4,600.
b. $2,600.
c. $1,600.
d. $600.

II. Gross Income

Learning Objectives

After completing this section, you should be able to:

- Describe the tax treatment of compensation and investment income and identify when employee benefits are included in income and when they are excluded.
- Recognize income from other sources, including self-employment, insurance and annuities, gifts and inheritances, prizes and awards, insurance and damages, debt discharges, and expense reimbursements.

Gross income consists of all income, from all sources, such as compensation for services, business income, interest, rents, dividends and gains from the sale of property. Only items specifically exempt may be excluded.

The person who earns and is entitled to receive income is taxed on it. He or she can't avoid tax on it by assigning it to another. But if a taxpayer assigns or transfers income-producing property before the income is earned, the assignee will be taxed on the income.

As a general rule, persons holding property as joint tenants (with rights of survivorship) each report one-half of the income from the property. A joint tenancy should be distinguished from a tenancy in common (without survivorship rights), in which each of the tenants-in-common is taxed on the income from his or her share.

Federal tax law recognizes the principle of community income in community property states (AZ, CA, ID, LA, NV, NM, TX, WA and WI) or countries, which treats half of community income and expenses as belonging to each spouse. Community income is all the income from community property (including business property) and salaries, etc., for the services of either or both spouses. Income from separate property during marriage is community income only in ID, LA, TX and WI. The IRS has officially acknowledged that registered domestic partners (RDPs) in the states of Nevada, Washington and California, as well as same-sex spouses in California, have full community property rights under state law that are recognized for federal tax purposes. (Clarification to Publication 555 (Rev 12-2010), Community Property—01-Mar-2011. See also Questions and Answers for Registered Domestic Partners in Community Property States and Same-Sex Spouses in California) Note: Since the publication of the IRS guidance, the state of Washington approved same-sex marriage effective December 6, 2012. The law provides for automatic conversion of domestic partnerships not involving a member age 62 or older into civil marriages unless dissolved within two years of the law's effective date.

When income must be reported depends on a taxpayer's method of accounting. A taxpayer may use one method of accounting to keep personal books and another to keep the books for his or her trade or business. But the two must be strictly separated. (Reg §1.446-1(c)(1)(iv)(b))

Various methods of tax accounting are permissible. For example, under the accrual method, income is reported in the tax year in which the right to the income becomes fixed and the amount of the income can be determined with reasonable accuracy. Under the cash method, gross income includes cash or property actually or constructively received during the tax year. Most individuals report their personal income using the cash method of accounting.

A. Compensation

Gross income includes compensation for services including: wages, salaries, fees, tips, salespersons' commissions (including commissions on sales to self or family), percentage of profits paid as compensation, commissions on insurance premiums, bonuses, termination or severance pay, "golden parachute" payments, jury duty fees and fringe benefits not excluded by statute. Pension or retirement allowances to employees generally are taxable to the recipient.

Although gifts are generally excluded from the recipient's gross income (see below), a transfer by or for an employer to or for the benefit of an employee can't be excluded as a gift. (Code Sec. 102(c)(1))

If services rendered by the taxpayer are paid for in property or services rather than money, the fair market value (FMV) of the property or services must be included in income. For example, if a vacation trip is awarded to a salesperson as a prize, the FMV of the trip is income. Where a price has been specified for the services being rendered, that price is considered the FMV of the property or services received if there's no evidence showing a different value. (Code Sec. 83; Reg §1.61-2(d))

Notes and other evidences of indebtedness received in payment for services or in settlement of a claim for compensation are taxable as compensation in the amount of their fair market value when received. When a taxpayer receives as compensation a non-interest-bearing note regarded as good for its face value at maturity, he treats as income its fair discounted value computed at the prevailing rate. As note payments are received, he includes in income that portion of each payment representing the proportionate part of the discount originally taken on the entire note. (Reg §1.61-2(d)(4))

Where an employer pays the debts or personal expenses of an employee, or reimburses the employee's payment, the employee must include the employer's payment or reimbursement in his or her income. There are some exceptions, such as medical expense reimbursements (see II.B.1.).

The amount of wages, salaries, tips, etc., that's includible in income is shown on a Form W-2 issued by the employer and is reported on the employee's return.

Review Question 4

Which of the following is **not** treated as compensation includible in an employee's gross income?

a. Tips from customers.

b. Commissions on sales to family members.

c. A $100 gift received from the employer as a "thank you" for exceptional services.

d. Medical expense reimbursements.

1. Restricted Property

A person receiving a beneficial interest in stock or other property for his or her services has compensation income equal to the value of that property at the time of receipt. But if the interest in the property is subject to substantial risk of forfeiture (is "restricted") and can't be transferred free of that risk, then income is deferred until the interest in the property either: (1) is no longer subject to that risk, or (2) becomes transferable free of the risk, whichever occurs earlier. (Code Sec. 83) But the employee (or other owner of the property) has income if he sells or disposes of the property before (1) or (2). (Code Sec. 83(a))

The amount included in income (in the year in which (1) or (2) above occurs) is the excess of: the fair market value of the property in that year (figured without regard to restrictions other than those that by their terms will never lapse), over the amount, if any, paid for the property. (Code Sec. 83(a))

A "substantial risk of forfeiture" exists if a person's rights to full enjoyment of the property are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any individual. (Code Sec. 83(c)(1); Reg §1.83-3(c)(1))

An employee who receives restricted stock or other property may elect to recognize the income immediately instead of deferring it. (Code Sec. 83(b)(1)).

2. Incentive Stock Options

If an employer corporation grants an employee an option to buy stock in the corporation and certain requirements are met, then the option is considered an incentive stock option (ISO). There are no regular income tax consequences when an ISO is granted or exercised; the employee has capital gain when the stock is sold at a gain. (Code Sec. 421(a)) To qualify for this favorable tax treatment, stock acquired through the exercise of an ISO can't be disposed of within two years after the option is granted or one year after the stock is transferred to the employee. (Code Sec. 422(a)(1)) Also, for the entire time from the date an ISO is granted until three months (one year in case of total and permanent disability) before its exercise, the option holder must be an employee of the option grantor. (Code Sec. 422(a)(2))

3. Nonstatutory Stock Options

If an employee receives a stock option from an employer corporation that does not meet ISO requirements (above), then the employee has compensation income. (Code Sec. 83) If the option has a readily ascertainable fair market value (FMV) at grant, it's subject to the restricted property rules (see II.A.1.) when the option is granted. (Code Sec. 83; Reg §1.83-7(a))

An option "ordinarily" has a readily ascertainable FMV only if it (or a substantially identical option) is actively traded on an established market. If not so traded, it has value only if certain conditions exist. (Reg §1.83-7(b))

If the option doesn't have a readily ascertainable FMV when granted, the employee doesn't realize compensation until the optioned stock is transferred at exercise. The amount of compensation is the FMV of the stock at transfer less any amount paid for the stock. (Reg §1.83-7(a))

4. Below-market Loans

An employee who receives a "below-market" compensation-related loan (except certain *de minimis* loans) generally recognizes compensation income. The amount of the income is equal to:

- on a compensation-related demand loan, the forgone interest (interest at the IRS-specified "applicable federal rate" over actual interest payable), and
- on any other compensation-related loan, the excess of the amount borrowed over the present value of all payments required to be made under the terms of the loan. (Code Sec. 7872(a)(1); Code Sec. 7872(b)(1))

B. Employee Benefits

A benefit provided to any person in connection with the performance of services is generally treated as compensation for those services. Unless it's specifically excluded, the benefit is includible in the gross income of the person performing the services, even if it's furnished to someone else.

Some employee benefits are excludable from an employee's income if the benefit plan meets certain requirements. For a discussion of these plan requirements, see Module 3, Specialized Tax Issues.

1. Health and Accident Plans

An employee can exclude from gross income amounts received from his or her employer, directly or indirectly, as reimbursement for expenses for the medical care of the employee and his or her spouse and dependents. However, reimbursement is includible in the employee's income to the extent it exceeds medical expenses or it's attributable to medical expense deductions taken in a previous year. (Code Sec. 105(b); Reg §1.105-2) Special rules apply to self-insured medical reimbursement plans that discriminate in favor of highly compensated employees, see Module 3, Specialized Tax Issues.

An employee also excludes from gross income the cost (i.e., premiums paid) of employer-provided coverage under an accident or health plan. (Code Sec. 106) However, if the employer-provided policy, trust, etc., provides other benefits, only the portion of the employer contributions for the accident and health coverage is excludable. (Reg §1.106-1)

Traditionally, the exclusions from gross income for employer-provided accident and health coverage and medical expense reimbursements have applied only to qualifying child and qualifying relative dependents as defined in Code Section 152 (i.e., children under age 19 or children under age 24 who are full-time students and other individuals who meet gross income and support tests). However, a provision added by the 2010 Health Care Act (P.L. 111-148 as amended by P.L. 111-152) requires health plans that provide dependent coverage to make that coverage available to an employee's adult child until the child reaches age 26. (Code Sec. 9815). A corresponding change extends the exclusion for reimbursements for medical care to any child who has not reached age 27 as of the end of the tax year. (Code Sec. 105(b)) This change also applies to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such child. (Notice 2010-38, 2010-20 I.R.B. 682)

Lump sum or installment amounts received under an employer's plan as payment for permanent loss or loss of use of a member or function of the body, or permanent disfigurement, of the employee, his spouse or his dependent are tax-free, but only if the payment is based on the nature of the injury without regard to the period the employee is absent from work. (Code Sec. 105(c))

Amounts received under a workers' compensation act or similar law for personal injuries or sickness are excludable from the employee's (or survivor's) income. But worker's compensation is includible in income to the extent it's attributable to medical expense deductions taken in an earlier year. (Code Sec. 104(a)(1); Reg §1.104-1(b))

2. Qualified Retirement Plans

Employer contributions to a qualified retirement plan are (within limits) excludable from an employee's income.

Distributions from a qualified retirement plan (reported to recipients on Form 1099-R) generally are taxed to the employee in the year distributed or otherwise made available to the employee. (Code Sec. 402(a); Reg §1.402(a)-1(a)).

A retirement plan distribution is not taxable when received if it is an eligible "rollover" distribution and the employee then transfers the benefit to an eligible retirement plan. (Code Sec. 402(c)(1)) A distribution must be rolled over within 60 days after receipt to be tax-free, but IRS may waive the 60-day rollover period for equitable reasons, including cases of casualty, disaster, or other events beyond an individual's control. (Code Sec. 402(c)(3); Code Sec. 408(d)(3))

For a discussion of qualified retirement plans, see Module 3, Specialized Tax Issues.

3. Meals and Lodging

Meals or lodging (including utilities) furnished to an employee and his family (spouse and dependents) is nontaxable to the employee if (Code Sec. 119):

- meals and lodging are furnished by or on behalf of the employer for the convenience of the employer (e.g., meals supplied because eating places near work are scarce, or because employees must for valid business reasons remain on-premises until their shifts end) (Reg §1.119-1(a)(2)), and
- in the case of meals, they are furnished on the employer's business premises, or in the case of lodging, the employee is required to accept the lodging as a condition of his employment (i.e., to properly perform his duties). (Reg §1.119-1(b))

The value (not the cost) of meals or lodging that fails to meet these tests generally is income to the employee. (Reg §1.61-2(d)(3); Reg §1.119-1(a)(1))

4. Split-dollar Life Insurance

Under a "split-dollar" insurance arrangement, the employer pays part of the premium for a life insurance policy on the life of the employee (to the extent of the annual increase in cash surrender value) and the employee pays the rest. Out of the insurance proceeds, the employer gets either the cash surrender value or the amount it paid; the employee can designate the beneficiary of the balance.

For arrangements entered into (or materially modified) after September 17, 2003, there are two mutually exclusive regimes for taxing split-dollar life insurance arrangements. Both the policy owner and the nonowner account for all amounts under the split-dollar life insurance arrangement under one of the following:

- *Economic benefit regime*—the policy owner is treated as providing economic benefits to the nonowner. This regime governs the taxation of what are known as endorsement split-dollar arrangements (e.g., employer owns the policy and employee's rights are derived from the employer's endorsement in the contract of those rights to him). This regime automatically applies if the arrangement is entered into in connection with the performance of services, and the employee or other service provider is not the contract owner. (Reg §1.61-22)

- *Loan regime*—the non-owner of the life insurance contract is treated as loaning premium payments to the contract owner. The loan regime governs what are known as collateral assignment split-dollar life insurance arrangements (e.g., employee owns the policy, which is used as collateral for employer's right to recover the premiums it pays). (Reg §1.7872-15)

Substantially different tax consequences result depending on which party owns the life insurance contract. The employer is treated as the owner of a split-dollar life insurance contract if the only economic benefit that the employee has under the arrangement is current life insurance protection. (Reg §1.61-22(c)(1))

In a split-dollar life insurance arrangement taxed under the economic benefit regime, the policy owner (e.g., employer) is treated as providing economic benefits to the non-owner (e.g., employee), and those benefits have to be accounted for fully and consistently by both the owner and the non-owner. The value of the economic benefits, less any consideration paid by the non-owner, is treated as transferred from the owner to the non-owner. Thus, where an employer is the owner and the employee the non-owner, the economic benefits are treated as compensation. (Reg §1.61-22(d)(1))

A payment made under a split-dollar life insurance arrangement is a split-dollar loan, and the policy owner and non-owner are treated, respectively, as borrower and lender, if: the payment is made directly or indirectly by the non-owner to the owner; the payment either is a loan under general tax law principles or if a reasonable person would expect the payment to be repaid in full to the non-owner; and repayment is to be made from, or secured by, the policy's death benefit or cash surrender value, or both. (Reg §1.7872-15(a)(2))

5. Group Term Life Insurance

An employee isn't taxed on premiums paid by the employer for insurance covering the employee's life under a qualifying group-term life insurance policy if the employee's total coverage under all such plans of all his employers doesn't exceed $50,000. If total coverage does exceed $50,000, the employee is taxed on the "cost" of coverage over $50,000 minus the amount he paid. (Code Sec. 79(a))

The employer must compute the "cost" of taxable group-term coverage and notify the employee on Form W-2 of the amount included in his or her income. The cost of group-term life insurance is determined on the basis of uniform premiums (computed on the basis of five-year age brackets) prescribed by IRS. (Code Sec. 79(c))

Review Question 5

A taxpayer who receives $60,000 of employer-provided group term life insurance coverage must include the cost of ___________ of insurance in gross income.

a. $0. b. $10,000.

c. $50,000. d. $60,000.

6. Dependent Care Assistance

Payments incurred by an employer for dependent care assistance under a qualifying plan are excluded from an employee's gross income. (Code Sec. 129(a)(1))

The amount an employee can exclude (computed on Form 2441 with Form 1040 or Form 1040A) can't exceed the employee's earned income (excluding employer dependent care assistance payments) or, for married employees, the earned income of the lower earning spouse. (Code Sec. 129(b)) The aggregate exclusion is further limited to $5,000 ($2,500 for a married individual filing separately). (Code Sec. 129(a)(2)(A))

Review Question 6

An employee receives $6,000 of dependent care assistance from his employer's qualifying plan. On the joint return he files with his wife, he reports $30,000 of earnings from his job and $4,000 of earnings from his wife's part-time employment. How much of the dependent care assistance is taxable to the employee?

a. $0. b. $1,000.

c. $2,000. d. $6,000.

7. Education Assistance

An employee's gross income doesn't include amounts paid or expenses incurred by the employer for educational assistance to the employee under an employer's qualified educational assistance program.

(Code Sec. 127(a)(1)) The maximum amount of educational assistance that an employee can receive tax free under an educational assistance plan during any calendar year is $5,250. The education received need not be job-related. (Code Sec. 127(a)(2)) The exclusion does not cover meals, lodging, and transportation (Code Sec. 127(c)(7)).

Expenses paid by an employer for education or training provided to the employee that aren't excludable under this provision can only be excluded from income if they qualify as a working condition fringe benefit (see II.B.9.) (Code Sec. 132(j)(8)).

8. Adoption Assistance

An employee may exclude amounts paid or expenses incurred by his employer for qualified adoption expenses connected with the employee's adoption of a child, if the amounts are furnished under an adoption assistance program in existence (and known to the employee) before the expenses are incurred. For 2013, the maximum exclusion for employer-provided adoption assistance is $12,970 per child (for both non-special needs and special needs adoptions). (Code Sec. 137) The dollar limit applies to the adoption of each child and is cumulative over all tax years (rather than an annual limit). In the case of an adoption of a child with special needs, the exclusion applies regardless of whether the employee has qualified adoption expenses. (Code Sec. 137(a); Code Sec. 137(b); Code Sec. 137(f))

The excludable amount is phased out for taxpayers with adjusted gross income (AGI, as specially computed) over a threshold amount. (Code Sec. 137(b)(2), Code Sec. 137(f)) For tax years beginning in 2013, the phase-out range is $194,580 to $234,580.

Review Question 7

In 2013, an employee receives $14,000 of adoption assistance from her employer in connection with her adoption of a child with special needs. The employee's AGI for 2013 is $100,000. She incurs a total of $6,000 of qualified expenses in connection with the adoption. How much of the adoption assistance is excludable from the employee's income for 2013?

a. $14,000.
b. $12,970.
c. $6,000.
d. $0.

9. Fringe Benefits

Fringe benefits received by an employee are taxable unless specifically excluded. A fringe benefit isn't included in gross income if it's excluded under a specific Code Section (e.g., education assistance, group term life insurance; see above) (Code Sec. 61(a)), or it qualifies as one of the following: (Code Sec. 132(a)):

- *No additional cost service.* These are services provided by an employer to an employee for personal use by the employee, his spouse or dependent children, if (1) the services are ordinarily offered for sale to nonemployee customers in the ordinary course of the line of business in which the employee works, (2) the employer incurs no substantial additional cost (including foregone revenue) in providing the services to the employee—computed without regard to any amounts paid by the employee for the services (Code Sec. 132(b)), and (3) special nondiscrimination rules are satisfied. (Code Sec. 132(j)(1))
- *Qualified employee discount.* A "qualified employee discount" is an employee discount allowed with respect to qualified property or services provided by an employer to an employee, his spouse or dependent children, to the extent the discount doesn't exceed certain limits. The excludable amount of a qualified employee discount for property is limited to the gross profit percentage of the price at which that property is offered by the employer to customers. (Code Sec. 132(c)(1)(A)) The excludable amount for services is limited to 20% of the price at which the employer offers the service to nonemployee customers. (Code Sec. 132(c)(1)(B); Code Sec. 132(k))

- *Working condition fringe.* A working condition fringe is any property or services provided to an employee by the employer to the extent the cost of the property or services would have been deductible by the employee as a business expense or through depreciation if the employee had paid for the property or services personally. (Code Sec. 132(d)) Examples are: employer-paid business travel and the use of employer-provided vehicles for business purposes. An employee's business use of an employer-provided cellular phone will be treated as a working condition fringe benefit if the phone is provided to the employee primarily for noncompensatory business reasons (e.g., to enable the employer to contact the employee for emergencies, to enable the employee to speak with clients when away from the office, or to enable the employee to contact clients in other time zones outside of normal business hours). Moreover, if that requirement is met, the employee's personal use of the phone will be considered a *de minimis* fringe benefit (see below). (Notice 2011-72, 2001-38 I.R,B. 407)

- *De minimis fringe.* A *de minimis* fringe is any property or service whose value is so small that accounting for it is unreasonable or administratively impracticable, taking into account the frequency with which similar fringe benefits are provided by the employer to its employees. (Code Sec.132(e)(1)) Examples of *de minimis* fringes include: occasional meals, supper money, or local transportation provided because of overtime work. (Reg §1.132-6(d)(2))

- *Qualified transportation fringe.* These benefits include qualified van pooling, transit passes, parking at or near the employer's business premises, and qualified bicycle commuting reimbursements (Code Sec. 132(a)(5); Code Sec. 132(f)). For purposes of determining the amount that is excludable from gross income, vanpooling and transit passes are treated as a single benefit, while qualified parking is treated as a separate benefit. As a general rule, the monthly limit for transit passes and/ vanpool benefits is set at $100 (indexed) while the exclusion for qualified parking is $175 (indexed). However, for months beginning on or after February 17, 2009 and through December 2013, the higher limit applies to both types of benefit. (Code Sec. 132(f)(2)) For 2013, the limits for qualified parking and for transit passes and/or transportation in a commuter highway are both set at $245 per month. A qualified bicycle commuting reimbursement for any year is any reimbursement made during the 15-month period beginning with the first day of the year for reasonable expenses incurred by an employee for the purchase and repair of a bicycle, bicycle improvements, and bicycle storage. The maximum annual exclusion is equal to $20 multiplied by the number of the employee's qualified bicycle commuting months for the year. A qualified bicycle commuting month means any month during which (1) the employee does not receive any other qualified transportation fringe benefit and (2) the employee regularly uses a bicycle for a substantial portion of travel between the employee's residence and place of employment. (Code Sec. 132(f)(2)(C); Code Sec. 132(f)(5)(F))

- *Qualified moving expense reimbursement.* A qualified moving expense reimbursement is any amount received (directly or indirectly) by the taxpayer from an employer as a payment of (or reimbursement for) moving expenses that would have been deductible had the taxpayer paid them directly (for employee's moving expense deduction, see IV.Q.). (Code Sec. 132(a)(6))

- *Employer-provided retirement advice.* These are any retirement planning services provided to an employee and his spouse by an employer maintaining a qualified employer plan (as defined in Code Sec. 219(g)(5)). (Code Sec. 132(m))

Caution: Expired or expiring provisions may be extended by Congress.

An employee who is taxed on a fringe benefit must include in gross income the fair market value (FMV) of the benefit minus: (1) any payment for the benefit, and (2) any amount specifically excluded by a Code provision. (Reg §1.61-21(b)(1)) The FMV of a fringe benefit generally is the amount that an individual would have to pay for the particular benefit in an arm's-length transaction. (Reg §1.61-21(b)(2)) Unless a special valuation rule applies, an employer-provided vehicle is valued at the comparable lease cost (Reg §1.61-21(b)(4)), and flights on an employer-provided aircraft at comparable charter or lease cost. (Reg §1.61-21(b)(6); Reg §1.61-21(b)(7))

Special valuation rules may be used under certain circumstances for certain commonly provided fringe benefits (e.g., automobiles, noncommercial flights, commuting). (Reg §1.61-21(b); Reg §1.61-21(c)(1), (c)(3)) Where the special rules aren't used, either by choice or because they aren't permitted, or where they're improperly applied, the value of the fringe benefit must be determined under the general valuation principles above. (Reg §1.61-21(c)(5))

An employee can't use a special valuation rule to value a fringe benefit unless the employer uses the same rule to value it. (Reg §1.61-21(c)(2))

Review Question 8

An employee of a law firm hires the firm to handle a personal legal matter. The employee is charged only $2,500 for the services, although the firm would normally charge a nonemployee $4,000 for the same services. How much must the employee include in gross income due to the employee discount?

a. $0.

b. $700.

c. $1,500.

C. Investment Income

1. Dividend income

When a corporation distributes its earnings to its shareholders, the distribution is usually a dividend. Dividends are taxed to noncorporate shareholders at the rates that apply to net capital gain if they consititute "qualified dividend income." (Code Sec. 11(h)(11)) Thus, for 2013 and later years, the rates are 0% for dividends falling below the 25% bracket, 15% for dividends in the 25%, 28%, 33% or 35% brackets; and 20% for dividends in the 39.6% bracket (see III.C.3.).Dividends that do not qualify are taxed at ordinary income rates, to the extent the distributing corporation has earnings and profits. (Code Sec. 301(c)(1)) The part of a distribution in excess of E&P is treated as a tax-free return of capital and is applied against (reduces) the shareholder's basis in the stock. (Code Sec. 301(c)(2)) Any remaining excess (once basis is reduced to zero) is treated as payment for the stock, i.e., as capital gain if the stock is a capital asset in the shareholder's hands. (Code Sec. 301(c)(3))

Review Question 9

An individual in the 35% regular tax bracket receives qualified dividend income of $1,000. How much tax will he owe on the dividend income?

a. $50.

b. $150.

c. $280.

d. $350.

For tax purposes, a dividend is a distribution of property by a corporation to its shareholders with respect to its stock, out of accumulated or current earnings and profits. (Code Sec. 316(a)) The distribution must be made in the ordinary course of the corporation's business, but it may be extraordinary in amount. (Reg §1.316-1(a)(1)) A dividend needn't be proportionate and needn't be formally declared.

"Property" includes money, securities and any other property (except the corporation's own stock or rights to that stock). (Code Sec. 317(a)) Property also includes any economic benefit the corporation gives its shareholders, in whatever form (Reg §1.317-1), e.g., paying their debts.

For dividends received after 2002 and before 2013, "qualified dividend income" is dividend income received from domestic corporations and qualified foreign corporations (U.S. possession corporations and corporations eligible for benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program, but not foreign personal holding companies, foreign investment companies, or passive foreign investment companies). (Code Sec. 1(h)(11)(B)(i)) Dividends paid by other foreign corporations also are qualified if paid on stock or ADRs readily tradable on an established U.S. securities market. (Code Sec. 1(h)(11)(C))

Qualified dividend income does not include: (1) dividends paid on stock unless the stock has been held for more than 60 days during the 121 day period beginning 60 days before the ex-dividend date (more than 90 days during the 181 day period beginning 90 days before the ex-dividend date for preferred stock dividends attributable to a period of more than 366 days) (Code Sec. 1(h)(11)(B)(iii)(I)); (2) dividends on stock to the extent that the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property (Code Sec. 1(h)(11)(B)(iii)(II)); (3) any amount that the taxpayer elects to treat as investment income to support an investment interest deduction (Code Sec. 1(h)(11)(D)(i)); (4) dividends from certain corporations that for the distribution year or the preceding year are exempt from tax; (5) dividends deductible by mutual savings banks (Code Sec. 1(h)(11)(B)(ii)(II)); and (6) deductible dividends paid on employer securities owned by an employee stock ownership plan (ESOP). (Code Sec. 1(h)(11)(B)(ii)(III))

With certain exceptions, a stock dividend—i.e., a corporation's distribution of its own stock, or rights (e.g., options or warrants) to buy its stock, that's made to shareholders with respect to their stock (i.e., not as compensation)—isn't taxable to the shareholder. (Code Sec. 305) But a corporation's distribution of stock, or rights to buy stock, in another corporation (even if affiliated) is a regular dividend in kind, taxed under the general rules.

Dividends are taxable in the year received or unqualifiedly made subject to the shareholder's demand. This applies to both cash and accrual shareholders. Thus, if a corporation pays a dividend on December 30 of one year, and the shareholder receives the check on January 2 of the following year, the shareholder reports it on the earlier year's return. (Reg §1.301-1(b))

2. Interest Income

Unless specifically exempt, any interest received by or credited to a taxpayer is taxable as ordinary income. (Code Sec. 61(a)(4); Reg §1.61-7(a))

For tax purposes, interest is the price paid for the use of another's money or for the right to defer payment of money owed to another, regardless of the form of the transaction. Interest generally includes the FMV of gifts or services received for opening or adding to accounts in financial institutions, but does not include a *de minimis* premium (for a deposit of less than $5,000, the premium costs the bank $10 or less; for a deposit of $5,000 or more, it costs $20 or less).

To be interest, generally a payment must be made with respect to a bona fide debt. But other "interest" payments imposed by law, e.g., on judgments, tax refunds, installment sales, etc., are also interest.

For certain deferred payment or installment sales where the sales contract fails to provide for interest at a minimum rate specified by the Code or by IRS, part of the payments received is treated as interest ("unstated interest") that's taxable to the seller despite any contrary intention of the parties. (Code Sec. 483).

If a debt instrument is acquired from an issuer for an amount less than what the issuer will have to pay the holder when the instrument matures, the difference is "original issue discount" (OID). The holder of the instrument must report part of the OID as interest income in each tax year the debt instrument is held even though the OID won't be paid until maturity. (Code Sec. 1272)

The OID current inclusion rules apply to all debt instruments issued with OID (Code Sec. 1272) *other than:*

- Tax-exempt obligations (see below). (Code Sec. 1272(a)(2)(A); Code Sec. 1286(d))
- U.S. savings bonds. (Code Sec. 1272(a)(2)(B))
- Short-term obligations (i.e., with a fixed maturity date not more than one year from the date of issue). (Code Sec. 1272(a)(2)(C))
- Debt instruments issued by natural persons before March 2, 1984. (Code Sec. 1272(a)(2)(D))
- Certain nonbusiness loans of $10,000 or less between natural persons. (Code Sec. 1272(a)(2)(E))

Gain on the disposition of a “market discount bond” is ordinary income to the extent of the accrued market discount on the bond (Code Sec. 1276(a)(1)) (unless the holder elects to include the discount currently). This ordinary income is treated as interest income, with exceptions. (Code Sec. 1276(a)(4)) Market discount bonds are any bonds having a market discount other than short-term obligations (one year or less), tax-exempt obligations bought before May, 1, 1993, U.S. savings bonds and certain installment obligations. (Code Sec. 1278(a)(1)(A); Code Sec. 1278(a)(1)(B))

Interest on state and local bonds (i.e., obligations of a state, the District of Columbia, a U.S. possession, certain Indian tribal governments or any political subdivision of the foregoing) is exempt from federal income tax (Code Sec. 103(a), (c); Code Sec. 7871(a)(4)) (with certain exceptions).

Taxpayers using the cash method of accounting (most individuals) report interest in the tax year it’s actually or constructively received (except OID), regardless of when the interest is accrued on the debtor’s books. Generally, interest isn’t constructively received if the taxpayer’s control of its receipt is subject to substantial limits or restrictions. Accrual method taxpayers report interest in the tax year in which the right to receive the interest becomes fixed, regardless of when it is received.

3. Rents and Royalties

Rents are includible in gross income, whether paid in cash or property. (Code Sec. 61(a)(5); Reg §1.61-1(a)) If paid in property, the property’s fair market value (at receipt) is the amount taxed as rent.

Rents are reported by cash basis taxpayers when received, and by accrual basis taxpayers when due unless they’re considered uncollectible.

An advance rental is currently taxable (Reg §1.61-8(b)), even if it’s refundable or can be applied against the purchase price. But a security deposit isn’t taxable rent.

A bonus or extra payment by a tenant to the lessor or sublessor on the execution of the lease is taxable as rent to the lessor or sublessor. If the tenant pays the landlord for permission to cancel the lease, the payments are rent to the landlord (whether cash or accrual basis) in the year received. (Reg §1.61-8(a)) Payments to the landlord for modifying a lease or consenting to a sublease are also considered rent.

Royalties (payments received for the use of copyrights, patents, trademarks, secret processes and similar intangibles, and for the right to exploit mineral or other natural resources) are taxable as ordinary income (Code Sec. 61(a)(6)). This is true regardless of the name given to them by the parties or the form of payment (e.g., lump sum or property such as stock).

Royalties are included by cash basis taxpayers on receipt (actual or constructive), and by accrual basis taxpayers when their rights to them are fixed.

D. Social Security and Unemployment Benefits

Social security benefits may be partly taxable. Unemployment benefits are fully taxable.

1. Social Security Benefits

Whether, and to what extent, social security benefits are taxable depends on the taxpayer’s income level. A portion of social security benefits is taxed if provisional income—the sum of “modified adjusted gross income” of the recipient plus one-half of the social security benefits received—exceeds certain base amounts. The part that can be taxed is up to 50% of the benefits. This is known as the Tier 1 tax. If the taxpayer’s provisional income is more than a second, higher set, of base amounts, then up to 85% of the benefits are includible in gross income. This is the Tier II tax. (Code Sec. 86).

“Modified AGI” means AGI: (1) determined without regard to the social security benefits; the deduction for qualified education loan interest; the deduction for higher-education expenses; the exclusions for foreign earned income and housing costs, savings bond proceeds used for education expenses, employer-provided adoption assistance, and income from sources within U.S. possessions and Puerto Rico, and (2) increased by the amount of tax-exempt interest received or accrued by taxpayer during the tax year. (Code Sec. 86(b)(2))

Tier I: If provisional income exceeds a "base amount," the taxpayer includes in gross income the lesser of:

- 50% of the social security benefits received that year; (Code Sec. 86(a)(1)(A)); or
- 50% of the excess of provisional income over the "base amount." (Code Sec. 86(a)(1)(B))

The "base amount" is $32,000 for married individuals filing a joint return; zero for a married individual filing a separate return who doesn't live apart from his spouse for the entire tax year; and $25,000 for all other individuals (Code Sec. 86(c)(1)), such as those filing as single, head of household or qualifying widow(er).

Tier II: If provisional income exceeds an "adjusted base amount," the taxpayer includes in gross income the lesser of:

- 85% of the social security benefits received that year; or
- the sum of: (a) the amount included under the above 50% rule or, if less, one-half of the difference between taxpayer's "adjusted base amount" and "base amount," plus (b) 85% of the excess of provisional income over the "adjusted base amount." (Code Sec. 86(a)(2))

The "adjusted base amount" is $44,000 for married individuals filing jointly; zero for a married individual filing separately who doesn't live apart from his spouse for the entire tax year); and $34,000 for all other individuals. (Code Sec. 86(c)(2))

Review Question 10

The maximum percentage of social security benefits subject to tax is:

a. 0%. b. 50%.

c. 85%. d. 100%.

2. Unemployment Benefits

Unemployment compensation (reported to recipients on Form 1099-G) is fully taxable. (Code Sec. 85(a)) Unemployment compensation includes any amount received under a law of the U.S. or a state that's in the nature of unemployment compensation. (Code Sec. 85(b)) It also includes disability benefits paid under federal or state law as a substitute for unemployment benefits to those who are ineligible for unemployment benefits because they're disabled.

E. Self-employment Income

Income (or loss) from a business operated, or a profession practiced, as a sole proprietor is reported on Form 1040, Schedule C or C-EZ. If an individual operates more than one business as a sole proprietor, a separate Schedule C or C-EZ must be prepared for each business. An individual can't report his income on Schedule C or C-EZ if he earns it as an "employee."

Self-employed professional persons such as accountants, lawyers, doctors, and authors receive gross income in the form of fees or royalties. The amount of this income is taxable.

In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. (Reg §1.61-3(a))

Cost of goods sold doesn't include selling expenses, losses, or any other items not ordinarily used in the computation of the cost of goods sold. (Reg §1.61-3(a))

The cost of goods sold is determined in accordance with the method of accounting consistently used by the taxpayer. (Reg §1.61-3(a))

In order to determine the cost of goods sold and the gross profit on sales where the production, purchase, or sale of merchandise is an income-producing factor it is necessary to take inventories of goods on hand at the beginning and end of each tax year.

Cost of goods sold is to be differentiated from the statutory deduction under Code Sec. 162 for business expenses (see IV.P.). Under Code Sec. 162, business expenses that are ordinary and necessary expenditures connected with the taxpayer's trade or business are deductible from gross income. On the other hand, the cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (Reg §1.162-1(a))

For a more detailed discussion of business income, see Module 2, *Taxation of Businesses.*

F. Other Income

1. Life Insurance

Amounts received under a "life insurance contract" that are paid by reason of the insured's death aren't included in the gross income of the recipient (i.e., beneficiary) (Code Sec. 101(a)) (unless the policy was transferred for value). The exclusion applies to lump sum payments made at the time of the insured's death, and to amounts paid later to the extent the payment doesn't exceed the amount payable at death. (Reg §1.101-1(a)(1))

To qualify as a life insurance contract, a contract must be a life insurance (or endowment) contract under local law and satisfy either (a) a cash value accumulation test, or (b) a combined guideline premium requirement/cash value corridor test. (Code Sec. 101(f); Code Sec. 7702(a); Code Sec. 7702(h))

For life insurance contracts that don't qualify, the exclusion is limited to the excess of the death benefits over the contract's net surrender value (i.e., value on surrender). (Code Sec. 7702(g)(2)) The net surrender value is treated as an annuity payment (see II.F.2.). Also, the owner of the contract is taxed (in the year it fails to qualify) on the income earned on it. This income equals the excess, for the year, of: (1) the sum of the net surrender value increase plus the cost of life insurance protection provided, over (2) premiums paid. (Code Sec. 7702(g)(1)(B))

If a life insurance contract is transferred for valuable consideration, e.g., by sale, during the insured's lifetime, the transferee's exclusion for the life insurance proceeds received by reason of the insured's death is limited to the value of the consideration paid for the contract, plus the net premiums and other amounts paid later. (Code Sec. 101(a)(2))

Payments made under life insurance or endowment contracts before the death of the insured (e.g., loans, refunds, dividends) generally are treated as amounts "not received" under an annuity contract (see II.F.2.). (Code Sec. 72(a))

2. Annuity Payments

If a payment under an annuity, life insurance or endowment contract is received "as an annuity" (i.e., a sum of money (or property) payable at regular intervals over a period of more than one full year from the starting date) (Reg §1.72-2(b)), all or part of it may be tax-free. The part of each "annuity" payment that represents return of investment (e.g., premiums paid) is excludable from the recipient's income until the entire investment is recovered. Excess receipts are fully taxable. (Code Sec. 72(b)(1); Reg §1.72-4(a))

The excludable portion is computed by multiplying each payment received by an "exclusion ratio." The exclusion ratio is determined by dividing the investment in the contract by the contract's expected return as of the annuity starting date, and rounding to the nearest tenth. (Code Sec. 72(b); Reg §1.72-4(a)) But the excludable portion of any payment can't exceed the amount of investment in the contract that is unrecovered immediately before the payment is received. (Code Sec. 72(b)(2))

Once computed, the exclusion ratio is applied to each "annuity" payment received under the contract, until the total investment has been recovered tax-free. (Code Sec. 72(b); Reg §1.72-4(a)) But the ratio must be recomputed if the contract is transferred for valuable consideration, matures, is surrendered, or is exchanged. (Reg §1.72-4(a)(4))

If there was no investment in the contract, all payments are taxable in full. If investment exceeds total expected return, all payments are tax-free. (Reg §1.72-4(d)) Where the annuitant's death causes the annuity payments to stop, the amount of any investment in the contract that the annuitant hasn't yet recovered tax free may be deducted on his final income tax return. (Code Sec. 72(b)(3)(A))

For annuity rule purposes, the "expected return from the contract" is the total amount to be received (or estimated to be received) under the contract. It is computed as of the annuity starting date (Code Sec. 72(b)(1)) and doesn't take into account any amount for dividends or other payments not received as an annuity. (Code Sec. 72(c)(3); Reg §1.72-7(a))

Payments under life insurance, endowment and annuity contracts that aren't "annuities" (e.g., cash withdrawals, loans, dividends, etc.) are fully taxable if received on or after the annuity starting date. (Code Sec. 72(e)(2)(A); Code Sec. 72(e)(3)(A))

"Nonannuity" amounts received before the annuity starting date are: (1) not taxable, to the extent that, as of the date of distribution, they don't exceed the cost of the contract (i.e., accumulated net premiums paid) and (2) taxable, to the extent allocable to income (i.e., excess of the contract's cash value over the owner's investment) at that time. (Code Sec. 72(e)(2)(B); Code Sec. 72(e)(3)(B))

Review Question 11

A taxpayer invests $50,000 in an annuity with a total expected return of $150,000. If the first payment the taxpayer receives from the annuity is $3,000, how much of the payment is excludable from gross income?

a. $0.

b. $1,000.

c. $2,000.

d. $3,000.

3. Gifts and Inheritances

Gifts, bequests, devises and inheritances are excluded from income tax, regardless of the value involved. But this exclusion applies only to the property received—not to the income produced by the gift property thereafter. The term "property" to which the exemption relates includes money; it does not include future earnings or a gift of the income itself. Also the gift rule does not exclude from gross income amounts transferred by or for an employer, to or for the benefit of an employee (see II.F.4).

As a general rule, the income from gift property is taxable to the person receiving the gift (the donee). But if a gift is determined to be colorable (i.e., not really a gift), the income from the property will be taxable to the purported donor. The distinction between valid and colorable gifts is a question of fact and has been the subject of much litigation.

4. Prizes and Awards

Prizes and awards are generally includible in gross income (Code Sec. 74(a); Reg §1.74-1(b)) unless: the prize is primarily for religious, charitable, scientific, educational, artistic, literary, etc., achievement; the recipient was selected without any action on his part, and thus isn't required to render substantial future services; and the prize is transferred by the payor to a governmental unit or charity the recipient designated. (Code Sec. 74(b))

For a prize paid in property or services, the taxable amount is the prize's current fair market (resale) value. (Reg §1.74-1(a)(2))

Employee achievement awards are excludable only to the extent the employer can deduct the cost of the award—generally limited to $400 for any one employee, or $1,600 for a qualified plan award. For a discussion of employee achievement awards, see Module 2, Taxation of Businesses.

A scholarship or fellowship isn't taxable, to the extent it's a "qualified scholarship" granted to a degree candidate at an educational organization. (Code Sec. 117(a), (c)) A "qualified scholarship" is any amount received as a scholarship and used for tuition and fees required for enrollment at an educational organization, and for required fees, books, supplies and equipment. (Code Sec. 117(b)(2)) An "educational organization" is one that normally maintains a regular faculty, curriculum and regularly enrolled student body in attendance. (Code Sec. 117(b)(2)(A)) The exclusions for qualified scholarships doesn't apply to any amount received that represents payment for teaching, research or other services performed by the student as a condition for receiving the qualified benefit. (Code Sec. 117(c)(1))

5. Accident and Health Insurance

Amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness are generally excluded from income, except to the extent attributable to medical expenses that were deducted in a previous year. This exclusion doesn't apply to amounts received by an employee to the extent the amounts are (1) attributable to employer contributions that weren't includible in the employee's gross income, or (2) are paid by the employer. (Code Sec. 104(a)(3)) (But see II.B.1.)

Qualified long-term care insurance contracts issued after 1996 are treated as accident and health insurance contracts (Code Sec. 7702B(a)(1)). Pre-1997 contracts that met applicable state long-term care insurance requirements also qualify. (Reg §1.7702B-2) Amounts (other than policyholder dividends or premium refunds) received from such contracts are treated as amounts received for personal injury or sickness and as reimbursement for expenses actually incurred for medical care, and are excludable subject to a per diem limit.

Distributions from an Archer medical savings account (MSA) or a health savings account (HSA) that are used exclusively to pay the qualified medical expenses of the individual (account holder) or his spouse or dependents are excludable from gross income. (Code Section 220; Code Sec. 223). For a discussion of MSAs and HSAs, see IV.G.

6. Damages

Damages, other than punitive damages, received (by suit or agreement, in a lump-sum or as periodic payments) as compensation for personal physical injury or personal physical sickness are excluded from income (Code Sec. 104(a)(2)) If an action has its origin in a physical injury or physical sickness, then all nonpunitive damages from that injury or sickness are excluded, whether or not the recipient is the injured party. Emotional distress is not considered a physical injury or physical sickness, but the exclusion does apply to damages received up to the amount paid for medical care attributable to emotional distress. (Code Sec. 104(a)) Thus, the exclusion doesn't apply to damages (other than for medical expenses attributable to emotional distress) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. But the exclusion does apply to nonpunitive damages received based on a claim of emotional distress that are attributable to a physical injury or physical sickness.

The exclusion does not apply to "delay damages," i.e., damages awarded due to the delay in payment, which have been held to be in the nature of interest.

Punitive damages generally are taxable, regardless of the nature of the claim. (Code Sec. 104(a)(2))

7. Discharge of Indebtedness

Reduction or cancellation of debt (recourse or nonrecourse) is income to the debtor. (Code Sec. 61(a)(12))

Cancellation of debt (COD) income thus can result where a creditor accepts less than full payment as a complete discharge of the debt, or where events or circumstances make its collection unlikely. But if the debtor's payment of the liability would have given rise to a deduction, the debtor won't have income from the discharge. (Code Sec. 108(e)(2))

If the indebtedness is discharged when the debtor is insolvent (but not in a bankruptcy case), the discharge is excluded from the debtor's gross income up to the amount of the insolvency. (Code Sec. 108(a)(1)(B); Code Sec. 108(a)(2)(A); Code Sec. 108(a)(3)) No amount is included in a debtor's gross income by reason of a discharge of indebtedness in a bankruptcy case (Code Sec. 108(a)(1)(A)), even if the debtor is solvent after the discharge. (Code Sec. 108(a)(2))

A special mortgage forgiveness exclusion applies to discharges after December 31, 2006 and before January 1, 2014. Under this special rule, any debt discharge income from a discharge (in whole or in part) of qualified principal residence indebtedness is excluded from gross income. Qualified principal residence indebtedness is up to $2 million of acquisition indebtedness that was used to acquire, construct, or substantially improve the taxpayer's principal residence, or to refinance such debt (up to the amount refinanced), and that was secured by the residence. This exclusion applies where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure. The basis of the residence is reduced by the amount excluded under the above-described mortgage forgiveness exclusion, but not below zero. The mortgage forgiveness exclusion was originally scheduled to expire for debt discharged on or after January 1, 2010. However, the exclusion was extended to debt discharged before January 1, 2013 by the 2008 Economic Stabilization Act and further extended to debt discharged before January 1, 2014 by the American Taxpayer Relief Act of 2012. (Code Sec. 108(e)(1)(E) as amended by 2008 Economic Stabilization Act §303DivA and the American Taxpayer Relief Act of 2012 §202(a))

Caution: Expired or expiring provisions may be extended by Congress.

8. Employee Business Expense Reimbursements

An employee can exclude from gross income any advance, reimbursement or other expense allowance received under an "accountable plan." (Reg §1.62-2(c)(4)) By contrast, an advance, etc., made under a "nonaccountable plan," is fully taxable to the employee and subject to FICA and income tax withholding. (Reg §1.62-2(c)(5))

An advance, reimbursement or other expense allowance is treated as made under an "accountable plan" if the following conditions are met:

- the employee receives the advance, etc., for a deductible business expense (see IV.N.) that he paid or incurred while performing services as an employee of his employer,
- the employee adequately accounts to his employer for the expense within a reasonable period of time, and
- the employee is required to return any excess reimbursement or allowance within a reasonable period of time.

An advance, etc., that doesn't satisfy all three conditions is treated as paid under a nonaccountable plan—it is taxed to the employee and is subject to FICA and income tax withholding. (Code Sec. 62(c); Reg §1.62-2(c)(5))

If an employee is allowed to keep advances or reimbursements in excess of those that are substantiated, only the excess is treated as made under a nonaccountable plan. (Reg §1.62-2(c)(3)(ii))

The definition of "reasonable period of time" depends on the facts and circumstances. However, under a safe-harbor rule: (1) an advance within 30 days of the time the employee has the expense, (2) an expense adequately accounted for within 60 days after it was paid or incurred, or (3) an amount returned to the employer within 120 days after the expense was paid or incurred will be treated as having occurred within a reasonable period of time. (Reg §1.62-2(g)(2)(i)) If the employee is given a periodic statement (at least quarterly) that asks him to either return or adequately account for outstanding reimbursements and he complies within 120 days of the statement, the amount is adequately accounted for or returned within a reasonable period of time. (Reg §1.62-2(g)(2))

Review Question 12

Within 30 days prior to a business meeting, an employee receives a $500 advance for expenses to be incurred in connection with the meeting. The employee actually incurs $250 of deductible business expenses in connection with the meeting. What amount is included in the employee's income?

a. $500

b. $250

c. The facts are insufficient to determine the amount included in the employee's income.

III. Sales and Exchanges

Learning Objectives

After completing this section, you should be able to:

- Determine the basis of property and when gain or loss is recognized if the property is sold or exchanged.
- Discuss capital gains and losses and the netting process.

When a taxpayer sells or exchanges property at a price higher than his cost or tax basis, he realizes a gain. If he sells at less than his basis, he realizes a loss. He doesn't realize gain or loss when property merely goes up or down in value.

A. Recognized Sales and Exchanges

Realized gain or loss is generally recognized currently for tax purposes. However, in some cases the gain or loss may not be currently recognized for tax purposes because the Code authorizes a deferral of the gain or loss or an exclusion of the gain from income (see III.B.).

1. Computation and Reporting of Gain or Loss

Taxpayers have gain to the extent the amount realized from a sale or exchange exceeds their adjusted basis (usually cost, increased for improvements and decreased for depreciation or amortization (see III.A.2.). If the adjusted basis of the property disposed of exceeds the amount realized, the difference is a loss. (Code Sec. 1001(a))

The amount realized on a sale or other disposition of property is the amount of money plus the fair market value (FMV) of any property received by the seller. (Code Sec. 1001(b)) Where the buyer of property assumes a debt of the seller, or pays one (e.g., pays seller's taxes or legal fees), the amount of the debt is added to the amount realized by the seller. (Reg §1.1001-2(a))

FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. (Reg §1.170A-1(c)(2); Reg §1.412(c)(2)-1(c)(1); Reg §1.1445-1(g)(7))

If a taxpayer sells a capital asset (see III.C.1.), selling expenses (such as brokers' commissions) ordinarily reduce the amount realized, thus reducing the gain or increasing the loss realized on the sale.

If property is sold subject to a mortgage or other debt, the amount of the mortgage is included in the sales price whether or not the seller is personally liable on the mortgage debt. This is so whether or not the buyer assumes the mortgage.

In determining the gain or loss on property, its fair market value is treated as being not less than the amount of the nonrecourse debt to which it's subject. (Code Sec. 7701(g))

Review Question 13

A taxpayer sold a building and land with a basis of $50,000 to a buyer in exchange for $50,000 cash and property with a fair market value of $30,000. The buyer assumed a $20,000 outstanding mortgage on the building. The taxpayer paid $5,000 in broker's commissions on the sale. What is the taxpayer's amount realized on the sale?

a. $45,000. b. $50,000.

c. $95,000. d. $100,000.

A cash basis seller reports gain on a sale or exchange in the year the sales proceeds are received, actually or constructively. A loss is reported in the year the transaction is completed by a fixed, identifiable event. An accrual basis seller reports gain or loss in the year the sale is completed and an unqualified right to the purchase price arises—usually when title passes to the buyer.

Gain or loss on the sale of securities arises when the seller has sold or committed himself to sell specific shares. Gain or loss on the exchange of securities arises when the taxpayer acquires a right to specific securities.

In stock exchange transactions, cash and accrual basis taxpayers generally realize gain or loss when the sale is entered into (trade date), and not on the later settlement date.

2. Basis of Property

Basis is the amount of investment in property for tax purposes. It is the point of departure for determining gain or loss on the disposition of the property, for computing annual deductions for depreciation, amortization, depletion, casualty losses, bad debts, and losses from "at-risk" activities, and for many other tax computations. A taxpayer's basis for property acquired in a taxable exchange is usually its cost, subject to certain adjustments.

The original basis for property is its cost to the taxpayer, except where otherwise specifically provided (Code Sec. 1012) or where the transaction is not made at arm's length. Cost is the amount paid in cash, liabilities incurred, or other property. (Reg §1.1012-1(a)) Payments made in connection with the acquisition of property, e.g., commissions and legal fees, are included in basis as part of the property's cost.

IRS and most courts say that the cost basis of property received in an arm's-length taxable exchange is the fair market value of the property received in the exchange, at the time of the exchange. However, where the fair market value of the property received cannot be determined with a fair degree of certainty the fair market value of the property given up will be used as a way of valuing the property received.

But a substantial minority of courts say that the cost basis of property received in an arm's-length taxable exchange is the fair market value (on the date of the exchange) of the property given up.

When property isn't bought in an arms'-length deal, its basis is its fair market value. This can occur in sham transactions, or where the buyer, for personal reasons, pays more than what the property is worth (e.g., to help out a friend).

A taxpayer's cost of property includes the amount of a mortgage or other liability that he assumes in connection with the purchase, plus the amount of any liabilities that the purchased property is subject to (whether or not the taxpayer assumes the liability).

The basis of property acquired by exercising of an option or warrant, other than an option granted for services, is (a) the basis of the option plus (b) the option price.

When a residence or other nonbusiness property is converted from personal use to business or income producing use, for purposes of calculating losses or depreciation (but not for purposes of calculating gain) the basis for the property on the date of its conversion is the lower of its adjusted basis or fair market value on that date. This basis must thereafter be adjusted for depreciation, etc., after conversion. (Reg §1.167(g))

The basis of property received in a nontaxable exchange (see III.B.), depending on the type of transaction, generally will be the same as its basis in the hands of the transferor or will be the same as the basis of the property transferred by the recipient in the exchange. If gain is recognized in part on the transaction, the basis of the property received may have to be adjusted.

The basis of property acquired by gift is generally its basis in the hands of the donor ("carryover" basis). However, in determining loss, where the property's fair market value on date of gift was less than the donor's basis on that date; the property's basis is its fair market value on that date. (Code Sec. 1015(a))

Review Question 14

A taxpayer received property as a gift. The property originally cost the donor $25,000 and the donor's basis in the property at the time of the gift was $50,000, The property was worth $75,000 at the time of the gift. What is the taxpayer's basis for determining loss on a sale?

a. $0.

b. $25,000.

c. $50,000.

d. $75,000.

The basis of property acquired from a decedent by inheritance, bequest, devise, etc. is generally equal to its fair market value at the date of the decedent's death. (Code Sec. 1014(a)(1)) However, if the fiduciary elects for estate tax purposes to value the decedent's gross estate at the alternate valuation date (see Module 3, Specialized Tax Issues), the basis of the property is its fair market value on that alternate date. (Code Sec. 1014(a)(2))

Adjustment of basis. Basis must be increased or decreased to reflect certain events, such as capital improvements or depreciation, whether the original basis was cost or something else.

The basis of property is adjusted (increased) to include the amount of the capital expenditures with respect to the property. (Code Sec. 1016(a)(1)) A lessee's basis for his leasehold is increased by his capital expenditures. However, a lessee's capital improvements don't increase or diminish the lessor's basis of the leased property unless they are includible in the lessor's gross income as rent. (Code Sec. 1019)

Basis can't be increased for items that are deductible as expenses, except for certain items the taxpayer is allowed to capitalize at his or her election.

A stockholder's contribution of property to a corporation will increase the stockholder's basis for his or her corporate stock. A partner's contribution of cash to a partnership increases the partner's basis in his or her partnership interest.

Basis must be reduced for receipts representing return of capital, (Code Sec. 1016(a)(1); Reg §1.1016- 2(a)) such as damages taxpayer received for injury to his property.

Basis must be reduced for depreciation, cost recovery, and amounts expensed under Code Sec. 179 (see IV.P.2.). The amount of the reduction is the larger of:

- the amount of the depreciation, cost recovery, or expensing allowable under the law, or
- the amount that was actually allowed and resulted in a reduction of tax. (Code Sec. 1016(a)(2))

Allowable depreciation (or cost recovery) is the amount the taxpayer was entitled to deduct under the law, whether or not he actually took more or less and whether or not a tax benefit resulted. Where a taxpayer didn't adopt a depreciation method, the amount allowable is figured under the straight-line method. (Code Sec. 1016(a))

The depreciation (or cost recovery) allowed is the amount claimed on a tax return and allowed by IRS.

There must also be an adjustment to basis if property is partly lost or destroyed through casualty or theft. The basis is reduced by:

- the amount of insurance or other reimbursement received, and
- the amount of deductible loss. No reduction is required for the amount of a loss which is not deductible (see IV.L.).

3. Installment Sales

Special installment sale rules are used to report gain on the disposition of non-dealer property where at least one payment is to be received after the close of the tax year in which the disposition occurs. (Code Sec. 453(b)(1)) The amount of a payment that's income to the taxpayer is that portion of the installment payments received in the year that the gross profit realized or to be realized bears to the total contract price (the "gross profit ratio"). (Code Sec. 453(c); Reg §15A.453-1(b)(2)(i))

Payments include:

- amounts actually received by the seller (e.g., cash, other property, foreign currency, marketable securities, or evidences of indebtedness which are payable on demand or readily tradable (Reg §15A.453-1(b)(3)(i)) or secured by cash or a cash equivalent), (Reg §15A.453-1(b)(3)(i))
- the buyer's payments of the seller's selling expenses, and
- the amount by which qualifying debt assumed or taken subject to by the buyer exceeds the seller's basis. (Reg §15A.453-1(b)(3)(i))

Gross profit is the selling price less the property's adjusted basis (as increased by selling expenses). (Reg §15A.453-1(b)(2)(v)) The selling price is the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and without reduction to reflect any selling expenses. Neither interest (whether stated or unstated) nor original issue discount is part of the selling price. (Reg §15A.453-1(b)(2)(ii))

Gain recaptured under Code Sec. 1245 or Code Sec. 1250 (see III.C.7.) is fully taxed as ordinary income in the year of sale. Only gain that isn't recapture income is taken into account under the installment method.

(Code Sec. 453(i)) The recaptured amount is added to the adjusted basis of the property for purposes of determining basis recovered and gain recognized from each installment.

The total contract price is the selling price, reduced by debt on the property that the buyer assumes (or takes subject to) but only to the extent of the seller's basis in the property. (Reg §15A.453-1(b)(2)(iii))

A taxpayer can elect not to use the installment method. An election not to have the installment method apply to a sale is made by reporting an amount realized equal to the selling price (including the full face amount of any installment obligation) on the tax return filed for the year the sale occurs. (Reg §15A.453- 1(d)(3)(i))

The election out must be made on or before the due date (including extensions) for filing the return for the year the sale occurs. (Code Sec. 453(d)(2)) An election out may be revoked only with IRS consent. (Code Sec. 453(d)(3))

A taxpayer who elects not to report a deferred-payment sale on the installment method recognizes gain on the sale according to his method of accounting. The receipt of an installment obligation is treated as a receipt of property equal to the fair market value (FMV) of the obligation. (Reg §15A.453-1(d)(2)(i))

As noted above, the installment method generally cannot be used by dealers in property, real or personal (Code Sec. 453(b)(2)). However, the installment method may be used for dispositions by farmers (not merchants) of any property used or produced in the trade or business of farming (Code Sec. 453(l)(2)(A)).

The installment method also cannot be used for:

- Sales of stock or securities traded on an established securities market (Code Sec. 453(k)(2)(A)), but it can be used for unregistered restricted stock sold in a private placement.
- Sales at a loss.
- Sales of depreciable property between persons considered related for tax purposes unless it's established to IRS's satisfaction that the sale didn't have as one of its principal purposes the avoidance of federal tax. (Code Sec. 453(g))

B. Nonrecognized Sales and Exchanges

1. Exchange of Securities

No gain or loss is recognized on the exchange of common stock for other common, or preferred stock for other preferred, of the same corporation. (Code Sec. 1036(a)) The exchange is tax-free whether it's between a shareholder and the corporation or between two shareholders.

An exchange between individual shareholders, of common for preferred stock in the same corporation, isn't tax-free. (Reg §1.1036-1(a)) However, reorganization exchanges of stock for stock or stock and securities of the same or different corporations may be tax-free (see Module 2, *Taxation of Businesses*).

2. Exchanges of Insurance and Annuities

No gain or loss is recognized upon the exchange of a life insurance contract for another or for an endowment or annuity contract, an endowment contract for an annuity or endowment contract providing for regular payments beginning at a date not later than the beginning date under the old contract, or an annuity contract for another.

To qualify for tax-free exchange treatment, the insured or annuitant must remain the same. (Code Sec. 1035) The direct transfer of a portion of funds from one annuity contract to another annuity contract qualifies as a nontaxable exchange under Code Sec. 1035. Thus, the direct exchange of part of the cash surrender value of an annuity contract for a new annuity contract issued by a second insurance company is tax-free even though the original annuity contract continues to exist.

3. "Like-kind" Exchanges

No gain or loss is recognized where business or investment property is exchanged solely for like-kind property. Multi-party exchanges may qualify. However, gain, but not loss, is recognized if "boot" is also received.

This nonrecognition provision doesn't apply to: stock in trade (inventory) and other property held primarily for sale; stocks, bonds, and notes; choses in action; interests in a partnership; certificates of trust or beneficial interest; or other securities or evidences of indebtedness or interest. (Code Sec. 1031(a))

Nonrecognition for like-kind exchanges isn't elected. It's mandatory if the conditions are met.

"Like-kind" refers to the nature, character, or class of the property, not to its grade or quality. Thus, an exchange of real estate for real estate is an exchange of "like-kind" property. It doesn't matter where the real estate is located (but foreign and U.S. real property can't be like-kind) or whether it's improved or not. (Code Sec. 1031(h); Reg §1.1031(a)-1(b))

Personal property used predominantly within the U.S. and personal property used predominantly outside of the U.S. aren't of like kind. (Code Sec. 1031(h)(2)(A)) In general, predominant use of relinquished property is determined based on the 2-year period that ends when the property is relinquished, and predominant use of the replacement property is determined based on the 2-year period that begins on the acquisition date. (Code Sec. 1031(h)(2)(B))

Residential rental property used occasionally for personal purposes may qualify as investment property in a like-kind exchange if in each of the two 12-month periods immediately preceding the exchange the period of the taxpayer's personal use of the property did not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the property was rented at a fair rental. (Rev Proc 2008-16, 2008-10 IRB)

Review Question 15

Which of the following transactions qualifies for like-kind exchange treatment?

a. An exchange of inventory for other personal property.

b. An exchange of an apartment building in New York for unimproved land in Colorado.

c. An exchange of a rental building in Texas for a rental building in Mexico.

d. An exchange of stock in one corporation for stock in another corporation.

Trade-ins are a common type of nontaxable exchange. Whether the taxpayer pays money or not, the trade-in is still a nontaxable exchange. (Reg §1.1031(a)-1(c))

If a taxpayer receives "boot"—money or any other property that doesn't qualify for nonrecognition of gain—in a like-kind exchange:

- gain to the taxpayer is recognized (is taxable) in an amount not exceeding the value of the boot received (Code Sec. 1031(b)), but
- loss to the taxpayer isn't recognized (isn't deductible) to any extent. (Code Sec. 1031(c))

Where the taxpayer gives money in the nontaxable exchange, no gain is recognized. But if the boot given is property other than money, gain or loss may be recognized. Thus, where stock that has depreciated in value is given in connection with a like-kind exchange of real estate, loss on the stock is recognized to the extent the stock's adjusted basis exceeds its fair market value. (Reg §1.1031(d)-1(e))

Liabilities assumed are treated as a cash equivalent (boot). The taxpayer who assumes the liability is the one giving the boot, while the taxpayer whose liability is assumed receives the boot. If each party assumes a liability of the other, only the net liability is boot given or received. (Reg §1.1031(b)-1(c))

Like-kind treatment is barred if the property to be received is not identified (e.g., by being specified in the contract) on or before 45 days after the transfer, or isn't received within 180 days after the transfer or by the due date (with extensions) of the return for the year of transfer if earlier. (Code Sec. 1031(a)(3))

Where a taxpayer exchanges like-kind property with a party who is considered related for tax purposes, and, within two years of the date of the last transfer that was part of the exchange, either party disposes of the property received in the exchange, then gain or loss not recognized in the exchange is recognized on the date the later disposition occurs. A disposition includes indirect transfers. Exceptions are made for death, certain involuntary conversions, and non-tax-avoidance transactions. (Code Sec. 1031(f))

Multiple party exchanges. If a taxpayer wants to (or will only) exchange his property for like-kind property, but the party who wants taxpayer's property doesn't own the like-kind property, the taxpayer can still set up a nontaxable exchange if the other party acquires the like-kind property and taxpayer then exchanges his property for that like-kind property.

The exchange is nontaxable (if the time limits above are met) even where the taxpayer transfers property in exchange for a written promise by the transferee to deliver like-kind property to the taxpayer in the future, i.e., a deferred or nonsimultaneous exchange.

A multiparty nontaxable exchange can be set up by using a qualified intermediary (someone other than the taxpayer or a "disqualified person" such as taxpayer's agent) to facilitate the transaction. (Reg §1.1031(k)-1(g)(4)) Reverse exchanges (replacement property is acquired before the relinquished property is transferred) may be implemented using qualified exchange accommodation arrangements under IRS approved safe-harbor rules.

4. Involuntary Conversions

No gain is recognized when property is compulsorily or involuntarily converted into property similar or related in service or use. Where property is involuntarily converted into money or into property that isn't similar or related in service or use, a taxpayer can avoid tax on any gain, by so electing and buying property that's similar or related in service or use. The cost of the replacement property must be equal to or more than the net proceeds from the converted property. And the replacement must generally be made within two years after the close of the first tax year in which any part of the gain is realized. (Code Sec. 1033)

A loss on an involuntary conversion is recognized or not recognized without regard to the involuntary conversion rules. (Reg §1.1033(a)-1(a))

For this purpose, an "involuntary conversion" is the compulsory or involuntary conversion of taxpayer's property into similar property, dissimilar property or money as a result of the property's destruction, theft, seizure, requisition or condemnation (actual or threatened). (Code Sec. 1033(a)) Involuntary conversion includes certain sales—sales in actual or threatened condemnation, certain sales (or the destruction) of livestock due to disease (Code Sec. 1033(d)), and the sale or exchange of livestock (in excess of the number taxpayer would sell if he followed his usual business practices) solely on account of drought, flood, or other weather-related conditions. (Code Sec. 1033(e)) For a discussion of involuntary conversion of livestock, see Module 3, Specialized Tax Issues.

For purposes of the property replacement requirement "similar or related in service or use" means the use of the replacement property must be substantially similar to the use of the replaced property.

This test, as applied to an owner-lessor of property, looks to the use of the replacement property from the lessor's viewpoint, not the lessee's. If the replacement property involves similar business risks, management and landlord services, etc., it will qualify even though the lessee's use of the new property differs from the lessee's use of the old.

Tangible property acquired and held for productive use in a trade or business is treated as similar or related in service or use to property that (1) was held for investment or for productive use on a trade or business, and (2) was involuntarily converted as a result of a disaster for which a presidential determination was made. (Code Sec. 1033(h)(2))

As noted above, there is a deadline for the property's replacement. Converted property must be replaced within a period:

- beginning with (1) the date the property was destroyed, stolen, condemned, etc., or (2) the date condemnation or requisition was first threatened or became imminent, whichever is earlier, (Code Sec. 1033(a)(2)(B)) and
- ending (1) two years after the close of the first tax year in which any part of the gain is realized (three years in the case of condemnation or threat of condemnation of certain real property; four years for principal residences converted due to presidentially declared disasters), or (2) at a later date allowed by IRS upon application by the taxpayer. (Code Sec. 1033(a)(2)(B); Code Sec. 1033(g)(4))

5. Sales or Exchanges between Related Parties

No gain or loss is recognized on a transfer of property between spouses or between former spouses incident to divorce. No deduction is allowed for any loss from the sale or exchange of property between specified related taxpayers.

Under the spousal sale rule, no gain or loss is recognized on a transfer of property to (or in trust for the benefit of) the transferor's spouse, or to a former spouse incident to a divorce. (Code Sec. 1041(a)) Certain transfers to third parties on behalf of (i.e., in satisfaction of an obligation or liability of) the spouse or former spouse qualify for nonrecognition. (Reg §1.1041-1T(c)) However, the no-gain-or-loss rule doesn't apply to transfers in trust where liability exceeds basis, (Code Sec. 1041(e)) to transfers in trust of installment obligations, (Code Sec. 453B(g)) or where the transferee spouse is a nonresident alien. (Code Sec. 1041(d)) The transferee spouse is treated as acquiring the property by gift and the transferee's basis in the property received is the adjusted basis that the transferor spouse had in the property. (Code Sec. 1014(b)) This carryover basis rule applies whether the adjusted basis of the property is less than, equal to, or greater than its fair market value at the time of the transfer and applies for purposes of determining loss as well as gain upon later sale by the transferee. (Reg. §1.1041-1T(d), Q&A-11)

Review Question 16

A taxpayer transferred property to his spouse incident to their divorce. The taxpayer's basis in the property was $9,000 and its value at the time of the transfer was $7,000. The transferee spouse's basis in the property is:

a. $0. b. $7,000.

c. $8,000. d. $9,000.

A transfer of property is incident to divorce if it occurs within one year after the date the marriage ceases (Code Sec. 1041(c)(1)) or the transfer is related to the cessation of the marriage. (Code Sec. 1041(c)(2)) A transfer is related to the cessation if the transfer is under a divorce or separation instrument and the transfer occurs not more than six years after the date the marriage ceases. For later transfers, there's a presumption that the transfer isn't related to the cessation.

Under the related party sale rule, no deduction is allowed for losses from sales or exchanges between certain related taxpayers. (Code Sec. 267(a)) For this purpose, related parties include members of the seller's family, but only brothers and sisters (whole or half-blood). In-laws aren't members of the seller's family. Related parties also include certain owners and their businesses, certain commonly controlled businesses, estates and their beneficiaries, and certain trusts and their grantors and beneficiaries.

6. Sale of a Principal Residence

A taxpayer can exclude from income up to $250,000 of gain ($500,000 for joint filers meeting certain conditions) from the sale of a home owned and used by the taxpayer as a principal residence for at least 2 of the 5 years before the sale.

The exclusion doesn't apply if, within the 2-year period ending on the sale date, there was another home sale by the taxpayer to which the exclusion applied. (Code Sec. 121(a); Code Sec. 121(b)(3)) (See below for circumstance in which a partial exclusion may be available.)

Married taxpayers filing jointly for the year of sale may exclude up to $500,000 of home-sale gain if:

- either spouse owned the home for at least 2 of the 5 years before the sale,
- both spouses used the home as a principal residence for at least 2 of the 5 years before the sale, and
- neither spouse is ineligible for the full exclusion because of the once-every-two-year limit. (Code Sec. 121(b)(2)(A))

Review Question 17

A married couple sold their home for a gain of $600,000. Each spouse used the home as a principal residence since it was purchased five years ago. However, the wife was the sole owner of the home since the date of purchase. If the couple claims the maximum available home-sale exclusion, how much gain must they report on their joint return?

a. $500,000. b. $250,000.

c. $100,000. d. $0.

In the case of a sales or exchange after December 31, 2007, a surviving spouse will qualify for a maximum $500,000 exclusion on the sale of a home if the sale takes place no later than two years after the date of the deceased spouse's death and the requirements for claiming the maximum $500,000 exclusion on a joint return were met immediately before the deceased spouse's death. (Code Sec. 121(b)(4)) The maximum $500,000 exclusion is available to a surviving spouse only if he or she is unmarried at the time of the sale or exchange.

The exchange or involuntary conversion (destruction as well as condemnation) of a principal residence is treated as a sale for purposes of the homesale exclusion. (Code Sec. 121(a); Code Sec. 121(d)(5)(A)) A taxpayer may elect not to apply the exclusion to the sale or exchange of a principal residence. (Code Sec. 121(f))

The exclusion doesn't apply to gain attributable to post-May 6, 1997 depreciation claimed for rental or business use of a principal residence. (Code Sec. 121(d)(6))

If property is used for both residential and business (or investment) purposes, no allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit, but gain isn't excludible to the extent of any post-May 6, 1997, depreciation. However, gain is allocated if the part of the home for which the use requirement isn't met is separate from the dwelling unit. (Reg §1.121-1(e)(1))

Ownership and use test. In general, the full homesale exclusion applies only if the taxpayer owned the home and used it as a principal residence for at least 2 of the 5 years ending on the date that it is sold. (Code Sec. 121(a))

- Under the following circumstances, a taxpayer may "tack on" someone else's ownership and/or use period to his or her own ownership and/or use period.
- An unmarried individual whose spouse was deceased on the homesale date may tack on the decedent's ownership and use period to his or her own ownership and use period. (Code Sec. 121(d)(2))
- An individual who receives a home in a transaction authorized by Code Sec. 1041(a), such as a tax-free transfer from one spouse to another, may tack on the transferor's ownership period to his or her own ownership period. (Code Sec. 121(d)(3)(A))
- For purposes of the homesale exclusion, an individual is treated as using a home as his or her principal residence during any period of ownership that the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument. (Code Sec. 121(d)(3)(B))

Partial exclusion. In the case of certain sales or exchanges, the ownership and use requirements that apply to the exclusion of gain for principal residences do not apply and the limit of one sale every two years does not apply; but the amount of the gain excluded from gross income is reduced. (Code Sec. 121(c)(1))

The reduced exclusion applies to any sale or exchange if:

- the exclusion would not (but for these rules relating to the reduced exclusion) apply to the sale or exchange by reason of (1) a failure to meet the ownership and use requirements, (Code Sec. 121(c)(2)(A)(i)) or (2) the limit of only one sale every two years, (Code Sec. 121(c)(2)(A)(ii)), and
- the sale or exchange is by reason of a change in place of employment, health, or (to the extent provided in regulations) unforeseen circumstances. (Code Sec. 121(c)(2)(B))

A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. Whether these requirements are satisfied depends upon all the facts and circumstances. (Reg §1.121-3T(b))

When a taxpayer is eligible for the reduced exclusion, the maximum gain that can be excluded is equal to the full $250,000 or $500,000 exclusion multiplied by a fraction having as its:

- numerator—the shorter of (1) aggregate periods of ownership and use of the home by the taxpayer as a principal residence during the five years ending on the sale date, or (2) the period of time after the last sale to which the exclusion applied, and before the date of the current sale,
- denominator—two years (or its equivalent in months). (Code Sec. 121(c)(2)) Thus, for example, where the aggregate period of ownership and use by a single taxpayer is 1 year during the five years ending on the sale date, the maximum exclusion is $125,000 (assuming that there was no prior sale on which the exclusion applied within the one-year period).

Conversion to principal residence. For sales and exchanges after 2008, the homesale exclusion will not apply to the extent that it relates to the nonqualified use period of the residence. Generally, the nonqualified use period is any period, other than the portion of the period before January 1, 2009, that the property is not used as the principal residence of the taxpayer or spouse. For example, the change would affect taxpayers that own a vacation home, commence using it as a principal residence, and then sell it. Under one important exception, nonqualified use does *not* include any portion of the five-year homesale qualification period which is *after* the last date that the property is used as the principal residence of the taxpayer or spouse. (Code Sec. 121(b)(4), as amended by §3092 of the Housing Rescue and Foreclosure Prevention Act of 2008)

7. Wash Sales

Losses on the sale of (or on a contract or option to sell) stock or securities are not deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires or has entered into a contract or option to acquire stock or securities that are substantially identical. (Code Sec. 1091(a); Reg §1.1091-1(a))

"Substantially identical securities" requires something less than precise correspondence. Stock or securities of different issuers or obligors are not substantially identical. Stock or securities of the same issuer are substantially identical if they are substantially the same in all important particulars.

The wash sale rule also disallows a loss on the closing of a short sale of stock or securities, or the sale, exchange, or termination of a securities futures contract to sell, if, within the period beginning 30 days before the date the short sale is closed and ending 30 days after that date: (1) substantially identical stock or securities are sold, or (2) another short sale of (or securities futures contracts to sell) substantially identical stock or securities is entered into. (Code Sec. 1091(e))

The wash sale rule doesn't apply to a dealer in stocks or securities if the loss is sustained in a transaction made in the ordinary course of that business. (Code Sec. 1091(a))

C. Capital Gains and Losses

Gain or loss from the sale or exchange of a capital asset is known as capital gain or loss. Most properties owned by individuals are capital assets. The tax treatment of capital gains and losses depends on whether the gains and losses are short-term or long-term.

For individuals, the maximum tax rate on net long-term capital gains is lower than the top rate on ordinary income. The precise maximum tax rate on long-term capital gains depends on the type of capital asset sold and the taxpayer's marginal tax rate (the top rate of tax on the individual's ordinary income).

The short-term capital gains of individuals are taxed at the same rates as their ordinary income.

If an individual has both capital gains and losses for the year, there is a netting process. Short-term capital gains and losses are netted to get net short-term capital gain or net short-term capital loss. (Code Sec. 1222(5); Code Sec. 1222(6)) Long-term capital gains and losses are netted to get net long-term capital gain or net long-term capital loss. (Code Sec. 1222(7); Code Sec. 1222(8))

There's a further netting if one group shows a loss and the other a gain: If there's a net short-term gain, it's taxable at the same rate as ordinary income. If net long-term capital gains exceed net short-term capital losses, the excess is "net capital gain," which qualifies for favorable tax treatment (see III.C.3).

If capital losses exceed capital gains, a limited deduction against ordinary income is allowed with a carryover of unused losses (see II.C.4.).

Review Question 18

An individual has $20,000 of long-term capital gains and $7,000 of short-term capital losses for the year. Which of the following describes the tax treatment?

a. The $20,000 of gains are taxed at ordinary tax rates and the $7,000 of losses are deductible against ordinary income.

b. The $20,000 of gains are taxed at "favorable" tax rates and a limited deduction is allowed for the losses.

c. The losses are netted against the gain and the resulting $13,000 of gains are taxed at "favorable" tax rates.

d. The losses are netted against the gains and the resulting $13,000 of gains are taxed at ordinary income rates.

1. Capital Asset Defined

Capital assets include all assets held by the taxpayer except:

1. Stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year.
2. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.
3. Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of any properties described in (1) or (2), above.
4. Depreciable property (and amortizable Code Sec. 197 intangibles; see below) used in the taxpayer's trade or business.
5. Real property used in the taxpayer's trade or business.
6. Certain copyrights, and literary, musical or artistic compositions.
7. Certain letters, memoranda or similar property.

8. U.S. government publications (e.g., Congressional Record) received from the government without charge or below the price sold to the public, in the hands of the recipient and carryover basis transferees.

9. Commodities derivative financial instruments held by a commodities derivatives dealer (except for certain instruments not connected to the dealing activity);

10. Any hedging transaction (e.g., to manage risk of price changes or currency fluctuations) clearly identified as such before the close of the day on which it was acquired, originated, or entered into.

11. Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business. (Code Sec. 1221(a))

Property held for personal use is a capital asset, as is property used for the production of income (even if depreciable). But inventory, and real estate and depreciable property used in taxpayer's trade or business, aren't capital assets. (Reg §1.1221-1(b)) Examples of capital assets include stock and securities held for investment, including tax-exempt bonds.

When a sole proprietorship is sold, there isn't a sale of just one asset (the business). Rather, there's a sale of the individual assets that comprise the business. Thus, gain or loss on some assets will be ordinary while on others it will be capital.

Business goodwill is a capital asset unless it is treated as an amortizable section 197 intangible (see Module 2, *Taxation of Businesses*). To the extent that the section 197 rules don't apply, goodwill and covenants not to compete are treated as follows:

- Proceeds from the sale of a business that are allocable to goodwill are taxed under the capital gain and loss rules.
- Payments for a covenant not to compete that is severable from the sale of goodwill result in ordinary income.

2. Holding Period

The length of time that a capital asset is held before its sale or exchange determines whether the proceeds from the sale or exchange are taxable as long-term gain or loss or as short-term gain or loss. If a capital asset's holding period is one year or less, the gain or loss is short-term. (Code Sec. 1222(1); Code Sec. 1222(2)) If the holding period is more than one year, the gain or loss is long-term. (Code Sec. 1222(3); Code Sec. 1222(4))

The holding period is computed in terms of calendar months, not days. The holding period for an asset begins on the day after the day of acquisition and ends on the day of sale, exchange or other disposition. In other words, the taxpayer excludes the day of acquisition but includes the date of disposition. For example, if a capital asset is acquired on February 15, gain or loss on the sale of the asset is short-term when the asset is sold on February 15 of the following year. The gain or loss is long-term if it's sold on February 16 of the following year.

Review Question 19

If a capital asset is acquired on March 20, gain or loss will be long-term if the asset is sold on or after _______ of the following year.

a. March 19.

b. March 20.

c. March 21.

The holding period for stocks and securities acquired by purchase, whether on a registered securities exchange or in the "over-the-counter" market, is determined by reference to the "trade date" on which the stock or security is acquired and the "trade date" on which it is sold. The "settlement dates" aren't considered.

The holding period for property acquired through the exercise of an option begins the day after the option is exercised.

Gain or loss from the sale or exchange of inherited property is generally long-term. Property acquired from a decedent which is sold within the short-term capital gain holding period after the decedent's death is considered to be held for the long-term capital gain holding period where the heir received a "step-up" in basis for the property (see III.A.2.). (Code Sec. 1223(11))

The donee's holding period for property acquired by gift includes the donor's holding period if the property has the same basis for gain or loss (see III.A.2.) in whole or in part in the hands of the donee as it would have in the donor's hands. (Code Sec. 1223(2); Reg §1.1223-1(b)) But if the property is sold by the donee at a loss based on its market value on the date of the gift (and not based on the donor's basis), the holding period starts from the date of the gift.

The holding period for property received in a partially or wholly tax-free exchange (see III.B.), includes the holding period for the property surrendered. This "tacking on" applies where the new property has the same basis, in whole or in part, as the old property (Code Sec. 1223(1)), e.g., like-kind exchanges, or involuntary conversions.

3. How Net Capital Gain Is Taxed

If an individual has net capital gain (i.e., net long-term gain exceeds net short-term loss), the net capital gain is generally taxed as follows:

- Net capital gain that is "adjusted net capital gain" is taxed at the following rates for tax years beginning after 2012: 0% on gain that otherwise would be taxed at a 10% or 15% rate; 15% on gain that otherwise would be taxed at a 25%, 28%, 33%, or 35% rate; and 20% on gain that otherwise would be taxed at a 39.6% rate. (Code Sec. 1(h)(1)(B); Code Sec. 1(h)(1)(C); Code Sec. 1(h)(1)(D) as amended by the American Taxpayer Relief Act of 2012 §102)
- Net capital gain attributable to "collectibles gain" and section 1202 gain (see below) is taxed at a maximum rate of 28%. (Code Sec. 1(h)(4))
- That part of net capital gain attributable to "unrecaptured section 1250 gain" is taxed at a maximum rate of 25%.

Adjusted net capital gain. Adjusted net capital gain is:

- net capital gain less (a) qualified dividend income (see II.C.1) and (b) the amount of net capital gain that the taxpayer takes into account as investment income for purposes of the investment interest deduction, (see IV.J.4.)
- reduced by the sum of unrecaptured section 1250 gain and 28% rate gain, and
- increased by the amount of qualified dividend income (less the amount of qualified dividend income the taxpayer takes into account as investment income for purposes of the investment interest deduction). (Code Sec. 1(h)(3))

Effectively, adjusted net capital gain is the sum of that part of a taxpayer's net capital gain that is eligible to be taxed at a maximum rate of 15%/0%.

28% rate gain. The term 28% rate gain means the amount of net gain attributable to:

- collectibles gains and losses,
- the amount of gain on the sale of certain small business stock less the gain excluded under Code Sec. 1202 (see III.C.5.),
- the net short-term capital loss for the tax year, and
- the long-term capital loss carryover to the tax year. (Code Sec. 1(h)(5))

Collectibles gain or loss is gain or loss from the sale or exchange of a collectible which is a capital asset held for more than one year, but only to the extent such gain or loss is taken into account in computing gross income. (Code Sec. 1(h)(5)) Any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or any other tangible personal property specified by IRS for this purpose is a collectible.

Review Question 20

Which of the following is **not** included in the calculation of 28% rate gain?

a. Collectibles gains and losses.

b. Net long-term capital loss for the tax year.

c. Net short-term capital loss for the tax year.

d. Long-term capital loss carryover to the tax year.

Unrecaptured Section 1250 Gain. Depreciable real property must be depreciated using the straightline method. Code Sec. 1250 requires gain to be "recaptured" as ordinary income instead of capital gain, but only to the extent depreciation was claimed in excess of straight-line (see III.C.7). Thus, gain from the sale of depreciable real property is capital gain and not ordinary income.

Unrecaptured Section 1250 gain, taxed at a maximum rate of 25%, is the excess (if any) of:

- the amount of long-term capital gain which would be ordinary income if the Code Section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight line) over
- the excess (if any) of the amount of losses taken into account in computing 28% rate gain over the amount of gains taken into account in computing 28% rate gain. (Code Sec. 1(h)(6))

Netting gains and losses. The following netting and ordering rules apply where the taxpayer has capital losses:

- Short-term capital losses are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary income rates. If there's a net short-term capital loss, it reduces any net long-term gain from the 28% group, then gain from the 25% group, and finally reduces adjusted net capital gain (20%/15%/0%).
- Long-term capital losses are handled as follows:
    - A net loss from the 28% group (including long-term capital loss carryovers from prior years) is used first to reduce gain from the 25% group, then to reduce adjusted net capital gain.
    - A net loss from the 20%/15%/0% group is used first to reduce net gain from the 28% group, then to reduce gain from the 25% group.

4. Capital Losses

An individual taxpayer may deduct capital losses only to the extent of capital gains plus (if the losses exceed the gains) the lower of:

- $3,000 ($1,500 for married individuals filing separate returns), or
- the excess of the losses over the gains. (Code Sec. 1211(b))

If an individual sustains a net capital loss that exceeds the maximum deductible in the current year, the excess is carried forward to later years indefinitely until it's absorbed. (Code Sec. 1212(b)) Carrybacks aren't allowed.

The capital loss keeps its original character as long- or short-term when carried over. (Code Sec. 1212(b)(1))

For purposes of determining the amount of excess long-term or short-term capital loss that is carried over, that excess is reduced by assuming the existence of a short-term capital gain equal in amount to the least of:

1. $3,000 ($1,500 for married filing separately),

2. the excess of allowed losses over gains, or
3. "adjusted taxable income."

Adjusted taxable income is taxable income increased by the lesser of the amounts computed in (1) and (2), above, and increased by the personal exemption. (Code Sec. 1212(b)(2))

5. Special Transactions

Gain or loss from certain sales and exchanges are not subject to the general capital gain and loss rules outlined above.

Qualified small business stock. An individual may exclude 50% of gain on the disposition of qualified small business stock (QSBS) issued after August 10, 1993 and held for more than five years (Code Sec. 1202(a)(1)). The taxpayer must hold the QSBS for more than five years before the sale or exchange to claim the partial exclusion of gain. (Code Sec. 1202(a))

A 100% exclusion for both regular tax and AMT is temporarily allowed for gain under IRC Sec. 1202 from the sale of QSBS acquired after September 27, 2010 and before January 1, 2014, and held for more than five years. (Code Sec. 1202(a)(4) as amended by 2010 Tax Relief Act, P.L. 111-312, 12/17/2010 and the American Taxpayer Relief Act of 2012, P.L. 112-240, 1/2/2013)

Caution: Expired or expiring provisions may be extended by Congress.

For each corporation in which an individual invests, the total amount of gain eligible for the partial exclusion for a tax year may not exceed the greater of:

- $10,000,000 ($5,000,000 for married filing separately) (Code Sec. 1202(b)(1)(A); Code Sec. 1202(b)(3)(A)) reduced by taxpayer's total gain on dispositions of the corporation's stock that he took into account in earlier years. (Code Sec. 1202(b)(1)(A)) The amount of eligible gain is allocated equally between spouses who file jointly, to apply this limit to later years (Code Sec. 1202(b)(3)(B)); or
- ten times the aggregate adjusted bases of any of the corporation's QSBS that taxpayer disposed of during the year. (Code Sec. 1202(b)(1)(B)) For this purpose, the adjusted basis of any stock doesn't include any additions to basis after the date it was originally issued.

Section 1244 stock. Code Section 1244 provides that the loss on the sale, exchange or worthlessness of qualifying "small business" corporation stock is deductible, within limits, as an ordinary loss, even though gain on the stock is capital gain.

This ordinary deduction is available only if an individual was the original purchaser. Transferees of these original purchasers don't qualify. (Code Sec. 1244(a)

The aggregate amount of the ordinary loss deduction is limited to $100,000 on joint returns and $50,000 on other returns each year. Spouses may deduct the $100,000 maximum on a joint return even if only one spouse owned the stock. (Code Sec. 1244(b))

Review Question 21

Under Code Section 1244, the annual aggregate amount of the ordinary loss deduction from qualifying small business stock is limited to____________________ .

a. $100,000 on all returns.

b. $50,000 on all returns.

c. $100,000 on joint returns if both spouses owned the stock and $50,000 on all other returns.

d. $100,000 on joint returns and $50,000 on all other returns.

To qualify as Section 1244 stock, all of the following tests must be met: (Code Sec. 1244(c))

- The stock must be stock of a domestic corporation. It may be common or preferred, voting or nonvoting). (Reg §1.1244(c)-1(b)).

- The stock must have been issued for money or other property, other than stock, securities or services. But stock issued for the cancellation of corporate debt (that wasn't evidenced by a security or issued for services) does qualify. (Reg §1.1244(c)-1(d)(1))
- The issuing corporation must have met a test in which it shows that over 50% of its receipts were from business operations.
- The stock must have been issued by a domestic "small business" corporation. A corporation is a small business corporation if at the time the stock is issued its capital receipts don't exceed $1,000,000. Capital receipts means the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus. (Code Sec. 1244(c)(3)(A))

Short sales. In a short sale, an investor sells a security for delivery in the future. The short seller may meet his obligation to deliver by buying the security on the delivery ("closing") date. If the security has declined in value by the time he closes or covers the sale, he has a gain equal to the price at which he sold minus his cost; if the value has increased, his purchase price is higher than the sale price, and the short seller has a loss. The nature of the gain or loss on a short sale depends upon the nature of the property used to close the short transaction.

If the property used to close the short sale is a capital asset in the hands of the short seller, the gain or loss on the transaction is capital gain or loss. (Code Sec. 1233(a); Reg §1.1233-1(a)(2))

Where the property used to close the short sale is a capital asset, the period the seller held the property determines whether the gain or loss is long- or short-term. However, the capital gain is short-term, regardless of the actual holding period, where the seller either:

- as of the date of the short sale, has owned for not more than one year property that's "substantially identical" to that which he used to close the sale, or
- after the short sale and on or before its closing, acquires substantially identical property. (Code Sec. 1233(b); Reg §1.1233-1(c)(2))

This rule keeps the taxpayer from turning what would normally be a short-term capital gain into a long-term capital gain.

If property "substantially identical" to that sold short was held by the taxpayer for more than one year as of the sale date, any loss on closing of the short sale is long-term capital loss, regardless of how long he held the property used to close the sale. (Code Sec. 1233(d)) This rule applies only to stocks, securities and commodity futures. (Code Sec. 1233(e)(2)(A))

6. Section 1231 Transactions

Under Code Section 1231, if there's a net gain for the tax year from sales, exchanges, and involuntary or compulsory conversions of certain assets, the net gain is treated as long-term capital gain. A net loss is treated as an ordinary loss.

Section 1231 applies to assets used in taxpayer's trade or business that were held for more than one year at the time of disposition. These assets generally include depreciable tangible and intangible personal property, and real property, whether or not depreciable. They also include timber, certain livestock (other than poultry), and unharvested crops that are transferred with land. (Code Sec. 1231(b))

Section 1231 assets don't include:

- inventory,
- property held primarily for sale to customers in the ordinary course of taxpayer's business,
- copyrights or similar musical, artistic, etc., creations in the hands of the creator or certain other taxpayers, or
- U.S. government publications obtained without charge or below the price sold to the general public. (Code Sec. 1231(b); Reg §1.1231-1(c))

Review Question 22

Which of the following is **not** a Section 1231 asset?

a. Real property used in a trade or business.

b. Unharvested crops transferred with land.

c. Inventory.

d. Timber.

If the recognized gains are greater than the recognized losses on sales, exchanges and involuntary conversions of Section 1231 assets, the net amount is generally treated as a long-term capital gain. But, if those losses are greater than those gains, the net amount is treated as an ordinary loss. (Code Sec. 1231(a); Reg §1.1231-1(b))

There is an exception to the general rule. A net Section 1231 gain is treated as ordinary income, and not long-term capital gain, to the extent of nonrecaptured net Section 1231 losses. (Code Sec. 1231(c)(1)) A nonrecaptured net Section 1231 loss is the net Section 1231 loss for the five most recent preceding tax years that hasn't been offset by a net Section 1231 gain in an intervening tax year. (Code Sec. 1231(c)(2)) This prevents a taxpayer from staggering sales so that ordinary net Section 1231 losses are offset against other income instead of net Section 1231 gains.

Capital gain treatment under Section 1231 is also barred to the extent that the depreciation recapture rules apply. (see next section)

7. Depreciation Recapture

Two Code provisions restrict the possibility of converting ordinary income into capital gains by use of depreciation or amortization deductions.

One applies to personal property that is Section 1245 property; the other, to real property that is Section 1250 property. (Code Sec. 1245(a)(3); Code Sec. 1250(c)) Recapture applies only to the extent of gain on a sale or other "disposition" of property. (Code Sec. 1245(a)(1); Code Sec. 1250(a))

Section 1245 recapture. Section 1245 property includes all property depreciated under the Modified Accelerated Cost Recovery System (MACRS) (see IV.P.2.) other than residential real property (27.5-year class) and nonresidential real property (39-year class; 31.5-year class if placed in service before May 13, 1993).

A gain on the disposition of Section 1245 property is treated as ordinary income (and not capital gain) to the extent of depreciation or amortization allowed or allowable on the property. (Code Sec. 1245(a)) The Section 179 expense election is treated as a depreciation deduction for Section 1245 recapture purposes (Code Sec. 1245(a)(2)) An amortizable Sec. 197 intangible also is subject to recapture under Code Sec. 1245. (Code Sec. 197(f)(7))

The amount of gain treated as ordinary income on the disposition is limited to the lower of:

- the recomputed basis of the property minus the adjusted basis of the property. (Code Sec. 1245(a)(1)(A)) Recomputed basis is the adjusted basis of the property increased by the recapturable depreciation and amortization deductions reflected in the adjusted basis (Code Sec. 1245(a)(2)); or
- in the case of a sale, exchange or involuntary conversion, the amount realized minus the adjusted basis of the property; or in the case of any other disposition, the fair market value of the property minus the adjusted basis of the property. (Code Sec. 1245(a)(1)(B))

Section 1250 recapture. All real property subject to depreciation that isn't Section 1245 property is Section 1250 property. (Code Sec. 1250(c)) Thus, Section 1250 property includes MACRS residential real property (in the 27.5-year class) and nonresidential real property (in the 39-year class; 31.5-year class if placed in service before May 13, 1993).

Part or all of the gain on the sale or other disposition of Section 1250 property may be treated as ordinary income. (Code Sec. 1250(a)) But where property was held more than one year, there's no depreciation recapture if it was depreciated via straight line. (Code Sec. 1250(b)) Thus, Section 1250 has had limited applicability since the advent of MACRS. Residential rental or nonresidential real property depreciated under MACRS must generally be depreciated using the straight-line method.

IV. Deductions

Learning Objectives

After completing this section, you should be able to:

- Discuss standard and itemized deductions, the limitations associated with deductions, and exemptions and dependents under the current tax Code.
- Determine the tax benefits related to retirement contributions, medical and health savings accounts, and education expenses.

An individual's deductions can basically be categorized in two different ways:

1. Personal and business deductions. Some deductions are purely personal in nature, such as the personal exemption and the deductions for medical expenses and alimony, and can only be claimed by individuals (and, in many cases, trusts and estates). Other expenses, such as entertainment and uniforms, can be deducted only if they are connected with the individual's trade or business (either as an employee or as a self-employed taxpayer). Still other expenses, such as interest and taxes, may be deducted as either a business or personal expense, but are subject to different rules and restrictions depending on the situation.

"Expenses for the production of income," also known as "nonbusiness expenses," fall into a separate category. Available only to individuals (and trusts and estates), these are expenses of producing or collecting income, or expenses of managing, conserving, or maintaining property held for the production of income, where the income or property is not connected with a trade or business.

2. Deductions for adjusted gross income and itemized deductions. Deductions in computing AGI (also known as "above the line" deductions) include the business expenses of a self-employed taxpayer, a few business expenses of employees (e.g., reimbursed employee expenses), a few personal expenses (e.g., alimony and contributions to individual retirement accounts), and a few "nonbusiness" expenses (e.g., expenses of property held for the production of rent and royalty income).

Itemized deductions include most personal deductions, most employee business expense deductions, and most "nonbusiness" expense deductions.

A. Itemized Deductions and the Standard Deduction

In computing taxable income, an individual may either itemize deductions or claim the standard deduction. No itemized deductions are allowed unless an election to itemize is made on the return. (Code Sec. 63(e)(1); Code Sec. 63(e)(2)) A taxpayer who elects to itemize and wants to switch to the standard deduction, or vice versa, can do so. But the change cannot be made unless a separately filing spouse makes a consistent change (Code Sec. 63(e)(3)(A)), and both spouses consent in writing to the assessment of any deficiency resulting from the change. (Code Sec. 63(e)(3)(B))

1. Itemized Deductions

Itemized deductions are all allowable deductions except those subtracted from gross income in arriving at adjusted gross income (see I.A.), and except the deductions for personal exemptions. (Code Sec. 63(d))

If an individual's adjusted gross income exceeds the "applicable amount," certain otherwise allowable itemized deductions are reduced by the lesser of:

- 3% of the excess of adjusted gross income over the applicable amount, or

- 80% of the itemized deductions otherwise allowable for the tax year. (Code Sec. 68(a))

The reduction is determined after the application of any other limits on the allowance of an itemized deduction (Code Sec. 68(d)) and doesn't apply to the deductions for medical expenses, investment interest, nonbusiness casualty and theft losses, and gambling losses. (Code Sec. 68(c))

For 2013, the "applicable amount" is $300,000 for a joint return or surviving spouse, $275,000 for a head of household, $250,000 for an individual who isn't married and isn't a surviving spouse or head of household, and $150,000 (one-half the joint return amount) for a married individual filing separately. (Code Sec. 68(b)(1)(D) as amended by 2012 Taxpayer Relief Act §101(b)(2)(A)(i)) These figures will be adjusted for inflation after 2013.

Review Question 23

A single taxpayer's adjusted gross income is $50,000 more than the applicable amount for the tax year. The taxpayer has $10,000 of otherwise allowable itemized deductions for the tax year. What is the maximum amount of the reduction in the taxpayer's itemized deductions for the tax year?

a. $8,000. b. $1,500.

c. $300.

2. Standard Deduction

The standard deduction is the sum of the basic standard deduction and any additional standard deduction amounts available for the tax year (Code Sec. 63(c)(1)).The basic standard deduction amounts are adjusted each year for inflation. (Code Sec. 63(c)(4))

The basic standard deduction amounts for 2013 are:

BASIC STANDARD DEDUCTION

Filing Status	**2013**
Joint filers and surviving spouses	$12,200
Heads of household	$ 8,950
Singles	$ 6,100
Marrieds filing separately	$ 6,100

For 2013, the basic standard deduction of individuals who can be claimed as dependents by another taxpayer can't exceed the greater of (a) $1,000 or (b) $350 plus the individual's earned income. But the basic standard deduction can't be more than the regular basic standard deduction amount (e.g., $6,100 in 2013) (Code Sec. 63(c)(5)).

Review Question 24

In 2013, a single taxpayer, who was properly claimed as a dependent on the tax return of another taxpayer, had $500 of interest income and $5,800 of earned income. The taxpayer is entitled to claim a standard deduction of:

a. $0. b. $1,000.

c. $6,100. d. $6,150.

The standard deduction is zero for:

- a married individual filing separately whose spouse itemizes deductions;
- a nonresident alien individual;
- an individual filing a short-year return due to a change of accounting period. (Code Sec. 63(c)(6))

Elderly and blind taxpayers get an additional standard deduction. (Code Sec. 63(c)(3)) A taxpayer who is 65 before the close of his tax year is entitled to the additional standard deduction for the elderly. (Code Sec. 63(f)(1)) A taxpayer who is blind at the close of the tax year is entitled to the additional standard deduction for the blind. (Code Sec. 63(f)(2))The additional standard deduction amounts are: (Code Sec. 63(f)(1); Code Sec. 63(f)(2); Code Sec. 63(f)(3); Code Sec. 63(c)(4))

ADDITIONAL STANDARD DEDUCTION

Filing Status	**2013**
Married and surviving spouses	$1,200
Heads of household	$1,500
Singles	$1,500

A married individual who files a separate return can claim a spouse's additional standard deduction if the spouse has no gross income and isn't the dependent of another taxpayer. (Code Sec. 63(f)(1)(B); Code Sec. 63(f)(2)(B); Code Sec. 151(b))

A taxpayer who is blind must attach a statement saying so to the return; one who is partially blind must attach certification from an eye doctor. Where a physician certifies the blindness is irreversible, certification is necessary only once.

Review Question 25

A single taxpayer was born in 1940 and is legally blind. What is the amount of the taxpayer's total standard deduction for 2013?

a. $6,100.

b. $7,600.

c. $8,500.

d. $9,100.

B. Personal Exemptions

Each taxpayer may be entitled to an exemption for himself and spouse, and may qualify for an additional exemption for each dependent (see below).

The exemption amount is $3,900 for 2013. (Code Sec. 151(d))

However, an individual (e.g., a child) who can be claimed as a dependent by another individual (e.g., the child's parent) can't claim his or her own personal exemption. (Code Sec. 151(d)(2))

A resident alien can claim personal and dependency exemptions under the same rules as U.S. citizens. But no joint return can be made if either the husband or wife is a nonresident at any time during the year, unless the nonresident alien spouse elects to file a joint return and be treated as a resident for tax purposes. (Code Sec. 6013(g))

No exemption is allowed for any individual unless the individual's TIN is included on the return claiming the exemption. (Code Sec. 151(e))

1. Phase-out of Personal Exemption

The personal exemption amount of a taxpayer whose adjusted gross income (AGI) exceeds a specified threshold amount is reduced by an "applicable percentage." (Code Sec. 151(d)(3)(A))

This applicable percentage is 2% for each $2,500 (or fraction thereof) by which the AGI of a taxpayer (other than a married taxpayer filing separately) exceeds the threshold amount for that taxpayer. For married persons filing separately, the applicable percentage is 2% for each $1,250 (or fraction of that amount) by which the taxpayer's AGI exceeds the threshold amount. The applicable percentage can't exceed 100%. (Code Sec. 151(d)(3)(B))

For 2013, the threshold amounts are $300,000 for a joint return or surviving spouse, $275,000 for a head of household, $250,000 for an individual who isn't married and isn't a surviving spouse or head of household, and $150,000 (one-half the joint return amount) for a married individual filing separately. (Code Sec. 151(d)(3) as amended by 2012 Taxpayer Relief Act §101(b)(2)(B)(i)) These figures will be adjusted for inflation after 2013.

2. Exemption for Dependents

A taxpayer is entitled to a deduction equal to the exemption amount for each person who qualifies as his or her "dependent." (Code Sec. 151(c)) A person qualifies as the taxpayer's dependent if the person is the taxpayer's "qualifying child" or "qualifying relative." (Code Sec. 152(a)) However, if an individual is a dependent of a taxpayer for any tax year of that taxpayer that begins in a calendar year, the individual is treated as having no dependents for any tax year of the individual beginning in that calendar year. (Code Sec. 152(b)(1)) Also, an individual won't be treated as a dependent of a taxpayer if the individual has made a joint return with the individual's spouse for the tax year that begins in the calendar year in which the tax year of the taxpayer begins. (Code Sec. 152(b)(2)) Furthermore, an individual who isn't a U.S. citizen or national can't be a dependent unless he or she is a resident of the U.S., Canada or Mexico. However, a nonresident alien child can qualify as a dependent if he is legally adopted by the taxpayer or is lawfully placed with him for legal adoption by the taxpayer, provided that he has the same principal place of abode as the taxpayer and is a member of the taxpayer's household, and the taxpayer is a U.S. citizen or national. (Code Sec. 152(b)(3))

Qualifying child. A "qualifying child" is an individual who:

1. bears a relationship to the taxpayer specified below;
2. has the same principal place of abode as the taxpayer for more than one-half of that tax year; hasn't attained a specified age; and
3. hasn't provided over one-half of his or her own support for the calendar year in which the taxpayer's tax year begins. (Code Sec. 152(c)(1) , Code Sec. 152(c)(2))

The following relationships of an individual to the taxpayer meet requirement (1), above:

- a child (defined below) of the taxpayer or a descendant of such a child (Code Sec. 152(c)(2)(A)), or
- a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of these relatives. (Code Sec. 152(c)(2)(B)) The terms "brother" and "sister" include a brother or sister by the half blood. (Code Sec. 152(f)(4))

The term "child" means an individual who is:

- a son, daughter, stepson, or stepdaughter of the taxpayer (Code Sec. 152(f)(1)(A)(i)), or
- an eligible foster child of the taxpayer (Code Sec. 152(f)(1)(A)(i)), i.e., an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction. (Code Sec. 152(f)(1)(C))

In determining whether an individual is a son, daughter, stepson, stepdaughter, brother, or sister of the taxpayer, a legally adopted individual of the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer, is treated as a child of that individual by blood. (Code Sec. 152(f)(1)(B))

An individual meets the age requirement in (3), above, if he or she:

- hasn't attained the age of 19 as of the close of the calendar year in which the tax year of the taxpayer begins;
- is a student who hasn't attained the age of 24 as of the close of that calendar year; or
- is permanently and totally disabled, at any time during the calendar year. (Code Sec. 152(c)(3))

Effective for tax years beginning after December 31, 2008, the 2008 Adoption Act (P.L. 110-351) added a requirement that in order to be a taxpayer's qualifying child, an individual (other than an individual who is permanently and totally disabled) must be *younger* than the taxpayer. (Code Sec. 152(c)(3)(A) as amended by 2008 Adoption Act §501(a)) The rule is intended to address a situation under prior law in which a taxpayer caring for a younger sibling in a home with no parents was ineligible to claim the earned income credit based solely on the fact that the taxpayer was a qualifying child of the younger sibling if the taxpayer met the age, relationship, and residency tests.

The 2008 Adoption Act also provided that an individual who is married and files a joint return for the tax year beginning in the calendar year in which the tax year of the taxpayer claiming the individual begins can't be a qualifying child, unless the return is filed only as a refund claim. (Code Sec. 152(c)(1)(E) as amended by 2008 Adoption Act §501(b)) This rule applies to all child-related tax benefits, including the child tax credit.

Qualifying relative. A "qualifying relative" is an individual:

1. who bears a specified relationship to the taxpayer;
2. whose gross income for the calendar year in which that tax year begins is less than the exemption amount;
3. with respect to whom the taxpayer provides over one-half of his or her support for the calendar year in which that tax year begins; and
4. who isn't a "qualifying child" of that taxpayer or of any other taxpayer for any tax year that begins in the calendar year in which that tax year begins. (Code Sec. 152(d)(1))

The following relationships of an individual to the taxpayer meet the relationship test (item (1), above): a child or a descendant of a child including an eligible foster child or adopted child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; stepfather or stepmother; a nephew or niece; an uncle or aunt; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; and an individual (other than an individual who, at any time during the tax year, was the spouse of the taxpayer) who, for the tax year of the taxpayer, has as such individual's principal place of abode the home of the taxpayer and is a member of the taxpayer's household. (Code Sec. 152(d)(2))

Although a taxpayer generally cannot claim an individual as a qualifying relative if the individual is a qualifying child of another person, the IRS has provided an exception. An individual is not considered a qualifying child of another person if that person (1) is not required to file an income tax return and (2) does not file an income tax return, or files an income tax return solely to obtain a refund of withheld income taxes. Thus, for example, a taxpayer who provides a home for the child of a friend may be able to claim an exemption for the child if the friend has little or no income. (Notice 2008-5, 2008-2 IRB)

Review Question 26

In which of the following scenarios would the individual be considered a "child" for dependent classification?

a. Susie, who is 17 years old, got married in April 2013 and is planning on filing a joint return for 2013 with her new husband. Before April 2013, Susie lived with her parents and was their dependent.

b. Steven's parents moved to New Mexico and Steven decided to stay in Texas with his best friend's family for his senior year of high school. The friend's family is considering claiming Steven as a dependent, although Steven's family has provided financially for Steven and is claiming him as a dependent.

c. Melissa, the older sister of Edward, is mentally disabled. Melissa came to live permanently with Edward's family in January 2013 when Melissa and Edward's mother passed away. Edward is planning on claiming Melissa as his dependent for the 2013 tax year.

As noted above, a taxpayer can claim a qualifying relative as a dependent only if the taxpayer furnishes more than half that person's support for the calendar year in which taxpayer's tax year begins. The source of support funds is immaterial. Funds used for support are counted in total support even if they are tax-free (e.g., welfare or insurance benefits, borrowed amounts).

Support includes:

- food, school lunches, toilet articles and haircuts;
- clothing;
- recreation, including toys, summer camp, horseback riding, entertainment and vacation expenses;
- medical and dental care, including premiums on accident and health insurance;
- child care expenses, even though a credit is also allowed for these expenses;
- allowances, gifts;
- son’s or daughter’s wedding costs;
- lodging—when furnished in kind, it’s measured by its fair market value rather than actual cost (Reg §1.152-1(a)(2));
- education—these costs include board, uniforms at military schools, and tuition, even where free schooling is available. Scholarship payments received by a dependent are treated as support furnished by someone other than the taxpayer. However, scholarships aren’t counted in determining whether the taxpayer furnished more than half the dependent’s support if (1) the dependent is a child (including stepchild, foster child, or child adopted or placed for adoption) of taxpayer, and (2) is a full-time student at an educational institution (Reg §1.152-1(c));
- social security benefits received by a child and used for his support are considered provided by the child (Reg §1.152-1(a)(2)(ii));
- Armed Forces dependency allotments—the amount contributed by the government and the amount withheld from the pay of the member of the Armed Forces are treated as contributed by the member.
- There is an exception to the more-than-half-support requirement. A taxpayer who fails to furnish more than half a person’s support can claim that person as a dependent under a multiple support agreement. To qualify for the calendar year in which the taxpayer’s tax year begins, taxpayer meets these tests:
    - over half the person’s support was received from a group of persons (including the taxpayer), each of whom would have been entitled to claim the person as a dependent for a tax year beginning in the calendar year if he or she had furnished more than half the claimed dependent’s support; and
    - no one person furnished more than half that support; and
    - the taxpayer contributed more than 10% of support; and
    - each other eligible person who paid over 10% of the support agrees not to claim the person as a dependent by giving the taxpayer a signed statement to that effect. The statements needn’t be filed with IRS but a Form 2120, *Multiple Support Declaration*, showing the names, addresses and social security numbers of the other eligible persons must be attached to Form 1040 or Form 1040A. (Code Sec. 152(c); Reg §1.152-3(c))

Divorce or separation. When parents are divorced or separated, a dependency exemption will usually be claimed by the custodial parent because the custodial parent meets the principal-place-of-abode requirement under the definition of a “qualifying child.” However, a special rule applies if a child receives over one-half of his or her support during the calendar year from his or her parents:

- who are divorced or legally separated under a decree of divorce or separate maintenance;
- who are separated under a written separation agreement; or
- who live apart at all times during the last six months of the calendar year;

and the child is in the custody of one or both of his or her parents for more than one-half of the calendar year.

In this situation, the child may be treated as being the qualifying child of the noncustodial parent under certain conditions. The child is so treated if a decree of divorce or separate maintenance or written agreement between the parents applicable to the tax year provides that:

- the noncustodial parent is entitled to any deduction for dependents allowable for that child; or
- the custodial parent signed a written declaration that the custodial parent won't claim that child as a dependent for the tax year. (Code Sec. 152(e))

The custodial parent may use, but is not required to use, IRS Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, to waive the exemption. A written declaration in lieu of Form 8332 must conform to the substance of that form. A release not on a Form 8332 must be a document executed for the sole purpose of releasing the claim. A court order or decree or a separation agreement cannot serve as the written declaration. If a release of a claim to a child is for more than one year, the noncustodial parent must attach a copy of the written declaration to the parent's return for the first tax year for which the release is effective. Copies must also be attached to returns for later years. (Reg. §1.152-4(e))

C. Charitable Contributions

An individual who itemizes can deduct charitable contributions up to 50%, 30% or 20% of his or her adjusted gross income, depending on the type of property contributed and the type of donee. Amounts that exceed the ceilings can be carried forward for five years. The deduction allowed for property contributions is usually the property's fair market value, but the deduction is reduced for gifts of certain types of property.

An individual's charitable contributions are deductible only as an itemized deduction on Schedule A (Form 1040). (Reg §1.170A-1(a))

A deductible charitable contribution is one that:

- is to, or for the use of, a qualified charitable organization (Code Sec. 170(c));
- is paid within the taxpayer's tax year, regardless of the taxpayer's accounting method (Code Sec. 170(a));
- is within the applicable statutory ceilings for individuals (see below.) (Code Sec. 170(b)); and
- meets certain substantiation requirements. (Reg §1.170A-13)

No charitable deduction is allowed for the value of services a taxpayer renders to charity. (Reg §1.170A-1(g)) But the taxpayer is generally allowed a charitable deduction for his unreimbursed out-of-pocket expenses necessarily incurred in performing services free for a charity. (Code Sec. 170(f)(6); Reg §1.170A-1(g))

A taxpayer who uses his or her car in performing these services may deduct 14¢ per mile as a contribution (Code Sec. 170(i)), or the actual (unreimbursed) expenses for gas and oil. Parking fees and tolls are deductible in either case, as are deductions otherwise allowable for interest or taxes connected with the car, but not depreciation, insurance and repairs.

Taxpayers must substantiate their charitable deductions, and supply appraisals and other information for certain property contributions.

No charitable deduction is allowed for any contribution of cash, a check, or other monetary gift unless the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. (Code Sec. 170(f)(17)). This rule applies to any contribution of money, regardless of amount. The recordkeeping requirements may not be satisfied by maintaining other written records, such as a log of contributions. (Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p.305)

Under proposed IRS regulations, a "monetary gift" would include a transfer of a gift card redeemable for cash, and a payment made by credit card, electronic fund transfer, online payment service, or payroll deduction. A "bank record" would include a statement from a financial institution, an electronic fund transfer receipt, a canceled check, a scanned image of both sides of a canceled check obtained from a bank website, or a credit card statement. "Written communication" would include electronic mail correspondence. (Prop Reg §1.170A-15(b))

No charitable deduction is allowed for any (cash or property) contribution of $250 or more unless taxpayer substantiates it by a contemporaneous written acknowledgement (not just a cancelled check) from the donee (or its agent). (Code Sec. 170(f)(8)(A); Reg §1.170A-13(f)(1)) In general, the written acknowledgment must state: (1) the amount of cash and a description (but not the value) of any property other than cash contributed; (2) whether the donee provided any goods or services in consideration for the contribution; (3) a description and good-faith estimate of the value of those goods or services; and (4) if the goods or services consist entirely of intangible religious benefits (e.g., admission to a religious ceremony, but not religious school tuition or fees), a statement to that effect. (Code Sec. 170(f)(8)(B)(i); Reg §1.170A-13(f)(2))

For noncash contributions that are:

(1) more than $500 but not more than $5,000, the donor must attach to his or her return a description of the contributed property. (Code Sec. 170(f)(11)(B))

(2) more than $5,000 but not more than $500,000, the donor must obtain a "qualified appraisal" (one meeting specified IRS requirements) and attach to his or her return information about the property and appraisal (i.e., appraisal summary) as required by IRS. (Code Sec. 170(f)(11)(C))

(3) more than $500,000, the donor must attached a qualified appraisal to his or her return. (Code Sec. 170(f)(11)(D))

The above requirements in (2) and (3) don't apply to: patents, copyrights, stock in trade, inventory and publicly traded securities. (Code Sec. 170(f)(11)(A)(ii)(I))

1. Qualified Charitable Organizations

A qualified charitable organization is one that fits into one of the categories specified in the law and which IRS has ruled (or the donor establishes) is eligible to receive deductible charitable contributions. Qualified charitable organizations include:

- a corporation, trust, community chest, fund or foundation (including a private foundation) that is organized and operated exclusively for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to children or animals, or to foster and conduct national or international amateur sports competition (but only if none of the activities involves providing athletic facilities or equipment); and that is organized or created in the U.S. or its possessions, or under their laws; and none of whose net earnings inures to the benefit of any private shareholder or individual (Code Sec. 170(c)(2));
- a U.S. state or possession, their political subdivisions, the U.S., and the District of Columbia, but only if the gift is exclusively for public purposes (Code Sec. 170(c)(1));
- war veterans' organizations, their posts or auxiliaries, and trusts or foundations for the benefit of these organizations, organized in the U.S. or its possessions, if no part of their net earnings benefits any private shareholder or individual (Code Sec. 170(c)(3));
- a domestic fraternal society, order or association operating under the lodge system, if the gift is for a charitable purpose; and (Code Sec. 170(c)(4))
- a nonprofit cemetery company chartered solely for burial purposes, if no part of its net earnings benefits any private shareholder or individual. (Code Sec. 170(c)(5))

Contributions made to or for an individual (except for certain charity-sponsored students living in the taxpayer's home) aren't deductible unless made to the individual as an agent for a qualified organization.

2. Statutory Ceiling on Deductions

There's a ceiling on the amount an individual may deduct each year as a charitable contribution, based both on the type of property contributed and the type of charity to which the contribution is made. The ceilings for any tax year are a percentage of taxpayer's "contribution base" for the year, subject to an overall 50% ceiling for all charitable gifts. (Code Sec. 170(b)(1)).

If the contributions are all to "50% charities," the year's ceiling is 50% of taxpayer's contribution base for the year (except for contributions of certain appreciated capital gain property; see below). (Code Sec. 170(b)(1)(A))

If the contributions are all to "30% charities," or are "for the use" of any charities, the ceiling is 30% of taxpayer's contribution base (except for contributions of certain appreciated capital gain property, or, if less, 50% of his contribution base minus the taxpayer's contributions to 50% charities). (Code Sec. 170(b)(1)(B); Reg §1.170A-8(c))

An individual's "contribution base" for a year is his adjusted gross income (AGI) for the year, but without deducting any net operating loss carryback (see IV.L.5.) to that year. (Code Sec. 170(b)(1)(F))

For spouses filing joint returns, these ceilings apply to the couple's combined contributions and their combined contribution base. (Reg §1.170A-2(a)(1); Reg §1.170A-8(a)(1))

For purposes of the deduction ceilings for individuals, "50% charities" are:

- churches (or church conventions or associations);
- tax-exempt educational organizations;
- tax-exempt hospitals and certain medical research organizations;
- certain organizations holding property for state and local colleges and universities;
- a U.S. state or possession, or any political subdivision of any of these, or the U.S. or the District of Columbia, if the contribution is for exclusively public purposes;
- an organization organized and operated exclusively for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to children or animals, or to foster national or international amateur sports competition if it normally gets a substantial part of its support from the government or general public;
- certain private foundations;
- certain membership organizations more than one-third of whose support comes from the public. (Code Sec. 170(b)(1)(A))

For purposes of the deduction ceilings, "30% charities" are qualifying charitable organizations, that aren't 50% charities, e.g., war veterans' organizations, fraternal orders, cemetery companies, and certain private nonoperating foundations. (Code Sec. 170(b)(1)(B); Reg §1.170A-8(c))

If an individual's charitable gifts for a tax year exceed the percentage ceilings for the year, the excess may be carried forward and deducted for up to five years (subject to the later year's ceiling). (Code Sec. 170(d)(1))

Appreciated capital gain property: the ceiling on an individual's deduction in the tax year for gifts of certain appreciated capital gain property to 50% charities is 30% of his or her contribution base, unless the individual makes an election to limit the deduction for the gifts to his or her basis (in which case the 50% ceiling applies. (Code Sec. 170(b)(1)(C)) This rule applies to any capital asset which, if sold for fair market value at contribution, would have given rise to long-term capital gain, other than gifts of tangible personal property and gifts to certain private foundations (see next section). (Code Sec. 170(b)(1)(C))

An individual's deduction ceiling for gifts of appreciated long-term capital gain property to 30% charities is 20% of his contribution base (and there's no election for a reduced deduction like the one for gifts to 50% charities). (Code Sec. 170(b)(1)(D))

A special rule applied in tax years beginning in 2006 through 2013 for qualified conservation contributions (gifts of real property interests, including remainders and perpetual interests exclusively for conservation purposes). Any qualified conservation contribution by an individual is allowed to the extent the aggregate of those contributions doesn't exceed the excess of 50% of the taxpayer's contribution base over the amount of all other allowable charitable contributions. Thus, the 30% contribution base limitation on contributions of capital gain property by individuals doesn't apply to qualified conservation contributions. Instead, individuals may deduct the fair market value (FMV) of any qualified conservation contribution to a 50% charity to the extent of the excess of 50% of the contribution base over the amount of all other allowable charitable contributions. If the aggregate amount of an individual's qualified conservation contributions exceeds the applicable limitation, the excess is carried over to each of the 15 succeeding years in order of time. The carryover is treated as a qualified conservation contribution. (Code Sec. 170(b)(1)(E)(ii)). In other words, individuals can carry over any qualified conservation contributions that exceed the 50% limitation for up to 15 years.

Caution: Expired or expiring provisions may be extended by Congress.

3. Gifts of Property

A gift of property to a qualified charitable donee is generally a charitable contribution to the extent of the property's fair market value (FMV) at the time of the gift, whether or not it has appreciated (Reg §1.170A-1(c)). This rule does not apply to gifts of ordinary income-type property, and certain gifts of tangible personal property or capital gain property.

The property's FMV is reduced for restrictions placed by the donor on marketability or use (e.g., 3-year bar on transfer or license of donated patent).

No gain is realized on a charitable contribution of appreciated property (except for certain bargain sales).

A taxpayer's charitable deduction for the gift can't exceed the property's FMV (at contribution), even if it's less than his or her basis. Nor is a taxpayer allowed a loss deduction for the difference between the property's basis and FMV.

The following special limitations apply to charitable deductions for contributions of clothing and household items (defined below):

(1) No charitable deduction is allowed for any contribution of clothing or a household item unless the clothing or household item is in good used condition or better. (Code Sec. 170(f)(16)(A))

(2) Notwithstanding the rule at (1) above, IRS is authorized to issue regs denying a charitable deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and undergarments. (Code Sec. 170(f)(16)(B); Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p. 304)

(3) Rule (1) above does not apply to any contribution of a single item of clothing or a household item for which a deduction of more than $500 is claimed if the taxpayer includes with his return a qualified appraisal with respect to the property. (Code Sec. 170(f)(16)(C)). In other words, a taxpayer may claim a charitable deduction even if the contributed clothing or household item is not in good used condition, if the claimed deduction is for over $500 and the taxpayer includes a qualified appraisal for the property. (Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p. 304; Prop Reg §1.170A-18(b))

For purposes of these clothing and household item limitation rules, the term "household items" includes:

- furniture;
- furnishings;
- electronics;
- appliances;
- linens; and
- other similar items. (Code Sec. 170(f)(16)(D)(i))

Household items *do not* include:

- food
- paintings, antiques, and other objects of art;
- jewelry and gems; and
- collections. (Code Sec. 170(f)(16)(D)(ii))

Special rules also apply for charitable contributions of motor vehicles, boats and airplanes that aren't in a taxpayer's inventory or held for sale in the ordinary course of his business ("qualified vehicle donations"), if the donation's claimed value exceeds $500. (Code Sec. 170(f)(12)) The donor's charitable deduction can't exceed the gross proceeds from the charity's sale proceeds unless:

- there's a "significant intervening use" of the vehicle by the charity (actual, significant use to substantially further the charity's regularly conducted activities) prior to its sale;
- the charity materially improves the vehicle (significantly increases its value) prior to its sale (minor repairs or routine maintenance aren't enough); or
- the charity sells it at a price significantly below FMV (or gives it away) to a needy individual, in direct furtherance of its charitable purpose of relieving the poor and distressed or the underprivileged who need vehicles.

Ordinary income-type property. For charitable gifts of ordinary income-type property, the amount contributed (property's fair market value (FMV)), must generally be reduced by the amount which would have been recognized as gain other than long-term capital gain if the property had been sold by the donor for its then FMV. (Code Sec. 170(e)(1))

Ordinary income-type property is property which, if sold by taxpayer (donor) at its FMV on the date it was contributed, would have resulted in some amount of gain other than long-term capital gain. This includes: inventory or other property held for sale to customers; capital assets held for less than the long-term holding period; property subject to depreciation, etc., recapture; property used in taxpayer's trade or business; and art works, letters, memoranda and similar property created by or for taxpayer. (Code Sec. 170(e)(1); Reg §1.170A-4(b))

Tangible personal property and certain capital gain property. For certain gifts, the amount treated as contributed and deductible (subject to deduction ceilings above.) is the property's FMV reduced by the total amount of the gain that would have been long-term capital gain if the property were sold for its then FMV.

(Code Sec. 170(e)(1)(B)) The donor's charitable deduction is thus limited to his basis for these contributions:

- tangible personal property that's unrelated to the donee's exempt function (e.g., art to a church that then sells it) (Code Sec. 170(e)(1)(B)(i)); and
- any capital gain property except for publicly traded stock (limited to aggregate contributions of not more than 10% of the value of a corporation's outstanding stock by a donor and his or her family) given to a private foundation that isn't an operating foundation or community foundation and that doesn't make timely qualifying distributions. (Code Sec. 170(e)(1)(B)(ii); Code Sec. 170(e)(5))

Review Question 27

A taxpayer contributed a work of art to the Heart Fund, which will sell the artwork. The taxpayer's basis in the artwork was $10,000 and the fair market value was $28,000. If the taxpayer had sold the artwork, he would have had $18,000 of long-term capital gain on the sale. How much is the taxpayer treated as donating to the charity?

a. $0.	b. $10,000.
c. $18,000.	d. $28,000.

Gifts of partial interests in property. For transfers in trust, a charitable contribution of a partial interest in property (e.g., where the donor transfers only his right to use the property, or his income interest in it) qualifies for a charitable deduction if the interest is:

- a remainder interest transferred to a qualifying charitable remainder trust, or a pooled income fund (Code Sec. 170(f)(2)(A)); or
- an income interest in a qualifying charitable lead trust. (Code Sec. 170(f)(2)(B)) For transfers not in trust, no charitable deduction is allowed for a contribution of less than the donor's entire interest in the donated property except to the extent the deduction would have been allowed had the transfer been in trust. (Code Sec. 170(f)(3)(A)) However, this prohibition doesn't apply to contributions of:
  - a remainder interest in a personal residence or a farm (Code Sec. 170(f)(3)(B)(i));
  - an undivided portion of taxpayer's entire interest (even if partial) in property (Code Sec. 170(f)(3)(B)(ii)), such as a remainder or income interest;
  - a partial interest in property where all of taxpayer's interests in the property are given to one or more charities (e.g., income interest to one charity and remainder interest to another charity) (Reg §1.170A-6(a));
  - a partial interest in real property (including remainders and perpetual restrictions) exclusively for "conservation purposes." (Code Sec. 170(f)(3)(B)(iii); Code Sec. 170(h))

An income tax charitable deduction is not allowed for a contribution of a fractional interest in an item of tangible personal property (such as artwork) unless all interests in the item were owned by the donor, or by the donor and the donee, immediately before the contribution. (Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p. 308) Specifically, no deduction is allowed for a contribution of an undivided portion of a taxpayer's entire interest in tangible personal property unless, immediately before the contribution, all interests in the property are held by:

- the taxpayer, or
- the taxpayer and the donee. (Code Sec. 170(o)(1)(A))

The IRS is to provide for the recapture of the amount of any charitable deduction (plus interest) allowed for the contribution of an undivided interest of a taxpayer's entire interest in property where the following events haven't occurred within a "specified period" (defined below):

(1) the taxpayer does not contribute all of the remaining interest in the property to the donee (or, if the donee is no longer in existence, to any person described in (Code Sec. 170(c)) before the end of the "specified period," and

(2) during the "specified period," the donee hasn't: (a) had substantial physical possession of the property (the "possession" requirement); *and* (b) used the property in a use related to a purpose or function constituting the basis for the organization's tax exemption (the "related-use" requirement). (Code Sec. 170(o)(3)(A) ; Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p. 307)

The "specified period" starts on the date of the taxpayer's "initial fractional contribution" (i.e., the taxpayer's first charitable contribution of an undivided portion of his entire interest in the property) and ends on the earlier of these two dates: (1) the date that's 10 years after the date of the initial fractional contribution, or (2) the date of the taxpayer's death. (Code Sec. 170(o)(3)(A)(i))

Recapture occurs under (1), above, if a taxpayer makes an initial fractional contribution, then fails to contribute all of his remaining interest in the property to the same donee before the earlier of 10 years from the initial fractional contribution or the taxpayer's death (i.e., the end of the "specified period"). But recapture doesn't occur if the donee of the initial fractional contribution is no longer in existence at the end of the period, and the taxpayer's remaining interest is contributed to another charity. (Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p. 307)

Recapture occurs under (2), above, if the donee of a fractional interest in an item of tangible personal property fails to take substantial physical possession of the item, or fails to use the property for an exempt use, during the "specified period." (Joint Comm Staff, Tech Expln of the Pension Protection Act of 2006 (JCX-38-06), 8/3/2006, p. 307)

4. Timing of Deduction

An individual charitable contribution is deductible in the tax year it's paid (subject to percentage ceilings above (Code Sec. 170(a)), regardless of the donor's accounting method or when the gift was pledged. (Reg §1.170A-1(a))

A contribution is "paid" when it's unconditionally delivered to the donee. A contribution by check that's delivered unconditionally is paid when delivered, if it clears in due course. If the check is mailed unconditionally and clears in due course, the contribution is paid when mailed. (Reg §1.170A-1(b))

A contribution charged on a credit card is deductible by a cash basis donor in the year the charge is made, not in any later year when the credit card company is paid.

D. Medical Expenses

An individual who itemizes can deduct the amount of certain unreimbursed medical and dental expenses paid during the year.

For tax years beginning after December 31, 2012, the amount of medical expenses an individual may deduct (on Schedule A, Form 1040) in a tax year is generally limited to the amount by which his unreimbursed payments for those expenses exceed 10% of his adjusted gross income (AGI) for the year. (There's no ceiling on the deduction.) (Code Sec. 213(a) as amended by the 2010 Health Care Act) This represents an increase from the 7.5% of adjusted gross income floor that applied in prior years.However, for the years 2013 through 2016, if either the taxpayer or the taxpayer's spouse is age 65 before the end of the taxable year, the increased threshold will not apply and 7.5% of adjusted gross income deduction floor will continue to apply. (Code Sec. 213(a), (f) as amended by 2010 Health Care Act)

A taxpayer may deduct his or her own medical expenses, and those of a spouse and dependents if the status as spouse, etc., exists either when the medical care was rendered or when the expenses were paid. (Code Sec. 213(a); Reg §1.213-1(e)(3)) For this purpose, "dependent" is defined in Code Sec. 152. An individual may be a dependent for medical expense deduction purposes even if his or her gross income precludes a dependency exemption (see IV.B.2). (Code Sec. 213(a); Reg §1.213-1(a)(3)(i))

However, any expense taken into account under another provision of the Code (e.g., self-employed medical insurance deduction; see IV.P.4.) can't be treated as a medical expense. (Code Sec. 213(e); Code Sec. 35(g)(2); Code Sec. 162(l)(3))

Review Question 28

For regular tax purposes, a taxpayer under age 65 with adjusted gross income of $50,000 who incurs $8,000 of unreimbursed medical expenses can claim a medical expense deduction of ________ for 2013.

a. $3,000.

b. $4,250.

c. $5,000.

d. $8,000.

1. Which Expenses Are Deductible

Deductible medical expenses are amounts paid for the diagnosis, mitigation, treatment, or prevention of disease or for the purpose of affecting any structure or function of the body (Code Sec. 213(d)(1)) and the costs of nursing services (Reg §1.213-1(e)(1)(ii))

The costs of the following are deductible as medical expenses:

- Eyeglasses, artificial teeth or limbs (Reg §1.213-1(e)(1)(ii)), hearing aids, and similar items.
- Discretionary medical procedures affecting the structure or function of the body, including legal abortions and procedures to prevent or facilitate pregnancy (e.g., egg donor fees).
- Eye surgery to correct defective vision, including laser procedures (e.g., LASIK).
- Smoking cessation programs and prescribed drugs designed to alleviate nicotine withdrawal, but not non-prescription nicotine gum and nicotine patches.

- Legally procured prescription drugs (e.g., not aspirin) and insulin. (Code Sec. 213(b); Code Sec. 213(d)(3))
- Weight-loss program for treatment of a specific disease (e.g., obesity, hypertension), but not the cost of diet food.
- Diagnostic tests aiding in the detection of heart attack, diabetes, cancer, and other diseases (but not the collection and storage of DNA, absent a showing of how the DNA will be used for medical diagnosis).
- Self-initiated diagnostic tests for healthy individual, such as full-body electronic scans and pregnancy test kits. (Rev Rul 2007-72, 2007-50 IRB)

Expenses that aren't deductible as medical care include:

- Expenses merely beneficial to the individual's general health. (Reg §1.213-1(e)(1)(ii))
- Costs of cosmetic surgery or similar procedure (e.g., teeth whitening), unless necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma or a disfiguring disease (Code Sec. 213(d)(9))-e.g., breast reconstruction surgery after cancer mastectomy.
- Payments for illegal operations or treatments. (Reg §1.213-1(e)(1)(ii))

Qualified long-term care services are treated as medical care (Code Sec. 213(d)(1)(C)) (unless provided by a relative who isn't a licensed professional, or by a related corporation or partnership). (Code Sec. 213(d)(11)) These services include necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services, which are required by a chronically ill individual and provided under a plan of care prescribed by a licensed health care practitioner. (Code Sec. 7702B(c)(1))

The cost of insurance is deductible as a medical expense to the extent it represents amounts paid for insurance covering medical care as defined above. (Code Sec. 213(d)(1)(D)) When an insurance contract covers both medical care and other items (e.g., loss of income), no amount is treated as for medical care unless (1) the charge for medical insurance is separately stated, (2) the amount treated as paid for medical insurance doesn't exceed the separately-stated charge, and (3) the charge isn't unreasonably large in relation to the total premium for the contract. (Code Sec. 213(d)(6))

Amounts paid as voluntary premiums under Part B of Medicare (supplementary medical insurance benefits for the aged and disabled) are deductible as medical care, as are voluntary premiums under Medicare Part A (basic Medicare) (Code Sec. 213(d)(1)(D)), but not the mandatory employment or self-employment taxes paid for basic coverage under Medicare A. (Reg §1.213-1(e)(4)(i)(a))

Medical expenses include premiums paid for a qualified long-term care insurance contract, up to annual limits. (Code Sec. 213(d)(10)) Qualified long-term care insurance contracts must provide only coverage of qualified long-term care services, must not pay or reimburse expenses to the extent the expenses are reimbursable under Medicare (or would be but for a deductible or coinsurance amount), must be guaranteed renewable, and must meet other detailed requirements. (Code Sec. 7702B(b))

The cost of in-patient care (including meals and lodging) furnished by a hospital is a deductible medical expense. (Reg §1.213-1(e)(1)(v))

The cost of in-patient care (including meals and lodging) at a medical-care institution that is not a hospital qualifies if the individual is there primarily for the availability of medical care and the meals and lodging are a necessary incident to that care. If this test isn't met, only that part of the cost attributable to medical care qualifies. Medical care status depends on the patient's condition and the nature of the services he receives—not on the nature of the institution, which may be federal, state, local or private. Where this test is met, a medical deduction is allowed for:

- costs (including tuition, meals and lodging) of a mentally or physically handicapped person at a special school. (Reg §1.213-1(e)(1)(v)) Costs allocable to medical care at a regular school qualify if the school supplies a cost breakdown.

- costs of a nursing home or home for the aged. But if the person isn't there principally for medical reasons, only the cost of medical care qualifies. (Reg §1.213-1(e)(1)(v))

Amounts incurred for elevators, swimming pools and other permanent improvements to taxpayer's property (including capital expenditures to accommodate a residence to a physically handicapped individual) may be deductible medical expenses if the primary purpose is for the medical care of taxpayer, his spouse or dependents. But the medical deduction is limited to that portion of the expenses that exceeds the amount by which the improvement increases the value of taxpayer's property. (Reg §1.213-1(e)(1)(iii))

Some expenses incurred by or for a physically handicapped individual to remove structural barriers in his residence to accommodate his physical condition (e.g., constructing access ramps, widening doorways, installing support bars) are presumed not to increase the value of the residence and may be deductible in full. (Reg §1.213-1(e)(1)(iii))

Capital expenditures that are related only to the sick person and are detachable from the property aren't permanent improvements, so their full cost can be a medical expense, e.g., detachable inclinators and air conditioners. (Reg §1.213-1(e)(1)(iii))

All the costs of operating or maintaining a medical capital asset are deductible, even if none or only a portion of the cost of the asset itself qualifies. (Reg §1.213-1(e)(1)(iii))

2. When Expenses Are Deductible

Only medical expenses actually paid during the tax year are deductible. (Code Sec. 213(a)) Deduction is thus allowed for payments made in a year even though the expenses were incurred in an earlier year. (Reg §1.213-1(a)(1)) If the payment is made by credit card, the amount is deductible in the year the charge is made regardless of when the credit card bill is paid.

Advance payment of anticipated medical expenses doesn't qualify for a current deduction unless there is a contractual obligation to pay in the current year.

Certain insurance premiums paid by a taxpayer who is under 65 during the payment year, for medical care for himself, his spouse and dependents for the period after he reaches 65 are deductible in the year paid. (Reg §1.213-1(e)(4)(i)(b))

E. Alimony

Payments of alimony or separate maintenance are taxable to the payee spouse, in the year received. (Code Sec. 71(a); Reg §1.71-1(b)(5)) The payments are deductible by the payor spouse in the year paid, as a deduction from gross income. (Code Sec. 62(a)(10); Code Sec. 215(a)) The payor doesn't have to itemize to be allowed the deduction. These rules don't apply if the spouses file a joint return with each other. (Code Sec. 71(e)) To qualify as alimony, a payment must be made in cash, under a divorce or separation instrument. (Code Sec. 71(b)(1)) A transfer of property other than cash can't be alimony.

There must be no requirement that payments continue beyond the death of the payee spouse (e.g., to the estate) or that any substitute payment (in cash or property) be made after the death of the payee spouse—i.e., the payments must end at the payee spouse's death. (Code Sec. 71(b)(1)(D)) If this rule isn't satisfied, none of the payments (even those made during the payee spouse's life) is alimony. (Reg §1.71-1T(b), Q&A-10)

Spouses who are legally separated (but not divorced) under a divorce or separate maintenance decree must not live in the same household when the payment is made, or it won't be alimony. (Code Sec. 71(b)(1)(C)) But if the spouses aren't legally separated, a payment under a written separation agreement or temporary support order may be alimony even if they are members of the same household. (Reg §1.71- 1T(b), Q&A-9)

The spouses aren't treated as members of the same household if one spouse is preparing to leave it, and does leave within one month after the payment.

Payments made in cash by the payor spouse to a third party on behalf of the payee spouse under the terms of the divorce or separation instrument can be alimony. (Code Sec. 71(b)(1)(A)) Payments are on behalf of the payee spouse if they satisfy an obligation to that spouse. Thus, cash payments of the payee spouse’s rent, mortgage, tax or tuition liabilities that the payor spouse makes as required by the instrument can qualify as alimony, as can payments made to a third party (e.g., a charity) at the payee spouse’s written request if the spouses intend them to be alimony.

But payments made to maintain property owned by the payor spouse but used by the payee spouse (including mortgage payments, realty taxes, and insurance premiums) are not payments on behalf of the payee spouse (i.e., not alimony) even if made under the terms of the divorce or separation instrument. (Reg §1.71-1T(b))

A payor spouse who is required by the divorce or separation instrument to pay the mortgage on a home he owns jointly with the payee spouse may deduct one-half of those payments as alimony, if they otherwise qualify (a portion of the rest may be deductible as qualified residence interest if paid on a qualified home, see IV.J.5.).

A payment made under a divorce or separation instrument that’s “fixed” (or treated as fixed) as support for a child of the payor spouse isn’t alimony. (Code Sec. 71(c)(1)) This applies if the instrument designates a specified amount of money or a part of a payment to be child support. The actual amount may fluctuate. (Reg §1.71-1T(c))

A portion of a payment may be treated as fixed if the payment is to be reduced on the happening of a specified contingency relating to the child (Code Sec. 71(c)(2)), e.g., on the child’s 18th birthday, or when he dies, marries or leaves school. A payment may also be treated as fixed if it ends or is reduced at a time that can clearly be associated with the contingency. (Reg §1.71-1T(c))

If a divorce or separation instrument provides a specified amount for alimony and a specified amount for child support, and the payor spouse pays the payee spouse less than the amount designated for child support, then the entire payment is treated as child support and no part is treated as alimony. (Code Sec. 71(c)(3))

Review Question 29

Under a taxpayer’s divorce decree, he is to pay his ex-wife $1,500 a month in alimony until June of Year 4, the month their child will graduate from college. At that point, the alimony payment is reduced to $1,000 a month. Payments are to cease on the death of the ex-wife. During the period that the taxpayer pays $1,500 per month, how much of the payment will qualify as alimony?

a. $0. b. $500.

c. $1,000. d. $1,500.

If there are “excess” alimony payments (“front-loading”), the payor spouse must “recapture” the “excess” by including it in his gross income for the third post-separation year. (Code Sec. 71(f)(1)(A)) The same amount is deducted by the payee spouse in computing adjusted gross income for the payee’s third postseparation year. (Code Sec. 71(f)(1)(B))

The “recapture” amount is the sum of:

- the excess of (a) the alimony or separate maintenance payments in the second post-separation year, over (b) the sum of the payments in the third year plus $15,000 (Code Sec. 71(f)(2)(B)); plus

- the excess of (a) the payments in the first post-separation year, over (b) the sum of the average of the payments in the second year (minus any excess payment in (1), above) and third year, plus $15,000. (Code Sec. 71(f)(2)(A))

The first post-separation year is the first calendar year in which the payor spouse paid alimony, etc., to the payee spouse. The second and third post-separation years are the succeeding calendar years. (Code Sec. 71(f)(6))

There's no recapture if payments cease because either spouse dies or the payee spouse remarries before the close of the third post-separation year. Nor does recapture apply to temporary support payments or payments that fluctuate because of a continuing liability to pay, for at least three years, a fixed portion of income from business, property or services (including self-employment). (Code Sec. 71(f)(5))

F. Individual Retirement Accounts

Employees and self-employed individuals who aren't active participants in an employer-maintained retirement plan can deduct, within limits, contributions to an individual retirement account (IRA) or for the purchase of individual retirement annuities or endowment contracts. An individual who is an active participant in an employer plan (or whose spouse is) can't make deductible IRA contributions unless his or her adjusted gross income is below specified levels (see IV.F.2).

An individual retirement account (IRA) is a trust (or custodial account) created or organized in the U.S. with a written governing instrument. The assets of the account must be invested in a trusteed or custodial account with a bank, savings and loan association, credit union or other qualified person. (Code Sec. 408(a)(2))

IRAs may be set up by employers for employees and by unions for members if these employer- and association-sponsored IRAs separately account for the interest of each participant (or his spouse). (Code Sec. 408(c); Reg §1.408-2(c)) Qualified retirement plans, tax-sheltered annuities, and government retirement plans may allow employees to make voluntary contributions to separate IRA accounts or annuities. (Code Sec. 408(q))

Individual retirement annuities are nontransferable flexible premium annuity or endowment contracts issued by an insurance company. (Code Sec. 408(b))

No tax is paid on income earned on IRA contributions until the retirement savings are distributed, at which time the distribution is taxable (Code Sec. 408(d)(1)) unless there is a qualifying rollover of the distribution.

In addition to the "traditional" IRA described above, there is variant called the Roth IRA (see IV.F.4.). Contributions to a Roth IRA are not deductible, but qualifying distributions are tax-free.

1. Contribution Limit

Except for rollover contributions, the maximum amount that may be contributed to IRAs for any individual for a tax year is $5,500 for 2013. (Code Sec. 408(a)(1); Code Sec. 408(b)(4); Code Sec. 219(b)(1)(A); Code Sec. 219(b)(5)(A))

Individuals who turn age 50 before the close of the tax year may increase the maximum permitted annual contribution by $1,000. (Code Sec. 219(b)(5)(B)) These are referred to as "catch-up" contributions.

2. Deduction for IRA contributions

An individual who isn't an active participant in certain employer-sponsored retirement plans, and whose spouse isn't an active participant, can deduct, for a tax year, cash contributions to an IRA for that year, up to the lesser of: (1) the contribution dollar limits specified above or (2) 100% of the compensation that's includible in his or her gross income for that year. (Code Sec. 219(b)(1))

If the individual (or his spouse) is an active plan participant (for any part of a plan year in his tax year), and has AGI that exceeds an "applicable dollar limit," the contribution dollar limits are reduced (but not below zero). The reduction is equal to that portion of the contribution dollar limit that is equal to modified AGI in excess of the applicable dollar limit divided by $10,000 ($20,000 for joint return filers, except for non-active plan participants whose spouses are active plan participants). (Code Sec. 219(g)(1); Code Sec. 219(g)(2); Code Sec. 219(g)(3)(A); Code Sec. 219(g)(7)(B)) But the maximum IRA deduction can't be reduced below $200 unless the allowable contribution limit is reduced to zero. (Code Sec. 219(g)(2)(B))

For taxpayers filing joint returns, the otherwise allowable deductible contribution is phased out ratably for 2013 for MAGI between $95,000 and $115,000. For 2013, for single taxpayers and heads of household, the otherwise allowable deductible contribution is phased out ratably for MAGI between $59,000 and $69,000. For married taxpayers filing separate returns, the otherwise allowable deductible contribution will continue to be phased out ratably for MAGI between $0 and $10,000.

A special applicable dollar limit applies to an individual who is not an active participant in an employer plan during any part of the year, but whose spouse is an active plan participant. In this case, the applicable dollar limit for 2013 is $178,000 and the phase-out is complete when modified AGI reaches $188,000. The higher limit does not apply to the active-participant spouse. (Code Sec. 219(g)(7))

For tax years beginning after 2006, the income limits for deductible contributions for active participants in an employer sponsored plan and non-active participants whose spouses are active participants (but not for married filing separately) are indexed for inflation. (Code Sec. 219(g)(8))

For purposes of the IRA deduction, an individual is an "active participant" for any tax year in which he or she is eligible to participate in a defined benefit plan, or any year in which employer or employee contributions or forfeitures are added to his account in a defined contribution plan.

Married taxpayers can each make deductible contributions to separate IRAs, subject to the deduction phase-out rules explained above. An individual who files a joint return and has less taxable compensation than his or her spouse may contribute to a spousal IRA and deduct as much as the lesser of (1) the maximum dollar contribution limit for the year (e.g., $5,500 for 2013), plus allowable catch-up contributions or (2) the sum of (a) that individual's includible compensation for the tax year, plus (b) the includible compensation of the individual's spouse (reduced by the spouse's IRA contributions for the tax year). (Code Sec. 219(c))

Review Question 30

For 2013, the maximum deductible contribution that can be made to a regular IRA by an individual age 65 who is not an active participant in an employer sponsored retirement plan is:

a. $0 (no deductible contribution is allowed).

b. $5,500.

c. $6,500.

3. Distributions and Rollovers

Payouts from an IRA can be made without penalty once the participant attains age 59½ (or earlier in the case of death, disability, annuitized payments, certain medical-related distributions, higher education expenses, certain first-time homebuyer expenses, and IRS levies). Premature distributions from an IRA result in an additional tax equal to 10% of the amounts withdrawn that are includible in gross income. (Code Sec. 72(t)(1))

These distributions can be made in a lump-sum or in installments and are generally taxable as ordinary income under the annuity rules (see II.F.2.), when received. However, the distributions are tax-free if reinvested (i.e., "rolled over") within 60 days into that or another IRA. (Code Sec. 408(d)(3)(A))

In the case of distributions made before 2014, a taxpayer may exclude from gross income up to $100,000 of qualifying IRA distributions that are contributed to a qualifying charitable organization if the distribution is made on or after the taxpayer reaches age 70½. (Code Sec. 408(d)(8)(A), (F) as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240))

Caution: Expired or expiring provisions may be extended by Congress.

An IRA owner must begin making certain minimum annual withdrawals from an IRA when he or she reaches age 70½. (Code Sec. 408(a)(6); Code Sec. 408(b)(3)) Failure to make the required minimum withdrawals results in a nondeductible excise tax payable by the recipient. The tax is 50% of the excess of the minimum amount that should have been distributed over the amount actually distributed. (Code Sec. 4974(a))

4. Roth IRA

A Roth IRA is an IRA that is designated as a Roth IRA when it's established (Code Sec. 408A(b)). It's treated as a traditional IRA except to the extent that special rules apply to it. (Code Sec. 408A(a)) Contributions to a Roth IRA aren't deductible (Code Sec. 408A(c)(1)), and are limited based on modified adjusted gross income. Qualified distributions from a Roth IRA aren't included in income (Code Sec. 408A(d)(1)) and other distributions are treated as a return of investment to the extent of contributions to Roth IRAs. (Code Sec. 408A(d)(4)) Rollovers from traditional IRAs to Roth IRAs are taxable, but are not subject to the 10% premature distribution penalty tax. (Code Sec. 408A(d)(3))

Contribution limits. An individual can make annual nondeductible contributions to a Roth IRA in amounts up to lesser of (1) the same dollar limits that apply to traditional IRAs (see above), including catch-up contributions, or (2) 100% of compensation reduced by the amount of contributions for the tax year made to all other IRAs. (Code Sec. 408A(c)(1); Code Sec. 408A(c)(2))

For 2013, the allowable contribution phases out ratably over the following levels of modified AGI: $178,000 to $188,000 for joint filers; $0 to $10,000 for married filing separately; $112,000 to $127,000 for others. However, a $200 contribution may be made if the phase-out lowers the contribution limit to under $200 but more than $0. (Code Sec. 408A(c)(3)(A); Code Sec. 408A(c)(3)(B); Reg §1.408A-3, Q&A 3(b))

The AGI-based contribution limits for Roth IRAs apply whether or not the taxpayer is a participant in a qualified retirement plan.

Review Question 31

For 2013, the Roth IRA contribution limit for an unmarried 53-year-old individual with AGI of $130,000 is:

a. $0.

b. $200.

c. $5,500.

d. $6,500.

Distributions. "Qualified" distributions from Roth IRAs aren't included in income. (Code Sec. 408A(d)(1)) These are distributions made after the five-tax-year period beginning with the first tax year for which the taxpayer or the taxpayer's spouse made a contribution to a Roth IRA established for the taxpayer, (Code Sec. 408A(d)(2)(B)), and that are made:

- on or after attaining age 59½,
- at or after death (to a beneficiary or estate),
- on account of disability, or
- for a qualifying first-time home purchase expense. (Code Sec. 408A(d)(5); Reg §1.408A-6, Q&A 1)

Distributions that aren't qualified distributions are treated as made first from contributions to all of an individual's Roth IRAs and are nontaxable to that extent; distributions in excess of contributions are taxable. (Code Sec. 408A(d)(4)) The 10% early withdrawal tax applies to the portion of an early withdrawal that is includible in income. (Code Sec. 72(t))

Roth IRAs aren't subject to the required minimum distribution rules (see above).

G. Archer Medical Savings Accounts and Health Savings Accounts

The Code provides for two similar tax-favored vehicles that individuals can use to save and pay for medical expenses. The first is the Archer Medical Savings Account (MSA) created under the Health Insurance Portability and Accountability Act of 1996. The second is the Health Savings Account (HSA) created under Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

Note: Archer MSAs were a pilot project that was originally scheduled to expire at the end of 2000 but has repeatedly been extended. The last extension by the Tax Relief and Health Care Act of 2006 (P.L. 109-433) expired on December 31, 2007. As a general rule, no new MSAs are currently permitted; however, qualifying MSAs remain eligible for tax benefits.

Both Archer MSAs and HSAs allow eligible individuals to make deductible contributions to a savings account set up in tandem with "high deductible" health insurance plans. And both allow account owners to make tax-free withdrawals to pay qualifying medical expenses. But in other respects there are important differences between Archer MSAs and HSAs.

1. Archer MSA

Eligible small employers, their employees, and self-employed individuals can, subject to statutory limits, deduct contributions to an Archer MSA. (Code Sec. 106; Code Sec. 220) Otherwise allowable employer contributions are deductible only in the year they are paid. (Code Sec. 106(b)(3)) An eligible self-employed claims deductions for MSA contributions above the line, to arrive at adjusted gross income. (Code Sec. 62(a)(16)) Employer contributions to an MSA are excludable from the employee's income, and qualifying distributions for medical expenses are tax-free. If an individual is entitled to benefits under Medicare, the amount that is allowable as a deduction for an MSA contribution is zero. (Code Sec. 220(b)(7))

Contributions by individuals. In the case of an individual who is an "eligible individual" for any month during the taxable year, a deduction for the taxable year is allowed for cash contributions made during the taxable year by the individual to an Archer MSA (Code Sec. 220(a)) The deduction is subject to limitations discussed below.

A person is an "eligible individual" with respect to a month if:

- the individual is covered under a "high deductible health plan" (HDHP) as of the first day of the month,
- the individual is not, while covered under an HDHP, also covered under any health plan that—
  - is not an HDHP, and
  - provides coverage for any benefit that is covered under HDHP, and
- the HDHP covering the individual is—
  - established and maintained by the employer of the individual or the employer of the individual's spouse, and the employer is a "small employer," or
  - not established or maintained by any employer of the individual or of the spouse, and the individual is self-employed or the spouse of a self-employed individual. (Code Sec. 220(c)(1)(A)

For purposes of determining whether an individual is covered by another non-HDHP, the following coverage is disregarded:

- coverage for any benefit provided by certain "permitted insurance" (e.g., workers' compensation), and
- coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. (Code Sec. 220(c)(1)(B)).

As adjusted for inflation, for tax years beginning in 2013, a "high deductible health plan" is a health plan—

- with an annual deductible of at least $2,150 and not more than $3,200, in the case of self-only coverage,
- with an annual deductible of at least $4,300 and not more than $6450, in the case of family coverage, and
- under which the annual "out-of-pocket expenses" (see below) required to be paid (other than for premiums) for covered benefits do not exceed—
  - $4,300 for self-only coverage, and
  - $7,850 for family coverage. (Code Sec. 220(c)(2)(A))

"Out-of-pocket expenses" include deductibles, co-payments and other amounts that the participant must pay for covered benefits.

An HDHP may be offered by a variety of entities, including insurance companies and health maintenance organizations (HMOs). (Notice 96-53, Q & A 5, 1996-2 CB 219)

A "small employer" generally means, with respect to any calendar year, any employer if the employer employed an average of 50 or fewer employees on business days during either of the two preceding calendar years. For this purpose, a preceding calendar year is taken into account only if the employer was in existence throughout the year. (Code Sec. 220(c)(4)(A)) In the case of an employer that was not in existence throughout the first preceding calendar year, the above determination is based on the average number of employees that it is reasonably expected the employer will employ on business days in the current calendar year. (Code Sec. 220(c)(4)(B))

"Small employer" also includes, with respect to any calendar year, any employer if—

- the employer met the general requirement of being a small employer for any preceding calendar year after 1996,
- any amount was contributed to the Archer MSA of any employee of the employer with respect to coverage of the employee under a high deductible health plan of the employer during the preceding calendar year and the amount was excludable from gross income as an employer contribution or allowable as a deduction under Code Sec. 220(a), and
- the employer employed an average of 200 or fewer employees on business days during each preceding calendar year after 1996. (Code Sec. 220(c)(4)(C))

Deduction limitation. An individual's deduction for the taxable year for a contribution to an Archer MSA may not exceed the sum of the monthly limitations for months during the tax year that the individual is an eligible individual. (Code Sec. 220(b)(1))

The monthly limitation for any month is the amount equal to one-twelfth of—

- 65% of the annual deductible under the coverage in the case of an individual who has self-only coverage under the HDHP as of the first day of the month, or
- 75% of the annual deductible under the coverage in the case of an individual who has family coverage under the HDHP as of the first day of the month. (Code Sec. 220(b)(2))

Although the annual limitation is calculated using monthly data, the contribution for the year can be made in one or more payments, at the convenience of the individual.

No Archer MSA deduction is allowed for any amount paid for any taxable year to an Archer MSA of an individual if—

- any amount is contributed to any Archer MSA of the individual for the year and that amount is excludable from gross income under Code Sec. 106(b) (i.e., employer contributions), or
- any amount is contributed for the year to any Archer MSA of the spouse that is excludable from gross income under Code Sec. 106(b), if the individual's spouse is covered under the HDHP covering the individual. (Code Sec. 220(b)(5))

Review Question 32

For 2013, a single employee has self-only coverage under an HDHP with an annual deductible of $2,150. The employee's employer makes a $1,000 contribution to an Archer MSA for the year that is excludable from the employee's income. What is the maximum deduction the employee can claim for his own contributions to the MSA for 2013?

a. $0.

b. $397.50.

c. $1,397.50.

d. $2,150.

Distributions. Distributions from an Archer MSA that are used to pay the "qualified medical expenses" of the individual or the individual's spouse or dependents are excludable from gross income. (Code Sec. 220(f)(1)) As long as an individual for whom a medical expense was incurred was covered by an HDHP and no other plan (except for those that provide permitted coverage) in the month in which the medical expense was incurred, he or she does not have to be self-employed or employed by a small employer in order for the withdrawal from the Archer MSA to be excluded from income. (Code Sec. 220(d)(2)(C))

"Qualified medical expenses" are any expenses for medical care as defined under the rules relating to the itemized deduction for medical expenses (see IV.D.1.), but only if they are not reimbursed by insurance or otherwise. Qualified medical expenses do not include any insurance premiums, except for premiums for qualified long-term care insurance, health care continuation coverage for certain individuals who have lost employer-provided health coverage, and coverage while the individual is receiving unemployment compensation. (Code Sec. 220(d)(2))

Distributions that are not used to pay the qualified medical expenses of the individual or the individual's spouse or dependents are included in the individual's gross income. (Code Sec. 220(f)(2)) An additional tax of 15% of the amount includible in income also applies, unless a distribution not used for medical expenses is made after the individual attains the age of 65, dies, or becomes disabled. (Code Sec. 220(f)(4))

Termination. After 2007, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously made (or had made on their behalf) Archer MSA contributions and employees who are employed by a participating employer. (Code Sec. 220(i)(2))

2. Health Savings Account (HSA)

Eligible individuals may, subject to statutory limits, make contributions to a health savings account (HSA). Employers as well as other persons (e.g., family members) also may contribute on behalf of eligible individuals. (Code Sec. 106; Code Sec. 223) Employer contributions generally are treated as employer provided coverage for medical expenses under an accident or health plan (see II.B.1.) (Code Sec. 106(d)(1)) An account holder gets the deduction for contributions to his HSA even if someone else (e.g., a family member) makes the contributions. (Code Sec. 62(a)(19)) Employer contributions to an HSA are excludable from the employee's income, and distributions for qualifying medical expenses are tax-free.

Contributions by individuals. An individual who is an "eligible individual" for any month during the tax year is allowed a limited annual deduction equal to the total cash amount paid (either by the individual or on the individual's behalf) to the individual's HSA during the tax year. (Code Sec. 223(a))

An "eligible individual" (for whose benefit an HSA may be established) for any month, is any individual who:

- is covered under a "high deductible health plan" (HDHP) as of the first day of the month, and
- while covered under an HDHP, is not covered under any health plan—
  - which is not a high deductible health plan, and
  - which provides coverage for any benefit that is covered under the high deductible health plan. (Code Sec. 223(c)(1)(A))

Note that, unlike with Archer MSAs, there is no HSA requirement that the HDHP can only be set up by a "small employer" or self-employed individual.

As with an Archer MSA (see above), the determination as to whether an individual is an "eligible individual" is made without regard to coverage by certain "permitted insurance" and coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. (Code Sec. 223(c)(1)(B))

The definition of an HDHP for HSA purposes is different than it is for Archer MSA purposes. Under the HSA rules, an HDHP is a health plan that, for 2013:

- for self-only coverage, has an annual deductible that is at least $1,250, and that limits the annual expenses (the sum of the annual deductible and other annual out-of-pocket expenses) required to be paid under the plan (other than for premiums) to $6,250;
- for family coverage, has an annual deductible that is at least $2,500, and that limits the annual expenses (the sum of the annual deductible and other annual out-of-pocket expenses) required to be paid under the plan (other than for premiums) to $12,500. (Code Sec. 223(c)(2)(A))

These amounts are adjusted for cost of living increases. For 2014, the respective figures are $1,250 and $6,350 for self-only coverage and $2,500 and $12,700 for family coverage. (Rev Proc 2013-25, 2013-21 IRB 1110)

An HDHP may have a zero preventive care deductible or a preventive care deductible below the minimum annual deductible. (Code Sec. 223(c)(2)(C))

Unlike with Archer MSAs, a special rule applies in the case of network plans. A plan that uses a network of providers won't fail to be treated as a high deductible health plan due to its having an out-of-pocket limitation for services provided outside of the network that exceeds the applicable limitation for annual out-of-pocket expenses above. (Code Sec. 223(c)(2)(D)(i)) Further, for purposes of determining the monthly limit on the amount of allowable deductions under an HSA, a network plan's annual deductible for out-of-network services isn't taken into account. (Code Sec. 223(c)(2)(D)(ii))

Contribution limitation. For calendar year 2013, contributions to an HSA cannot exceed $3,250for individuals with self-only coverage ($3,300 for 2014) and $6,250 for individuals with family coverage ($6,550 for 2014). (Code Sec. 223(b)(1))

For an individual who has reached age 55 before the close of the tax year, the contribution limit that would otherwise apply is increased by an "additional contribution amount." (Code Sec. 223(b)(3)(A))

The additional contribution amount is $1,000 for tax years beginning in 2009 and thereafter.

Generally speaking, the annual contribution limit is the sum of the monthly limitations for any month in which the individual is an eligible individual. (Code Sec. 223(b)(2)) The monthly limitation is one-twelfth of the annual applicable dollar limitation. Thus, if an individual is an eligible individual for only six months during the year, the maximum contribution for the year is generally one-half of the regular annual limit. However, for tax years beginning after December 31, 2006, an individual who is an eligible individual during the last month of a tax year is treated as an eligible individual during *every month* of that tax year. Thus, the contribution limit for an individual who is an eligible individual during the last month of a tax year is the full annual contribution limit.

Review Question 33

For 2013, a 60-year-old individual has self-only coverage under an HDHP with an annual deductible of $2,500. How much can the individual contribute to an HSA for 2013?

a. $4,250.

b. $3,250.

c. $3,500.

Distributions. Any amount paid or distributed out of an HSA that's used exclusively to pay the "qualified medical expenses" of any "account beneficiary" (i.e., the individual on whose behalf the health savings account was established) is not includible in the account beneficiary's gross income. (Code Sec. 223(f)(1)) On the other hand, any amount paid or distributed from an HSA that's not used exclusively to pay the qualified medical expenses of the account beneficiary is included in the beneficiary's gross income. (Code Sec. 223(f)(2)) The tax imposed on the account beneficiary for any tax year in which there is a payment or distribution from the beneficiary's HSA that's includible in gross income is increased by 20% of the amount that's includible in the beneficiary's gross income. (Code Sec. 223(f)(4)(A)) However, the additional 20% tax does not apply if:

- the distribution is made after the account beneficiary becomes disabled or dies, (Code Sec. 223(f)(4)(B)), or

- the payment or distribution is made after the date on which the account beneficiary begins Medicare participation, typically age 65). (Code Sec. 223(f)(4)(C))

H. Education Expenses

There are a number of tax benefits designed specifically to help defray the costs of saving and paying for education expenses—for example, the exclusions for employer-sponsored education assistance plans (see II.B.7.) and scholarships (see II.F.4.). This section will cover deductions and other exclusions available for education expenses. For a discussion of education-related tax credits, see V.A.6. & V.A.7.

1. Above-the-Line Deduction for Higher Education Expenses

For tax years beginning before January 1, 2014 eligible individuals can claim an above-the-line deduction for higher education expenses. (Code Sec. 222(e) as amended by American Taxpayer Relief Act of 2012 (P.L. 112-240))

Caution: Expired or expiring provisions may be extended by Congress.

The deduction is available for "qualified tuition and related expenses" of the individual, his or her spouse, or dependents and can be claimed as an adjustment to gross income to arrive at adjusted gross income. (Code Sec. 222(a)) But this higher-education expense deduction cannot exceed the following applicable dollar limit:

- $4,000 for taxpayers whose modified AGI for the tax year does not exceed $65,000 ($130,000 for joint returns);
- $2,000 for taxpayers whose modified AGI exceeds $65,000 ($130,000 for joint returns), but doesn't exceed $80,000 ($160,000 for joint returns). (Code Sec. 222(b)(2)(B))

The deduction for higher-education expenses is allowed for any tax year only to the extent the qualified tuition and related expenses are for enrollment at a higher education institution during that year, except that the deduction is allowed for expenses paid during a tax year if the expenses are in connection with an academic term beginning during that year or during the first 3 months of the next year. (Code Sec. 222(d)(3))

The higher-education expense deduction is not allowed:

- unless the taxpayer includes on his or her tax return for the relevant year the name and TIN of the individual for whom the higher education expenses were paid, (Code Sec. 222(d)(2))
- for any expense for which a deduction was allowed to the taxpayer under any other provision of Chapter 1 of the Code (e.g., as a business expense), (Code Sec. 222(c)(1))
- for a tax year with respect to an individual's qualified tuition and related expenses if he or any other person elected to claim an education credit (see V.A.7.) with respect to that individual for that year. (Code Sec. 222(c)(2)(A))

The higher-education expense deduction cannot be claimed by:

- a taxpayer whose modified AGI exceeds the applicable dollar limits, (see above) (Code Sec. 222(b)(2))
- a married taxpayer filing separately for the tax year (Code Sec. 222(d)(4)), and
- a taxpayer who can be claimed as a dependent on another taxpayer's return (Code Sec. 222(c)(3)).

With certain exceptions, qualified tuition and related expenses are defined the same way as for purposes of the education credits (see V.A.6. & V.A.7.).

2. Deduction for Qualified Education Loan Interest

Student loan interest generally is treated as personal interest and thus isn't deductible. However, individuals may deduct a maximum of $2,500 annually for interest paid on qualified higher education loans. (Code Sec. 221). The deduction is claimed as an adjustment to gross income to arrive at adjusted gross income. (Code Sec. 62(a)(17))

No deduction is allowed under the higher-education loan provision for any amount for which a deduction is allowable under any other provision of the Code (e.g., home equity loan interest; see IV.J.5). (Code Sec. 221(f)(1))

For 2013, the deduction is phased out ratably for taxpayers with modified adjusted gross income (AGI), see below, between $60,000 and $75,000 ($125,000 and $155,000 for joint returns). (Code Sec. 221(b)(2), (f))

A person who is claimed as a dependent on another's return can't claim the education interest deduction. (Code Sec. 221(c)) The deduction may be claimed only by a person legally obligated to make the interest payments. (Reg §1.221-1(b)) Married couples must file joint returns to take the deduction. (Code Sec. 221(f)(2))

A "qualified higher education loan" is any debt incurred by the taxpayer solely to pay qualified higher education expenses that are:

- incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the debt was incurred,
- paid or incurred within a reasonable period of time before or after the debt is incurred, and
- attributable to education furnished during a period when the recipient was at least a half-time student. (Code Sec. 221(d)(1))

3. Business and Employment-related Education Expenses

Education expenses are deductible if made by a taxpayer either (a) to maintain or improve skills required in his business or employment or (b) to meet the express requirements of his employer or the requirements of law or regulations imposed as a condition to retaining his or her salary, status or employment. (Reg §1.162-5)

A lawyer who has actually practiced law may generally deduct the expenses of any further legal education on the grounds that it maintains or improves required skills even though the education qualifies him to practice as a specialist.

If the taxpayer isn't a lawyer but is employed in allied fields where a legal education is helpful or customary, deduction for costs of a legal education is denied. (Reg §1.162-5(b)(3))

Deductions aren't allowed if the education:

- is needed to meet the minimum requirements for taxpayer's present or intended employment, trade, business or profession, (Reg §1.162-5(b)(2))
- is undertaken to fulfill general educational aspirations or for other personal reasons, or
- is part of a program of study that will lead to qualifying the individual in a new trade or business. (Reg §1.162-5(b)(3)(i))

Expenses that are otherwise deductible won't be disallowed because the course of studies leads to a degree. (Reg §1.162-5(a))

Self-employed taxpayers claim education deductions on Schedule C, C-EZ, or F of Form 1040 (see IV.P); employees claim unreimbursed education expenses as miscellaneous itemized deductions on Schedule A, Form 1040 (see IV.O.).

4. Coverdell Education Savings Accounts

Taxpayers can contribute up to $2,000 per year to Coverdell Education Savings Accounts (ESAs) for beneficiaries under age 18 (and special needs beneficiaries of any age). An account is exempt from income tax, and distributions are tax-free if used for qualified education expenses.

A Coverdell ESA is a trust or custodial account created exclusively for the purpose of paying an individual beneficiary's qualified education expenses. (Code Sec. 530(b)(1); Code Sec. 530(g)) The trustee of a Coverdell ESA must be a bank (or other person that demonstrates that it will administer the trust properly).

Annual contributions to a Coverdell ESA for any beneficiary can't exceed $2,000, must be made in cash, and can't be made after the beneficiary turns age 18 (unless the beneficiary has special needs as determined by regulation). (Code Sec. 530(b)(1)(A)) Coverdell ESA contributions for a year may be made as late as the unextended tax return due date for that year. (Code Sec. 530(b)(5))

If the contributor is an individual, the $2,000 limit phases out ratably between $95,000 and $110,000 ($190,000 and $220,000 for joint filers) of modified AGI. (Code Sec. 530(c))

Review Question 34

Married taxpayers filing jointly with modified AGI of $205,000 wish to contribute to a Coverdell Education Savings Account (ESA) established on behalf of their one-year-old daughter. What is their contribution limit?

a. $0.	b. $1,000.
c. $2,000.	d. $5,000

Distributions from Coverdell ESAs. A distribution from a Coverdell ESA is included in the gross income of the distributee generally as provided under the annuity rules of Code Sec. 72 (see II.F.2). (Code Sec. 530(d)(1)) Thus, distributions consist of a pro-rata share of principal (always recovered tax-free) and accumulated earnings (which may be excludable under the Coverdell ESA rules). Distributions from a Coverdell ESA are entirely excluded if qualified education expenses of the beneficiary equal or exceed total Coverdell ESA distributions for the year. (Code Sec. 530(d)(2)(A))

Qualified education expenses include:

- Higher education tuition, fees, books, and supplies, and, for half-time or greater students, certain room and board charges. (Code Sec. 530(b)(2)(A))
- Elementary and secondary (K through 12) public, private or religious school tuition and expenses, including tutoring, room and board, transportation, uniforms, and extended day programs. (Code Sec. 530(b)(3))
- Special needs services for special needs beneficiaries enrolled in any of the above types of schools. (Code Sec. 530(b)(2)(A); Code Sec. 530(b)(3)(A)(i))
- The purchase of any computer technology or equipment or expenses for Internet access and related services for use by the beneficiary and his family during any of the years that the beneficiary is in school, but not expenses for computer software designed for sports, games or hobbies unless it is predominantly educational in nature. (Code Sec. 530(b)(3)(A))

Qualified education expenses are reduced by the same tax-free scholarships and similar payments that reduce qualified tuition and related expenses for education credit purposes (see V.A.6.) (Code Sec. 530(d)(2)(C)(i)(I)), and by those expenses taken into account in determining the education credit.

Distributions aren't taxed if rolled over within 60 days (but not more than once in a 12-month period) into a Coverdell ESA for the same beneficiary or for a member of the beneficiary's family who is under age 30. (Code Sec. 530(d)(5); Code Sec. 530(d)(6))

If Coverdell ESA distributions exceed qualified tuition expenses in a year, part of the earnings portion of the distributions is excludable and the balance of the earnings portion is taxable. The excludable part of the distributions is the earnings portion of the distributions times a fraction having as its numerator the year's qualified education expenses and as its denominator the year's total distributions. (Code Sec. 530(d)(2)(B))

Any taxable amount also is subject to a 10% additional tax, but not (1) if made on or after the beneficiary's death or disability, (2) to the extent the taxable amount doesn't exceed the amount of a tax-free scholarship received by the beneficiary, (3) to the extent the taxable amount doesn't exceed the "advanced education costs" received by the beneficiary at a U.S. service academy (e.g., U.S. Military

Academy), (4) if the distribution is taxable solely because of the rule (explained above) reducing the total amount of qualified education expenses by the expenses taken into account in determining the education credit for the year, or (5) if the tax is attributable to income on a contribution withdrawn (along with associated income) before June 1 of the year following the contribution year. (Code Sec. 530(d)(4))

5. Qualified Tuition (Section 529) Plans

Distributions from a qualified tuition program (QTP, or "Sec. 529 plan") are excludable to the extent used to pay for qualified higher education expenses. A QTP is a program established and maintained by a state (including a state agency or instrumentality), or one or more eligible educational institutions (including private ones) under which a taxpayer may:

- buy tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to a waiver or payment of qualified higher education expenses—i.e., a prepaid educational services account, or
- make contributions to an account set up to meet the designated beneficiary's qualified higher education expenses—i.e., an educational savings account. This option is available only for state (or state agency or instrumentality) programs. (Code Sec. 529(b)(1)(A); Prop Reg §1.529-2(c))

A QTP must provide adequate safeguards to prevent contributions in excess of amounts necessary for the beneficiary's qualified higher education expenses. (Code Sec. 529(b))

Distributions from a QTP: QTP distributions are includible in the distributee's income under the Code Sec. 72 annuity rules, to the extent not excluded under Code Section 529 or any other Code provision. (Code Sec. 529(c)(3)(A)).

In-kind distributions (e.g., tuition credits or waivers, payment vouchers) from state-sponsored QTPs aren't includible in gross income if the benefit, if paid for by the distributee, would have been a payment of a qualified higher education expense. (Code Sec. 529(c)(3)(B); Prop Reg §1.529-1(c))

Cash distributions are fully excludable if they don't exceed qualified higher education expenses, reduced by expenses for which in-kind distributions were received. If cash distributions exceed qualified expenses, the amount otherwise includible under the Code Sec. 72 annuity rules is reduced by the ratio of qualified expenses to distributions. (Code Sec. 529(c)(3)(B)(ii))

Qualified higher education expenses for QTP purposes are: (1) tuition, fees, books, supplies, equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services; and (2) room and board costs (subject to a limit) for students who are at least half-time. (Code Sec. 529(e)(3))

For QTP exclusion purposes, total annual qualified higher education expenses with respect to an individual are reduced by amounts received as excludable scholarships or educational assistance, and by any qualified higher education expenses taken into account in determining the education credits (see V.A.6. & V.A.7.) allowed to the taxpayer or any other person. (Code Sec. 529(c)(3)(B)(v))

Distributions from a QTP aren't taxed if transferred (rolled over) within 60 days (but not more than once in 12 months) to another QTP for the same designated beneficiary or to a QTP for a member of the designated beneficiary's family. (Code Sec. 529(c)(3)(C)(iii))

A 10% additional tax applies to QTP distributions includible in gross income, in the same way and with the same exceptions as for Coverdell ESA distributions (see previous section).

6. Exclusion for Savings Bond Income

Qualified U.S. savings bond income is excluded if redemption proceeds don't exceed qualified higher education expenses. The exclusion phases out at higher levels of modified adjusted gross income.

An individual who pays qualified higher education expenses during a tax year excludes from that year's gross income any amount of income from the redemption in that year of any "qualified U.S. savings bond" (Series EE bond issued after 1989, or Series I bond). (Code Sec. 135(a); Code Sec. 135(c)(1))

If taxpayer's aggregate redemption proceeds (principal plus interest) for a tax year exceed the qualified higher education expenses paid that year, the excluded interest is limited to the otherwise excludable amount times this fraction: the qualified expenses paid that year, divided by the year's aggregate redemption proceeds. (Code Sec. 135(b)(1))

A married individual must file a joint return to get the exclusion. (Code Sec. 135(d)(2))

The individual must have bought the bond(s) after having reached age 24 (Code Sec. 135(c)(1)(B)) and must be the sole owner (or joint owner with his spouse). The exclusion isn't available to the owner of a bond that was bought by another individual (other than a spouse). Nor is it available to a parent who buys the bonds and puts them in the name of a child or other dependent. But the owner may designate an individual (including a child) as the beneficiary for amounts payable at death without losing the exclusion.

For 2013, for joint returns and surviving spouses, the interest exclusion starts to phase out when modified AGI exceeds $112,050 and completely phases out at $142,050. For all others, the exclusion starts to phase out when modified AGI exceeds $74,700 and completely phases out at $89,700. (Code Sec. 135(b)(2))

Review Question 35

Married taxpayers with AGI of $85,000 redeem $8,000 ($4,000 interest, $4,000 principal) of qualified U.S. savings bonds and pay $6,000 of college expenses for their son. Assuming the redemption qualifies for the exclusion for savings bond income and the taxpayers file a joint return, how much of the interest is excludable?

a. $0.
b. $2,000.
c. $3,000.
d. $4,000.

I. "Nonbusiness" Expenses

Individuals may deduct most ordinary and necessary expenses that, though not connected with their trade or business, are paid or incurred for the collection or production of income; the management, conservation or maintenance of property held for the production of income; or the determination, collection or refund of any tax.

But a personal expense or a capital expenditure for which deductions are barred can't be deducted as a nonbusiness expense. (Code Sec. 262(a); Code Sec. 263; Reg §1.212-1(e))

Nonbusiness expenses are included in the deduction for "miscellaneous" expenses and are subject to a 2%-of-AGI floor (see IV.O.).

Nonbusiness expenses cover a wide variety of expenses related to investments (not amounting to a business) if they are ordinary and necessary for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income. (Code Sec. 212(1); Code Sec. 212(2))

A taxpayer may not deduct costs incurred in the production of tax-exempt income (Code Sec. 265(a)(1)) If expenses are attributable to both taxable and tax-exempt income, and can't be specifically identified, they must be prorated. (Reg §1.265-1(c))

An individual may deduct nonbusiness legal fees, e.g., attorney's fees, court costs, etc., if incurred to produce income, preserve income-producing property, etc. (Reg §1.212-1(k)) Nonbusiness legal expenses incurred to acquire, perfect, or defend title to property are not deductible, but any of those costs that are allocable to collecting accrued rents on the property may be deducted. (Reg §1.212-1(k))

Certain "nonbusiness" legal expenses may be deducted from gross income instead of as miscellaneous itemized expenses. These include attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with an action involving a claim (1) of unlawful discrimination, (2) of a violation of subchapter III of chapter 37 of title 31, United States Code ("Claims Against the U.S. Government") or (3) made under section 1862(b)(3)(A) of the Social Security Act (private cause of action under the Medicare Secondary Payer statute). (Code Sec. 62(a)(20)) Attorneys fees relating to whistleblower awards are also exempt from the miscellaneous deduction floor. (Code Sec. 62(a)(21))

Home office expenses (see IV.R.) allocable to "nonbusiness" investment activities aren't deductible (but this doesn't affect deductions for interest, taxes or casualty losses). (Code Sec. 280A) Expenses of a convention, seminar, or similar meeting aren't deductible as nonbusiness (investment) expenses. (Code Sec. 274(h)(7))

As a general rule, legal expenses in connection with divorce, separation or a support decree are personal expenses which cannot be deducted by either spouse. (Reg §1.262-1(b)(7)) However, the part of legal fees attributable to the production or collection of taxable alimony is deductible by the payee spouse.

Individuals may also deduct all the ordinary and necessary expenses incurred in connection with the determination, collection, or refund of any tax. (Code Sec. 212(3)) This applies to income, estate, gift, property and any other tax imposed by federal, state, municipal or foreign authorities. Included are the costs of: preparing tax returns, determining the extent of liability, contesting tax liability, getting tax counsel, protesting assessments, prosecuting refunds, compromising liability (Reg §1.212-1(e)), a tax text used by an individual to prepare his own tax return, tax advice (including estate planning), property appraisal to substantiate a claimed deduction, and contesting civil penalties whether or not the taxpayer is successful. A taxpayer can also deduct fees paid to an attorney for tax research and advice relating to a divorce and property settlement if the fee for the tax work is segregated.

J. Interest

Interest expense is one of the items mentioned earlier than can that fall into either the personal expense category or the business expense category, depending on the circumstances. Like taxes, bad debts, and losses (discussed below), whether interest is deductible or the amount of the deduction depends on which category it falls in.

Interest incurred in a business is generally fully deductible. Personal interest is generally not deductible, but there are some exceptions. Interest deductions for home mortgages and home equity loans are allowed, subject to restrictions. And interest paid in connection with personal investments can be deducted, but only up to the amount of the investment income. Interest paid on certain education loans may also be deducted (see IV.H.2.).

1. Interest Defined

Interest includes the amount paid: (1) for the borrower's use of money during the term of a loan, or (2) for his retention of money after the due date for repayment. Merely designating a payment as "interest" won't make it deductible. Nor does the fact that the payment is taxable interest to the lender make it deductible by the payor-borrower.

"Points" (loan origination fees, loan processing fees, loan discount fees, etc., that are a specified percentage of the amount borrowed) a borrower pays are deductible as interest only if they are solely for the use or forbearance of money and not a charge for services. But points paid for services of the lender in lieu of specific service charges (e.g., a one-point charge for appraisal, etc.) aren't deductible as interest. Nor is a "commitment fee" charged for the lender's agreement to make a future loan. For the timing of a deduction for "points," see IV.J.6.

A penalty paid for prepaying a debt (including a mortgage) is deductible as interest, as is a late payment charge (that isn't a service charge).

2. Who Can Deduct Interest

With some exceptions, a taxpayer's interest deduction is limited to interest paid or accrued on his or her own indebtedness, and not for interest on debts of other persons. But in the case of joint obligors—i.e., persons who are jointly and severally liable for a debt (e.g., co-signers on a note)—each obligor may deduct the amount of interest he or she actually pays on the debt.

A person who is only secondarily liable for the debt, e.g., as endorser or guarantor, generally can't deduct interest on the debt. But if he or she actually pays all or part of the debt, a deduction is allowed.

In certain cases, where a person other than taxpayer pays or accrues the interest on the taxpayer's debt, the payments are treated as made by taxpayer so he or she can deduct the interest. This occurs when the interest payor is acting (or is treated as acting) merely as taxpayer's agent (e.g., where a tenant pays the interest on the landlord's mortgage), or where taxpayer has given some consideration for the payor's payment.

3. Personal Interest

Individuals can't deduct "personal interest." (Code Sec. 163(h)(1)) Generally speaking, personal interest is all interest other than:

- Interest properly allocable to trade or business debt (other than the trade or business of being an employee).
- Interest paid on qualified education loans (see IV.H.2).
- Qualified residence interest (see below).
- Interest considered in computing income or loss from a passive activity (see IV.L.4).
- Investment interest (see below).

4. Investment Interest

The amount of "investment interest" that may be deducted in any tax year by an individual generally is limited to taxpayer's "net investment income" for the year. (Code Sec. 163(d)(1)) Interest that's disallowed because of this limit can be carried over and deducted in later years, subject to the later year's investment income limit. (Code Sec. 163(d)(2))

"Investment interest" is interest paid or accrued on indebtedness properly allocable to property held for investment. (Code Sec. 163(d)(3)(A)) But the deduction limit doesn't apply to interest expense that must be capitalized (e.g., construction interest).

Property held for investment is: (1) any property that produces income properly allocable to portfolio income under the passive activity rules (see IV.L.4) (Code Sec. 163(d)(5)(A)(i)); and (2) any interest in an activity involving a trade or business in which taxpayer doesn't materially participate, if that activity isn't "passive" under the passive activity rules. (Code Sec. 163(d)(5)(A)(ii))

Investment interest includes interest on a home mortgage (other than "qualified residence interest," see below) if its purpose is to acquire investment property.

Investment interest also includes any amount allowable as a deduction in connection with personal property used in a short sale. (Code Sec. 163(d)(3)(C))

For purposes of the deduction limit, a taxpayer's "net investment income" for a tax year is the excess of "investment income" over "investment expenses" for the year. (Code Sec. 163(d)(4)(A))

"Investment income" is the sum of: (1) gross income from property held for investment; (2) any excess of net gain attributable to the disposition of investment property over net capital gain determined by taking into account only gains and losses from these dispositions; plus (3) so much of taxpayer's net capital gain (or net gain, if less) described in (2), as he or she elects (on Form 4952) to include in investment income. Qualified dividend income (see II.C.1.) is included in (3) if the taxpayer so elects. (Code Sec. 163(d)(4)(B))

To the extent that the taxpayer elects to include net capital gain and qualified dividend income in investment income, the net capital gain and qualified dividend income are excluded from "adjusted net capital gain" (see III.C.3.) and are no longer eligible for the capital gain tax rates. Thus, the increase in the allowable investment interest deduction resulting from the election is matched by a corresponding increase in the taxpayer's ordinary income.

"Investment expenses" are deductible expenses other than interest that are directly connected with the production of investment income (Code Sec. 163(d)(4)(C)), but limited to the amount allowed after the 2%-of-AGI floor (see IV.O.).

Investment income and expenses don't include any amounts taken into account in computing income or loss from a passive activity (see IV.L.4). (Code Sec. 163(d)(4)(D))

5. Qualified Residence Interest

Taxpayers may claim itemized deductions for "qualified residence interest." Qualified residence interest" is not subject to the prohibition against personal interest deductions (Code Sec. 163(h)(2)(D); Reg §1.163-10T(b)), or the investment interest limitations (Code Sec. 163(d)(3)(B)(i); Reg §1.163-10T(b)).

"Qualified residence interest" is any interest paid or accrued during the tax year on acquisition indebtedness or home equity indebtedness with respect to any property that, at the time the interest is accrued, is taxpayer's "qualified residence." The deduction is available only to the extent the interest is paid or accrued while the debt is secured by the residence. (Code Sec. 163(h)(3)(A); Reg §1.163-10T(j)(1)) For a cash basis taxpayer, it also includes certain "points" paid on debt incurred in connection with his principal residence (see next section). (Reg §1.163-10T(j)(2)(i))

"Acquisition indebtedness" is debt that:

- meets the dollar limitation described below;
- is incurred in acquiring, constructing or substantially improving taxpayer's "qualified residence" (or adjoining land); and
- is secured by the residence. (Code Sec. 163(h)(3)(B)(i))

In general, acquisition debt must be an obligation of the taxpayer. New debt a taxpayer incurs to refinance his acquisition indebtedness also qualifies, but only up to the amount of the refinanced debt. (Code Sec. 163(h)(3)(B)(i)) Debt is treated as incurred in acquiring, etc., a residence if the debt proceeds can be traced to payment of the costs of the acquisition, etc.

The aggregate amount of debt that may be treated as acquisition indebtedness for any period (i.e., interest on such debt deductible as "qualified residence interest,") can't exceed $1,000,000 ($500,000 for a married individual filing a separate return). (Code Sec. 163(h)(3)(B)(ii)) In a reported decision, the United States Tax Court has held that the $1 million limitation on qualified acquisition indebtedness and the $100,000 limitation on home equity indebtedness apply on a per-residence basis rather than a per-taxpayer basis. Consequently, co-owners not married to each other may not deduct more than a proportionate share of interest on $1.1 million. (Sophy v Comm., 138 T.C. No. 8 (2012))

A "qualified residence" is:

- The taxpayer's principal residence (i.e., one that would qualify for exclusion of gain under Code Sec. 121 (see III.B.6.) (Code Sec. 163(h)(4)(A)(i)(I)); and/or
- any other residence (second residence) taxpayer properly elects to treat as qualified for the tax year, even if he didn't use it as a residence that year.

A second residence that taxpayer rents out to others during the year can't qualify unless he also uses it as a residence (i.e., uses it for personal purposes during the year for more than the greater of 14 days or 10% of the number of days it is rented out for a fair rental). (Code Sec. 163(h)(4)(A)(i)(II); Code Sec. 163(h)(4)(A)(iii); Reg §1.163-10T(p)(3)(iii)) A taxpayer who has more than one residence that meets these tests may elect each year which to treat as the second (qualified) residence. (Code Sec. 163(h)(4)(A)(i); Reg §1.163-10T(p)(3)(iv))

A residence for this purpose includes a condominium or stock in a cooperative housing corporation (coop). Any indebtedness secured by stock in a co-op is treated as secured by the house or apartment taxpayer is entitled to occupy. Even if local restrictions prohibit using the stock as security, it will be treated as securing the debt if taxpayer can show the debt was incurred to acquire the stock. (Code Sec. 163(h)(4)(B); Reg §1.163-10T(p)(3))

A residence under construction may be treated as a qualified residence for a period of up to 24 months, but only if it otherwise qualifies as of the time it's ready for occupancy. (Reg §1.163-10T(p)(5))

As noted earlier, interest paid or accrued on home equity indebtedness is also deductible. Home equity indebtedness is defined as any debt (other than acquisition indebtedness) secured by taxpayer's qualified residence to the extent the aggregate amount of the debt doesn't exceed the fair market value of the residence (as reduced by the amount of acquisition indebtedness owed on it). (Code Sec. 163(h)(3)(C)(i)) Unlike acquisition debt, home equity debt generally may be used for any purpose without affecting its deductibility. The aggregate amount treated as home equity indebtedness (i.e., interest on such debt deductible as qualified residence interest) for any period may not exceed $100,000 ($50,000 for a married individual filing a separate return). (Code Sec. 163(h)(3)(C)(ii))

Mortgage insurance premiums. Premiums paid in 2007 through 2013 for qualified mortgage insurance can be treated as qualified residence interest. Premiums are deductible only if paid in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer. (Code Sec. 163(h)(3)(E)(i) as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240))

The rules do not make qualified mortgage insurance a category of acquisition indebtedness, but rather make it a separate category of qualified residence interest. Therefore, qualified mortgage insurance is not subject to the amount limitations on acquisition indebtedness, and did not affect the amount of indebtedness that can qualify as acquisition indebtedness under those limitations.

Amounts paid for qualified mortgage insurance are deductible as residence interest only if the amounts satisfy the following conditions: (1) the amounts were paid or accrued before January 1, 2014; (2) the amounts were not properly allocable to any period after December 31, 2013; and (3) the amounts were paid or accrued with respect to a mortgage insurance contract issued after December 31, 2006. (Code Sec. 163(h)(3)(E))

"Qualified mortgage insurance" means (1) mortgage insurance provided by VA, the FHA, or the RHA and (2) private mortgage insurance (as defined by Sec. 2 of the Homeowners Protection Act of 1998). (Code Sec. 163(h)(4)(E))

Except for married taxpayers filing separate returns, the amount of premiums otherwise treated as interest were reduced by 10% for each $1,000 (or fraction thereof) that the taxpayer's adjusted gross income (AGI) for the tax year exceeded $100,000. For married taxpayers filing separate returns, the reduction was 10% for each $500 (or fraction thereof) that the taxpayer's AGI for the tax year exceeded $50,000. (Code Sec. 163(h)(3)(E)(ii)) Thus, for example, if a married couple filed a joint return showing $106,000 of AGI, the amount of premiums otherwise deductible was reduced by 60%.

Caution: Expired or expiring provisions may be extended by Congress.

Review Question 36

A taxpayer's first mortgage (acquisition indebtedness) on his home is currently $150,000. The home is valued at $225,000. The maximum amount of home equity debt that can qualify for interest deductions is:

a. $75,000.

b. $100,000.

c. $225,000.

6. Timing of Interest Deductions

The proper time for deducting interest is generally determined by the taxpayer's method of accounting.

An accrual method taxpayer deducts interest when all the events have occurred that fix the fact of liability, the amount of the liability can be determined with reasonable accuracy, and "economic performance" has occurred (see Module 2, Taxation of Businesses).

A cash method taxpayer (as most individuals are) may deduct interest only if it is actually paid during the tax year. (Code Sec. 163(a)) The payment can be made with funds borrowed from another creditor, but not with funds borrowed from the same creditor, or by giving a note for the interest or adding the unpaid interest to principal.

Interest that is prepaid, including "points," is generally deductible only in the tax year to which, and to the extent that, the interest is allocable—i.e., as it accrues. (Code Sec. 461(g)(1)) Cash method taxpayers thus generally deduct points ratably over the term of the loan.

A taxpayer who "pays" points by receiving discounted loan proceeds gets no current deduction. Instead, the discount is deducted over the life of the loan.

A special rule applies in the case of points paid in connection with a principal residence. A cash method taxpayer may (but doesn't have to) deduct points paid on indebtedness incurred in connection with the purchase or improvement of (and secured by) his principal residence, in the tax year of actual payment—i.e., in advance, not over the life of the loan. The charging of points must reflect an established business practice in the geographical area where the loan is made, and the deduction allowed can't exceed the number of points generally charged there. (Code Sec. 461(g)(2))

For loans used to acquire the residence, cash basis taxpayers may currently deduct amounts that meet the above tests and are:

- clearly designated (on Form HUD-1) as points incurred in connection with the debt (including "points" on VA and FHA loans)-i.e., they aren't paid in lieu of nondeductible amounts that are ordinarily stated separately, e.g., appraisal fees;
- computed as a percentage of the stated principal amount of the debt; and
- paid directly by taxpayer to the lender (or mortgage broker). This condition is met where taxpayer provides, from funds that haven't been borrowed for this purpose as part of the overall transaction, an amount at least equal to what is required to be applied as points at closing (even if the amount so provided is used for down payments, escrow deposits, etc., actually paid at closing).

For loans used to improve the residence, the points must be paid with funds other than those borrowed from the lender or mortgage broker.

K. Taxes

A Federal income tax deduction is allowed for certain federal, state, local, and foreign taxes incurred during a tax year. But a distinction exists between taxes that are incurred in a trade or business and taxes that are incurred for nonbusiness purposes. Business taxes are generally deducted to arrive at adjusted gross income. Nonbusiness taxes are taken as itemized deductions to calculate taxable income.

Deductible state, local and foreign taxes are:

- state, local and foreign income, war profits and excess profits taxes;
- state, local and foreign real property taxes;
- state and local personal property taxes; and
- other state, local and foreign taxes (e.g., occupational taxes) paid or accrued in business or for the production of income unless incurred in connection with an acquisition or disposition of property. (Code Sec. 164(a)(1), Code Sec. 164(a)(3))

State or local sales or use taxes paid or incurred in connection with the acquisition or disposition of property aren't deductible, except as noted below. (The buyer treats them as part of the cost, the seller as a reduction in the amount realized.) Other sales taxes are deductible only if paid or incurred in a trade or business or for the production of income. (Code Sec. 164(a)).

For tax years beginning before 2014, taxpayers can elect to deduct (as an itemized deduction) state and local general sales taxes and compensating use taxes, *in lieu* of deducting state and local income taxes. (Code Sec. 164(b)(5)(A)) A general sales tax is a sales tax that is imposed at one rate with respect to retail sales of a broad class of items. A compensating use tax is a tax imposed on the use, storage, or consumption of an item, and which is complementary to a general sales tax on that item. The deduction, which was scheduled to expire for tax years beginning after December 31, 2009, was extended for tax years beginning before 2014. (Code Sec. 164(b)(5)(I) as amended by 2010 Tax Relief Act (P.L. 111-312) and the American Taxpayer Relief Act of 2012 (P.L. 112-240))

Caution: Expired or expiring provisions may be extended by Congress.

These federal taxes are deductible as taxes:

- Federal (and state) generation-skipping transfer (GST) tax imposed on income distributions (see Module 3, *Specialized Tax Issues*);
- Estate tax attributable to income in respect of a decedent (see Module 3, *Specialized Tax Issues*);
- Self-employment taxes (see VII.G.) are one-half deductible (Code Sec. 164(f)).

Taxes not included above (e.g., gasoline, diesel and other motor fuel taxes, transfer taxes on securities and real estate, Social Security (FICA) and unemployment (FUTA) taxes on employers, motor vehicle registration fees) aren't deductible as taxes (although some motor vehicle fees may qualify as personal property taxes), but may be deductible as business expenses or expenses for the production of income. (Reg §1.164-2(f))

These taxes aren't deductible as taxes, expenses or otherwise:

- Federal income taxes, including amounts withheld from wages, interest, etc.
- Alternative minimum tax.
- Social Security (FICA) tax on employees, and Railroad Retirement tax on employees and employee representatives. (Code Sec. 275(a)(1); Reg §1.164-2(a))
- Federal war profits and excess profits taxes. (Code Sec. 275(a)(2); Reg §1.164-2(b))
- Estate, inheritance, legacy, succession and gift taxes (Code Sec. 275(a)(3); Reg §1.164-2(c)) except as noted above, whether state, federal or foreign.
- Income, war profits and excess profits taxes of any foreign country or U.S. possession if taxpayer takes the foreign tax credit for them (see V.C.). (Code Sec. 275(a)(4); Reg §1.164-2(d))

1. Who Can Deduct Taxes

Taxes generally are deductible only by the person on whom they are imposed. (Reg §1.164-1(a))

One who voluntarily pays a tax imposed on another isn't entitled to a deduction. Thus, a shareholder can't deduct his or her payment of the corporation's taxes, or vice versa.

Property taxes are ordinarily imposed on, and therefore are deductible by, the property owner. A person who owns a beneficial interest in property may deduct property taxes he or she pays in order to protect that interest.

Taxes on property that's leased are deductible by the landlord, even if it's the tenant who makes the payment. (Reg §1.162-11(a)) But a tenant deducts taxes paid on improvements the tenant makes where the useful life of the improvements will terminate before the end of the lease.

An individual's deduction for taxes on property he or she owns with other persons as tenants-in-common may be limited to the individual's s pro rata share of the taxes, i.e., the amount attributable to his or her interest, even if the individual pays all the taxes on the property. This pro rata share limit applies where the individual is only assessed for his or her share, where the individual has a right to contribution from the other tenants, or where his or her share won't be subject to sale on the default by the other tenants.

Tenants by the entirety (i.e., spouses) and joint tenants with right of survivorship are entitled to deduct in full the taxes they pay on the jointly-owned property.

2. When Taxes Can Be Deducted

A cash method taxpayer's taxes are deductible for the tax year he or she pays them. State and local taxes withheld from the taxpayer's wages are deductible in the year they are withheld. The tax is deductible in the year of payment even if taxpayer contests the liability and seeks to recover the payment.

A cash basis taxpayer may deduct an advance payment of tax in the year of payment as long as it's an actual good faith payment and not a mere deposit. But an advance payment of state taxes that are later refunded won't be deductible unless taxpayer had a reasonable basis, at the time of payment, for believing he or she owed the taxes.

Deduction in the year of payment also is allowed for advance estimated tax payments made under a pay-as-you-go tax collection system.

An accrual basis taxpayer deducts a tax liability in his tax year in which all events have occurred which determine that he is liable for the tax and fix the amount of that liability, and "economic performance" has occurred—i.e., the tax is paid. (Code Sec. 461(h); Reg §1.461-1(a)(2); Reg §1.461-4(g)(6)).

An accrual basis taxpayer who pays an additional tax without protest or appeal deducts that additional tax in the year the tax was originally due, and not when it's later assessed or paid.

L. Losses

Taxpayers may sustain a loss when their property is transferred, stolen, destroyed, confiscated, abandoned, taken by foreclosure or becomes worthless, and they receive less than their investment (basis) in the property. This loss may be deductible. Subject to the limits discussed below, taxpayers may deduct losses they sustain that aren't compensated for by insurance or otherwise. (Code Sec. 165(a))

Individuals may deduct losses only if they're from a trade or business (Code Sec. 165(c)(1)), a "transaction entered into for profit" (Code Sec. 165(c)(2)), or a casualty or theft. (Code Sec. 165(c)(3))

An individual's losses on personal transactions are deductible only if they qualify as casualty or theft losses. (Code Sec. 165(c)(3)) Thus, no loss deduction is allowed for a loss on taxpayer's residence or car (if used only for personal purposes) unless the loss is from casualty or theft.

Property that a taxpayer holds partly for personal use and partly for business or income-producing use is treated as two properties: one personal, one business (or income-producing). Loss on the personal part (except by casualty or theft) isn't deductible.

A loss is generally deductible only for the tax year it's sustained. (Code Sec. 165(a)) This is the year the loss occurs, as evidenced by closed and completed transactions and as fixed by identifiable events in that year. (Reg §1.165-1(d))

The Code also addresses the issue of operating losses. If an individual's business expenses exceed gross income, the individual can carry the net loss backward or forward to other tax years (see L.5.). On the other hand, in certain activities, if an individual's expenses exceed income, the expenses may not be currently deductible (see L.4.) to the extent that they exceed income. In other activities, the currently deductible expenses may be limited to the amount the individual has invested in an activity (see L.3.). And there is still another limitation on deductible expenses when an activity is not engaged in for profit (see next section).

1. Losses from a Business or Transaction Entered into for Profit

A trade or business ("business") is a pursuit or occupation carried on for profit, whether or not profit actually results. An isolated transaction isn't a business. A taxpayer may engage in one business, in more than one business, or in no business.

A transaction is entered into for profit if a taxpayer intends to receive income from it overall. For a transaction involving property, a taxpayer must intend to receive income from it or to profit from disposing of it. Profit must be the primary motive, not merely incidental. A loss deduction is possible where a secondary nonprofit motive exists, as long as the profit motive predominates.

An activity is presumed to be engaged in for profit for a tax year if it shows a profit for any three or more out of five consecutive years ending in that tax year (or two out of seven years, for breeding, showing, or racing, of horses). (Code Sec. 183(d); Reg §1.183-1(c)) A taxpayer who hasn't engaged in an activity for more than five years (seven, for horse breeding, etc.) can elect to postpone the determination as to whether these presumptions apply until the close of the fourth tax year (sixth, for horse breeding, etc.) after the tax year taxpayer first engages in the activity. (Code Sec. 183(e); Reg §12.9)

Deductions attributable to an activity not engaged in for profit (e.g., a hobby-type activity) (Code Sec. 183(a); Reg §1.183-1(a)) are allowed only as follows:

- The full amount of deductions (e.g., state and local property taxes) otherwise allowable for the tax year without regard to whether the activity is engaged in for profit (Code Sec. 183(b)(1); Reg §1.183-1(b)(1)(i))-referred to as "Category 1 deductions."
- Amounts allowable as deductions only if the activity is engaged in for profit, but only if the allowance doesn't result in a basis adjustment, and only to the extent the gross income from the activity exceeds the deductions in (1), above (Code Sec. 183(b)(2); Reg §1.183-1(b)(1)(ii)) "Category 2 deductions."
- Amounts allowable as deductions only if the activity is engaged in for profit, that if allowed would result in a basis adjustment (e.g., depreciation), but only to the extent the gross income from the activity exceeds deductions allowed or allowable under (1) and (2) (Code Sec. 183(b)(2); Reg §1.183-1(b)(1)(iii); Reg §1.183-1(b)(3)) "Category 3 deductions."

In other words, deductions attributable to the "not for profit" activity are allowed to the extent of income from it or to the extent of the full amount of related deductions that are allowable regardless of profit-seeking, whichever is larger. However, the deductions allowable under these rules are subject to the 2%-of-AGI floor on miscellaneous itemized deductions (see IV.O.) (Reg §1.67-1T(a)(1)(iv)).

Worthless stock or securities. A taxpayer may deduct a loss from the worthlessness of stock or other securities (i.e., a bond, debenture, note, certificate or other evidence of indebtedness issued by a corporation or by a government (or its political subdivision) with interest coupons or in registered form). (Code Sec. 165(a); Code Sec. 165(g)(1))

The taxpayer must show that the security had value at the end of the year preceding the deduction year and that an identifiable event caused a loss in the deduction year.

The amount of the loss is, to the extent not compensated for (e.g., recovered through insurance), the security's adjusted basis for determining loss on sale. (Code Sec. 165(b); Reg §1.165-1(c))

The deduction is a capital loss if the security is a capital asset to taxpayer. (Code Sec. 165(g)(1)) An ordinary loss deduction is allowed if the security is not a capital asset (Reg §1.165-5(b)) or qualifies as Section 1244 stock (see III.C.4.).

Total worthlessness of the security is generally required for the deduction. No loss deduction is allowed for partial worthlessness. (Reg §1.165-4; Reg §1.165-5)

Demolition losses. No deduction is allowed to the owner or lessee of a building for any loss on demolition of the building, or for any of the demolition expenses. (Code Sec. 280B(1)) The loss or expenses must be capitalized and added to the basis of the land. (Code Sec. 280B(2))

Abandonment losses. A loss deduction is allowed for loss of usefulness or for the obsolescence of nondepreciable property, both tangible and intangible (e.g., land, a contract), if:

- the loss is incurred in business or a transaction entered into for profit;
- it arises from the sudden termination of usefulness in the business or transaction; and
- the property is permanently discarded from use, or the business or transaction is discontinued. (Reg §1.165-2)

The loss is an ordinary loss not subject to capital loss limitations. (Reg §1.165-2(b)) The loss can't exceed the adjusted basis of the property for determining loss on a disposition. (Reg §1.165-1(c))

Gambling losses. A taxpayer may deduct gambling losses suffered in the tax year, but only to the extent of that year's gambling gains. (Code Sec. 165(d); Reg §1.165-10) "Gains" include "comps" (complimentary goods and services a taxpayer receives from a casino). Losses from one kind of gambling (e.g., horse bets) are deductible against gains from another kind (e.g., newspaper pool). Individuals not engaged in the gambling business deduct gambling losses (to extent of gambling gains) only as miscellaneous itemized deductions (but not subject to the 2%-of-AGI floor; see IV.O.).

2. Casualty and Theft Losses

Losses from fire, storm, auto accident or other casualty, and losses from theft, are deductible, regardless of whether the loss is sustained in a business or profit transaction. An early deduction for disaster losses is available.

A "casualty" is the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature such as a fire, storm, shipwreck, car crash, or similar event. Progressive deterioration from a steadily operating cause isn't a casualty.

Amount of casualty loss. The amount of a casualty loss depends on whether an individual held the property for personal or for business purposes.

For property held for personal use, the amount of the casualty loss is the lesser of: (1) the property's adjusted basis (i.e., its basis for determining loss on disposition), or (2) its decline in value (i.e., its fair market value (FMV) immediately before the casualty minus its FMV immediately afterward). This applies whether the property is totally destroyed or merely damaged. (Reg §1.165-7(b)) The loss is reduced for any salvage value, insurance or other compensation received. (Reg §1.165-1(c)(4))

For property used in business or held for the production of income, the amount of the casualty loss is determined under the same rules as for personal-use property, except that if the property is totally destroyed, the amount of the loss is the property's adjusted basis in all cases. (Reg §1.165-7(b)(1))

Costs of repairing, replacing, or cleaning up property after a casualty can be used to measure the amount of the loss (decline in value) if: the repair, etc., is necessary to restore the property to its pre-casualty condition; the amount spent isn't excessive; the repairs do no more than take care of the damage suffered; and the post-repair value is no greater than the pre-casualty value. (Reg §1.165-7(a)(2))

Limitation on casualty loss deduction. As a general rule, a taxpayer may deduct a casualty loss on property not used in business or held for production of income only to the extent that:

- the casualty loss exceeds $100, and
- all of taxpayer's casualty losses for the tax year exceed 10% of adjusted gross income for the year. (Code Sec. 165(h))

Each personal-use property casualty is subject to a separate floor to determine the extent to which it's deductible. But events closely related in origin give rise to a single casualty. Thus, one storm's damage to taxpayer's house and car is a single casualty, so a single floor applies in determining the deduction. (Code Sec. 165(h)(1); Reg §1.165-7(b)(4)(ii))

Also, a single floor applies where one casualty causes loss to joint filers, whether the loss is to property jointly or separately owned. But separate floors apply to each spouse if they file separately, even if the property is jointly owned. (Code Sec. 168(h)(4)(B); Reg §1.165-7(b)(4)(iii))

After applying the per-casualty floor, personal-use property casualties are then subject to this percentage-of-AGI limit: If personal casualty losses for a tax year exceed personal casualty gains for that tax year, a taxpayer may deduct the losses for that year, but only to the extent of the sum of:

1. the amount of the personal casualty gains for the year, plus
2. the amount by which (a) the excess of personal casualty losses over gains ((1) above), exceeds (b) 10% of taxpayer's AGI (computed without regard to casualty gains). (Code Sec. 165(h)(2)(A))

If the personal casualty losses for a tax year exceed the personal casualty gains for that year, the deduction for personal casualty losses is allowable in computing AGI, to the extent of those gains. (Code Sec. 165(h)(4)(A)) If the personal casualty gains for any tax year exceed the personal casualty losses for that year, all these gains and losses are treated as capital gains and losses (Code Sec. 165(h)(2)(B)) not subject to the 10% floor.

Where property is held for both business (or profit) and personal purposes (e.g., a home office), these limits apply only to the personal part of the loss. (Reg §1.165-7(b)(4)(iv))

Review Question 37

Which of the following limitations applies when determining a taxpayer's personal casualty loss deduction?

a. Reduction of the loss from each casualty by a flat dollar casualty deduction floor.

b. Reduction of the overall loss by a flat dollar casualty deduction floor.

c. Reduction of the overall loss by 10% of adjusted gross income.

d. Reduction of the loss from each casualty by a flat dollar casualty deduction floor and reduction of the overall loss by 10% of adjusted gross income.

When casualty losses are deductible. A casualty loss, like other losses, is generally considered "sustained" (and deductible) only during the tax year the loss occurs, as fixed by identifiable events occurring in that year. (Code Sec. 165(a); Reg §1.165-1(d)(1)) A loss may be sustained in the tax year even though repairs or replacements aren't made until a later year. And a loss may be sustained in a year after the casualty occurs, as when trees died a year after the year a blizzard damaged them.

Special rules apply in the case of a loss that's attributable to a disaster occurring in an area the President later says is entitled to federal disaster assistance. A taxpayer may elect to deduct a disaster loss for the tax year the loss occurred, or for the tax year before the year the loss occurred. (Code Sec. 165(i))

Individuals who incur a disaster loss with respect to nonbusiness property are subject to the regular per-casualty/10%-of-AGI floors. (Code Sec. 165(i))

A taxpayer whose residence is located in a federally-declared disaster area may deduct any loss attributable to the disaster as a casualty loss if the residence is rendered unsafe by the disaster, and he or she is ordered (within 120 days after the disaster designation) by the state or local government to demolish or relocate the residence. (Code Sec. 165(k)) A non-casualty loss in a federally-declared disaster area may qualify as a disaster loss if incurred in the course of a trade or business or profit-seeking transaction. For example, a farmer might deduct a loss from a drought disaster, even though loss from drought is ordinarily not deductible as a casualty loss.

The early deduction is elected on the return (original or amended) for the previous year, or on a refund claim. The election must be made by the later of: (1) the due date for the disaster year return (without regard to extensions), or (2) the due date for the previous year return with permitted extensions. Once made, the election becomes irrevocable after 90 days. (Reg §1.165-11(e))

Theft losses. Theft losses are deductible under rules that closely follow those for casualty losses, including the per-theft/10%-of-AGI floors. (Code Sec. 165(a); Code Sec. 165(h)(1); Code Sec. 165(h)(2))

A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it, and includes larceny, robbery, embezzlement (Reg §1.165-8(d)), burglary, extortion, kidnapping for ransom, blackmail and false representation. A taking by a person known to have a claim to the property (e.g., spouse, joint owner) isn't a theft unless there's evidence of criminal intent.

For theft of business or investment property, the deductible loss is the adjusted basis of the property minus insurance or other compensation received or recoverable. (Reg §1.165-8(c))

For theft of personal-use property, the loss is: (1) the lesser of the property's fair market value (FMV) immediately before theft or its adjusted basis, reduced by (2) insurance or other compensation received or recoverable. (Reg §1.165-8(c)) The per-theft/10%-of-AGI floors are then applied to determine the amount of the loss that is deductible. (Code Sec. 165(c)(3))

If stolen personal-use property is recovered in the deduction year, the loss is the lesser of: (1) the property's adjusted basis, or (2) the decline in its FMV between theft and recovery. If it's recovered after the deduction year, the excess of the earlier deduction over the loss determined as above is included in income, to the extent the earlier loss deduction decreased taxpayer's tax.

3. "At-risk" Loss Limitations

Any loss from an individual's business or income-producing activity for the tax year is deductible in that year only to the extent that the individual is "at risk" with respect to the activity at the end of the year. (Code Sec. 465(a)) The losses so limited are the excess of the deductions allocable to the activity that otherwise would be allowed for the year, over the income (other than recapture, see III.C.7) received or accrued by taxpayer during the year from that same activity. (Code Sec. 465(d))

Any loss thus disallowed is treated as allocable to the same activity in the next tax year, and may be deducted in the later year subject to that year's at-risk limit for the activity. (Code Sec. 465(a)(2)) Thus, a current year's "loss" may include "suspended" loss accounts from earlier years. (Code Sec. 465(d))

An individual is considered at risk for an activity to the extent of:

- the amount of money and the adjusted basis of other property the individual contributed to the activity (Code Sec. 465(b)(1)), plus
- amounts borrowed with respect to the activity to the extent taxpayer is personally liable for the repayment of or has pledged property, other than property used in the activity, as security for the borrowed amount. The borrowings can't exceed the fair market value of taxpayer's interest in the pledged property. No property is treated as security if it is directly or indirectly financed by indebtedness secured by property contributed to the activity. (Code Sec. 465(b)(1); Code Sec. 465(b)(2))

Amounts "at risk" don't include borrowings from any person who has an interest in the activity other than as a creditor, or from a related person as specially defined. Any amounts, including equity capital contributed by an individual, aren't treated as at risk if the amounts are protected against loss through nonrecourse financing, guarantees, stop-loss agreements or similar arrangements. (Code Sec. 465(b)(4))

In determining the amount at risk for any tax year, the amount for that year is reduced by any losses allowed under these limitations in an earlier year. (Code Sec. 465(b)(5))

In the case of real property, an individual is considered at risk for his or her share of any "qualified nonrecourse financing" secured by the real property. (Code Sec. 465(b)(6)(A)) This means financing:

- borrowed by the individual with respect to the activity of holding real property (as specially defined);
- borrowed by the individual from a qualified person (as specially defined) or from any federal, state, or local government or instrumentality or is guaranteed by any federal, state or local government;
- except as regulations provide, on which no one is personally liable for repayment; and
- that isn't convertible debt. (Code Sec. 465(b)(6)(B); Reg §1.465-27)

4. Passive Activity Loss Limitations

"Passive activity" losses may be used only to offset passive activity income (which doesn't include "portfolio income"). Thus, an individual can't use the losses to offset income from, for example, compensation (or interest or dividends). Any excess losses are carried forward to the following year(s) until used, or until the individual disposes of the interest in the activity (or substantially all of the activity) in a taxable transaction. Passive activity credits may be used only to offset tax on income from passive activities, with a carryover of any excess. Nonetheless, as to rental real estate activities, an individual who "actively participates" may get a limited deduction allowance, and so may certain individuals who "materially participate" in the real property business.

A "passive activity" loss for a tax year is the amount, if any, by which the aggregate losses from all passive activities for the tax year exceed the aggregate income from all passive activities for that year—i.e., the excess of passive activity deductions over passive activity gross income. (Code Sec. 469(d)(1); Reg §1.469-2T(b)(1))

A deduction is a "passive activity deduction" for a tax year only if it:

- arises in connection with the conduct of an activity that is a passive activity for that year, or
- is carried over as a passive activity deduction from an earlier tax year. (Reg §1.469-2T(d)(1))

Passive activity gross income is, in general, gross income from a passive activity. (Reg §1.469- 2T(c)(1)) Passive activity gross income does not include portfolio income (Code Sec. 469(e)(1)(A)(i)(I); Reg §1.469-2T(c)(3)(i)), or compensation for personal services. (Code Sec. 469(e)(3);Reg §1.469- 2T(c)(4)) Gain recognized on the sale, exchange or other disposition of an interest in property generally is treated as passive activity gross income for the year the gain is recognized, if the activity in which the property was used was a passive activity for the year of disposition. (Reg §1.469-2T(c)(2)(i)(A))

"Portfolio income" (treated as gross income not from a passive activity), includes all gross income, other than income derived in the ordinary course of a trade or business, attributable to interest; dividends from a C corporation or an S corporation's accumulated earnings and profits; annuities; royalties; gain (loss) from the disposition of property that produces portfolio income; gain (loss) from the disposition of property held for investment and certain other investment-type income (Code Sec. 469(e)(1)(A); Reg 1.469-2T(c)(3)(i))

A passive activity is generally any activity involving the conduct of any trade or business in which taxpayer doesn't "materially participate."

An individual materially participates in an activity for a tax year if and only if the individual meets at least one of the following tests:

- The individual participates in the activity for more than 500 hours during the year. (Reg §1.469- 5T(a)(1))
- The individual's participation in the activity for the tax year is substantially all of the participation by all individuals (including nonowner individuals) for the year. (Reg §1.469-5T(a)(2))
- The individual participates in the activity for more than 100 hours during the tax year and the individual's participation is not less than that of any other individual (including nonowners) for that year. (Reg §1.469-5T(a)(3))
- The activity is a "significant participation activity" for the tax year, and the individual's aggregate participation in all significant participation activities for that year exceeds 500 hours. A "significant participation activity" is a trade or business in which the individual significantly participates (for more than 100 hours), but in which he doesn't otherwise materially participate. (Reg §1.469- 5T(a)(4); Reg §1.469-5T(c))
- The individual materially participated in the activity for any five tax years (consecutive or not) during the 10 immediately preceding tax years. (Reg §1.469-5T(a)(5))
- The activity is a personal service activity, and the individual materially participated in the activity for any three tax years (consecutive or not) before the tax year. (Reg §1.469-5T(a)(6); Reg §1.469-5T(d))
- The individual meets a facts and circumstances test. (Reg §1.469-5T(a)(7))

Rental activities. Rental activities are generally passive activities (Code Sec. 469(c)(2)) without regard to material participation. (Code Sec. 469(c)(4)) However, there are a couple of exceptions to this rule.

One exception applies to an individual who has at least a 10% interest in any rental real estate activity and "actively participates" in that activity ("active participation" is a lower standard than "material participation"). In this case, the individual, may offset up to $25,000 of nonpassive income with that portion of the passive activity loss, or of the deduction equivalent of the passive activity credit, attributable to the rental real estate activity. Under a phase-out rule, the $25,000 "ceiling" is reduced by 50% of the excess of taxpayer's AGI above $100,000. (Code Sec. 469(i)(1); Code Sec. 469(i)(2); Code Sec. 469(j)(5))

The second exception applies to real estate professionals. For any tax year in which an individual qualifies, the rule treating all rental activities as passive activities doesn't apply. (Code Sec. 469(c)(7)(A)(i)) Instead, the taxpayer's rental real estate activity is not a passive activity if the taxpayer materially participates in it. (Reg §1.469-9(e)(1)) Thus, qualifying individuals who materially participate in a rental real estate activity may use losses or credits from the activity to offset other, non-passive income.

An individual qualifies for a particular tax year if:

- more than half of the personal services the individual performs during that year are performed in real property trades or businesses in which the individual materially participates (Code Sec. 469(c)(7)(B)(i)), and
- the individual performs more than 750 hours of services during that year in real property trades or businesses in which he or she materially participates. (Code Sec. 469(c)(7)(B)(ii))

An individual who owns at least one interest in rental real estate and who meets the above tests is a qualifying individual. (Reg §1.469-9(b)(6))

5. Net Operating Loss

A net operating loss (NOL) sustained in one year by an individual may be used to reduce the taxable income for another year.

An NOL is the excess of business deductions (computed with certain modifications) over gross income in a particular tax year. A deduction is allowed for that loss, through an NOL carryback or carryover, in some other tax year(s) in which gross income exceeds business deductions. (Code Sec. 172(a); Reg §1.172-1(a))

An NOL for any tax year may be carried back two years and forward 20 years. A three-year carryback period applies to NOLs arising from property losses of individuals due to fire, storm, shipwreck, or other casualty, or from theft. In addition, for a small business or a taxpayer engaged in the trade or business of farming, a three-year carryback period applies to NOLs attributable to Presidentially declared disasters. A small business is one whose average annual gross receipts are $5 million or less. (Code Sec. 172(b)(1)(F)) A special five-year carryback period may apply to certain farming losses (see Module 3, *Specialized Tax Issues*).

A taxpayer may elect not to use the carryback period and instead only carry over the NOL for the allowed carryforward period. Once the election is made for any tax year, it's irrevocable for that year. (Code Sec. 172(b)(3); Reg §301.9100-12T(d))

Review Question 38

The carryback period for a net operating loss arising from a calendar-year individual's property loss due to a fire is:

a. Two years.

b. Three years.

c. Five years.

M. Bad Debts

Bad debts are deductible whether or not connected with taxpayer's business. A deduction is allowed for total worthlessness and, in some cases, for partial worthlessness of a debt.

1. Amount of Deduction

The amount deductible for a wholly worthless debt is its adjusted basis for determining loss on a sale or exchange, regardless of its face value. (Code Sec. 166(b); Reg §1.166-1(d)) The adjustments used to figure adjusted basis are generally the debtor's payments on the debt. But a deduction allowed for a debt's partial worthlessness reduces the debt's basis to that extent, whether or not taxpayer got a tax benefit from his deduction.

If the creditor (taxpayer) has no basis in the debt, there's no deduction. So there's no deduction for wages, rents, alimony, etc., that were never received, unless these items were included in income. (Reg §1.166-1(e)) Where a taxpayer reports receivables at fair market value rather than face, the deduction can't exceed fair market value. (Reg §1.166-1(d)(2))

2. Type of Debt

An individual must determine whether a debt is a business or nonbusiness debt. Business bad debts are fully deductible against income (Code Sec. 166(a)), while nonbusiness bad debts are short-term capital losses of limited deductibility. (Code Sec. 166(d)(1)(B))

Business and nonbusiness debts are deductible when wholly worthless, but only business debts are deductible when partly worthless (see below). (Code Sec. 166(a); Code Sec. 166(d)(1)(A))

A business debt is either:

- a debt created or acquired in the course of taxpayer's trade or business (whether or not it was related to that business when it became worthless), or
- a debt the loss from whose worthlessness is incurred in taxpayer's trade or business. This applies if the loss is proximately related to taxpayer's business when the debt becomes worthless. A bad debt is proximately related to business if business is the dominant motivation for the debt. (Reg §1.166-5(b))

A nonbusiness debt is a debt other than a business debt. (Code Sec. 166(d)(2); Reg §1.166-5(b), Reg §1.166-5(d))

3. Partially Worthless Debts

A deduction is allowed for partially worthless debts (Code Sec. 166(a)(2)) only if:

- the debt is a business debt;
- IRS is satisfied that the specific debt is recoverable only in part;
- the amount deducted was charged off on the books during the tax year; and
- the debt is not evidenced by a security. (Code Secs. 166(d)(1) and 166(e); Reg §1.166-5(b)).

A taxpayer may charge off and deduct a debt for partial worthlessness as it occurs. Or the taxpayer can defer the charge-off and deduction to a later year when partial worthlessness is greater, thus deducting several years' partial worthlessness in one year. Or he or she can defer deduction until total worthlessness (but not beyond the year of total worthlessness). (Reg §1.166-3(b))

N. Employee Business Expenses

Employees are engaged in the trade or business of being employees and thus are allowed to deduct certain ordinary and necessary expenses, within limits.

Unreimbursed employee business expenses are generally deductible only as miscellaneous itemized deductions subject to the 2%-of-AGI floor (see next section). (Reg §1.67-1T(a)(1)(i))

Deductible employee expenses include:

- the expenses of seeking new employment in his same trade or business, whether or not the employee gets the new job;
- dues, fines paid to remain in a union, strike funds, compulsory payments for unemployment benefits, and a mandatory service charge paid to a union by a nonmember;

- cost and maintenance of clothing if (1) the employee's occupation is one that specifically requires special apparel or equipment as a condition of employment, and (2) the special apparel or equipment isn't adaptable to general or continued usage so as to take the place of ordinary clothing;
- membership dues in professional or business societies;
- small tools and supplies:
- salesperson's briefcase used in business;
- salesperson's commissions paid to a third party who made the sales;
- expenses incurred by a securities analyst for a stock brokerage firm in seeking to get new business for the employer and by so doing increase his or her own salary;
- expenses for business use of home (see IV.R.);
- qualifying education expenses (see IV.H.3.);
- travel expenses (including meals and lodging) while away from home on business;
- the costs of entertaining customers or clients if the entertainment is directly related or associated with business; and
- gas, oil and depreciation for an automobile used for business-related transportation (but not commuting).

Some of these items are subject to special limitations and are discussed in detail in Module 2, *Taxation of Businesses*.

An employee can deduct from gross income in computing adjusted gross income employee expenses for which the employee is reimbursed by the employer under an express agreement for reimbursement or other expense allowance under an accountable plan. (There's no normal "deduction," however, since the reimbursement is excluded from the employee's gross income (see II.F.8.). That is, there's no deduction to the extent there's no inclusion of the reimbursement.) (Code Sec. 62(a)(2)(A); Reg §1.62-2(c)(4))

If the reimbursement is for less than the total expenses paid or incurred by the employee, the unreimbursed expenses are deductible from adjusted gross income (not gross income), as an itemized deduction, subject to the 2%-of-AGI floor. (Reg §1.62-1T(e)(3))

O. Miscellaneous Itemized Deductions

Miscellaneous itemized deductions are allowed only to the extent that they, in the aggregate, exceed 2% of adjusted gross income. (Code Sec. 67(a)) To the extent any other limit or restriction is placed on a miscellaneous itemized deduction, that other limit applies before the 2% floor. (Reg §1.67-1T(a)(2)) Miscellaneous itemized deductions that don't exceed 2% of AGI are lost. There's no carryover.

Miscellaneous itemized deductions include unreimbursed employee business expenses, such as union and professional dues and home office expenses; expenses related to investment income or property, such as investment counseling or advisory fees; any allowable losses from traditional IRAs or Roth IRAs; tax return preparation costs and related expenses; appraisal fees paid to determine the amount of a casualty loss or a charitable contribution of property; and hobby expenses to the extent of hobby income. (Reg §1.67-1T(a)(1))

If an expense relates to both a trade or business activity (not subject to the 2% floor) and a production of income or tax preparation activity (subject to the 2% floor) the taxpayer must allocate it between the activities on a reasonable basis. (Reg §1.67-1T(c))

P. Expenses of Self-employed Taxpayers

Self-employed individuals can deduct all of their ordinary and necessary business expenses on Schedule C, C-EZ, or F of Form 1040.

Business expenses are the normal current costs of operating a business. Among the items includible as business expenses are heat, light and power, management expenses, wages and salaries, incidental repairs, operating expenses of trucks and automobiles used in the business, traveling expenses while away from home in pursuit of business, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident or similar losses connected with the business, and rentals for the use of business property. (Reg §1.162-1)

Deductible business expenses generally do not include the cost of goods sold. Where producing, buying or selling merchandise is an income-producing factor, inventories are needed to determine the correct cost of goods sold (see II.E). However, the IRS has excepted non-tax-shelters with average annual gross receipts of $1 million or less from having to account for inventories.

The cost of property used in a trade or business also generally cannot be deducted as a business expense. Instead, the Code allows an annual deduction of a portion of the cost or other basis. This annual deduction may be depreciation under the Modified Accelerated Cost Recovery System (MACRS) or useful life depreciation (for property outside of MACRS). However, the Code does provide a limited exception to the depreciation requirement in Section 179. Qualifying taxpayers can elect to expense up to a statutory amount per year of the cost of certain eligible personal property used in the active conduct of a trade or business.

1. Capital Expenditures

Capital expenditures generally can't be deducted except through depreciation, expensing, depletion, or amortization deductions.

A capital expenditure differs from a deductible expense because the anticipated benefit of the capital expenditure extends beyond the tax year.

Capital expenditures include amounts paid or incurred to add to the value, or to substantially extend the useful life, of property owned by the taxpayer. (Code Sec. 263; Reg §1.263(a)-1)

Examples of capital expenditures include:

- Original cost of getting a business license that's good or renewable for an indefinite period.
- Initiation fees or initial admission fees paid for business association, etc., memberships.
- Installation costs of purchased machinery, equipment, etc., including labor, material and freight charges. But costs of retiring and removing old depreciable assets in connection with the installation or production of replacement assets don't have to be capitalized.
- Costs other than interest incurred to borrow funds and other finance costs are capital expenditures to be amortized over the life of the loan.
- Payments made to get the goodwill of a business, including payments for the use of an individual's name in a business bought from him; the cost of acquiring a dealer's franchise; the cost of acquiring customer lists.

2. Depreciation

As a capital cost, the cost of property used in a trade or business generally cannot be deducted as a business expense. Instead, the Code allows an annual deduction of a portion of the cost or other basis. This annual deduction may be depreciation under the Modified Accelerated Cost Recovery System (MACRS) or useful-life depreciation (for property outside of MACRS). However, the Code does provide a limited exception to the depreciation requirement in Section 179. Qualifying taxpayers can elect to expense up to a statutory amount per year of the cost of certain eligible personal property used in the active conduct of a trade or business. MACRS depreciation and the Section 179 expensing deduction are discussed in detailed in Module 2, Taxation of Businesses.

3. Amortization

Taxpayers can claim a deduction for "amortizable section 197 intangibles" by amortizing the adjusted basis (for purposes of determining gain) of that intangible ratably over a 15-year period beginning on the later of: the first day of the month in which the intangible is acquired, or, for property held in connection with the conduct of a trade or business or a production-of-income activity, the first day of the month in which the conduct of the trade or business or the activity begins. (Code Sec. 197(a); Reg §1.197-2(f)(1)(i)) No other depreciation or amortization deduction is permitted for any amortizable section 197 intangible. (Code Sec. 197(b))

4. Special Deductions for Self-employed

Most business expenses are deductible by corporations as well as by self-employed individuals and are discussed in depth in Module 2, Taxation of Businesses. However, two deductible expenses should be mentioned here as they relate exclusively to self-employed taxpayers.

Health insurance premiums. A self-employed individual can deduct as a business expense 100% of the amount paid during the tax year for medical insurance on himself, his spouse and his dependents. (Code Sec. 162(l)(1)(B))

No deduction is allowed to the extent the deduction exceeds the individual's net earnings from self-employment derived from the business for which the plan providing the coverage is established. (Code Sec. 162(l)(2)(A))

No individual who's eligible to participate in any subsidized health plan maintained by any employer of the individual or of the individual's spouse is entitled to the deduction. This test for eligibility is made for each calendar month. This rule is applied separately to (1) plans that provide coverage for qualified long-term care services or are qualified long-term care insurance contracts and (2) plans which don't include such coverage and aren't such contracts. (Code Sec. 162(l)(2)(B)) Thus, a self-employed individual eligible for employer-subsidized health insurance may still be able to deduct long-term care insurance premiums, so long as he isn't eligible for employer-subsidized long-term care insurance.

Review Question 39

In one tax year, a self-employed individual pays $10,000 in premiums for health insurance for himself, his spouse and his dependents. He also pays $4,000 in premiums for health insurance for his mother, who is not his dependent. The individual has net earnings from self-employment of $38,000 for the year. Neither the individual nor his spouse is eligible to participate in an employer-sponsored subsidized health plan for any portion of the year. How much of the premiums can the individual deduct as a business expense on his return for the year.

a. $0. b. $7,000.

c. $10,000. d. $14,000.

Retirement plans for self-employeds (Keogh Plans). Self-employed persons can be covered by tax exempt retirement plans set up for employees of their business. A sole proprietor is treated as both an employee and his own employer.

Plans covering the self-employed are governed by the same general rules as other qualified retirement plans.

Self-employed individuals who have "earned income" (net earnings from self-employment) for the tax year, can participate in qualified pension and profit-sharing plans. (Code Sec. 401(c)).

"Earned income" means net earnings from self-employment to the extent that the net earnings constitute compensation for personal services actually rendered. (Code Sec. 401(c)(2)(A); Reg §1.401-10(c)) Thus, wages earned as common-law employee, interest, dividends, and pensions aren't included, nor is income from the sale or exchange of a capital asset. But income from the sale, licensing, or other disposition of property (other than good will) by the person whose personal efforts created the property is considered earned income. (Code Sec. 401(c)(2)(C)) Thus, authors, inventors and artists can establish and participate in Keogh plans. If a trade or business shows a net loss for a year, no deduction on behalf of a self-employed is allowed.

A self-employed individual who has another business or a job as a common law employee generally isn't prevented from setting up his own plan while participating in another plan. (Reg §1.401-10(b)(3)(ii)) Each trade or business that a self-employed individual engages in is considered a separate employer. (Reg §1.401-10(b)(2)).

Self-employed individuals participating in employee retirement plans of their business can also contribute to individual retirement arrangements, subject to the same income limits on IRA deductions that apply to other employees covered by employer plans.

Contributions by self-employed persons are deductible if made to qualified pension, profit-sharing, stock bonus or annuity plans. The contribution limits applicable to self-employed plans are the same as those applicable to qualified plans generally (see Module 3, Specialized Tax Issues), except that self-employed individuals must base contributions on "earned income" rather than "compensation." (Code Sec. 415(c)(3)(B)) "Earned income" is defined as net earnings from self-employment after taking into account the Keogh contribution. By reducing the amount of earned income by the Keogh plan deduction before computing the maximum contribution, the effect is to allow contributions that are less than maximum percentage deduction available to plan participants who are not self-employed.

Q. Moving Expenses

An employee or self-employed individual who moves his residence because of a change in his principal place of work may deduct the reasonable expenses of (Code Sec. 217(b)(1)):

- moving household goods and personal effects from the old residence to the new place of residence, and
- traveling (including lodging) from the old residence to the new place of residence.

If a taxpayer uses his or her auto to travel to the new home, the taxpayer may deduct actual expenses (e.g., gas and oil) or a standard mileage rate. The optional standard mileage rate for computing moving expenses is 24¢ per mile for 2013. (Notice 2012-72, 2021-50 IRB 673).

Moving expenses are "above-the-line" deductions; that is, they are deductible from gross income in arriving at adjusted gross income. (Code Sec. 62(a)(15))

There's no deduction for moving expenses to the extent the taxpayer is reimbursed for the expenses by his or her employer and the reimbursements are excludable from the taxpayer's income. Such reimbursements are, in fact, excludable if they are for expenses that the taxpayer would have been able to deduct had there been no reimbursement. (Code Sec. 132(a)(6))

Distance test. To qualify for the deduction, the employee or self-employed individual must meet a 50-mile distance test: The new work site must be at least 50 miles farther from the individual's old principal residence than was the old principal work place. If the individual didn't have a full-time job before the move, the new job site must be at least 50 miles from his old residence. (Code Sec. 217(c)(1))

Time test. To qualify for the deduction, a 39-week or 78-week test must be met: (Code Sec. 217(c)(2))

- *39-week test:* An employee must be employed full-time in the general location of his or her new principal place of work for at least 39 weeks during the 12-month period immediately following his arrival in the new area. (Code Sec. 217(c)(2)(A))
- *78-week test:* The taxpayer must be a "full time employee" or must "perform services as a self-employed individual on a full time basis" in the general location of his or her new principal place of work for at least 78 weeks during the 24-month period immediately following the taxpayer's arrival there. Thirty-nine of the 78 weeks must be during the 12-month period above. (Code Sec. 217(c)(2)(B))

Joint filers qualify for the deduction if either spouse satisfies the 39-week or 78-week test. But weeks worked by one spouse can't be added to weeks worked by the other. (Reg §1.217-2(c)(4)(v); Reg §1.217- 1(c)(4))

Failure to meet the 39- or 78-week test doesn't bar a deduction if the failure was caused by: (1) death or disability, or (2) involuntary separation from employment (other than for willful misconduct), or retransfer for the benefit of the employer (not initiated by the employee), after getting full-time employment in which the taxpayer could reasonably have been expected to meet the test. (Code Sec. 217(d)(1))

Review Question 40

A taxpayer moves from New York to Chicago in connection with a change of employment. He will qualify for a moving expense deduction if he is employed full-time in the Chicago area for at least _____ weeks during the 12-month period following his arrival.

a. 12.

b. 24.

c. 39.

d. 78.

R. Business or Rental Use of a Residence

With certain exceptions, an individual can't take otherwise allowable deductions for a "home office" or other business use of a dwelling unit that is also used as a residence during the tax year. (Code Sec. 280A(a)) Residential use includes personal use of a dwelling unit by the individual or a related party. A taxpayer uses a dwelling unit as a residence if his personal use exceeds the greater of 14 days during the tax year or, 10% of the days the unit is rented at a fair rental.

The disallowance rule does not prevent an individual from taking deductions for items such as real estate taxes, casualty losses, mortgage interest, and the like, which are deductible without regard to the use of the home for a trade or business or other income-producing activity. (Code Sec. 280A(b))

Review Question 41

A taxpayer who rents out his vacation home for 180 days will be treated as using it as a residence (thus triggering limitations on his or her expense deductions) only if he uses the home for personal purposes more than _____ days.

a. 10.

b. 18.

c. 30.

There are several statutory exceptions to the disallowance rule.

1. Regular and Exclusive Business Use

The disallowance rule does not prohibit the deduction of expenses related to the use of a part of the home (e.g., as a home office), if the use is:

- Regular;
- Exclusive;
- For the individual's trade or business; and
- One of three additional conditions is met:
- The use is carried on in a separate structure, which is detached from the home;
- The area devoted to the use serves as a place where customers, clients, or patients can meet and deal with the taxpayer in the normal course of the taxpayer's trade or business; or
- The area devoted to the use serves as the "principal place of business" of the taxpayer's trade or business (including, in certain circumstances, a nonprincipal place of business used for the administrative or management activities of the trade or business).

Before expenses can be considered for the home office deduction they have to be allocated if the expenses apply to both the personal and business use of the home. So the cost of heating, mortgage interest, and realty taxes, for examples, are allocated between personal and business use. And only the business portion of the cost is considered for the home office deduction.

Effective for tax years beginning on or after January 1, 2013, the IRS has authorized an optional safe harbor method that individuals can use to determine the amount of their deductible home office expenses, effective for tax years beginning on or after Jan. 1, 2013. (Rev. Proc. 2013-13, 2013-6 IRB 478)

The safe harbor—$5 × square feet of qualified use up to 300 square feet, up to a maximum deduction of $1,500—provides an alternative to the calculation, allocation, and substantiation of actual expenses required under Code Sec. 280A. The $5 rate may be updated from time to time, as warranted. Adjustments are provided for determining the allowable square footage for a taxpayer with a qualified business use of a home for only a part of a year.

The safe harbor is an alternative to deducting actual expenses related to a home office. However, a taxpayer who itemizes deductions and uses the safe harbor may deduct any allowable expenses related to the home that are deductible without regard to whether there was a qualified business use of the home for that tax year (e.g., deductions for qualified residence interest, property taxes, and casualty losses). A taxpayer using the safe harbor method for a tax year may also deduct any allowable trade or business expenses unrelated to the qualified business use of the home for that tax year.

A taxpayer may elect from tax year to tax year whether to use the safe harbor method or calculate and substantiate actual expenses under Code Sec. 280A. A taxpayer elects the safe harbor by using the method to compute the deduction for the qualified business use of a home on his timely filed, original federal income tax return for the tax year. Once made, an election for the tax year is irrevocable.

A taxpayer using the safe harbor for a tax year can't deduct any depreciation (including first-year bonus depreciation) or Code Sec. 179 expensing for the part of his home that is used in a qualified business use for that tax year. If the taxpayer calculates and substantiates actual Code Sec. 280A expenses for a later year, he must calculate the depreciation deduction by using the appropriate optional depreciation table applicable for the property, regardless of whether the taxpayer used an optional depreciation table for the property in its placed-in-service year.

2. Storage Use

If an individual has no other place of business, the general disallowance rule does not prohibit the deduction of an allocable portion of expenses related to the use of a part of the home to store the taxpayer's retail or wholesale inventory.

3. Qualified Day Care

The general disallowance rule does not prohibit deductions for the allocable portion of expenses related to the use of the home for qualified day care for children, those 65 or older, or those who are physically or mentally incapable of taking care of themselves.

4. Rental Use

The general disallowance rule does not prohibit the deduction of expenses related to the rental of a dwelling or part of a dwelling. However, the Code does impose a limit on the rental expense deductions in certain cases.

For any tax year in which the owner uses the rented dwelling unit for personal purposes, the owner's deduction for maintenance, utilities, depreciation, etc., can't exceed the percentage of those total expenses for the year "attributable" to the rental period. (Code Sec. 280A(e)(1)) In addition, if a taxpayer who rents out a dwelling unit also uses the dwelling unit "as a residence" (i.e., exceeds the 14 day/10% personal use threshold discussed above), the deductions attributable to rental use are further limited. The deductions attributable to rental use cannot exceed the gross income derived from rental use for that year, minus the sum of:

- deductions allocable to rental use that are allowable whether or not the unit (or portion of it) was used for rental (e.g., interest and taxes), and

- deductions allocable to the rental activity that aren't allocable to the use of the home itself. Excess rental expenses may be carried forward to later years. (Code Sec. 280A(c)(5))

The proper ratio for allocating interest and taxes to the rental period is: (1) number of days for which the property is rented, to (2) number of days of total use (according to IRS, but not according to some courts: they would use "number of days in the year").

If a home is rented for less than 15 days a year, the owner can't deduct any of the rental expenses, but isn't taxed on any of the rental income. (Code Sec. 280A(g))

5. Additional Limitations on Business Use of a Residence

When deductions are allowed for the business use of a dwelling unit (e.g., regular and exclusive use as a principal place of business), the amount of the deduction allowed for expenses related to the business use is limited to the gross income derived from the business use reduced by business expenses, such as salaries, that are not related to the use of the dwelling. (Code Sec. 280A(c)(5)) Moreover, deductions for expenses related to the "regular and exclusive" use or the use for day care are taken in a specific order. This means the deductions that are taken first have a better chance of coming in under the gross-income limit than do expenses falling later in the order. Deductions that can't be taken because of the gross-income limit can be carried over, with a higher priority.

V. Tax Credits

Learning Objectives

After completing this section, you should be able to:

- Distinguish between refundable and nonrefundable credits.
- Apply the eligibility requirements for, and limitations on, personal tax credits.

An income tax credit provides a taxpayer with a direct reduction in the amount of his or her tax liability, while a deduction merely reduces the amount of income subject to tax.

The three main categories of tax credits are personal, business, and foreign. Personal credits provide tax benefits to certain qualifying taxpayers (e.g., the elderly or disabled, etc.) Business credits offer special incentives for the achievement of certain economic objectives. The foreign tax credit may apply to both business and nonbusiness taxpayers.

Some of the personal credits are refundable, i.e., the excess of the credit over taxpayer's tax liability is refunded to the taxpayer; others are not.

Among the refundable credits are:

- Earned income credit (EIC);
- Credit for income tax withheld;
- Credit for excess social security tax withheld;
- Child tax credit (partly refundable);
- Alternative minimum tax (AMT) refundable credit for individuals;
- American opportunity tax credit (partly refundable);

Among the nonrefundable credits are:

- Credit for the elderly and the permanently and totally disabled;
- Credit for child and dependent care expenses;
- Adoption credit;

- Credit for certain home mortgage interest;
- Lifetime Learning credit;
- Nonbusiness energy property credit;
- Residential energy efficient property credit;
- Saver's credit for elective deferrals and IRA contributions.

The aggregate amount of all nonrefundable personal tax credits cannot reduce an individual's regular tax liability below the level of his or her tentative alternative minimum tax. (Code Sec. 26(a))

Review Question 42

Which of the following credits is refundable for 2013?

a. The credit for the elderly and permanently disabled.

b. The adoption credit.

c. The American Opportunity tax credit.

d. The credit for child and dependent care expenses.

A. Personal Tax Credits

1. Earned Income Credit

Low-income workers can qualify for a refundable earned income credit (EIC). (Code Sec. 32) The amount of the credit depends on the taxpayer's earned income and the number of qualifying children, if any. The credit is calculated as a percentage of an inflation-adjusted earned income level. Generally, earned income includes wages, salaries, and other employee compensation plus net earnings from self-employment. The credit is gradually reduced or phased out above certain income levels. The credit isn't available at all to a taxpayer with excess investment income.

The EIC is computed by multiplying the taxpayer's allowable earned income by a credit percentage. (Code Sec. 32(a)(1)) The credit allowable can be determined from IRS Tables.

Credit percentages. An EIC rate of 7.65% is allowed to a taxpayer without children. The credit rate for a taxpayer with one qualifying child is 34%. A taxpayer with two or more qualifying children is generally entitled to a higher credit of 40%. (Code Sec. 32(b)(1)) However, the credit percentage for families with three or more qualifying children is increased to 45% for 2009 through 2017. (Code Sec. 32(b)(3) as amended by the American Taxpayer Relief Act of 2012)

Earned income level. All credit percentages are applied against the taxpayer's earned income up to a statutory level (as adjusted for inflation). (Code Sec. 32(j)(1)). For 2013, this statutory level is $6,370 for a taxpayer with no qualifying children, $9,560 for a taxpayer with one qualifying child, and $13,430 for a taxpayer with two or more qualifying children.

High income phase-out. The earned income credit is phased out by a percentage of the taxpayer's adjusted gross income (AGI) (or, if greater, earned income) in excess of the statutory phase-out level (as adjusted for inflation). (Code Sec. 32(j)(1)); Code Sec. 32(b)) The phase-out percentages are 15.98% for taxpayers with one qualifying child, 21.06% for taxpayers with two or more qualifying children, and 7.65% for taxpayers with no qualifying children.

As a general rule, the credit phase-out amounts for married couples filing a joint return are increased by $3,000, as adjusted annually for inflation. However, for 2009 through 2017, the threshold phase-out level for married couples filing joint returns is increased to $5,000 (adjusted for inflation) above the threshold phase-out level for other filers. (Code Sec. 32(b)(3) as amended by the American Taxpayer Relief Act of 2012)

Thus, for 2013, the phase-out of the EIC begins at $13,310 for joint filers with no qualifying children and $7.970 for others with no qualifying children. The phase-out begins at $22,870 for joint filers with one or more qualifying children and $17,530 for others with one or more qualifying children.

Excess investment income. A taxpayer with excess "disqualified" income in the tax year can't claim the earned income tax credit. (Code Sec. 32(j)). Disqualified income is mainly investment income (e.g., interest and dividends). For 2013, a taxpayer loses the EIC when disqualified income exceeds $3,300.

Eligible individual. Any individual who has a "qualifying child" for the tax year is an eligible individual for EIC purposes. (Code Sec. 32(c)(1)(A)(i)) An individual who doesn't have a qualifying child for the tax year is also an eligible individual if:

- the individual's principal place of abode is in the U.S. for more than half the tax year (U.S. Armed Forces personnel are considered to have their personal abode in the U.S. for the time they are stationed outside the U.S. on extended active duty),
- either the individual or the individual's spouse (if any) is older than 24 but younger than 65 before the end of the tax year,
- the individual can't be claimed as the dependent of another taxpayer for any tax year beginning in the same calendar year as the individual's tax year (Code Sec. 32(c)(1)(A)(ii)), and
- the individual isn't a nonresident alien for any part of the tax year, or has elected under Code Sec. 6013(g) or Code Sec. 6013(h) to be treated as a U.S. resident. (Code Sec. 32(c)(1)(E))

A "qualifying child" for purposes of the earned income credit, means a qualifying child of the taxpayer, as defined for purposes of the dependency exemption (see IV.B.) but without the requirement that the child not have provided more than half of his or her own support, and without regard to a release of the dependency exemption by a custodial parent (Code Sec. 32(c)(3)(A))

Advance payment. For 2010 and earlier tax years, an eligible individual could elect to receive advance payment of the earned income credit by providing his or her employer with a Form W-5. (Code Sec. 3507(b))

Effective for tax years beginning after Dec. 31, 2010, the Education Jobs and Medicaid Assistance Act (P.L. 111-226) eliminated the advance payment option for claiming the EITC. (Code Sec. 3507, as repealed by Education Jobs and Medicaid Assistance Act Sec. 219)

2. Child Tax Credit

Individuals may claim a maximum child tax credit of $1,000 for each qualifying child under age 17 at the close of the calendar year in which the tax year begins. (Code Sec. 24).

The amount of the credit allowable is reduced (not below zero) by $50 for each $1,000 (or fraction thereof) of modified AGI above $110,000 for joint filers, $75,000 for unmarried individuals, and $55,000 for married filing separately. (Code Sec. 24(b))

A "qualifying child" for purposes of the child tax credit is defined a child under age 17 who is a qualifying child for purposes of the personal exemption (see IV.B.) The 2008 Adoption Act provides that for tax years beginning after 2008, the child tax credit is only allowed for a qualifying child for whom the taxpayer is allowed a dependency deduction. (Code Sec. 24(a) as amended by 2008 Adoption Act. §501(c)(1))

No child credit is allowed for a child for a tax year unless the taxpayer includes the child's name and TIN on the return for the year. (Code Sec. 24(e))

Review Question 43

Married taxpayers filing jointly who have three children ages 9, 16, and 18 and AGI of $115,000 are entitled to a total child tax credit of:

a. $0.

b. $1,750.

c. $2,000.

d. $3,000.

The child tax credit is refundable to the extent of the greater of:

- 15% of earned income above an inflation-adjusted threshold amount, or
- for a taxpayer with three or more qualifying children, the excess of his social security taxes for the tax year over his earned income credit for the year. (Code Sec. 24(d)(1)(B)(i); Code Sec. 24(d)(3))

The inflation-adjusted threshold amount for calculating the refundable child tax credit is generally $10,000 as adjusted for inflation. However, the threshold is reduced to $3,000 for tax years beginning in 2009 through 2018. (Code Sec. 24(d)(4) as amended by the American Taxpayer Relief Act of 2012)

3. Credit for the Elderly and Disabled

A credit is available to an individual who: (1) reaches 65 before the end of the tax year, or (2) is under 65 at the end of the tax year, is retired with a permanent and total disability, and receives disability income from a public or private employer. (Code Sec. 22(b))

Permanently and totally disabled means that the individual is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of at least 12 months. (Code Sec. 22(e)(3))

Married individuals must file a joint return to claim the credit unless they qualify as married living apart. (Code Sec. 22(e)(1)) A nonresident alien isn't eligible for the credit (Code Sec. 22(f)) unless he or she is married to a U.S. spouse with whom he files jointly and both spouses elect to be taxed on worldwide income. (Reg §1.37-1(d))

The credit is 15% of the specified initial amount (1, below), reduced by both an amount that is based on the taxpayer's adjusted gross income (2, below) and the sum of the taxpayer's income from tax-free pensions and annuities (3, below):

1. The initial amount with respect to which the credit may be computed is—
   - $5,000 for a single person 65 or over;
   - $5,000 for a married couple filing jointly if only one spouse is a qualified individual 65 or over;
   - $7,500 for a married couple filing jointly if both spouses are qualified individuals and 65 or over;
   - 3,750 for a married individual 65 or over filing a separate return. (Code Sec. 22(c)(2)(A)) For individuals under age 65, see below.
2. Where a taxpayer's AGI exceeds certain amounts, the applicable initial amount determined in (1) above must be reduced by one-half of the excess. The reduction is one-half of AGI in excess of $7,500 for a single person or $10,000 for a married person filing jointly ($5,000 if filing separately). (Code Sec. 22(d)) The reduction applies regardless of the taxpayer's age.
3. The initial amount as adjusted under (2) above must be further reduced by the sum of the amounts received by the individual (or, in the case of a joint return, by either spouse) as a pension or annuity or as a disability benefit—
   - that's excluded from gross income and payable under title II of the Social Security Act, the Railroad Retirement Act of 1974, or a law administered by the VA; or
   - that's excluded from gross income under any provision of law other than the Internal Revenue Code. (Code Sec. 22(c)(3)(A))

For purposes of the above rules, a social security benefit, or workers' compensation that reduces a social security benefit, is treated as an amount received as a pension or annuity. (Code Sec. 86(f)(1))

IRS requires a physician's statement establishing disability. For joint returns where both spouses are retired on permanent and total disability, each spouse must file a physician's statement.

Taxpayers under age 65 compute the credit in the same way as above, except that the “initial amount” is limited to the lower of the initial amount shown in (1) above or:

- for other than joint returns, the taxpayer’s disability income for the year;
- for a married couple filing jointly neither of whom has reached age 65, the sum of the spouses’ disability incomes;
- for a married couple filing jointly only one of whom has reached age 65, the sum of $5,000 plus the disability income of the spouse who hasn’t reached age 65. (Code Sec. 22(c)(2)(B))

4. Child and Dependent Care Credit

Taxpayers can claim credit for child and dependent care expenses that enable them to be gainfully employed. (Code Sec. 21(a))

Computing the credit. The credit is 35% of “employment-related expenses” incurred by taxpayers with AGI of $15,000 or less. The percentage decreases by 1% for each $2,000 (or fraction of that amount) of AGI over $15,000, but not below 20%. Thus, for taxpayers with AGI over $43,000, the applicable percentage is 20%. (Code Sec. 21(a)(1); Code Sec. 21(a)(2))

The maximum amount of employment-related expenses that may be used to compute the credit is $3,000 for expenses incurred for one qualifying individual, or $6,000 incurred for two or more qualifying individuals, at any time during the tax year. (Code Sec. 21(c); Reg §1.44A-2(a)) However, these maximum dollar amounts must be reduced, dollar-for-dollar, by the aggregate amount excludable from gross income under the exclusion for dependent care assistance (see II.B.6). (Code Sec. 21(c))

A qualifying individual means someone who:

- is under the age of 13 and for whom the taxpayer is entitled to a dependency exemption (Code Sec. 21(b)(1)(A));
- is a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than half of the tax year (Code Sec. 21(b)(1)(B)); or
- the taxpayer’s spouse, if the spouse is physically or mentally incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than half of the tax year. (Code Sec. 21(b)(1)(C))

If the other requirements are satisfied, an otherwise eligible taxpayer may claim the credit for a child who lives with the taxpayer for more than half the year, even if the taxpayer doesn’t provide more than half the cost of maintaining the household.

Employment-related expenses. Employment-related expenses qualifying for the credit include expenses for household services and for the care of qualifying individuals. Thus, costs of a housekeeper, maid, babysitter, or cook ordinarily qualify. Payments for services provided outside the taxpayer’s household are taken into account only if incurred for the care of: a dependent who is under 13 years old or any other qualifying individual who regularly spends at least eight hours each day in the taxpayer’s household. (Code Sec. 21(b)(2)(B))

However, the expenses incurred for services that are performed by a dependent care center qualify for the credit only if the center complies with all applicable laws and regulations of a state or unit of local government, and the dependent on whose behalf the expenses are incurred spends at least eight hours each day in the taxpayer’s household. (Code Sec. 21(b)(2)(B); Code Sec. 21(b)(2)(C))

Payments to relatives of a taxpayer or to members of his household for services are counted in computing the credit only if the person to whom the payments are made isn’t a dependent of the taxpayer or his spouse or a child of the taxpayer who is under age 19 at the close of the tax year. (Code Sec. 21(e)(6))

Earned income limit. The amount of employment-related expenses that may be taken into account can’t exceed (1) in the case of an individual who isn’t married at the close of the tax year, that individual’s earned income, or (2) in the case of an individual who is married at the close of the tax year (even if only married for part of the year), the lesser of the individual’s earned income or the earned income of the spouse for the year. (Code Sec. 21(d)(1))

The income considered to be earned by a spouse who is a full-time student or who is incapable of self-care is $250 per month if there's one qualifying individual in the household or $500 a month if there are two or more qualifying individuals. However, this income is deemed to be earned only by one spouse for any given month. (Code Sec. 21(d)(2))

Claiming the credit. The credit is available to married couples only if they file a joint return. (Code Sec. 21(e)(2))

A married individual living apart from his or her spouse may claim the credit on a separate return if he or she (1) maintains a household that is the principal place of abode of a qualifying individual for more than half of the tax year and from which the other spouse is absent for the last six months of the tax year and (2) furnishes over one-half the cost of that household for the tax year. (Code Sec. 21(e)(4))

Divorced or legally separated parents who seek to claim the credit for a child under 13 must meet the custody test. That is, where the child receives more than half of his or her support during the year from parents and is in the custody of one or both of the parents for more than half of the calendar year, the child is a qualifying individual with respect to the parent who has the longer period of custody (i.e., that parent may claim the child for purposes of the credit). That parent need not be able to claim the child as a dependent and may even have released the dependency exemption to the other parent. (Code Sec. 21(e)(5))

No credit can be claimed unless the taxpayer reports on his or her return the correct name, address and taxpayer identification number (TIN) of the dependent care provider. A tax-exempt provider doesn't have to supply a TIN. (Code Sec. 21(e)(9)) The dependent care provider should provide this information and certify the TIN on Form W-10. If the care provider doesn't comply with a request for the required information, the taxpayer should furnish whatever information is available and include a statement that the other required information was requested but wasn't given.

No credit is permitted with respect to any qualifying individual unless his or her TIN is included on the return claiming the credit. (Code Sec. 21(e)(10))

5. Adoption Credit

An individual may claim an income tax credit for qualified adoption expenses. (Code Sec. 23). The credit is refundable, and is allowed against income tax and alternative minimum tax. (AMT).

The maximum credit is $12,970 for 2013, for both special needs and non-special needs adoptions. For 2013, the credit begins to phase out for taxpayers with modified adjusted gross income (AGI) over $194,580 and is fully eliminated at modified AGI of $234,580. All these dollar amounts are adjusted annually for inflation.

To get the credit, the taxpayer must include (if known) the name, age and taxpayer identification number (TIN) of the child on the return. Married individuals must file jointly to claim the credit (Code Sec. 23(f)(2))

The credit for an expense paid or incurred before the tax year in which the adoption becomes final is allowed for the tax year following the tax year during which it is paid or incurred. For an expense paid or incurred during or after the tax year in which the adoption becomes final the credit is allowed for the tax year in which the expense is paid or incurred.

The credit for a foreign adoption isn't available unless the adoption becomes final. Expenses paid or incurred in the year the foreign adoption is finalized or in an earlier year are allowed in the year the adoption is final; and expenses after the year the foreign adoption becomes final are taken into account when paid or incurred. (Code Sec. 23(e)) A taxpayer can't claim a credit for any employer-reimbursed adoption expense (see II.B.8.).

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to, and the principal purpose of which is, the taxpayer's legal adoption of an eligible child. (Code Sec. 23(d)(1)(A))

6. Hope Scholarship Credit (American Opportunity Credit)

Two tax credits—the Hope scholarship credit and the Lifetime Learning credit (see next section)—are generally available to individual taxpayers who pay higher education expenses at accredited post-secondary educational institutions for themselves, their spouses, or their dependents. For tax years 2009 through 2017, however, taxpayers can claim a liberalized version of the Hope Scholarship credit, renamed the American Opportunity Credit (see below).

The Hope credit is available only for qualified expenses of the first two years of undergraduate education; the Lifetime Learning credit is available for qualified expenses of any post-high school education at "eligible educational institutions." Both credits can't be claimed in the same tax year for expenses of any one student. The credits phase out for higher-income taxpayers.

The Hope scholarship credit is a personal nonrefundable credit that may be elected by individuals. The credit equals 100% of up to $1,000 (indexed) of qualified higher-education tuition and related expenses plus 50% of the next $1,000 (indexed) of expenses paid for education furnished to an eligible student in an academic period. (Code Sec. 25A(a)(1); Code Sec. 25A(b)(1))

The Hope credit phases out ratably for taxpayers with modified AGI of $40,000 to $50,000 ($80,000 to $100,000 for joint return filers). (Code Sec. 25A(d)) The phase-out ranges are indexed annually for inflation.

Married taxpayers must file jointly to claim the credit. (Code Sec. 25A(g)(6)) The student's name and TIN must be included on the return of the taxpayer claiming the credit. (Code Sec. 25A(g)(1)) The Hope credit and the income exclusion for Coverdell education savings account (ESA) distributions (see IV.H.4.) are allowed for the same student for the same year, as long as a credit isn't claimed for education expenses used to generate the tax-free Coverdell ESA distribution. (Code Sec. 530(d)(2)(C)(i))

The Hope credit may be elected for a student's expenses only for two tax years, and only for students who have not completed the first two years of post-secondary education as of the beginning of the tax year. (Code Sec. 25A(b)(2); Reg §1.25A-3(d)(1)(iii)) Additionally, for at least one academic period during the year, the student must be enrolled for at least half of the normal full-time workload for his course of study. (Code Sec. 25A(b)(3)(B); Reg §1.25A-3(d)(1)(ii))

If a dependency deduction for an individual is allowed to another taxpayer, the dependent can't claim the Hope credit and qualified tuition and expenses paid by the dependent during the tax year are treated as paid by the taxpayer who is allowed the dependency deduction. (Code Sec. 25A(g)(3)) If a third party (not the taxpayer, spouse, or dependent) pays a student's qualified expenses directly to an educational institution, the student is treated as receiving the payment from the third party and, in turn, paying the expenses. If the student in such a case is claimed as a dependent on another's return, the expenses deemed to be paid by the student would be treated as expenses of the taxpayer claiming the student as a dependent. (Reg §1.25A-5(a); Reg §1.25A-5(b)) If a taxpayer is eligible to but does not claim a student as a dependent, only the student can claim the education credit for the student's qualified tuition and related expenses. (Reg §1.25A-1(f))

If qualified tuition and expenses are paid during one tax year for an academic period that begins during the first 3 months of the next tax year, the academic period is treated for Hope credit purposes as beginning in the earlier year. (Code Sec. 25A(g)(4)) Thus, the credit is allowed only in the tax year in which the expenses are paid. (Reg §1.25A-3(e))

A nonresident alien for any portion of the year may elect a Hope (or Lifetime Learning credit) only if he elects under Code Sec. 6013(g) or Code Sec. 6013(h) to be treated as a resident alien. (Code Sec. 25A(g)(7)) A Hope credit isn't allowed for a student convicted (as of the end of the tax year for which the credit is claimed) of a felony offense for possessing or distributing a controlled substance. (Code Sec. 25A(b)(2)(D))

American Opportunity Credit. For tax years beginning in 2009 through 2017, the American Opportunity Credit equals the sum of 100% of the first $2,000 of qualified expenses plus 25% of the next $2,000 of qualified expenses, for a maximum credit of $2,500 per eligible student. (Code Sec. 25A(i)(1) as amended by the American Taxpayer Relief Act of 2012) Moreover, unlike the Hope credit, the American Opportunity credit is allowed for each of the first four years of the student's post-secondary education in a degree or certificate program.

The American Opportunity credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's alternative minimum tax liability.

In addition, 40% of a taxpayer's otherwise allowable American Opportunity credit is refundable. However, no portion of the credit is refundable if the taxpayer claiming the credit is a child to whom the "kiddie tax" applies for the tax year (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support, who has at least one living parent and does not file a joint return). By contrast, the Hope credit is a nonrefundable credit.

Finally, for 2009 through 2017, the definition of qualifying expenses for purposes of the American Opportunity credit is expanded to include course materials in addition to tuition and fees.

Qualified Expenses. Qualified tuition and related expenses for Hope/American Opportunity credit and Lifetime Learning credit (see next section) purposes means tuition and fees required for the enrollment or attendance of the taxpayer, his spouse, or his dependent, at a post-secondary educational institution eligible to participate in the federal student loan program.

Student activity fees and fees for course-related books, supplies, and equipment qualify for the Hope or Lifetime Learning credit only if they must be paid directly to the educational institution for the enrollment or attendance of the student. (Reg §1.25A-2(d)(2))

Room and board, insurance, transportation, or other similar personal, living, or family expenses, don't qualify for the credits, whether or not paid to an educational institution. (Code Sec. 25A(f); Reg §1.25A-2(d)(2); Reg §1.25A-3(d)(3))

The cost of any course of instruction at an eligible institution taken to acquire or improve job skills qualifies for the Lifetime Learning credit, but not the Hope or American Opportunity credits, even if it involves sports, games, hobbies or is a noncredit course. (Code Sec. 25A(c)(2)(B); Reg §1.25A-2(d)(5))

Qualified tuition and related expenses must be reduced by scholarship amounts excludable from income under Code Sec. 117 (and other tax-free payments). However, qualified amounts are not reduced by amounts paid by gift, bequest, devise, or inheritance. (Code Sec. 25A(g)(2)) No credit is allowed for any expense for which an income tax deduction is allowed. (Code Sec. 25A(g)(5))

For 2009 through 2017, the definition of qualifying expenses for purposes of the American Opportunity credit is expanded to include course materials in addition to tuition and fees.

7. Lifetime Learning Credit

Taxpayers may elect a Lifetime Learning credit equal to 20% of up to $10,000 of qualified tuition and related expenses paid (defined in previous section) during the tax year. The maximum credit is $2,000. (Code Sec. 25A(a)(2); Code Sec. 25A(c)(1))

Unlike the Hope and American Opportunity credits, which are available for the qualifying expenses of each qualifying student, the Lifetime Learning credit is available only per taxpayer. So, for example, a joint filing couple with two children could claim no more than a $2,000 Lifetime Learning credit, even if each family member is a qualifying student with qualifying expenses.

The same phase-out rules, treatment of expenses paid by dependent, adjustment for tax-free scholarships or other payments, treatment of certain prepayments, denial of double benefit, denial of credit to marrieds not filing jointly, and nonresident alien bar, that apply for Hope credit purposes also apply to the Lifetime Learning credit. (Code Sec. 25A(d); Code Sec. 25A(e); Code Sec. 25A(f); Code Sec. 25A(g); Code Sec. 25A(h)) For 2013, the Lifetime Learning credit phases out ratably for taxpayers with modified AGI of $53,000 to $63,000 ($107,000 to $127,000 for joint return filers).

Expenses for a student for whom a Hope scholarship credit is allowed for the tax year don't qualify for the Lifetime Learning credit. (Code Sec. 25A(c)(2))

Review Question 44

A couple has two children in college. One boy was a second semester freshmen in the spring of 2013 and a first semester sophomore in the fall. The other was a second semester junior in the spring and a senior in the fall. The couple paid $10,000 in qualified tuition and related expenses for each son in 2013. Assuming the couple's AGI falls below the applicable phase-out ranges, what is the maximum amount of education-related credits the couple can claim on their 2013 return?

a. $2,000 b. $2,500

c. $4,000 d. $5,000

8. Lower-income Savers' Credit

An eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (below) of up to $2,000 of his qualified retirement savings contributions. (Code Sec. 25B(a)) For 2013, the applicable percentage (50%, 20%, or 10%) depends on filing status and modified AGI, as follows:

1. Joint filers: $0 to $35,500, 50%; $35,500 to $38,500, 20%; and $38,500 to $59,000, 10% (no credit if AGI is above $59,000).
2. Heads of households: $0 to $26,625, 50%; $26,625 to $28,875, 20%; and $28,875 to $44,250, 10% (no credit if AGI is above $44,250).
3. All other filers: $0 to $17,750, 50%; $17,750 to $19,250, 20%; and $19,250 to $29,500, 10% (no credit if AGI is above $29,500).

The credit is in addition to any deduction or exclusion that would otherwise apply for a contribution. An individual who is 18 or over (other than a full-time student, or an individual allowed as a dependent on another taxpayer's return for a tax year beginning in the calendar year in which the individual's tax year begins) is eligible for the credit. (Code Sec. 25B(c))

The credit is available for elective contributions to 401(k) plans, 403(b) annuities, Sec. 457 plans, SIMPLE or SEP plans, traditional or Roth IRAs (see IV.F.4.), and voluntary after-tax employee contributions to a qualified retirement plan. (Code Sec. 25B(d)(1))

The amount of any credit-eligible contribution is reduced (but not below zero) by distributions received from any of the above savings arrangements during a testing period. The testing period is (1) the tax year for which the credit is claimed, (2) the preceding two tax years, and (3) the period after the end of the tax year and before the due date for filing the taxpayer's return for the year. (Code Sec. 25B(d)(2)) Certain payouts, such as qualified plan loans that are not treated as distributions, won't reduce a credit-eligible contribution.

Review Question 45

John Johnson, a single taxpayer, has modified adjusted gross income of $24,000 for 2013. In October 2013, John makes a $4,000 contribution to his traditional IRA. In January 2014, he takes a $1,000 withdrawal from his IRA. Assuming he makes no other contributions or withdrawals for 2013 and 2014, John can claim a savers' credit of _________ on his 2013 return,

a. $400 b. $100

c. $200 d. $300

9. Energy-related Personal Tax Credits

The Code provides a number of personal credits designed to encourage energy conservation and to promote the use of alternative energy sources.

Nonbusiness energy property credit. The 2005 Energy Tax Act (P.L. 109-58) created a temporary tax credit for certain energy-saving home improvements placed in service after 2005 and before 2008. The 2008 Energy Act, which was included as part of the 2008 Emergency Economic Stabilization Act (P.L.

110-343, 10/3/2008), reinstated the credit for one year for property placed in service after December 31, 2008, and before January 1, 2010. Subsequentlythe credit was extended through December 31, 2013. (Code Sec. 25C as added by 2005 Energy Act §1333(a) and amended by 2008 Energy Act §302(f)(1)DivB), the American Recovery and Reinvestment Act §1121.the Tax Relief Act §710(a) and the American Taxpayer Relief Act of 2012 §401(a)) Thus the credit applies to qualifying improvements placed in service in tax years 2006 and 2007 or in tax years 2009 through 2013; the credit is not available for improvements placed in service in 2008 or after 2013.

Caution: Expired or expiring provisions may be extended by Congress.

Under the rules in effect for 2013, the nonbusiness energy property credit is equal to the sum of: (Code Sec. 25C(a))

1. 10% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the tax year, and
2. the amount of the residential energy property expenditures paid or incurred by the taxpayer during the tax year.

Thus, the nonbusiness energy property credit consists of a 10% credit for the purchase of energy-efficient building envelope components that meet certain requirements and specified credits for the purchase of specific energy-efficient property.

The credit allowed for residential energy property expenditures can't exceed:

- $50 for each advanced main air circulating fan;
- $150 for each qualified natural gas, propane, or oil furnace or hot water boiler; and
- $300 for each item of energy-efficient building property.

Under current rules, a taxpayer's maximum nonbusiness energy property credit for all tax years is $500, of which no more than $200 may be for expenditures on windows. Thus, the nonbusiness energy property credit allowed to a taxpayer for 2013 cannot exceed the excess (if any) of $500 over the aggregate nonbusiness energy property credits allowed to that taxpayer for all earlier tax years ending after Dec. 31, 2005.

The nonbusiness energy property credit allowed for amounts paid or incurred for exterior windows and skylights by a taxpayer for 2013 cannot exceed the excess (if any) of $200 over the aggregate nonbusiness energy property credits allowed for those amounts for all earlier tax years ending after Dec. 31, 2005.

Residential energy efficient property credit. The 2005 Energy Tax Act (P.L. 109-58) created a temporary tax credit for residential energy efficient property placed in service after 2005 and before 2009. The 2008 Energy Act extended the credit for eight years through December 31, 2016, while the American Recovery and Reinvestment Act of 2009 modified the credit for tax years beginning after 2008. (Code Sec. 25D as added by 2005 Energy Act §1335(a) and amended by 2008 Energy Act §106(a)DivB and American Recovery and Reinvestment Act of 2009 §1103)

For property placed in service after 2008 and before 2017, an individual is allowed an annual credit for the purchase of residential energy efficient property equal to the sum of:

1. 30% of the amount paid for qualified solar energy property (i.e., property that uses solar power to generate electricity in a home);
2. 30% of the amount paid for qualified solar water heating property;
3. 30% of the amount paid for qualified fuel cell property, up to a maximum credit of $500 for each 0.5 kilowatt of capacity;
4. 30% of the amount of any small wind energy property (i.e., property that uses a wind turbine to generate electricity for use in a home) expenditure; and
5. 30% of the qualified geothermal heat pump property expenditures. (Code Sec. 25D(a); Code Sec. 25D(b))

The equipment in (1), (2), (4), and (5) can be installed in a taxpayer's residence (including a vacation home). The equipment in (3) must be installed in a taxpayer's principal residence (as defined in Code Sec. 121), which may include a co-op or condo. (Code Sec. 25D(d); Code Sec. 25D(e)) Cost includes installation as well as hardware costs. (Code Sec. 25D(e)(1)) All equipment must be installed in a home located in the U.S. (Code Sec. 25D(d)) and can't be used to heat a swimming pool or hot tub. (Code Sec. 25D(e)(3))

Alternative motor vehicle credit. Taxpayers can claim an alternative motor vehicle credit for qualifying vehicles that run on alternative fuels. The portion of this credit attributable to a vehicle that is depreciable is treated as part of the general business credit (see 5.B.)). The remainder of the credit is a personal credit that may offset the excess of the regular tax (reduced by the sum of the credits allowed under Code Sec. 21 through Code Sec. 26 (nonrefundable personal credits), Code Sec. 27 (foreign tax credit), and Code Sec. 30 (qualified electric vehicles credit), over the tentative minimum tax for the tax year. (Code Sec. 30B(g))

The credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease, for the year the vehicle is placed in service. (Code Sec. 30B(b)) A vehicle must be used predominantly in the U.S. to qualify for the credit. Any deduction otherwise allowable under Code Sec. 179A is reduced by the amount of the credit allowable. No credit is allowable for the portion of the cost of any property taken into account under Code Sec. 179 expensing. (Code Sec. 30(B)(h)(7))

The credit is the sum of the following five credits: (Code Sec. 30B)

1. New qualified fuel cell motor vehicle credit for the purchase of a fuel cell vehicle (before 2015 (Code Sec. 30B(j))) is determined by a base credit amount that depends upon the weight class of the vehicle, and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy.

2. New advance lean-burn technology motor vehicle credit for the purchase (before 2011) (Code Sec. 30B(j))) of an advanced lean burn technology motor vehicle is the sum of two components: a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard and a conservation credit based on the estimated lifetime fuel savings of a qualifying vehicle compared to a comparable 2002 model year vehicle.

3. New qualified hybrid motor vehicle credit for a purchase (before 2011 for a passenger car or light truck, before 2010 for other vehicles (Code Sec. 30B(j))) of an auto or light truck (vehicles weighing 8,500 pounds or less). The credit amount varies with the vehicle's rated fuel economy compared to a 2002 model year. A new qualified hybrid motor vehicle is a motor vehicle that draws propulsion energy from onboard sources of stored energy, which includes both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). (Code Sec. 30B(d))

4. New qualified alternative fuel motor vehicle credit is equal to 50% of a vehicle's incremental cost, plus an additional 30% if the vehicle meets certain emissions standards, but not more than between $4,000 and $32,000, depending on the weight of the vehicle (for property purchased before 2011). (Code Sec. 30B(j)) A new qualified alternative fuel motor vehicle is a motor vehicle that's only capable of operating on an alternative fuel, compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85% methanol. (Code Sec. 30B(e))

5. Plug-in conversion credit is equal to 10% of the cost, up to a maximum credit of $4,000, of converting any motor vehicle into a qualified plug-in electric drive motor vehicle. (Code Sec. 30B(i) as amended by American Recovery and Reinvestment Act §1143) To be eligible for the credit, a qualified plug-in traction battery module must have a capacity of at least 4 kilowatt hours. The plug-in conversion credit is added to the credits that are components of the alternate motor vehicle credit. (Code Sec. 30B(a)(5) as amended by American Recovery and Reinvestment Act §1143) The credit is available for property placed in service after February 17, 2009, and before 2012.

Note: For 2013 and 2015, only the qualified fuel cell motor vehicle credit (1 above) is available.

Caution: Expired or expiring provisions may be extended by Congress.

New qualified plug-in electric drive motor vehicle credit. The 2008 Energy Act created a new tax credit for new qualified plug-in electric drive motor vehicles. The credit was subsequently modified by the American Recovery and Reinvestment Act of 2009. The credit is available for qualified vehicles purchased after December 31, 2008, and before January 1, 2015. (Code Sec. 30D as added by 2008 Energy Act §205(a)DivB and modified by 2009 American Recovery and Reinvestment Act §1141(a))

For vehicles acquired after 2009, the credit is equal to the sum of: (1) $2,500; plus (2) for a vehicle that draws propulsion energy from a battery with not less than five kilowatt hours of capacity, $417 for each kilowatt hour of capacity in excess of five kilowatt hours, but not in excess of $5,000. Thus, the maximum credit is $7,500, regardless of weight. The post-2009 credit phases out beginning in the second calendar quarter following that in which a manufacturer sells its 200,000th plug-in electric drive motor vehicle for use in the U.S. after 2009 (50% credit reduction in second and third quarter; 75% in fourth and fifth quarter; 0 credit allowed thereafter).

The portion of the credit for such a vehicle that is attributable to property of a character subject to an allowance for depreciation (generally, property used in a trade or business or for the production of income) is treated as part of the general business credit; the non-depreciable property portion is treated as a personal credit. The credit is available to the vehicle owner, including the lessor of a vehicle subject to a lease.

10. First-time Homebuyers Credit

The Housing Assistance Tax Act of 2008 (Division C P.L. 110-289) added a new refundable tax credit for first-time homebuyers The credit, as enacted in the 2008 Housing Act, applied to principal residences purchased on or after April 1, 2008, and before July 1, 2009. However, the first-time homebuyer credit was subsequently modified and extended to apply to principal residences purchased under a written binding contract entered into before May 1, 2010, provided the sale was completed by September 30, 2010. (Code Sec. 36). While the credit is no longer available to homebuyers, taxpayers who claimed the credit may be subject to recapture of all or a portion of the credit.

The credit was equal to 10% of the purchase price, subject to a maximum limitation. The maximum credit was $8,000 ($4,000 for a married individual filing separately) for homes purchased after December 31, 2008, and before May 1, 2010. The maximum credit was $7,500 ($3,750 for married individuals filing separately) for homes purchased on or before December 31, 2008. For individuals who qualify as long-term residents of a principal residence and purchased a new principal residence after November 6, 2009, and before May 1, 2010, a reduced version of the first-time homebuyer credit was allowed up to a maximum of $6,500.

In the case of qualifying purchases made on or before December 31, 2008, the credit is recaptured ratably over 15 years with no interest charge. Beginning in the second tax year after the tax year in which the home is purchased. the taxpayer's tax is increased by 6 2/3% of the amount of the credit for each tax year in the recapture period. (Code Sec. 36(f)(1))

If a taxpayer disposes of the principal residence before the end of the recapture period, the taxpayer's tax for the year of disposition is increased by the excess of the credit allowed over the amount recaptured in previous years ("accelerated recapture"). (Code Sec. 36(f)(2)(A)) No further recapture is required. (Code Sec. 36(f)(2)(B)) Accelerated recapture is also required in the year in which the residence ceases to be the taxpayer's principal residence and, if the taxpayer is married, the principal residence of the taxpayer's spouse. (Code Sec. 36(f)(2))

In the case of qualifying purchases made on or after January 1, 2009, recapture applies only if the taxpayer disposed of the home or the home otherwise ceased to be the principal residence of the taxpayer within 36 months from the date of purchase.

B. Business Tax Credits

Certain business incentive credits are combined into one "general business credit" for purposes of determining how much is allowed for each credit for the tax year.

Among the credits that make up the general business credit are:

- the investment credit (Code Sec. 38(b)(1)), (which includes the rehabilitation credit, the energy credit and the reforestation credit);
- the work opportunity credit (Code Sec. 38(b)(2));
- the incremental research credit (Code Sec. 38(b)(4));
- the disabled access credit (Code Sec. 38(b)(7));
- the employer social security credit (Code Sec. 38(b)(11));
- the employer-provided child care credit (Code Sec. 38(b)(15));
- the small employer pension plan startup credit (Code Sec. 38(b)(14);
- the energy efficient home credit (Code Sec. 38(b)(23));
- the energy efficient appliance credit (Code Sec. 38(b)(24));
- the differential wage payment credit (Code Sec. 38(b)(33)); and
- the small employer health insurance credit (Code Sec. 38(b)(36)).

These credits are discussed in Module 2, Taxation of Businesses.

C. Foreign Tax Credit

Most U.S. taxpayers who pay income taxes to foreign governments may deduct those taxes for U.S. tax purposes (see IV.K.) or may credit them dollar-for-dollar against their U.S. income tax liability.

The foreign tax credit is elective and is allowed against U.S. income tax for income tax paid to a foreign country (or province, state, city, etc., thereof) or U.S. possession. (Code Sec. 901; Reg §1.901-1(a)) Taxpayers may choose each year between taking a credit or a deduction for foreign income taxes. (Code Sec. 27; Code Sec. 164) If a credit is claimed for any foreign income taxes, no deductions may be claimed for other foreign income taxes. However, foreign taxes that are otherwise deductible (e.g., foreign real property taxes) may be deducted. (Reg §1.901-1(c))

VI. Withholding and Estimated Taxes

Learning Objectives

After completing this section, you should be able to:

- Demonstrate an understanding of tax withholding requirements.
- Compute required installments of estimated taxes.

Code Sec. 6654 imposes a penalty on individual taxpayers for their failure to make timely payments of estimated tax, as required, over the course of the tax year.

The withholding tax credit allowed under Code Sec. 31 is treated as payment of estimated tax. (Code Sec. 6654(g)(1)) The credit is allowed when withholding is mandatory, such as with income tax withheld from wages, and when it is optional, such as with pensions and annuities.

Individuals who owe more in taxes than is withheld from their wages and other income, or who have no withholding, generally must estimate the tax due and pay it over the course of the tax year, usually in four installments.

A. Wage Withholding

Employers must withhold income tax from wages paid to employees, but not from amounts paid to independent contractors. Employees are entitled to minimum, and sometimes additional, withholding exemptions or allowances. Withheld tax must be paid through tax deposits or electronic funds transfers.

"Wages" cover all types of employee compensation, including salaries, fees, bonuses, commissions and fringe benefits. It's immaterial whether payments are based on the hour, day, week, month, year or on a piecework or percentage plan, or whether they're called wages, salaries, fees, etc. (Code Sec. 3401(a); Reg §31.3401(a)-1(a)(2); Reg §31.3401(a)-1(a)(3))

Noncash wages are the fair market value of the goods, lodging, meals or other consideration given for services. (Reg §31.3401(a)-1(a)(4))

Vacation allowances and back pay, including retroactive wage increases, are wages. (Reg §31.3401(a)- 1(b)(3)) Supplemental unemployment compensation benefits are treated as wages for income tax purposes. (Code Sec. 3402(o)(1)(A); Code Sec. 3402(o)(2))

Withholding is computed on gross wages before any deductions by the employer for social security tax, pensions, union dues, insurance, etc.

Wages includes tips. (Code Sec. 3401(f)) However, withholding isn't required on cash tips of less than $20 a month received by an employee, or for tips paid in any medium other than cash (such as passes, tickets or other goods or commodities). (Code Sec. 3401(a)(16); Reg §31.3401(a)(16)-1) But if cash tips amount to $20 or more in a month, none of the cash tips are exempt. The $20 test is applied separately with respect to cash tips received by the employee for his services to each employer. (Reg §31.3401(a)(16)-1)

Household and other employees who aren't subject to income tax withholding may elect to have tax withheld, if their employers agree. (Code Sec. 3402(p)) Other employees can also have their withholding increased voluntarily. (Code Sec. 3402(i))

1. Computing Withholding

There are two principal systems of withholding: (1) the percentage or exact method, and (2) the wage bracket method. Whichever method is used, the employer applies the withholding allowances and marital status indicated by the employee.

An employer should ask each new employee to fill out a Form W-4 withholding allowance certificate before employment begins. (Code Sec. 3402(f)(2)(A)) Employers must take into account the marital status and exemptions and allowances of each employee on the basis of that Form W-4. A certificate filed by a new employee is effective on the first payment of wages. (Code Sec. 3402(f)(3)) If an employee fails to furnish a certificate, the employer must withhold tax as if the employee were a single person with no withholding exemptions or allowances. (Code Sec. 3401(e); Reg §31.3402(f)(2)-1(e))

Percentage method. Under the percentage method, the income tax to be withheld is computed as follows:

1. Multiply the amount of one withholding exemption (from a table provided by IRS) by the number of withholding exemptions claimed.
2. Subtract the amount claimed in (1) above from the employee's wages.
3. Compute the tax by referring to the appropriate percentage table. There are tables for both single persons (including heads of household) and married persons. For each category, there is a weekly, biweekly, semimonthly, monthly, quarterly, semiannual, annual and a daily (or miscellaneous period) table. (Code Sec. 3402(b))

Wage bracket table method. These tables show the amount to be withheld from various amounts paid to employees with different numbers of withholding exemptions. The tables may be used for weekly, biweekly, semi-monthly, monthly, and daily or miscellaneous payroll periods. (Code Sec. 3402(c))

2. Withholding Exemptions

An employee is allowed:

- a regular exemption for himself, unless he's claimed as another's dependent;

- a regular exemption for his or her spouse, unless the spouse is employed and claims a regular exemption;

- an exemption for each dependent he or she may claim on his tax return; (Code Sec. 3402(f)(1); Reg §31.3402(f)(1)-1)

- additional withholding allowances (see below).

A taxpayer working for more than one employer must allocate his allowances on separate Form W-4s filed with each employer. (Code Sec. 3402(f)(7); Reg §31.3402(m)-1(f)(2))

The withholding exemption allowance is the same amount as allowed for a personal exemption (see IV.B.). (Code Sec. 3402(a)(2))

Additional withholding allowances. An employee may claim (on Form W-4) additional withholding allowances for:

- estimated tax credits (except for any earned income credit if the employee is receiving advance payments); and

- estimated itemized deductions and other deductions including the additional standard deduction for the aged and blind, but only if his or her spouse doesn't have in effect a Form W-4 claiming the same allowances. (Code Sec. 3402(m); Reg §31.3402(m)-1)

An additional withholding allowance (called a "standard deduction allowance") can be claimed by an employee who is single and has only one job; by an employee who is married and has only one job if his or her spouse does not work; or by another employee if the employee's wages from a second job or a spouse's wages (or the total of both) are $1,000 or less. (Code Sec. 3402(f)(1)(E))

3. Employees with No Tax Liability

Employees with no tax liability can be exempt from income tax withholding. To qualify, the employee certifies on Form W-4 that he or she:

- expects to have no federal income tax liability for the current year, and

- had no federal income tax liability in the preceding year. (Code Sec. 3402(n); Reg §31.3402(n)-1)

An employee who can be claimed as a dependent on someone else's tax return (whether or not actually claimed) cannot claim exemption from withholding if his income exceeds $1,000 for 2013 and includes more than $350 of unearned income, such as interest and dividends. Special calculations have to be made by an employee who is 65 or older and/or blind.

4. Amending Withholding Certificate

The employee must amend his Form W-4, reducing the number of allowances, within ten days: (Code Sec. 3402(f)(2)(B); Reg §31.3402(f)(2)-1(b))

- when the spouse he or she has been claiming is divorced or legally separated from the employee or claims her or her own allowance on a separate W-4;

- when the employee loses the right to the exemption for a claimed dependent;

- when the employee loses the right to the number of withholding allowances he has claimed.

5. Wage and Tax Statement—Form W-2

An employer in business must give each employee copies of Form W-2, on or before January 31 of the year after the calendar year for which the wages were paid. If an employee leaves the job before the end of the calendar year and isn't expected to return within the calendar year, Form W-2 must be provided not later than 30 days after the employer receives a written request for it from the employee if that 30-day period ends before the regular January 31 deadline. (Code Sec. 6051; Reg §31.6051-1(d))

If an employee doesn't receive a Form W-2, he or she should ask his employer for it. If the employer doesn't provide the form, the employee should telephone the IRS toll-free at the number listed in the instructions to Form 1040, Form 1040A, or Form 1040EZ to have IRS ask the employer to send a copy or duplicate form. If the employee hasn't received a Form W-2 in time to file a tax return, the employee should file a return estimating wages and the income tax withheld.

B. Non-payroll Withholding Taxes

Income tax on gambling winnings, payments subject to backup withholding, retirement plan payments, IRAs, annuities and certain other deferred compensation are withheld under "non-payroll withheld taxes" rules.

1. Gambling Winnings

Payers must withhold 25% on proceeds of more than $5,000 (Code Sec. 3402(q)(1)) from:

- a wagering transaction in a pari-mutuel pool with respect to horse races, dog races or jai alai if the amount of the proceeds is at least 300 times as large as the amount wagered; (Code Sec. 3402(q)(3)(C)(ii))
- a wager placed in a state-conducted lottery; (Code Sec. 3402(q)(3)(B))
- a sweepstakes, wagering pool or lottery (other than a state-conducted lottery); (Code Sec. 3402(q)(3)(C)(i))
- all other wagering transactions if the amount of the proceeds is at least 300 times as large as the amount wagered. (Code Sec. 3402(q)(3)(A))

"Proceeds" means the amount received from the wager reduced by the amount of the wager. (Code Sec. 3402(q)(4)(A)) Amounts paid with respect to identical wagers are treated as paid with respect to a single wager. (Reg §31.3402(q)-1(c)(1)(ii))

A person who receives gambling winnings subject to withholding must provide certain information on Form W-2G or Form 5754 and give it to the payor. (Code Sec. 3402(q)(6); Reg §31.3402(q)-1(e))

Review Question 46

An individual buys a $1 ticket in a state lottery and wins $5,001 to be paid in a lump sum. How much tax will be withheld by the payer?

a. $0.

b. 25 cents.

c. $1,250.

d. $1,250.25.

2. Pension and Annuities

Withholding of 20% is required on any designated distribution that's an eligible rollover distribution unless there's a direct trustee-to-trustee transfer. Withholding is required on periodic and lump-sum payments from certain employee plans and certain annuities. However, certain recipients may elect not to have tax withheld.

Withholding on eligible rollover distributions. Unless a distributee elects to have a retirement plan distribution paid directly to an eligible retirement plan as a trustee-to-trustee transfer, a payor must withhold 20% of any designated distribution that's an "eligible rollover distribution."

An eligible rollover distribution (Reg §31.3405(c)-1; Q&A-16) is any distribution to an employee from a qualified trust (not from an IRA, SEP, or SIMPLE plan) other than:

- a required distribution under Code Sec. 401(a)(9);
- any distribution that is one of a series of substantially equal periodic payments made (a) not less frequently than annually for the life (or life expectancy) of the employee (or joint lives or expectancies of the employee and his designated beneficiary), or (b) for a specified period of ten years or more; or
- a hardship distribution from a 401(k) or 403(b) plan. (Code Sec. 3405(c)(3); Code Sec. 402(c)(4); Code Sec. 402(f)(2)(A); Code Sec. 403(b)(8)(B); Reg §1.402(c)-2, Q&A-3)

No withholding is required if the total distribution paid to the distributee under the plan within one tax year is expected to be less than $200. (Reg §31.3405(c)-1, Q&A-14)

Withholding on designated distributions. Withholding is required for “designated distributions,” (Code Sec. 3405(d)(1)) but the recipient generally may elect out unless the distribution is an eligible rollover distribution (see above).

Designated distributions are periodic as well as nonperiodic (including lump-sum) payments from pension, profit sharing, stock bonus or other employer-provided deferred compensation plans, as well as from IRAs (other than Roth IRAs) and commercial annuities (whether or not the contract was purchased under an employer’s plan for employees). (Code Sec. 3405(e)) Annuity payments and other distributions under a state or local government deferred compensation plan, other than a Code Sec. 457 plan, including the Civil Service Retirement System, are subject to income tax withholding as well. (Reg §35.3405-1T)

A recipient may elect not to have any tax withheld. The election remains in effect until revoked. (Code Sec. 3405(a)(2)) The election is made (or revoked) on Form W-4P.

3. Backup Withholding

A payor of any “reportable payment” must withhold 28% of the payment if:

- The payee has failed to furnish his taxpayer identification number (TIN) to the payor (Code Sec. 3406(a)(1)(A)) or furnishes an “obviously incorrect number,” (Code Sec. 3406(h)(1)) such as one without nine digits or which includes letters of the alphabet. (Reg §31.3406(h)-1(b))
- The IRS or a broker has notified (the “B-notice”) the payor that the TIN furnished by the payee is incorrect. (Code Sec. 3406(a)(1); Code Sec. 3406(d)(2))
- There has been a notified payee underreporting with respect to interest and dividends. (Code Sec. 3406(a)(1)(C))
- The payee has failed to make the exemption certification (on Form W-9) with respect to interest and dividends. (Code Sec. 3406(a)(1)(D))

Reportable payments include most payments for which information returns are required, such as an interest or dividend payment. (Code Sec. 3406(b)(1)) Original issue discount (OID) is treated as a payment of interest for backup withholding purposes, but the amount withheld is limited to the cash paid. (Reg §31.3406(b)(2)-2(a))

C. Estimated Taxes

An individual must pay 25% of a “required annual payment” by April 15, June 15, September 15 and January 15, to avoid an underpayment penalty. The required annual payment for most taxpayers is the lower of 90% of the tax shown on the current year’s return or 100% of the tax shown on the prior year’s return even if filed late. However, any taxpayer whose adjusted gross income on the prior year’s return is over $150,000 (over $75,000 if married filing separately) must pay the lower of 90% of the tax shown on the current year’s return or 110% of the tax shown on the prior year’s return.

To avoid the underpayment penalty, an individual must either: (1) pay each "required installment" by the due date of that installment, (2) meet one of more of the exceptions to the penalty, or (3) get a waiver of the penalty from the IRS. Unless the annualized income method is used, the amount of each required installment is 25% of the required annual payment (see above).

Any withholding is treated as a payment of estimated tax. An equal part of the withheld tax is considered paid on each installment date unless the individual establishes the dates the amounts were actually withheld. (Code Sec. 6654(g)(1))

Review Question 47

A single individual's return for the prior year showed $100,000 of adjusted gross income and a tax liability of $10,500. His current year tax liability is $12,000. What is the amount of the individual's required annual estimated tax payment for the current year?

a. $10,500 b. $10,800

c. $11,500 d. $12,000

1. Annualized Income Method

For any installment for which the taxpayer establishes that the "annualized income installment" is less than the required installment (above), the annualized income installment becomes the required installment. (Code Sec. 6654(d)(2)(A)(i))

The annualized income installment is the excess (if any) of:

1. an amount equal to the "applicable percentage" (below) of the tax computed by placing on an annualized basis the taxable income for the months in the tax year ending before the due date for the installment, over
2. the sum of any earlier required installments for the tax year. (Code Sec. 6654(d)(2)(B))

The applicable percentages are 22.5%, 45%, 67.5% and 90%, respectively, for the first, second, third and fourth required installments. (Code Sec. 6654(d)(2)(C)(ii))

If, for any installment, the required installment is the annualized income installment, then the amount by which the installment determined under the general rules above exceeds the annualized income installment must be added to the next required installment that isn't an annualized income installment. (Code Sec. 6654(d)(2)(A)(ii)).

2. Penalty for Underpayment

The penalty for underpayment of estimated tax equals the product of the interest rate (using simple interest) (Code Sec. 6622(b)) on deficiencies times the amount of the underpayment for the period of the underpayment. (Code Sec. 6654(a))

The amount of the underpayment is the excess of the "required installment" over any amount paid on or before the due date of the installment. (Code Sec. 6654(b)(1))

The period of underpayment runs from that due date to the earlier of: (1) April 15 following the close of the tax year, or (2) the date the underpayment is paid. (Code Sec. 6654(b)(2)) A payment is credited against unpaid installments in the order the installments are required to be paid. (Code Sec. 6654(b)(3))

The underpayment penalty doesn't apply:

- if the tax shown on the return (or the tax due if no return is filed) is less than $1,000 after reduction for withholding tax paid, (Code Sec. 6654(e)(1))
- if the individual was a U.S. citizen or resident for the entire preceding tax year, that tax year was 12 months, and the individual had no tax liability for that year, (Code Sec. 6654(e)(2))

- for the fourth installment, if the individual (who isn't a farmer or fisherman) files his return by the end of the first month after the end of tax year (January 31 for calendar year taxpayers) and pays in full the tax computed on the return, (Code Sec. 6654(h)), or
- under certain circumstances with respect to a period during which a Title 11 bankruptcy case is pending. (Code Sec. 6658(a))

The underpayment penalty may be waived by IRS:

- if failure to pay was due to casualty, disaster, or other unusual circumstances where it would be inequitable or against good conscience to impose the penalty, or
- for reasonable cause during the first two years after the taxpayer retires (after reaching age 62) or becomes disabled. (Code Sec. 6654(e)(3))

VII. Tax Returns and Payment of Taxes

Learning Objectives

After completing this section, you should be able to:

- Determine a taxpayer's tax filing status and tax filing and payment responsibilities.
- List the special liability rules and relief provisions for joint return filers.

An individual taxpayer must file an income tax return if his gross income equals or exceeds a specified amount. U.S. citizens and residents use Form 1040 (Reg §1.6012-1(a)(6)), Form 1040A (Reg §1.6012- 1(a)(7)(i)), or Form 1040EZ.

All taxpayers can use Form 1040. Form 1040A may be used by a taxpayer in any filing status who has income only from wages, salaries, tips, IRA distributions, pension and annuities, taxable social security and railroad retirement benefits, mutual fund capital gain distributions, Alaska Fund dividends, taxable scholarships and fellowship grants, interest, dividends and unemployment compensation, who has only certain adjustments to gross income (educator expenses, IRA deduction, student loan interest deduction, tuition and fees deduction), who doesn't itemize, whose taxable income is less than $100,000, and who has only certain tax credits. Form 1040A may be used even if the taxpayer owes alternative minimum tax.

Single taxpayers or married taxpayers filing jointly under 65 who aren't blind can use Form 1040EZ if they claim no dependents, have income only from wages, salaries, tips, taxable scholarships or fellowships, unemployment compensation, Alaska Permanent Fund Dividends, and interest (of $1,500 or less), have no adjustments to gross income, claim no itemized deductions, have taxable income of less than $100,000 and have no tax credits other than the earned income credit (but no advance payment of that credit).

A. Filing Status

A taxpayer's filing status has an important bearing on his or her tax liability. It can affect the amount of income that must be reported, the availability of deductions and credits and their amounts, and the tax rate schedules to be used.

There are four filing statuses:

- Single persons (not married at year's end), including certain marrieds living apart;
- Married couples filing joint returns, and certain widows and widowers who qualify as "surviving spouses;"
- Heads of household; and
- Married persons filing separate returns.

1. Joint Returns

A husband and wife may file a joint return even if only one has income (Code Sec. 6013(a)) and even if they have different accounting methods. But they must be legally married as of the end of the tax year. (Code Sec. 6013(d))

If the parties file a joint return during their "marriage" and later get an annulment, they must refile as separate unmarried persons.

A joint return can't be filed:

- if either spouse was a nonresident alien at any time during the tax year (Code Sec. 6013(a)(1)), except that where one spouse is a nonresident alien for the entire year (Code Sec. 6013(g)) or where a nonresident alien spouse becomes a U.S. resident during the tax year (Code Sec. 6013(h)), both spouses can elect to file a joint return by agreeing to subject their worldwide income to U.S. taxation;
- if the spouses have different tax years, except when one spouse dies. A joint return may be filed for a husband and wife where their tax years start the same day and end on different days because of the death of either or both (unless the survivor remarries before the close of his or her tax year). The joint return must be made with respect to the tax year of each spouse. (Code Sec. 6013(a)(2))

A surviving spouse may file a joint return for the deceased and surviving spouse if: the deceased spouse didn't previously file a return for the tax year; an executor/administrator hasn't been appointed by the time the joint return is made; and an executor/administrator hasn't been appointed before the due date for filing the return of the surviving spouse (including extensions). (Code Sec. 6013(a)(3))

If an executor or administrator is appointed on or before the filing due date, the surviving spouse can't file a joint return for the decedent. Only the fiduciary can act for the decedent, so both the fiduciary and the surviving spouse must sign the joint return.

Qualifying widow(er). Even though joint return filing is not available, a surviving spouse (qualifying widow(er)) whose spouse died during either of the surviving spouse's two tax years immediately preceding the current tax year (Code Sec. 2(a)(1)) may qualify to be taxed at joint return rates. (Code Sec. 1(a)(2)) Joint return rates are available if the surviving spouse:

- hasn't remarried at any time before the close of the tax year (Code Sec. 2(a)(2)(A)),
- "maintains" (pays more than 50% of the costs of) a home which is the "principal place of abode" of a son or daughter (including adopted and foster children) or a stepson or stepdaughter,
- is entitled to a dependency exemption for at least one child (Code Sec. 2(a)(1)), and
- was entitled to file a joint return with the deceased spouse for the year of death. (Code Sec. 2(a)(2)(B)))

2. Married Individuals Living Apart

A married taxpayer is considered single for tax purposes if he or she meets all of the following tests:

- Files a separate return.
- Maintains as his or her home a household that for more than half the tax year is the principal place of abode of a son, daughter, stepson or stepdaughter for whom taxpayer is entitled to a dependency exemption even if the taxpayer allows the other parent to claim the exemption for the child. (Code Sec. 7703(b)(1))
- Furnishes more than half the cost of maintaining the household. (Code Sec. 7703(b)(2))
- Doesn't have the other spouse living with him or her during the last six months of the tax year. (Code Sec. 7703(b)(3))

These individuals, if they otherwise qualify, can thus use head of household rates (see next section).

Either or both spouses can qualify as unmarried taxpayers by meeting the tests. If one spouse qualifies and the other doesn't, the spouse who doesn't must use married-filing-separately rates.

3. Head of Household

An unmarried taxpayer may qualify as a head of household by maintaining as his or her home a household that is the principal place of abode for more than half the year of:

- a "qualifying child" of the taxpayer, (see IV.B.2.), or
- a person who would be the taxpayer's qualifying child if the taxpayer hadn't released the dependency deduction to the noncustodial parent. (Code Sec. 2(b)(1)(A)(i))

However, the taxpayer won't qualify as a head of household if the qualifying child is married at the close of the taxpayer's tax year (Code Sec. 2(b)(1)(A)(i)(I)), and isn't a dependent of the taxpayer because he or she filed a joint return (Code Sec. 152(b)(2)) or because he or she isn't a U.S. citizen or resident (Code Sec. 152(b)(3)), or both. (Code Sec. 2(b)(1)(A)(i)(II))

Also, an unmarried taxpayer may claim head-of-household status if he or she (1) pays more than half of the cost of maintaining as his or her home a household that is the principal place of abode for more than half the year of an individual for whom the taxpayer may claim a dependency exemption (Code Sec. 2(b)(1)(A)(i)), or (2) maintains a household that for the tax year is the principal place of abode for either of his or her parents, if taxpayer is entitled to a dependency deduction for either parent. (Code Sec. 2(b)(1)(B))

Review Question 48

An individual's spouse died in 2011. The individual filed a joint return for 2011. She has not remarried and has a 12-year old daughter who lives with her and for whom she claims a dependency exemption. What is the individual's filing status for 2013?

a. Married filing jointly.

b. Qualifying widow(er).

c. Single.

B. Filing Requirements

An income tax return must be filed by every individual U.S. citizen and resident alien who has gross income (including excluded home sale gain and foreign earned income (Code Sec. 6012(c))) that equals or exceeds the following amounts in 2013:

(1) Single (Code Sec. 6012(a)(1)(A)(i))	$10,000
--65-or-over (Code Sec. 6012(a)(1)(B))	11,500
(2) Married filing joint return (Code Sec. 6012(a)(1)(A)(iv))	20,000
--one 65-or-over (Code Sec. 6012(a)(1)(B))	21,120
--both 65-or-over (Code Sec. 6012(a)(1)(B))	22,400
(3) Married filing separate return (Code Sec. 6012(a)(1)(A))	3,900
(4) Head of Household (Code Sec. 6012(a)(1)(A)(ii))	12,850
--65-or-over (Code Sec. 6012(a)(1)(B))	14,400
(5) Surviving spouse (Code Sec. 6012(a)(1)(A)(iii))	16,100
--65-or-over (Code Sec. 6012(a)(1)(B))	17,300

The above rules don't apply to an individual who can be claimed as a dependent by another taxpayer. That individual/dependent must file a return if (a) his or her unearned income is more than $1,000 for 2013 plus any additional standard deduction for the aged and blind, or (b) his or her total gross income is more than the standard deduction. (Code Sec. 6012(a)(1)(C)(i))

An individual who has $400 or more net earnings from self-employment (see VII.G.) must file a return even though his or her gross income is less than the required amount. (Code Sec. 6017)

Some individuals may have to file an income tax return even though they have gross income below the levels listed above. These include:

- Individuals who received tips from which social security tax wasn't withheld.
- Individuals owing alternative minimum tax.
- Individuals who must pay a tax with respect to an IRA, qualified retirement plan, Archer medical savings account, health savings account, Coverdell education savings account, or qualified tuition program.
- Individuals who must pay a tax resulting from recapture of certain tax credits.

C. Joint Return Liability

Generally speaking, each spouse is jointly and severally liable for the full amount of the tax, penalties (other than civil fraud (4883)), and interest arising out of a joint return, regardless of the amount of his or her separate taxable income. (Code Sec. 6013(d)(3)) Only the spouse committing fraud can be subjected to fraud penalties. However, as discussed below, there are important exceptions to this joint liability rule.

1. "Innocent" Spouse

An individual who has filed a joint return may seek relief from joint and several liability under "innocent spouse" procedures. (Code Sec. 6015(a)(1)) Under procedures prescribed by IRS, an individual will be relieved of liability for tax (including interest, penalties, and other amounts) for a tax year to the extent the liability is attributable to an understatement if:

- a joint return was filed for the tax year;
- there is an understatement of tax on the return attributable to erroneous items of the other spouse;
- the individual establishes that, in signing the return, the individual didn't know or have reason to know of the understatement;
- taking into account all the facts and circumstances, it would be inequitable to hold the individual liable for the deficiency; and
- the individual elects the benefits of the innocent spouse provision, by filing Form 8857 (separately from the tax return) with a specified attached statement, no later than two years after IRS has begun collection activities with respect to the individual. (Code Sec. 6015(b)(1))

An individual who knew or had reason to know of the understatement, but establishes that he or she didn't know or have reason to know of its extent, is relieved of liability for that portion of the understatement that the individual didn't know or have reason to know about. (Code Sec. 6015(b)(2))

2. Separate Liability

An individual who files a joint return and meets certain eligibility requirements can elect to limit his or her liability for any deficiency to his or her allocable share. This "separate liability" (or "allocation of liability") election may be made in addition to the innocent spouse election. (Code Sec. 6015(a)(2)) Separate liability relief is available only for unpaid liabilities resulting from understatements; refunds are not authorized. (Reg §1.6015-3(c)(1))

An individual is eligible to make the election only if, when the election is filed, he or she is no longer married to, or is legally separated from, the spouse with whom the joint return was filed, or wasn't a member of the same household as that spouse at any time during the previous 12-month period. If IRS demonstrates that assets were transferred between spouses in a fraudulent scheme joined in by both spouses, a separate liability election filed by either spouse will be invalid. (Code Sec. 6015(c)(3)(A))

Except as provided below, an electing spouse's liability for any deficiency that IRS assesses won't exceed the portion of the deficiency properly allocable to that spouse. (Code Sec. 6015(c)(1); Code Sec. 6015(d)(3)(A))

The liability is generally allocated between the spouses in proportion to the net items taken into account in determining the deficiency as if the spouses had filed separate returns. (Code Sec. 6015(d)(1)) However, the limitation on an electing spouse's tax liability is increased by the value of property transferred to that spouse by the nonelecting spouse principally to avoid tax. A transfer (except for divorce or separate maintenance transfers) made at any time starting after one year before the first letter of proposed deficiency is sent is rebuttably presumed to be for tax avoidance. (Code Sec. 6015(c)(4)) Also, except where a joint return was signed under duress, the election doesn't apply to the extent that IRS has evidence that the electing spouse had actual knowledge of an item giving rise to all or part of a deficiency allocable to the other spouse. (Code Sec. 6015(c)(3)(C))

3. Equitable Relief

If under all the facts and circumstances it's inequitable to hold a spouse liable for any portion of any unpaid tax or deficiency, and relief isn't available under the innocent spouse or separate liability election (above) rules, the IRS may relieve that spouse of liability for that unpaid tax or deficiency (Code Sec. 6015(f); Reg §1.6015-4) and in limited cases may issue a refund.

All of the following threshold conditions must be met to be considered for this relief:

- a joint return must have been made for the tax year, and the liability for which relief is sought, subject to limited exceptions, must be attributable to the nonrequesting spouse;
- relief must not be available under the innocent spouse or separate liability election;
- relief must be applied for no later than two years after IRS's first collection activity with respect to the individual;
- the liability must be unpaid when relief is requested (although relief in the form of a refund may be available for certain installment payments made after the request for relief is made);
- no assets were transferred between the individuals filing the joint return as part of a fraudulent scheme;
- there were no disqualified assets transferred to the individual by the nonrequesting spouse (if there were, relief will be available only to the extent the liability exceeds their value); and
- the individual did not file the joint return with fraudulent intent.

Review Question 49

An individual moved out of her marital home in November 2012, but did not obtain a divorce or legal separation. In February 2013, she received a collection notice from the IRS for unpaid taxes shown on the 2011 joint return she filed with her spouse. All of the income shown on the 2011 return was attributable to the individual's spouse. Which of the following is a true statement?

a. The individual is entitled to innocent spouse relief because the unpaid taxes are attributable to erroneous items of the other spouse.

b. The individual is not entitled to elect separate liability relief even though she is living apart from her spouse.

c. The IRS may not grant the individual relief from joint liability because the taxes in question did not arise from a deficiency.

D. Decedent's Return

A final income tax return must be filed for a deceased person who would be required to file if alive, for the part of the year up to the date of death. A decedent's final return is filed by the person entrusted with his property. Ordinarily, this would be the executor or administrator of his estate. (Code Sec. 6012(b)(1)) (For the surviving spouse filing a decedent's joint return, see VII.A.1.)

A decedent's last tax year ends on his death. A cash basis decedent's final return includes only the income he actually or constructively received before he died. An accrual basis decedent's return includes income and deductions properly accruable at death (but not solely by reason of death). After-death income and deductions "in respect of a decedent" must be reported by decedent's estate or others who acquire his rights or obligations.

Personal exemptions and the standard deduction allowed on a decedent's final income tax return aren't reduced because the return is for a short year.

E. Time for Filing

Income tax returns (including self-employment tax returns) of U.S. citizens and resident aliens must be filed on or before the fifteenth day of the fourth month following the close of the tax year (April 15 for calendar year taxpayers). (Code Sec. 6072(a))

A decedent's final return is due on the filing date that would have applied had the taxpayer lived. (Reg §1.6072-1(b))

An individual who is required to file an individual income tax return is allowed an automatic six-month extension of time to file the return after the date prescribed for filing the return if the individual files an application satisfying the requirements discussed below. (Reg §1.6081-4T(a))

To satisfy the requirements for the automatic extension, an individual has to:

- submit a complete application on Form 4868 or in any other manner prescribed by the IRS.
- file the application on or before the *later* of the: (a) due date for filing the return; or (b) expiration of any extension of time to file granted to a taxpayer outside the U.S. or Puerto Rico (see below);
- file the application with the IRS office designated in the application's instructions.
- show on the application the full amount properly estimated as tax for the tax year. Reg §1.6081-4T(b) .

An individual income tax return filing extension does not extend the time for paying any tax due on the return.

A U.S. citizen or resident whose tax home and abode is outside the U.S. and Puerto Rico (Reg §1.6081-5(a)(5)) and a U.S. citizen or resident in military or naval service on duty outside the U.S. and Puerto Rico (Reg §1.6081-5(a)(6)), get automatic two-month extensions until the fifteenth day of the sixth month after the close of the tax year. A statement should be attached to the return which shows that the taxpayer qualified for this extension. (Reg §1.6081-5(b)) Individual taxpayers in this category can receive an additional four-month extension (for a total of six months) by filing Form 4868, with the appropriate box checked, on or before the expiration date of the initial two-month extension. (Reg §1.6081-5T(b)(2)) However, there is no automatic extension for a U.S. citizen or resident merely traveling outside the U.S. and Puerto Rico.

If a due date falls on Saturday, Sunday or legal holiday, there is an automatic extension of time to the next succeeding day that is not a Saturday, Sunday or legal holiday. The rule applies to not only tax return filing but to other specified acts required to be performed under the Code.

"Legal holiday" includes: (1) the legal holidays throughout the state or possession where the office at which the act to be performed is located even if not a legal holiday in the state or possession where the taxpayer resides, and (2) all legal holidays in the District of Columbia (Code Sec. 7503), i.e., New Year's

Day–January 1; Inauguration Day–January 20 (every fourth year); Martin Luther King, Jr.'s birthday–third Monday in January; Washington's birthday–third Monday in February; Emancipation Day–April 16, Memorial Day–last Monday in May; Independence Day–July 4; Labor Day–first Monday in September; Columbus Day–second Monday in October; Veterans Day–November 11; Thanksgiving Day–fourth Thursday in November; Christmas Day– December 25. If a holiday in the District of Columbia falls on Sunday, the following Monday is a holiday in the District of Columbia. When a legal holiday in the District of Columbia (other than Inauguration Day) falls on a Saturday, it's treated as falling on the preceding Friday.

An amended income tax return (on Form 1040X) may be filed to claim a refund after an original return has been filed if the period of limitations is open. (Reg §301.6402-3(a)(2))

F. Payment of Tax

The tax is due on the original due date for filing the return despite any extensions of time for filing the return. (Code Sec. 6151(a); Reg §1.6151-1(a))

IRS will accept personal checks or money orders drawn on any banking institution incorporated by the U.S., a state, territory, etc., if the check or money order is payable in U.S. currency at par. Express, telegraphic, and similar money orders are also acceptable. (Reg §301.6311-1)

Taxes (including interest and penalties) also may be paid by any commercially acceptable means that IRS deems appropriate by regulation, including credit or debit cards approved by IRS in the manner and in accordance with IRS forms, instructions, and procedures. (Code Sec. 6311(a); Code Sec. 6311(d)(1); Reg §301.6311-2T)

Tax payment by credit or debit card is deemed made when the issuer properly authorizes the transaction, provided payment is actually received by IRS in the ordinary course of business and is not returned due to error resolution processing. (Reg §301.6311-2(b)) Where quarterly estimated tax payments (see VI.C.) aren't necessary, payments are generally made with the individual's return.

Taxpayers can apply for a reasonable extension of time (not to exceed six months, unless taxpayer is abroad) to pay the tax. (Code Sec. 6161(a)(1)) The application must be filed on or before the date prescribed for payment of the tax. (Reg §1.6161-1(c)) IRS grants extensions only on a satisfactory showing that payment on the due date will result in undue hardship (more than an inconvenience), e.g., that taxpayer would have to sell property at a great financial sacrifice (i.e., below fair market value) to pay the tax. (Reg §1.6161-1(b))

Taxpayers can also request an agreement to pay tax in installments. The IRS must enter into an installment agreement requested by an individual whose aggregate tax liability (without interest, penalties, additions to tax, and additional amounts) is not more than $10,000; and who (or whose spouse for joint return liability) hasn't failed to file or to pay income tax, or entered into another installment agreement, during any of the preceding five tax years, if IRS determines that the taxpayer is financially unable to pay the liability in full when due (and the taxpayer submits information that IRS may require to make this determination). The agreement must require full payment within three years, and the taxpayer must agree to comply with all Code provisions while it's in effect. (Code Sec. 6159(c))

IRS grants installment agreement requests to taxpayers who agree to pay a balance due of $25,000 or less within a five-year period, without requiring a collection manager's approval.

G. Self-employment Tax

Self-employed persons pay social security and Medicare taxes for themselves as part of their income tax. This self-employment tax is based on net earnings from self-employment (see below), not on taxable income.

The self-employment tax is imposed at a rate of 15.30%: a combination of a 12.40% Old Age, Survivors, and Disability Insurance tax (OASDI, the equivalent of the Social Security tax), and a 2.90% Medicare tax. (Code Sec. 1401(a); Code Sec. 1401(b))

For 2013, the 12.40% OASDI tax is computed on the first $113,700 of self-employment income. Thus, the maximum OASDI tax for 2013 is $14,098.80 (12.40% of $113,700). The 2.90% Medicare tax is computed on the entire self-employment income (no ceiling).

Self-employment income consists of net earnings from self-employment This is gross income, under the individual's income tax accounting method, from a trade or business carried on by him, less allowable deductions attributable to that business, plus the distributive share of partnership taxable income or loss from a partnership of which he is a member. (Reg §1.1402(a)-1) Among the deductions allowed is an amount equal to 7.65% times the taxpayer's net earnings from self-employment for the tax year (determined without regard to this deduction). (Code Sec. 1402(a)(12))

In computing the gross income and deductions of a trade or business (or the distributive share of partnership ordinary income or loss), certain items are excluded. These include:

- operating loss carrybacks and carryovers;
- nonbusiness deductions;
- the deduction for a self-employed person's health insurance costs (Code Sec. 162(l)(4));
- deduction for personal exemptions; and
- standard deduction;

Net earnings from self-employment don't include:

- dividends or interest on investments (Code Sec. 1402(a)(2));
- gains (or deduction for losses) from property that's not inventory or held for sale to customers (Code Sec. 1402(a)(3));
- rents from real estate held for income or value growth, (Code Sec. 1402(a)(1)) but rent is self-employment earnings if received by real estate dealers who get rent on property held for sale to customers in the normal course of business (Reg §1.1402(a)-4(a)), or if the rent is for living quarters where services (e.g., maid service) are also rendered primarily for the occupant's convenience; (Reg §1.1402(a)-4(c)(2))
- a shareholder's share of the income of an S corporation, whether distributed or not (see Module 2, *Taxation of Businesses*).

A passive activity loss that's disallowed for income tax purposes (see IV.L.4.) isn't taken into account in computing net earnings from self-employment. (Reg §1.469-1T(d)(3))

Tax on self-employment income is computed on the separate self-employment income of each spouse, whether or not they file joint returns. But the spouses are jointly and severally liable for self-employment tax due on a joint return. (Reg §1.6017-1(b))

H. Electronic Filing

Tax returns (Form 1040, Form 1040A and Form 1040EZ) can be filed electronically (but not after October 15 even with a filing extension) including returns that show a balance due. However an electronic return can't be filed for returns for years other than the current tax year, amended returns, returns that cover fiscal year tax periods, or in certain other situations.

An electronic return is a composite return consisting of data transmitted to IRS electronically and of paper documents (filed later) that can't be electronically transmitted, such as documents prepared by third parties. The IRS has developed procedures for accepting signatures in digital or electronic form (Code Sec. 6061(b)) Any payment may be mailed separately to IRS (use Form 1040-V or the scanable payment voucher that's included in some tax packages), debited from the taxpayer's checking or savings account, or paid by phone using a MasterCard, VISA, Discover Card, or American Express Card. Credit card payment options also are available to users of certain tax preparation software.

VIII. Individual Alternative Minimum Tax

Learning Objective

After completing this section, you should be able to:

- Identify basic structural and computational elements of the alternative minimum tax.

The alternative minimum tax (AMT) prevents a taxpayer with substantial income from avoiding significant tax liability through exclusions, deductions, and credits. The AMT equals the excess (if any) of the "tentative minimum tax" over the regular tax. It's paid only if and to the extent it exceeds the taxpayer's regular tax. (Code Sec. 55(a))

The Code provides for both an individual and corporate AMT. The corporate AMT is discussed in Module 2, Taxation of Businesses.

A. Computing the AMT

For an individual (other than a married person filing separately), the tentative minimum tax for the tax year is equal to 26% of the "taxable excess" that doesn't exceed $175,000, plus 28% of the taxable excess above $175,000, reduced by the AMT foreign tax credit for the tax year (computed in a manner roughly similar to the computation of the regular foreign tax credit). (Code Sec. 55(b)(1)(A)(i))

For married filing separately, $87,500 replaces $175,000 above. (Code Sec. 55(b)(1)(A)(iii))

However tentative minimum tax attributable to capital asset sales and exchanges and qualified dividend income is determined using the lower rates that apply to long-term gains for regular tax purposes (see III.C.3).

"Taxable excess" means the excess of alternative minimum taxable income (AMTI) for the tax year over the "exemption amount." (Code Sec. 55(a)(1)(A)(ii))

In recent years, the AMT exemption amounts for individuals have been temporarily increased or "patched" by Congress. However, the American Taxpayer Relief Act of 2012 ends this patchwork approach by permanently increasing the exemption amounts, and indexing them for inflation after 2012. (Code Sec. 55(d)(1))

The indexed exemption amounts for 2013 are:

- $80,800 for joint filers and surviving spouses;
- $51,900 for unmarried individuals (other than surviving spouses); and
- $40,400 for married taxpayers filing separately.

The AMT exemption amount is reduced by an amount equal to 25 percent of the excess of AMTI over $150,000 for married taxpayers filing jointly and surviving spouses, $112,500 for single taxpayers and $75,000 for married taxpayers filing separately. (Code Sec. 55(d)(3))

Review Question 50

A married couple filing jointly has AMTI of $170,000. What is the amount of the reduction in their otherwise allowable AMT exemption amount?

a $42,500.	b. $37,500.
c. $23,750.	d. $5,000.

B. Alternative Minimum Taxable Income

Alternative minimum taxable income (AMTI) is taxable income plus or minus various "adjustments," plus tax preferences. (Code Sec. 55(b)(2)) The AMT can apply if a taxpayer has only adjustments even if he has no tax preferences. Preferences are just one component of the AMT calculation; a taxpayer without preferences must still compute AMT with the adjustments.

AMT adjustments differ from preferences. Adjustments involve a substitution of AMT treatment of an item for the regular tax treatment. A preference involves the addition of the difference between the AMT treatment and the regular tax treatment. Some (but not all) adjustments can be negative amounts, i.e., they may result in alternative minimum taxable income that's less than taxable income. Tax preferences can't be negative amounts.

Adjustments and preferences in computing an individual's AMTI include:

- *Itemized deductions adjustment.* Itemized deductions for AMT purposes are computed the same as for regular tax purposes, except:
- Medical expenses are deductible only to the extent they exceed 10% of the taxpayer's adjusted gross income. (Code Sec. 56(b)(1)(B))
- Property and income taxes aren't deductible unless they are deductible in computing adjusted gross income. The itemized deduction for state and local sales taxes also doesn't apply in calculating AMTI. (Code Sec. 56(b)(1)(A)(ii))
- Net investment income (the limit on the deduction for investment interest) for AMT purposes, equals the sum of interest on tax exempt bonds that's includible in alternative minimum taxable income net of expenses associated with that interest, plus net investment income for regular tax purposes. (Code Sec. 56(b)(1)(C))
- No deduction is allowed for miscellaneous itemized deductions. (Code Sec. 56(b)(1)(A)(i))
- Itemized deductions otherwise allowed in computing alternative minimum taxable income are not reduced by the Code Sec. 68 overall limitation on itemized deductions, which reduces certain itemized deductions by 3% of AGI above certain levels (IV.A.1.), as they are for regular tax purposes. (Code Sec. 56(b)(1)(F))
- *Standard deduction and personal exemptions adjustments.* The standard deduction and the deduction for personal exemptions aren't allowed. (Code Sec. 56(b)(1)(E))
- *State, etc., tax recoveries adjustment.* If an itemized deduction for state, etc., taxes paid is permitted for regular tax purposes but is denied for AMT purposes (above), and any portion of that tax is refunded, the refund isn't included in alternative minimum taxable income. (Code Sec. 56(b)(1)(D)
- *Incentive stock option (ISO) adjustment.* The Code Sec. 83 restricted property rules (which may require earlier recognition of income), rather than the Code Sec. 421 stock option rules, apply, unless the stock is acquired and disposed of in the same tax year. (Code Sec. 56(b)(3))
- *Qualified small business stock exclusion preference.* Seven percent of the amount excluded from gross income at the disposition of "qualified small business stock" (see II.C.5) is an AMT preference. (So if 50% of gain is excluded, the preference is 7% of 50%, or 3.5% of the total gain.) (Code Sec. 57(a)(7))
- *Passive losses.* The rules limiting the deduction for regular tax purposes of losses from passive activities (see IV.L.4.) apply for AMT purposes except that:
  - the amount of losses that otherwise would be disallowed under the regular tax limitation is reduced by the amount, if any, by which the taxpayer is insolvent; and
  - in computing income and losses from passive activities, other AMT adjustments and preferences are taken into consideration. (Code Sec. 58(b))

- *Interest income*. Tax exempt interest earned on certain private activity bonds is a preference item. (Code Sec. 57(a)(5))

Depreciation adjustment. For property placed in service after 1998, AMT depreciation is computed using the 150% declining balance method (switching to straight-line in the year necessary to maximize the allowance), except that straight line is used for Sec. 1250 property and other property for which straight line depreciation is used for regular tax purposes. The MACRS recovery period is the same for AMT and regular tax purposes. (Code Sec. 56(a)(1)(A); Code Sec. 56(a)(1)(C)(ii))

The AMT adjustment (i.e., the amount that must be added or subtracted in the calculation of alternative minimum taxable income) that's generated by the above calculations is determined by subtracting the amount of AMT depreciation for all property covered by the above rule from the MACRS depreciation for that property.

C. Credits against the AMT

As a general rule, the aggregate amount of all nonrefundable personal tax credits (other than the adoption credit, the child tax credit, and the saver's credit) is limited to the excess of (1) the taxpayer's regular tax liability for the tax year, over (2) the taxpayer's tentative minimum tax for the tax year, determined without regard to the AMT foreign tax credit. However, for tax years beginning in 2009, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) extended a special relief provision (which was also available for tax years 2000 through 2008) that allowed the combined total of nonrefundable personal credits to the extent of the sum of: (1) regular tax liability reduced by the foreign tax credit and (2) the alternative minimum tax. In other words, nonrefundable credits are allowed to the full extent of the regular tax and the AMT for 2009. (Code Sec. 26(a)(1); Code Sec. 1400C(g)) In addition, for years when that relief provision does not apply (i.e., after 2009 unless it is again extended), the 2008 Energy Act added the residential energy efficient property credit (Code Sec. 25D) to the credits that aren't subject to the credit limitation. (Code Sec. 26(a)(1) as amended by 2008 Energy Act §106(e)(2)(D)DivB)

Caution: Expired or expiring provisions may be extended by Congress.

D. AMT Credit

This is an income tax credit equal to the "adjusted net minimum tax" that a taxpayer paid in previous years with respect to "deferral preferences," less any minimum tax credits taken in those years. (Code Sec. 53(a); Code Sec. 53(b)) The credit is limited to the excess of: (1) taxpayer's regular tax liability for the year to which the credit is being carried, over (2) the sum of the following for the year to which the credit is being carried: all nonrefundable tax credits, and the tentative minimum tax. (Code Sec. 53(c);Code Sec. 53(d)(2))

For individuals, the adjusted net minimum tax ("ANMT") is generally:

1. the total alternative minimum tax for the year,
2. less the amount of alternative minimum tax liability that would have arisen if the only applicable preferences and alternative minimum tax adjustments were "exclusion preferences" and if the 90% alternative minimum tax foreign tax credit didn't apply.

Deferral preferences are all of the alternative minimum tax preferences and adjustments except "exclusion" preferences, such as tax-exempt interest, the exclusion of a portion of the gain on qualified small business stock, alternative tax itemized deductions, the standard deduction, and the personal exemptions.

Refundable part of minimum tax credit. For tax years beginning after December 20, 2006, if an individual has a long-term unused minimum tax credit for any tax year beginning before January 1, 2013, the regular AMT credit limit (above) cannot be less than the "AMT refundable credit amount" for the tax year. In other words, the minimum tax credit allowable for the tax year is the greater of the AMT refundable credit amount or the amount of the credit otherwise allowable.

Under a change made by the 2008 AMT Relief Act (which was included as part of the Emergency Economic Stabilization Act (P.L. 110-343, 10/3/08)), an individual's AMT refundable credit amount for a tax year beginning after 2007 and before 2013 is the amount equal to the greater of:

- 50% of the long-term unused MTC for the tax year, or
- the amount (if any) of the AMT refundable credit amount determined for the taxpayer's preceding tax year. (Code Sec. 53(e)(2))

Thus, as a general rule, the law change allows 50% of long-term unused MTCs to be refunded over each of two years. By contrast, under prior law, long-term unused MTCs were generally refunded at a rate of 20% over 5 years.

In addition, the 2008 law change eliminates the AGI-based phase-out of the AMT refundable credit amount, which was required under prior law. Therefore, an individual who otherwise qualifies for an AMT refundable credit is entitled to the full amount of the credit, without regard to the amount of AGI.

The additional credit allowable under this provision is refundable (i.e., the excess of the credit over the taxpayer's tax liability may be refunded). (Code Sec. 53(e)(4))

Caution: Expired or expiring provisions may be extended by Congress.

Solutions to Module 1 Review Questions

1. a. Incorrect. According to Code Sec. 62, interest on a qualified education loan is deducted from gross income to arrive at adjusted gross income. Itemized deductions do not include amounts deducted from gross income to arrive at AGI.

   b. Correct. Itemized deductions include non-business deductions, such as those for home mortgage interest, which are not deducted per the Internal Revenue Code from gross income to arrive at AGI.

   c. Incorrect. A contribution to an IRA is deducted from gross income to arrive at adjusted gross income as stated in Code Sec. 62.

2. a. Incorrect. The tax rate schedule for single individuals does not apply to an individual who qualifies as a surviving spouse under Code Sec. 2(a).

   b. Incorrect. The tax rate schedule for married taxpayers filing separately does not apply to an individual who qualifies as a surviving spouse under Code Sec. 2(a).

   c. Correct. As provided in Code Sec. 1(a), widows and widowers who qualify as surviving spouses as defined in Code Sec. 2(a) use the same tax rate schedule as married taxpayers filing jointly.

   d. Incorrect. Although a surviving spouse may be a head of household, the head of household rate schedule is not used by a surviving spouse per the Internal Revenue Code.

3. a. Incorrect. An individual subject to the "kiddie" tax pays tax at his or her parents' marginal rate only on unearned income.

   b. Incorrect. This would be correct *if* an individual subject to the "kiddie" tax was required to pay tax at his or her parents' marginal rate on all unearned income.

   c. Incorrect. This would be correct *if* an individual subject to the "kiddie tax" was required to pay tax at his or her parents' marginal rate on unearned income over $1,000 for 2013.

   d. Correct. An individual subject to the "kiddie" tax pays tax at his or her parents' highest marginal rate on unearned income over $2,000 for 2013 if that tax is higher than what the individual would otherwise pay.

4. a. Incorrect. Tips are treated as compensation for services that is included in gross income as shown on Form W-2.

   b. Incorrect. According to Form W-2, salespersons' commissions (including commissions on sales to self or family) are included in gross income as compensation.

   c. Incorrect. Although gifts are generally excluded from the recipient's gross income, a transfer by or for an employer to or for the benefit of an employee can't be excluded as a gift per the Internal Revenue Code.

   d. Correct. Where an employer pays the debts or personal expenses of an employee, or reimburses the employee's payment, the employee must generally include the employer's payment or reimbursement in his or her income. However, there are some exceptions, including medical expense reimbursements as stated in Code Sec. 105(b).

5. a. Incorrect. $60,000 of group term life insurance is above the maximum excludable amount.

   b. Correct. The cost of group term life insurance above $50,000 is taxable, per Code Sec. 79(a).

   c. Incorrect. $50,000 is the amount of excludable group term life insurance coverage, not the includable amount, in these circumstances.

   d. Incorrect. A portion of the group term life insurance is a tax-free fringe benefit.

6. a. Incorrect. Payments incurred by an employer for dependent care assistance under a qualifying plan are excluded from an employee's gross income. (Code Sec. 129(a)(1))

   b. Incorrect. The maximum annual exclusion for dependent care assistance is $5,000, but there is an additional limitation on the exclusion. (Code Sec. 129(b))

   c. Correct. For married employees, the exclusion for dependent care assistance cannot exceed the earned income of the lower earning spouse. (Code Sec. 129(b))

   d. Incorrect. A portion of the dependent care assistance is excludable from income. (Code Sec. 129(b))

7. a. Incorrect. $14,000 exceeds the maximum exclusion for adoption assistance available to the employee for 2013. (Code Sec. 137(b)(1))

   b. Correct. In the case of an adoption of a child with special needs, the maximum exclusion applies regardless of the amount of the employee's qualified adoption expenses. (Code Sec. 137)

   c. Incorrect. In the case of an adoption of a child with special needs the exclusion may exceed the amount of the employee's qualified adoption expenses. (Code Sec. 137)

   d. Incorrect. A portion of the adoption assistance is excludable from the employee's income. (Code Sec. 137(b)(1))

8. a. Incorrect. Employee discounts are excludable from gross income subject to a limitation that this discount exceeds. Therefore, a part of the benefit is taxable. (Code Sec. 132(c)(1)(B))

   b. Correct. The maximum excludable employee discount for services is 20%. Thus, the maximum here is $800 ($4,000 × 20%). Since the discount is $1,500 ($4,000 minus $2,500), the excess $700 is includable in income. (Code Sec. 132(c)(1)(B))

   c. Incorrect. A portion of the employee discount is excludable from income. (Code Sec. 132(c)(1)(A))

9. a. Incorrect. Although qualified dividends are eligible for favorable tax rates, a taxpayer in the 35% bracket is subject to a rate higher than 5% on qualified dividend income.

   b. Correct. Qualified dividends that would otherwise be taxed in the 35% regular income tax bracket are taxed at a rate of 15% ($1,000 × .15 = $150). (Code Sec. 1(h)(11))

   c. Incorrect. A taxpayer in the 35% bracket pays tax on qualified dividend income at a rate lower than 28%.

   d. Incorrect. Qualified dividends are eligible for favorable tax rates. Therefore, the taxpayer's regular 35% tax rate will not apply to his dividend income.

10. a. Incorrect. For taxpayers with income above a "base amount," social security benefits are not entirely excludable from income. (Code Sec. 86(a)(1))

    b. Incorrect. In some cases, depending upon a taxpayer's income, more than 50% of social security benefits may be includable in gross income. (Code Sec. 86(a)(2))

    c. Correct. Under no circumstances will more that 85% of a taxpayer's social security benefits be included in gross income. (Code Sec. 86(a)(2))

    d. Incorrect. Depending on a taxpayer's income, a portion of social security benefits may be taxable, but not 100%. (Code Sec. 86(a)(1))

11. a. Incorrect. Under the annuity rules, a portion of each payment received is excludable from gross income until the entire investment is recovered. The remainder of each payment is fully taxable. (Code Sec. 72(b))

    b. Correct. Under these facts, one-third of the payment is excludable from income. This fraction is determined by dividing the cost of the annuity ($50,000) by the total expected return ($150,000). (Code Sec. 72(b))

    c. Incorrect. On these facts, the taxpayer's "exclusion ratio" for the annuity payment is less than two-thirds. (Code Sec. 72(b))

    d. Incorrect. Only a portion of the annuity payment is excludable from income. (Code Sec. 72(b))

12. a. Incorrect. The full amount of an advance, reimbursement, or other expense allowance is taxable to an employee if it is made under a nonaccountable plan. However, the facts do not indicate whether the advance in question was made under an accountable or nonaccountable plan. (Code Sec. 62(c))

    b. Incorrect. If an advance is made under an accountable plan that requires an employee to substantiate expenses but allows the employee to retain amounts in excess of expenses, only the excess is included in the employee's income. However, the facts do not indicate whether the employee was required to substantiate expenses to the employer. (Reg §1.42-2(c)(3)(iii))

    c. Correct. The amount of the advance included in the employee's income depends on whether or not the employee substantiated the expenses to the employer and whether or not the employee returned unsubstantiated amounts, which cannot be determined from the question.

13. a. Incorrect. The taxpayer realized a *gain* of $45,000 on the sale. However, that is not his amount realized.

    b. Incorrect. The taxpayer's amount realized is not limited to the cash received on the sale.

    c. Correct. The taxpayer's amount realized is the sum of the cash received, the fair market value of the property received, and the amount of the mortgage assumed by the buyer less the broker's commissions paid by the taxpayer.

    d. Incorrect. The total of the cash received, the fair market value of the property received, and the amount of the mortgage assumed by the buyer is $100,000. However, that is not the amount realized on the sale.

14. a. Incorrect. A donee's basis is determined by reference either to the donor's basis or the fair market value of the property at the time of the gift. Therefore, on these facts, the donor's basis cannot be zero.

    b. Incorrect. This answer assumes the taxpayer's basis is equal to the donor's original cost for the property. A donee's basis is determined by reference either to the donor's basis or the fair market value of the property at the time of the gift. The donor's original cost for the property is irrelevant.

    c. Correct. The basis of property acquired by gift is generally equal to the donor's basis on the date of the gift (in this case, $50,000). The property's fair market value on the date of the gift is used to determine loss only if that value was less than the donor's basis on the date of the gift. (Code Sec. 1015(a))

    d. Incorrect. This answer assumes the taxpayer's basis for determining loss is equal to the fair market value of the property on the date of the gift. However, that rule applies only if the fair market value of the property is less than the donor's basis on the date of the gift. (Code Sec. 1015(a))

15. a. Incorrect. The like-kind exchange provision doesn't apply to stock in trade (inventory) and other property held primarily for sale. (Code Sec. 1031(a))

    b. Correct. An exchange of real estate for real estate is an exchange of like-kind property; it doesn't matter where the real estate is located (but foreign and U.S. real estate can't be like kind) or whether it's improved or not. (Code Sec. 1031(h))

    c. Incorrect. Foreign and U.S. real estate can't be like-kind. (Code Sec. 1031(h)(2)(B))

    d. Incorrect. The like-kind exchange provision doesn't apply to stocks, bonds, or notes. (Code Sec. 1031(a))

16. a. Incorrect. There is no rule giving a spouse a zero basis in property received incident to divorce.

    b. Incorrect. The basis rule for property received from a spouse incident to divorce does not state that the basis is equal to the property's value.

    c. Incorrect. The basis rule for property received from a spouse incident to divorce does not state that the basis is midway between its value and the transferor spouse's basis.

    d. Correct. When property is transferred incident to divorce, the transferee spouse's basis is the same as that of the transferor spouse. (Code Sec. 1014(b))

17. a. Incorrect. $500,000 is the maximum home-sale exclusion available to married couples filing jointly if certain requirements are met; it is not the amount of reportable gain. (Code Sec. 121(b)(2)(A))

    b. Incorrect. This answer assumes that only one spouse qualifies for the home sale exclusion; however, on these facts, both spouses qualify.

    c. Correct. The couple qualifies for the maximum $500,000 home sale exclusion because one spouse met the ownership test and both spouses met the use requirement.

    d. Incorrect. The couple's $600,000 gain exceeds both the $250,000 and $500,000 limits on the home sale exclusion. Therefore, they must report a portion of their gain on their joint return.

18. a. Incorrect. When there are net long-term capital gains and net short-term capital losses, or vice versa, the items are netted against each other before determining the tax treatment. If there is a net loss after the netting, only a limited amount of the loss may be offset against ordinary income.

    b. Incorrect. When there are net long-term capital gains and net short-term capital losses, or vice versa, the items are netted against each other before determining the tax treatment. A limited deduction against ordinary income is allowed, but only if the netting produces a net loss, which is not the case here.

    c. Correct. If net long-term capital gains exceed net short-term capital losses, the excess is "net capital gain," which qualifies for favorable tax treatment.

    d. Incorrect. If net long-term capital gains exceed net short-term capital losses, the excess is "net capital gain." Net capital gain is not taxed at ordinary income rates.

19. a. Incorrect. An asset must be held for more than one year to qualify for long-term capital gain treatment.

    b. Incorrect. Measurement of the one-year holding period of a capital asset excludes the day of the acquisition but includes the date of the disposition.

    c. Correct. The holding period for an asset begins on the day after the day of acquisition and ends on the day of sale, exchange or other disposition. In other words, the taxpayer excludes the day of acquisition but includes the date of disposition.

20. a. Incorrect. 28% rate gain includes collectible gains and losses. (Code Sec. 1(h)(5))

    b. Correct. Net long-term capital loss for the tax year is not included in the calculation of 28% rate gain per Code Sec. 1(h)(5).

    c. Incorrect. Net short-term capital loss for the tax year is taken into account in calculating net 28% rate gain. (Code Sec. 1(h)(5))

    d. Incorrect. A net long-term capital loss carryover to the tax year is taken into account in computing 28% rate gain. (Code Sec. 1(h)(5))

21. a. Incorrect. The aggregate amount of the ordinary loss deduction is $100,000 on joint returns, but a different limit applies to other returns. (Code Sec. 1244(b))

    b. Incorrect. The aggregate amount of the ordinary loss deduction is $50,000 for most returns; however, a different limit applies to joint returns. (Code Sec. 1244(b))

    c. Incorrect. The $100,000 maximum applies on a joint return even if only one spouse owned the stock. (Code Sec. 1244(b))

    d. Correct. The aggregate amount of the ordinary loss deduction is limited to $100,000 on joint returns and $50,000 on other returns each year. Spouses may deduct the $100,000 maximum on a joint return even if only one spouse owned the stock. (Code Sec. 1244(b))

22. a. Incorrect. Section 1231 applies to assets used in a taxpayer's trade or business, including real estate. (Code Sec. 1231(b))

    b. Incorrect. Section 1231 assets include unharvested crops that are transferred with land. (Code Sec. 1231(b))

    c. Correct. Section 1231 assets don't include inventory. (Code Sec. 1231(b))

    d. Incorrect. Section 1231 assets include timber. (Code Sec. 1231(b))

23. a. Incorrect. The taxpayer's itemized deductions are subject to reduction because his adjusted gross income exceeds the "applicable amount" for the year. However, the maximum reduction in this case is not equal to 80% of the otherwise allowable deductions as this answer implies.

    b. Correct. The taxpayer's otherwise allowable deductions are reduced by the lesser of 3% of the excess of adjusted gross income over the applicable amount or 80% of otherwise allowable deductions. In this case, 3% of $50,000 excess adjusted gross income ($1,500) is the lesser amount (Code Sec. 68(a))

    c. Incorrect. The taxpayer's itemized deductions are subject to reduction because his adjusted gross income exceeds the "applicable amount" for the year. However, the maximum reduction is not equal to 3% of the otherwise allowable itemized deductions as this answer implies.

24. a. Incorrect. The standard deduction of a taxpayer who may be claimed as a dependent is subject to a special limitation, but is not limited to zero.

    b. Incorrect. The standard deduction of a taxpayer who may be claimed as a dependent is only limited to $1,000 for 2013 if $1,000 exceeds his or her earned income plus $350. That is not the situation is this example.

    c. Correct. The standard deduction of a taxpayer who may be claimed as a dependent is limited to the greater of (a) $1,000, or (b) earned income plus $350, but not more than the regular standard deduction of $6,100.

    d. Incorrect. The standard deduction of a taxpayer who may be claimed as a dependent can never exceed the regular standard deduction of $6,100 for 2013.

25. a. Incorrect. The taxpayer will qualify for an additional standard deduction amount over and above the regular $6,100 standard deduction for single taxpayers for 2013.

    b. Incorrect. This answer assumes that the taxpayer will qualify for the basic standard deduction of $6,100 and an additional standard deduction amount of $1,500 for 2013. However, the taxpayer's additional standard deduction amount is greater than $1,500.

    c. Incorrect. This answer assumes that the taxpayer will qualify for a basic standard deduction amount of $6,100 plus two additional standard deduction amounts of $1,200 each on account of being both elderly and blind. However, $1,200 is not the correct amount of the additional standard deductions for a single taxpayer.

    d. Correct. For 2013, the taxpayer is entitled to the regular $6,100 standard deduction for singles, plus an additional standard deduction for the elderly in the amount of $1,500, and an additional standard deduction for the blind in the amount of $1,500.

26. a. Incorrect. Susie cannot be claimed as a dependent child by her parents for 2013 because she is filing a joint return with her spouse.

    b. Incorrect. Although Steven is living with his friend's family, he doesn't meet the requirements of a qualifying child for the friend's family. Also, a taxpayer generally cannot claim an individual as a qualifying relative if the individual is a qualifying child of another person.

    c. Correct. The 2008 Adoption Act added a requirement that in order to be a taxpayer's qualifying child, an individual must be younger than the taxpayer; but the Act also allowed an exception for individuals who are permanently and totally disabled. Melissa would be considered Edward's qualifying child for dependent exemption purposes.

27. a. Incorrect. Contributions of property are treated as charitable donations, subject to special rules for determining the amount.

    b. Correct. A charitable contribution of appreciated tangible personal property unrelated to the exempt purpose of a donee organization is treated as a donation equal to the basis of the property contributed.

    c. Incorrect. This amount is the long-term capital gain the taxpayer would have realized on a sale of the property, not the amount of the donation.

    d. Incorrect. A special rule applies under which a taxpayer is treated as making a donation equal to less than the fair market value of appreciated tangible personal property when the donation is unrelated to the exempt purpose of the donee organization.

28. a. Correct. The deduction floor is 10% of AGI in 2013 for taxpayers who have not reached age 65 by the end of the tax year The taxpayer's $8,000 of medical expenses exceeds the 10% floor ($5,000) by $3,000 which is the allowable deduction.

    b. Incorrect. This answer assumes expenses are deductible in excess of a 7½%-of-AGI deduction floor. However, the deduction floor in 2013 is not 7 ½% of AGI for taxpayers under age 65.

    c. Incorrect. This amount represents 10% of AGI, which is the "floor" used in determining medical expenses for taxpayers under age 65 in 2013, not the amount of the deduction.

    d. Incorrect. Unreimbursed medical expenses are deductible only to the extent they exceed a percentage of AGI.

29. a. Incorrect. Although a portion of the payment will be treated as nondeductible child support, a portion will qualify as alimony.

    b. Incorrect. The amount by which the payment is reduced following the child's graduation is treated as nondeductible child support, not alimony.

    c. Correct. The amount by which the payment is reduced following the child's graduation is treated as nondeductible child support, and the remaining $1,000 qualifies as alimony.

    d. Incorrect. In these circumstances, a portion of the $1,500 monthly payment is treated as nondeductible child support.

30. a. Incorrect. The individual described in this question may make a deductible IRA contribution.

    b. Incorrect. This answer fails to consider the additional deductible amount that may be contributed to a regular IRA by a taxpayer age 50 or older. (Code Sec. 219(b)(5)(B))

    c. Correct. The general deduction limit for regular IRA contributions is $5,500 for 2013. However, taxpayers age 50 or over may make an additional deductible contribution of $1,000, for a total contribution of $6,500.

31. a. Correct. An unmarried individual of any age cannot make a 2013 contribution to a Roth IRA if AGI exceeds $127,000.

    b. Incorrect. This answer incorrectly applies the phase-out rules for Roth IRA contributions. A $200 contribution may be made only if the phase-out lowers the contribution to less than $200 but more than $0.

    c. Incorrect. $5,500 is the general contribution limit for Roth IRAs for 2013, but this answer fails to consider the contribution phase-out for taxpayers with AGI above a specified amount.

    d. Incorrect. $6,500 is the maximum contribution for Roth IRAs for taxpayers 50 or older for 2013, but this answer fails to consider the contribution phase-out for taxpayers with AGI above a specified amount.

32. a. Correct. An individual cannot claim a deduction for a contribution to an Archer MSA if any amount is contributed to an Archer MSA of the individual for the year and that amount is excludable from gross income under Code Sec. 106(b) (i.e., employer contributions).

    b. Incorrect. This answer incorrectly assumes that an employer can make a deductible contribution equal to the difference between an employer's contribution (in this case, $1,000) and the maximum contribution for the year (in this case, 65% of the $2,150 deductible, or $1,397.50).

    c. Incorrect. $1,397.50 (65% of the $2,150 deductible) is the overall limit on contributions to the employee's MSA for 2013. However, there is a restriction when an employer has made contributions for the year.

    d. Incorrect. Contributions to an MSA are always limited to less than the annual deductible for HDHP for the year.

33. a. Correct. $4,250 is the maximum deductible contribution that can be made for 2013 to an HSA for a 60-year-old individual with self-only health coverage ($3,250 maximum regular contribution plus $1,000 additional contribution for an individual who has reached age 55 before the end of the tax year).

    b. Incorrect. $3,250 is the maximum regular deductible contribution that can be made for 2013 to an HSA for an individual with self-only coverage. The individual described in the question is entitled to make a contribution on top of the regular contribution because the individual has reached age 55.

    c. Incorrect. While this answer correctly allows the individual an additional contribution of $1,000 because the individual reached age 55 before the end of the tax year, it incorrectly assumes that the individual's regular HSA contribution is limited to the amount of the HDHP deductible.

34. a. Incorrect. Married couples filing jointly with AGI of $220,000 or more cannot make a contribution to an ESA. However, these taxpayers have AGI below that amount.

    b. Correct. The regular maximum contribution to an ESA is $2,000 per beneficiary. However, the maximum contribution is phased out ratably for joint filers with AGI between $190,000 and $220,000. Since the AGI of the taxpayers in this question is exactly half way through the phase-out range, the maximum contribution is reduced by 50% to $1,000. (Code Sec. 530(c))

    c. Incorrect. The regular maximum contribution to an ESA is $2,000 per beneficiary. However, because the AGI of the taxpayers in this question exceeds $190,000, the maximum contribution is reduced under a phase-out rule.

    d. Incorrect. The regular maximum contribution to an ESA is $2,000 per beneficiary and phase-out rules may apply. Thus, a $5,000 contribution would not be allowed for a beneficiary for a year.

35. a. Incorrect. Since some of the savings bond redemption proceeds are used to cover college expenses, a portion of the interest is excludable.

    b. Incorrect. This answer allows an exclusion for 50% of the interest income ($2,000 out of $4,000), which is not the correct percentage in these circumstances.

    c. Correct. Since 75% of the redemption proceeds were used for college expenses ($6,000 out of $8,000), 75% of the interest is excludable (75% of $4,000 = $3,000).

    d. Incorrect. Since less than 100% of the redemption proceeds were used for college expenses, less than 100% of the interest is excludable.

36. a. Correct. Generally interest on up to $100,000 of home equity debt is deductible, but that figure is reduced to the value of the home minus acquisition debt. (Code Sec. 163(h)(3)(C)(ii))

    b. Incorrect. Generally interest on up to $100,000 of home equity debt is deductible. However, an additional limitation applies in these circumstances.

    c. Incorrect. This choice cannot be correct because it is larger than the amount of home equity (the difference between the fair market value of the property and the first mortgage debt).

37. a. Incorrect. The flat dollar per-casualty reduction is not the only limitation applicable to personal casualty losses.

    b. Incorrect. The flat dollar reduction applies to each casualty.

    c. Incorrect. The 10%-of-AGI reduction is not the only limitation applicable to personal casualty losses. (Code Sec. 165(h))

    d. Correct. A taxpayer's casualty loss deduction is determined by reducing each loss by the per-casualty deduction floor, and then reducing the remaining overall loss by 10% of AGI.

38. a. Incorrect. Two years is the general carryback period for NOLs, but a longer carryback period applies to an individual's NOL from property losses caused by a fire or other casualty.

    b. Correct. An individual's NOL from property losses caused by a fire or other casualty can be carried back three years.

    c. Incorrect. A five-year carryback period is not available for an individual's NOL from property losses caused by a fire or other casualty. A special five-year carryback period may apply to certain farming losses.

39. a. Incorrect. Self-employed taxpayers can deduct health insurance premiums a business expenses provided certain requirements are met.

    b. Incorrect. There is no percentage limitation on the deduction for self-employeds' health insurance premiums. (Code Sec. 162(i)(1)(B))

    c. Correct. Provided the taxpayer and his spouse are not participants in an employer provided health plan and net earnings from self-employment exceed the cost of the health insurance, the premiums for the taxpayer and his spouse and dependents are fully deductible as business expenses. (Code Sec. 162(i)(1)(B))

    d. Incorrect. The deduction for self-employed's health insurance premiums does not apply to insurance for individuals who are not the taxpayer's dependents.

40. a. Incorrect. To satisfy the time test for a moving expense deduction, a taxpayer-employee must be employed in the new area for more than 12 weeks during the 12-month period following his arrival.

    b. Incorrect. To satisfy the time test for a moving expense deduction, a taxpayer-employee must be employed in the new area for more than 24 weeks during the 12-month period following his arrival.

    c. Correct. To satisfy the time test for a moving expense deduction, a taxpayer-employee must be employed full-time in the new area for at least 39 weeks during the 12-month period following his arrival. (Code Sec. 217(c)(2)(A))

    d. Incorrect. A taxpayer-employee will satisfy the time test for a moving expense deduction if he is employed full-time in the new area for less than 78 weeks during the 12-month period following his arrival.

41. a. Incorrect. A vacation home can be used for personal purposes for at least 14 days without triggering the expense deduction limitations.

    b. Correct. The maximum number of days the vacation home can be used for personal purposes without triggering the expense deduction limitation is the greater of 14 days or 10% of the rental days. In this case, since 10% of the 180 rental days (18) is greater than 14, the expense deduction limitation applies only if the taxpayer uses the home for personal purposes more than 18 days.

    c. Incorrect. The correct application of the personal use limitation does not result in a maximum of 30 days in these circumstances per Code Sec. 280A(a).

42. a. Incorrect. The credit for the elderly and permanently disabled is not refundable per Code Sec. 22.

    b. Incorrect. The adoption credit is not refundable for 2013.

    c. Correct. The American Opportunity credit is partially refundable for 2013.

    d. Incorrect. In accordance with the Internal Revenue Code, the credit for child and dependent care expenses is not refundable.

43. a. Incorrect. A child tax credit of $1,000 is allowable for each child under age 17 subject to a phase-out for joint filers with AGI over $110,000 with phase-out limitations. (Code Sec. 24(b))

    b. Correct. A child tax credit of $1,000 is allowable for each child under age 17 subject to a phase-out for joint filers that reduces the total credit by $50 for each $1,000 of AGI above $110,000. Here, the credit is reduced by $250 (5 × $50) to $1,750.

    c. Incorrect. A child tax credit of $1,000 is allowable for each child under age 17. However, the credit is subject to a phase-out for joint filers. (Code Sec. 24(b))

    d. Incorrect. The maximum child credit is $1,000 for each child under age 17. Since one of the children in this example is over age 17, not all of the children are eligible for the credit. (Code Sec. 24)

44. a. Incorrect. While $2,000 is the maximum Lifetime Learning credit the couple can claim for 2013 (20% of up to $10,000 of expenses), that is not the maximum amount of education-related credits available to the couple for 2013. (Code Sec. 25A(a)(2))

    b. Incorrect. While $2,500 is the maximum American Opportunity credit (100% of the first $2,000 of expenses plus 25% of the next $2,000 of expenses) that can be claimed for an eligible student for 2013, this does not take into account all of the credits available to the couple for 2013. (Code Sec. 25A(i)(1))

    c. Incorrect. This answer incorrectly assumes that the couple can claim the maximum Lifetime Learning credit (20% of up to $10,000 of expenses) for each son. However, the limit on Lifetime Learning credit is applied on a per taxpayer basis, not on a per-student basis. (Code Sec. 25A(a)(2))

    d. Correct. The couple may claim the maximum $2,500 American Opportunity credit (100% of the first $2,000 of expenses plus 50% of the next $2,000 of expenses) for each child for 2013. The American Opportunity credit is available on a per-student basis. (Code Sec. 25A(i)(1))

45. a. Incorrect. John is entitled to a 10% savers' credit, but the credit is not computed on his full $4,000 contribution.

    b. Incorrect. This assumes that the $1,000 withdrawal during the testing period reduces the $2,000 maximum contribution limit on which the credit is based and that John's credit is limited to 10% of $1,000. That assumption is incorrect.

    c. Correct. John's qualified contribution of $4,000 is reduced to $3,000 because of the $1,000 withdrawal during the testing period. Thus, John is entitled to a credit equal to 10% of the lesser of (1) $3,000 or (2) the $2,000 contribution limit. So John can claim a credit of $200 (10% of $2,000).

    d. Incorrect. While John must reduce his $4,000 qualified contribution to $3,000 on account of his $1,000 distribution during the testing period, he cannot claim a savers' credit on the full $3,000.

46. a. Correct. Withholding is not required since the proceeds of the wager ($5,001 - $1) are not greater than $5,000. (Code Sec. 3402(q)(1))

    b. Incorrect. This answer incorrectly treats the amount paid above the withholding threshold as the amount subject to withholding. (Code Sec. 3402(q)(4)(A))

    c. Incorrect. Gambling proceeds are subject to withholding if they exceed $5,000. However, this answer assumes the full amount paid is the amount of the gambling proceeds. (Code Sec. 3402(q)(1))

    d. Incorrect. This answer incorrectly assumes that entire $5,001 amount received is subject to 25% withholding ($5,001 × 25% = 1,250.25). (Code Sec. 3402(q)(4)(A))

47. a. Correct. The individual's required annual payment is the lesser of (1) 90% of his current year tax ($10,800) or (2) 100% of his prior year tax ($10,500). Therefore, his required annual payment is $10,500.

    b. Incorrect. $10,800 represents 90% of the individual's current year tax. However, the taxpayer could pay a different amount based on the IRS laws.

    c. Incorrect. $11,500 represents 110% of the individual's prior year tax. However, the taxpayer is not required to pay this much based on his current year AGI.

    d. Incorrect. The individual is not required to prepay 100% of his current year tax since his current year AGI is not above the required threshold.

48. a. Incorrect. A surviving spouse may be entitled to file a joint return for the year of the deceased spouse's death provided certain conditions are met. However, joint filing status does not extend beyond the year of the deceased spouse's death. (Code Sec. 6013(a)(3))

    b. Correct. A surviving spouse who has not remarried and who has a dependent child may file as a qualifying widow(er) eligible for joint return rates for two tax years following the year of the deceased spouse's death. (Code Sec. 1(a)(2))

    c. Incorrect. Although the individual is unmarried, single is not the best filing status for the individual for 2013. Other filing statuses provide greater tax relief.

49. a. Incorrect. Traditional innocent spouse relief is available only if unpaid taxes arise from an understatement attributable to an erroneous item of the other spouse. In this case, the tax due was shown on the return but not paid. (Code Sec. 6015(a)(1))

    b. Correct. Separate liability relief can be elected only if an individual is divorced, legally separated, or has lived apart from the spouse with whom the joint return was filed for at least 12 months. (Code Sec. 6015(c)(3)(A))

    c. Incorrect. The IRS may relieve a spouse of liability for an unpaid tax if it would be inequitable to hold the spouse liable. (Code Sec. 6015(f))

50. a. Incorrect. The AMT exemption amount is reduced by 25% of AMTI in excess of a threshold amount, not by 25% of AMTI as this answer assumes. (Code Sec. 55(d)(3))

    b. Incorrect. This answer incorrectly reduces the AMT exemption by 25% of $150,000. However, $150,000 is the threshold amount for calculating the reduction applicable to joint filers. (Code Sec. 55(d)(3)(A))

    c. Incorrect. This answer incorrectly assumes the threshold amount for calculating the reduction for joint filers is $75,000. However, $75,000 is the threshold amount applicable to married taxpayers filing separately. (Code Sec. 55(d)(3)(C))

    d. Correct. The regular AMT exemption for joint filers is reduced by 25% of AMTI in excess of $150,000 (25% of $170,000-$150,000 = $5000). (Code Sec. 55(d)(3)(A))

Module 1 Glossary

401(K) PLAN**.** A qualified employment-based defined-contribution plan that allows employees to make tax-deferred contributions.

1244 STOCK. Stock in a qualifying small business corporation. Under Section 1244 of the Internal Revenue Code, a loss sustained on the disposition of qualifying stock may be deducted as an ordinary loss, rather than as a more limited value capital loss.

ACCRUAL METHOD. Accounting method in which items are recognized and reported when all events have occurred to fix the right to receipt of the income or to establish the fact of liability.

ADJUSTED GROSS INCOME (AGI). All taxable income of an individual filer from whatever sources derived less certain deductions allowed as defined in IRC Sec. 62. AGI is used as a threshold in individual income taxation to calculate eligibility (or phase-out of eligibility) for many deductions, credits, or taxability of specific types of income.

AMORTIZATION. Similar to depreciation and typically used in connection with intangible costs. Using amortization, a taxpayer can recover the cost or basis in property proportionately over a specific number of years or months.

AMOUNT REALIZED. The total of all money received plus the fair market value of all property or services received from a sale or exchange. The amount realized also includes any liabilities assumed by the buyer and any liabilities to which the property transferred is subject.

ALTERNATIVE MINIMUM TAX (AMT). A tax imposed as a backup to regular tax originally intended to ensure that higher income taxpayers paid their fair share of tax. AMT is separate from, but parallel to, regular tax, and a taxpayer pays the greater of regular tax or AMT.

ALTERNATIVE MINIMUM TAXABLE INCOME (AMTI). Taxable income plus or minus alternative minimum tax adjustments, plus alternative minimum tax preferences. It is used to determine AMT.

ANNUITY. A contract issued by an insurance company under which, for a fixed amount of investment, the investor will receive regular payments in the future.

AT RISK RULES. Rules that limit the amount of loss a taxpayer may deduct to the amount he or she risks losing in the activity.

BASIS. A measure of a taxpayer's investment in property that is used for computing gain or loss on the sale of the property and for other tax purposes.

CAFETERIA PLAN. An employee benefit arrangement under which employees may choose their own menu of benefits consisting of cash and qualified benefits. No amount is included in the gross income of an employee solely because, under the plan, the employee may choose among the benefits of the plan.

CAPITAL GAIN. Gain from the sale or exchange of a capital assets (most property owned by individuals) that is either long-term (if held for more than one year) or short term. Long-term gain qualifies from favorable tax treatment.

CASH METHOD. An accounting method under which income is reported in the year in which it is actually or constructively received. Expenses are generally deducted in the year they are paid.

COMPENSATION. Income received as payment for services rendered.

DEFERRAL. Recognizing and reporting items in a time period subsequent to the period of realization.

DEFINED CONTRIBUTION PLAN. A profit-sharing plan or other employment-based retirement plan in which benefits depend on investment performance.

DEFINED BENEFIT PLAN. A pension plan or other employment-based retirement plan that promises retirees a certain benefit upon retirement, regardless of investment performance.

DE MINIMIS FRINGE BENEFIT. Property or service provided to employees by employer whose value is so small that accounting for it is unreasonable or administratively impracticable, taking into account the frequency with which similar fringe benefits are provided by the employer to its employees. *De minimis* fringe benefits are excludible from income.

DEPENDENT. A qualifying child or qualifying relative of the taxpayer for whom the taxpayer may claim an exemption.

DEPENDENT CARE CREDIT. Tax credit available to taxpayers who incur household and dependent care expenses so that they can be gainfully employed.

DEPENDENT CARE ASSISTANCE. Payment for or provision of services by employer that if paid for by the employee would be considered employment-related expenses under the child and dependent care credit rules. Within limits, payments incurred by an employer for dependent care assistance under a written plan are excluded from an employee's gross income.

DEPRECIATION. Loss in the value of tangible property over the time the property is being used. Deductions can be claimed for this loss if property is used in a trade or business or held for the production of income.

DIVIDENDS RECEIVED DEDUCTION. A deduction allowed C corporations for the dividends received or accrued from domestic corporations. Subject to specific disallowances, reductions, and limitations.

EARNED INCOME CREDIT (EIC). A tax credit for low-income taxpayers that is calculated by multiplying earned income by a credit percentage. A taxpayer's number of children affects the calculation, and the credit is subject to income phase-out ranges so as to focus its benefits on low income individuals.

EXEMPTION. An amount (adjusted annually for inflation) allowed as a deduction for the taxpayer, the taxpayer's spouse and each of the taxpayer's dependents.

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA) TAX. A tax withheld from an employee's wages made up of two components—Social Security tax and Medicare tax—and matched at the same percentages by the employer.

FIDUCIARY. An individual or entity holding a position of trust or confidence. Used here in connection with trusts and estates.

FLEXIBLE SPENDING ACCOUNT (FSA). An employee benefit designed to reimburse employees for expenses incurred for certain qualified benefits, up to a maximum amount not substantially in excess of the salary reduction and employer flex-credits allocated for the benefit. The three types of FSAs are dependent care assistance, adoption assistance and medical care reimbursements.

GROSS INCOME. All income from all sources (other than tax-exempt income) that must be included on a taxpayer's tax return.

HEALTH SAVINGS ACCOUNT (HSA). An arrangement that allows eligible individuals or their employers to make deductible contributions to a savings account set up in tandem with a "high deductible" health insurance plan. Distributions from HSAs used to pay qualified medical expenses of the account holder and/or spouse and dependents aren't taxable.

INCENTIVE STOCK OPTION (ISO). An option to purchase stock of a corporation granted to an individual in connection with that individual's employment. An ISO plan must meet specifications of IRC Sec. 422.

INDIVIDUAL RETIREMENT ACCOUNT (IRA). A retirement account set up by an individual as a means of setting money aside for his or her retirement years.

INVOLUNTARY CONVERSION. Compulsory or involuntary conversion of taxpayer's property into similar property, dissimilar property or money as a result of the property's destruction, theft, seizure, requisition or condemnation (actual or threatened). Gain on conversion is excludible from income if certain requirements are met.

ITEMIZED DEDUCTIONS. Deductions allowed on Schedule A (Form 1040) for medical and dental expenses, taxes, interest, charitable contributions, casualty and theft losses, and miscellaneous deductions. They are subtracted from adjusted gross income in figuring taxable income.

KIDDIE TAX RULES. Rules that require unearned income of certain children to be taxed at the parents' marginal tax rate.

LIKE KIND EXCHANGES. Exchange of business or investment properties that are similar in nature or character. Gain from exchange is excludible from income.

MARITAL DEDUCTION. For estate tax purposes, a deduction is allowed for the value of all property included in the gross estate that passes to the decedent's surviving spouse in a manner qualifying for the deduction. A similar deduction applies for gift tax purposes.

MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS). A system used to recover the basis of most business and investment property placed in service after 1986. Under MACRS, recovery property is depreciated by applying to its depreciable basis a prescribed depreciation method for its prescribed recovery period.

PHASEOUT RANGES. Income ranges in which certain deductions, credits, and personal exemptions are reduced and eventually eliminated altogether.

PRINCIPAL RESIDENCE. A taxpayer's primary residence that is eligible for gain exclusion if (1) owned for at least two of the previous five years and (2) occupied for at least two of the previous five years, based on the date of sale.

QUALIFIED RETIREMENT PLAN. A pension, profit sharing or stock bonus trust plan that can provide tax-deferred benefits because it does not discriminate in favor of highly compensated employees and meets a number of other requirements specified by the Internal Revenue Code.

QUALIFIED SMALL BUSINESS STOCK. Certain qualifying stock that is eligible for a 50% gain exclusion if held for more than five years prior to sale.

ROTH IRA**.** An individual retirement account that accepts nondeductible contributions but allows tax-exempt withdrawals.

SAVINGS INCENTIVE MATCH PLAN FOR EMPLOYEES (SIMPLE). An employment-based defined-contribution plan available only to small businesses. Plan may offer limited tax-deferred retirement benefits with exemption from certain tax rules in exchange for meeting statutory mandates regarding vesting and employer contributions.

SECTION 179 DEDUCTION. An elective deduction allowing taxpayers, to expense (currently deduct) up to a statutory amount per year of the cost of certain eligible personal property used in the active conduct of a trade or business.

SELF-EMPLOYMENT TAX (SE TAX). A tax imposed on individuals with self-employment income of $400 or more to provide Social Security and Medicare benefits to those individuals.

STANDARD DEDUCTION. An amount (based on filing status) that can be subtracted from adjusted gross income in figuring taxable income. The standard deduction is not used if itemized deductions are claimed.

STANDARD MILEAGE RATE. Amount established by the IRS for optional use in determining a tax deduction for the use of an automobile. Claimed in lieu of deduction for actual expenses.

TAX YEAR. The time period covered by a tax return. Usually this is January 1 to December 31, a calendar year, but taxpayers can elect fiscal tax year with different beginning and ending dates.

TAXABLE INCOME. AGI less the greater of the standard deduction or total itemized deductions, less personal and dependency exemptions.

UNIFIED CREDIT. A single credit that applies for both estate and gift tax purposes, which effectively excludes a cumulative amount of transfers from estate and gift tax.

UNRELATED BUSINESS INCOME TAX. A tax imposed on many, but not all, exempt organizations that have net income from any unrelated trade or business.

WORKING CONDITIONS FRINGE BENEFIT. Any property or services provided to an employee by the employer to the extent the cost of the property or services would have been deductible by the employee as a business expense or through depreciation if the employee had paid for the property or services personally Working condition fringes are excludible from income.

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EXAMINATION FOR CPE CREDIT

RIA's 2014 Federal Tax Review Course

Module 1 (QZN144)

Test Instructions

1. Following these instructions is an examination consisting of multiple choice questions. You may complete the exam by logging on to our online grading system at **cl.thomsonreuters.com.** Click the purchase link and a list of exams will appear. You may search for the exam using the acronym QZN144. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   If you prefer, you may continue to mail your completed answer sheet to the address below. The answer sheet is identified with the acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. If more than one person wants to complete this self-study course, each person should submit an original **Examination for CPE Credit Answer Sheet**. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2014**. Send the completed **Examination for CPE Credit Answer Sheet** along with your payment to the address below. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. If you are faxing your answer sheet, we can only accept credit cards as payment.

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6. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY MATERIALS.** Be sure to keep a completed copy for your records.

7. Please allow a minimum of three weeks for grading.

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RIA's 2014 Federal Tax Review Course Examination for Module 1, Taxation of Individuals

Section I: Overview of Individual Income Taxes

1. Itemized deductions are deducted from ________________________.

   a. Gross income　　b. Adjusted gross income

   c. Taxable income　　d. Alternative minimum taxable income

2. Which of the following is **not** currently a federal income tax rate bracket for individuals?

   a. 15%　　b. 25%

   c. 33%　　d. 38%

3. A 17-year-old child has $1,000 of adjusted gross unearned income for 2013 and no earned income. The marginal tax rate of the child's parents is 28%. What is the child's tax liability?

   a. $0　　b. $85

   c. $238　　d. $950

Section II: Gross Income

4. Which of the following is a true statement regarding the taxation of compensation received in the form of restricted property?

   I. An employee recognizes no income until the property is either: (1) no longer subject to a substantial risk of forfeiture or (2) becomes transferable free of the risk, whichever occurs earlier.

   II. An employee who receives restricted property may elect to recognize income immediately instead of deferring it.

   III. The amount included in the employee's income in the year restrictions lapse is the difference between the employee's basis for the property and the amount, if any, the employee paid for the property.

   a. I and III only　　b. I and II only

   c. II and III only　　d. I, II, and III

5. An employee isn't taxed on premiums paid by the employer on insurance covering the employee's life under a qualifying group-term life insurance policy, if the employee's total coverage under all such plans of all his employers doesn't exceed $______.

   a. 10,000　　b. 25,000

   c. 50,000　　d. 100,000

6. For married couples filing jointly, the exclusion for employer-provided dependent care assistance payments cannot exceed the lesser of (1) the earned income of the lower earning spouse or (2) $_______________.

   a. $1,000　　b. $2,400

   c. $2,500　　d. $5,000

7. Which of the following statements regarding the Code Section 127 exclusion for employer-provided education assistance is **incorrect**?

    I. The exclusion cannot exceed $5,250.

    II. The exclusion is available only for job-related education.

    III. The exclusion is available for the cost of education-related meals and lodging.

    a. I and II only b. II and III only

    c. I and III only d. I, II, and III

8. Which of the following is included in an employee's gross income?

    a. Workers' compensation benefits for personal injuries.

    b. Amount received from an employer accident and health plan for loss of a limb or permanent disfigurement.

    c. Vacation awarded to a salesperson as a prize.

    d. $25,000 of employer-provided group-term life insurance coverage.

9. If a debt instrument is acquired from an issuer for an amount less than what the issuer will have to pay the holder when the instrument matures, the difference is:

    a. Bond premium b. Bond acquisition premium

    c. Market discount d. Original issue discount

Section III: Sales and Exchanges

10. A taxpayer exchanges property in which his basis was $10,000 for like-kind property worth $8,000 plus $4,000 in cash. What amount of gain is recognized?

    a. $2,000 b. $4,000

    c. $8,000 d. $0

11. H bought his home 10 years ago and has used it as his principal residence since that time. H married W on July 1, 2011. Although W does not have an ownership interest in the home, she has used it as her principal residence since the couple's marriage. H sells the home on August 1, 2013, realizing a gain of $400,000. H and W can claim a ________ home-sale exclusion.

    a. $200,000 b. $250,000

    c. $400,000 d. $500,000

12. A taxpayer who is not a dealer sells a piece of equipment for $18,000. The sales price is payable in three annual installments. The taxpayer's basis in the property at the time of the sale was $11,000. Of the $7,000 gain on the sale, $6,000 is subject to depreciation recapture under Code Sec. 1245. How much of the gain can be taken into account under the installment method?

    a. $0 b. $1,000

    c. $6,000 d. $7,000

13. Which of the following is **not** a capital asset?

    a. A principal residence.

    b. A vacation home.

    c. Real estate used in a taxpayer's trade or business.

    d. Undeveloped land held for investment purposes.

14. A capital asset is acquired on February 15 of Year One. To meet the long-term holding period requirement, the asset must be held until at least:

    a. July 16, Year One b. December 31, Year One

    c. February 15, Year Two d. February 16, Year Two

15. What is the maximum tax rate that can apply to a taxpayer's net gain from the sale of collectibles?

    a. 10% b. 20%

    c. 25% d. 28%

16. To qualify for the partial exclusion of gain on the sale or exchange of Qualified Small Business Stock, the taxpayer must have held the stock for more than ______ years before the sale or exchange.

    a. Two b. Three

    c. Four d. Five

Section IV: Deductions

17. What is the standard deduction for 2013 for a married couple filing jointly, both of whom are in their seventies and one of whom is blind?

    a. $12,200 b. $13,350

    c. $14,600 d. $15,800

18. If an individual's charitable gifts for the year exceed the amount he can deduct under the percentage of AGI limitations, the excess contribution is:

    a. Never deductible b. Carried forward five years

    c. Carried back three years and forward five years d. Carried forward indefinitely

19. Which of the following costs generally may not be claimed as a deductible medical expense?

    a. Teeth whitening.

    b. Smoking cessation program.

    c. Insulin.

    d. Laser eye surgery.

20. Which of the following payments made by a taxpayer under the terms of a divorce agreement does not result in any alimony deduction?

    a. Payment of the ex-spouse's college tuition.

    b. Payment for insurance on a home owned by the taxpayer and occupied by the ex-spouse.

    c. Payment of the ex-spouse's rent.

    d. Mortgage payment on a home owned jointly with the ex-spouse and occupied by the ex-spouse.

21. In 2013, H and W, husband and wife, pay $5,000 of interest on a student loan for H's education. They have $98,000 of AGI and file a joint return for the year. How much student loan interest can they deduct on their 2013 return?

    a. $0 b. $2,000

    c. $2,500 d. $5,000

22. Contributions to a Coverdell education savings account for a non-special-needs beneficiary can only be made for beneficiaries under what age?

    a. 18　　b. 21

    c. 25　　d. 29

23. Investment interest that cannot be deducted in the current year because of the “net investment income” limitation is:

    a. Never deductible

    b. Carried forward five years

    c. Carried back three years and forward five years

    d. Carried forward to later years, subject to limitations.

24. Which of the following taxes is not deductible?

    a. State income tax　　b. State personal property tax

    c. Federal income tax　　d. Local real property tax

25. A self-employed taxpayer who pays $2,400 in self-employment taxes is entitled to a deduction of __________ for federal income tax purposes.

    a. $0　　b. $800

    c. $1,200　　d. $2,400

26. What is the general timing rule for claiming a deduction for a casualty loss?

    a. It can only be claimed for the year of the loss.

    b. It can only be claimed for the year preceding the year of the loss.

    c. At the taxpayer’s election, it can be claimed either in the year of the loss or the year preceding the year of the loss.

    d. It is claimed 50% in the year of the loss and 50% in the year preceding the year of the loss.

27. A taxpayer rents out the upstairs apartment in the two-family home he owns and is considered an “active participant” in that rental activity. His AGI is $95,000. What is the maximum loss he can deduct from the property against nonpassive income?

    a. $0　　b. $10,000

    c. $15,000　　d. $25,000

28. Miscellaneous itemized deductions subject to the 2%-of-AGI deduction floor include:

    a. Casualty losses　　b. Gambling losses

    c. Investment advisory fees　　d. Medical expenses

29. Deductible moving expenses do **not** include:

    a. The cost of moving household goods from the old home to the new home.

    b. Gas and tolls incurred in moving from the old home to the new home.

    c. Lodging costs incurred while moving from the old home to the new home.

    d. Temporary living expenses at new work location.

30. A taxpayer relocates in connection with a job change. Which of the following statements best describes the distance test for deductible moving expenses?

    a. The distance between the taxpayer's new home and his old home must be at least 50 miles.

    b. The distance between the taxpayer's new job and his old home must be at least 50 miles.

    c. The distance between the taxpayer's new job and his old home must be at least 50 miles greater than the distance between his old job and his old home.

    d. The distance between the taxpayer's old job and his old home must be at least 50 miles greater than the distance between his new job and his new home.

Section V: Tax Credits

31. For 2013, what is the maximum amount of earned income taken into account in calculating the earned income credit for a single taxpayer with one qualifying child?

    a. $6,370 b. $9,560

    c. $13,430 d. $16,450

32. For 2013, for a taxpayer with less than three qualifying children, the child tax credit is refundable to the extent of 15% of earned income above $_________.

    a. $12,000 b. $10,000

    c. $8,500 d. $3,000

33. Married taxpayers filing jointly spend $9,500 per year on day care for their three children under age 13. The wife's earned income is $48,000 and the husband's is $4,200. The couple's child care credit will be based on $ _________ of their child care expenses.

    a. $9,500 b. $9,000

    c. $6,000 d. $4,200

34. The American Opportunity credit may be elected for a student's expenses for:

    a. Any year of post-secondary education.

    b. Any of the first four years of post-secondary education.

    c. Any of the first two years of post-secondary education.

    d. The first year of post-secondary education.

35. The maximum Lifetime Learning Credit a taxpayer may claim is _______% of $ ______ of qualified tuition and related expenses.

    a. 10%; $3,000 b. 10%; $10,000

    c. 20%; $5,000 d. 20%; $10,000

36. Joint filers with modified AGI of $36,000 in 2013 can claim a tax credit for _______ of qualified retirement savings contributions up to $2,000.

    a. 0% b. 10%

    c. 20% d. 50%

37. What is the maximum low-income savers' credit for a taxpayer who contributes $1,000 to a Roth or regular IRA?

    a. $0 b. $100

    c. $500 d. $1,000

Section VI: Withholding and Estimated Taxes

38. If an employee fails to furnish his employer with a withholding allowance certificate, the employer should withhold tax from the employee's wages:

    a. At a flat 20% rate.

    b. At a flat 25% rate.

    c. As if the employee is married with two withholding exemptions.

    d. As if the employee is single with no withholding exemptions.

39. When an employee loses the right to an exemption for a dependent, he must amend his withholding allowance certificate within:

    a. Ten days

    b. Two weeks

    c. One month

    d. Two months

40. A taxpayer transferred $20,000 from his qualified retirement plan to another qualified plan by having the trustee of the old plan transfer the funds directly to the trustee of the new plan. How much of the transferred amount must be withheld for income taxes?

    a. $0

    b. $4,000

    c. $6,000

    d. $6,200

41. When backup withholding is required on a reportable payment, the payer must withhold at a rate of:

    a. 20%

    b. 25%

    c. 28%

    d. 30%

42. What is the required annual estimated tax payment for a single individual with $100,000 of adjusted gross income?

    a. 90% of the tax shown on the current year's return.

    b. 100% of the tax shown on the current year's return.

    c. The lower of 90% of the tax shown on the current year's return or 100% of the tax shown on the prior year's return.

    d. The lower of 90% of the tax shown on the prior year's return or 100% of the tax shown on the current year's return.

43. Married taxpayers filing jointly have a tax liability of $30,000 in 2013 and $50,000 in 2014. Their AGI is $140,000 and they are not eligible to use the annualized income method for calculating estimated tax payments. What is the least amount they can pay in estimated tax for 2014 to avoid an estimated tax penalty?

    a. $30,000

    b. $33,000

    c. $45,000

    d. $50,000

Section VII: Tax Returns and Payment of Taxes

44. A taxpayer whose spouse died within the preceding two years may use joint return rates for the current year's return:

    a. Under any circumstances.

    b. Only if she remarries.

    c. If she maintains as her home a household in which any dependent relative lives.

    d. If she maintains as her home a household in which a dependent child lives.

45. An individual is eligible to make a separate liability election with respect to a joint return if he or she is no longer married to, or is legally separated from, the spouse with whom the joint return was filed or wasn't a member of the same household as that spouse at any time during the previous ______ .

    a. Six months b. 12 months

    c. 18 months d. Two years

46. Under current IRS rules dealing with tax return filing extensions,

    a. Individuals may receive a four-month automatic extension by Filing Form 4868.

    b. Individuals may receive a six-month automatic extension by filing Form 2688.

    c. Individuals may receive a six-month automatic extension by filing Form 4868.

    d. Failure to pay tax by the original tax return due date will no longer subject a taxpayer to interest and penalties if a filing extension has been granted by the IRS.

47. The IRS must grant an installment agreement request for a taxpayer owing $______ or less who will pay off the balance within a _______ period (provided certain conditions are met).

    a. $10,000; three-year b. $15,000; five-year

    c. $25,000; three-year d. $25,000; five-year

Section VIII: Individual Alternative Minimum Tax

48. What is the maximum alternative minimum tax rate for individuals?

    a. 20% b. 26%

    c. 28% d. 34%

49. How much of an AMT adjustment will be made for a taxpayer with itemized deductions of $10,000 in property taxes, $4,000 of miscellaneous itemized deductions, and $2,000 of charitable deductions?

    a. $2,000 b. $6,000

    c. $14,000 d. $16,000

50. With regard to the AMT credit, deferral preferences are all of the alternative minimum tax preferences and adjustments ______ "exclusion" preferences such as ________.

    a. Including, tax-exempt interest

    b. Except, tax-exempt interest

    c. Including, alternative itemized deductions

    d. Except, miscellaneous itemized deductions

INTRODUCTION

RIA's 2014 Federal Tax Review Course Module 2 is an interactive self-study CPE course which addresses the taxation of businesses. There is a charge for grading and processing your answer sheet for this course module. To obtain credit, your **Examination for CPE Credit Answer Sheet** must be submitted for grading by **November 30, 2014**.

Taking the Course

You are asked to read the material and, during the course, test your comprehension of each of the learning objectives by answering self-study quiz questions. After answering each quiz question, you can evaluate your progress by comparing your answer to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied you understand the material, answer the examination questions. You may either record your answer choices on the printed Examination for CPE Answer Sheet or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

This RIA self-study course is part of Thomson Reuters Tax & Accounting, Learning Solutions, self-study offerings. PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours. Credit hours for CPE courses vary in length. Credit hours for this course are listed on the "Overview" page.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

After completing this course, you can receive CPE credit by logging on to our Online Grading System at cl.thomsonreuters.com. Click the purchase link and a list of exams will appear. You may search for the exam using the acronym QZN145. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading System, please refer to the Test Instructions located at the beginning of the examination. If you prefer, you may continue to mail your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters Tax & Accounting for grading. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. The examination contains instructions for obtaining CPE credit. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher. Please take a few minutes to complete the **Course Evaluation** and return it to us so that we can provide you with the best possible CPE.

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RIA's 2014 Federal Tax Review Course

OVERVIEW

COURSE DESCRIPTION: **RIA's Federal Tax Review Course Module 2** is a general refresher course in Federal taxation of businesses. It is designed to reinforce basic tax law interpretations while keeping practitioners up to date on the latest and most important changes. The course has been updated to reflect the latest in tax legislation through the American Taxpayer Relief Act of 2012.

PUBLICATION/REVISION DATE: November 2013

RECOMMENDED FOR: Users of RIA's Federal Tax Handbook

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of federal taxation

CPE CREDIT: 10 QAS Hours, 10 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours.

This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

CTEC CREDIT: 10 Federal Tax Update Hours

EA CREDIT: 10 Federal Tax Law/Tax Related Matters Hours

RTRP CREDIT: 10 Federal Update Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmarked by **November 30, 2014**

KNOWLEDGE LEVEL: Update

After completing Course Module 2, you should be able to:

- Distinguish among the basic forms of business organizations.
- Classify business entities under the "check-the-box" regulations.
- Identify accounting periods and methods and when an entity can freely choose its tax year.
- Describe the tax rules governing accounting for inventories.
- Distinguish between ordinary and necessary business expenses and capital expenses.
- Identify expenses required to be inventoried or capitalized under the uniform capitalization rules.
- Delineate the tax treatment of business start-up and organization expenses.
- Recognize when payments, awards and reimbursement to employees qualify for deductions.
- Determine when and how to claim deductions for business rent, interest, taxes, charitable contributions, and other payments.
- List the special tax rules governing travel and entertainment expenses.
- Apply the deduction for manufacturing/production activities.
- Discuss depreciation rules and the related available deductions.
- Apply the income limitations and other restrictions on the Section 179 expensing allowance.
- Recognize the restrictions on deductions for listed property.
- Identify property subject to amortization and depletion.
- Explain the operation of the general business credit.
- Apply the requirements for business tax credits.
- Identify dividends eligible for the dividends-received deduction and estimated tax payments for corporations.
- Determine when a corporation is subject to the personal holding company tax, accumulated earnings tax, and corporate alternative minimum tax.
- Determine the tax consequences of incorporating a business.
- Identify stock redemptions that are considered dividend distributions and those that are considered sales or exchanges, and the tax treatment of shareholders and corporations when there is a complete or partial liquidation.
- Identify the different types of corporate reorganizations.
- Determine the eligibility of a corporation to elect S corporation status.
- Demonstrate an understanding of the tax treatment of an S corporation and its shareholders.
- Determine the tax treatment of contributions to a partnership.
- Recognize how partnership income and deductions are treated for tax purposed by the partnership and the individual partners.

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RIA'S 2014 FEDERAL TAX REVIEW COURSE

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MODULE 2: TAXATION OF BUSINESSES

I. Forms of Business Organization

Learning Objectives

After completing this section, you should be able to:

- Distinguish among the basic forms of business organizations.
- Classify business entities under the "check-the-box" regulations.

One of the first decisions business owners must make is how their business should be structured. Nontax considerations, of course, play an important role in this decision. Such factors as an owner's vision of the size and nature of the business, the potential for lawsuits, and the degree of complexity the owner is willing to deal with, must be taken into account. But the choice of business structure also has major long-term tax implications. The choice can determine who must pay income tax, when it must be paid, and, most importantly, how much must be paid.

The basic forms of business organizations are:

- Sole proprietorship: The sole proprietorship is a simple, informal structure that is inexpensive to form; it is usually owned by a single person or a marital community. A self-employed owner operates the business, is personally liable for all business debts, can freely transfer all or part of the business, and can report profit or loss on personal income tax returns. This form of organization is discussed in Module 1, Taxation of Individuals.
- General partnership: Partnerships are relatively simple to form; they require an agreement between two or more individuals or entities to jointly own and operate a business. Profit, loss, and managerial duties are shared among the partners, and each partner is personally liable for partnership debts. Partnerships do not pay taxes, but must file an information return; individual partners report their share of profits and losses on their personal returns. Short-term partnerships are also known as joint ventures.
- Limited partnership (LPs): LPs have complex formation requirements, and require at least one general partner who is fully responsible for partnership obligations and normal business operations. The LP also requires at least one limited partner, often an investor, who is not involved in everyday operations and is shielded from liability for partnership obligations beyond the amount of his or her investment. LPs do not pay tax, but must file a return for informational purposes; partners report their share of profits and losses on their personal returns.
- C corporation: This is a complex business structure with more startup costs than many other forms. A corporation is a legal entity separate from its owners, who own shares of stock in the company. Corporations may be subject to increased licensing fees and more government regulation than other structures. Profits are taxed both at the corporate level and again when distributed to shareholders. Shareholders are not personally liable for corporate obligations unless corporate formalities have not been observed; such formalities provide evidence that the corporation is a separate legal entity from its shareholders. Failure to observe formalities may expose the shareholders to liability for the corporation's debts.
- S (or Subchapter S) corporation: This structure is identical to the C corporation in many ways, but offers avoidance of double taxation. If a corporation qualifies for S status with the IRS, it is taxed like a partnership; the corporation is not taxed, but the income flows through to shareholders who report the income on their individual returns.
- Limited liability company (LLC): The LLC is generally considered advantageous for small businesses because it combines the limited personal liability feature of a corporation with the tax advantages of a partnership or sole proprietorship. Profits and losses can be passed through the company to its members or the LLC can elect to be taxed like a corporation. LLCs do not issue stock and are not required to observe corporate formalities. Owners are called members, and the LLC is managed by the members or by appointed managers.

A. Partnerships

A "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through, or by means of which, any business, financial operation or venture is carried on if it isn't, within the meaning of the Code, a corporation, trust or estate. (Code Sec. 761(a)) Under the "check-the-box" entity classification regulations (see below), a partnership is a business entity, with two or more members, that isn't mandatorily classified as a corporation, and that has elected, or defaulted to, partnership tax status. (Reg §301.7701-2(c)) Under default provisions, unless a domestic eligible entity elects otherwise, it's a partnership if it has two or more members. (Reg §301.7701-3(b)(1)(i))

An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner (see below) when the entity's membership is reduced to one member. (Reg §301.7701-3(f)(2)) Partnerships are "pass-through entities"—that is, their income is subject to tax only once, at the partner level. They share this characteristic with S corporations, but not C corporations (whose income is taxed twice, once at the corporate level and again at the shareholder level). Partnerships also offer these advantages over S corporations:

- There are no limitations on who may be a partner, or on how many persons may be partners, unlike an S corporation, which is subject to limitations on who may be a shareholder and on how many shareholders the corporation may have.
- There is far greater flexibility in allocating the enterprise's profits, losses and credits among partners of a partnership than among shareholders of an S corporation.
- A partner's basis in his or her partnership interest, unlike a shareholder's basis in S corporation shares, includes the partner's share of partnership liabilities.

Husband and wife partnerships. Effective for tax years beginning after 2006, a qualified joint venture conducted by a husband and wife who file a joint return for the tax year is not treated as a partnership for tax purposes. (Code Sec. 761(f)(1)(A) as amended by 2007 Small Business Act §8215(a)) All items of income, gain, loss, deduction, and credit are divided between the spouses according to their respective interests in the venture (Code Sec. 761(f)(1)(B)), and each spouse takes into account his or her respective share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor. (Code Sec. 761(f)(1)(C))

In addition, each spouse's share of income or loss from a qualified joint venture is taken into account in determining the spouse's net earnings from self-employment. (Code Sec. 1402(a)(17) as amended by 2007 Small Business Act §8215(b)(1))

A qualified joint venture is any joint venture involving the conduct of a trade or business if:

1. the only members of the joint venture are a husband and wife (Code Sec. 761(f)(2)(A)),
2. both spouses materially participate in the trade or business (Code Sec. 761(f)(2)(B)), and
3. both spouses elect the application of this rule. (Code Sec. 761(f)(2)(C))

For this purpose, material participation is determined under the Code Sec. 469(h) passive loss rules without regard to the rule that treats participation by one spouse as participation by the other.

The IRS has stated that a qualified joint venture includes only businesses owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited partnership or limited liability company).

In addition, under longstanding IRS rules, where a husband and wife in a community property state are sole owners of an entity that is not treated as a corporation, IRS will accept their treatment of it as either a partnership or a disregarded entity.

B. Corporations

The following entities are automatically treated as a corporation for tax purposes:

- A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.

- A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association.
- An insurance company.
- A state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act.
- A business entity wholly owned by a state or any of its political subdivisions.
- A business entity that's taxable as a corporation under a provision of the Code other than Code Sec. 7701(a)(3), such as a publicly traded partnership.
- Certain foreign business entities, and the business entities formed under the laws of U.S. territories and possessions. (Reg §301.7701-2(b))

C corporations generally are subject to tax at graduated rates on their taxable income. The benefits of the graduated rates phase out after taxable income reaches a specified amount. C corporations that are personal service corporations (see VI.) are taxed at a flat 35% rate. (Code Sec. 11(b)(2))

Some C corporations are also subject to an alternative minimum tax (see VI.E.).

Penalty taxes are imposed on corporations with unreasonable earnings accumulations (see VI.D.), and on personal holding companies (see VI.C.).

C. S Corporations

An eligible corporation may elect to be taxed as an S corporation which, with limited exceptions, isn't taxed at the corporate level. Instead, it's a pass-through entity: its items of income, loss, deduction and credit are passed through to, and taken into account by, its shareholders in computing their individual tax liabilities.

The S election is made by the corporation by filing a Form 2553 signed by its authorized officer. All shareholders owning stock in the corporation on the day it elects S status must consent to the election. (Code Sec. 1362(a)(2); Reg §1.1362-6(b)(2)(i)) An S election for a tax year may be made during the preceding tax year, or by the 15th day of the third month of the tax year for which it's to be effective. (Code Sec. 1362(b)(1))

Only a "small business corporation" may elect to be an S corporation. (Code Sec. 1362(a)(1)) This means the corporation (or an unincorporated entity that's taxable as a corporation, see below) must meet certain requirements, including the following:

- It must be a domestic corporation (created under the law of the U.S. or of any state). (Code Sec. 1361(b)(1))
- It must not be (1) a financial institution that uses a reserve method of accounting for bad debts, (2) taxable as an insurance company (with certain exceptions), or (3) allowed a tax credit for income from Puerto Rico or U.S. possessions.
- It can't have more than 100 shareholders. (Code Sec. 1361(b)(1)(A),) For purposes of the 100 shareholder provision, all members of the same family are automatically treated as one shareholder when calculating the 100-shareholder limit. (Code Sec. 1361(c)(1)(A)(ii)).
- All shareholders must be individuals, decedents' estates, bankruptcy estates, certain qualifying trusts (see below) or tax-exempt charitable organizations (Code Sec. 1362(b)(1)(B); Reg §1.1361-1(f)), except that an otherwise eligible S corporation can be wholly owned by another S corporation. A partnership can hold S corporation stock as a nominee for an eligible shareholder. (Reg §1.1361-(e)(1))
- No shareholder may be a nonresident alien (Code Sec. 1361(b)(1)(C)), or be married to a nonresident alien who has a current ownership interest in his or her stock under local law (unless the spouses elect under Code Sec. 6013(g) to be taxed as U.S. residents). (Reg §1.1361-1(g)(1))
- It must have only one class of stock. (Code Sec. 1361(b)(1)(D); Reg §1.1361-1(b)(1))

Review Question 1

A corporation's stock is owned by 110 shareholders. 80 of the shareholders are unrelated individuals. However, 10 shareholders are all members of Family X, 10 are members of Family Y, and 10 are members of Family Z. Is the corporation eligible to elect S corporation status?

a. No, the corporation is not eligible for S status because it has more than 100 shareholders.

b. Yes, but only if any one of Families X, Y, or Z elects to be treated as a single shareholder.

c. Yes, the corporation is eligible to elect S status because it has fewer than 100 shareholders.

A corporation is treated as having only one class of stock if:

- all outstanding shares of its stock confer identical rights to distribution and liquidation proceeds, based on certain governing provisions (i.e., corporate charter, by-laws, state law, etc.) (Reg §1.1361-1(l)(1); Reg §1.1361-1(l)(2)(i)); and
- it hasn't issued any instrument or obligation or entered into any arrangement that's treated as a second class of stock. (Reg §1.1361-1(l)(4))

The one-class-of-stock rule isn't violated solely because of differences in voting rights. Thus, voting and nonvoting common can be issued. (Code Sec. 1361(c)(4))

Only the following trusts may be S corporation shareholders:

- Grantor trusts, which are domestic trusts that are treated as being owned by an individual ("grantor") who is a U.S. citizen or resident, during the period the trust holds the S corporation stock. The grantor, not the trust, is treated as the shareholder. (Code Sec. 1361(c)(2)(A)(i); (B)(i); Reg §1.1361-1(h)(1)(i), (3)(i)(A))
- Code Sec. 678 trusts, which are trusts where a person other than the grantor is treated as the substantial owner of the trust, during the period the trust holds the S corporation stock. The deemed owner, who must be a U.S. citizen or resident, is treated as the shareholder. (Code Sec. 1361(c)(2)(A)(i), (B)(i); Reg §1.1361-1(h)(1)(i), 3(i)(A))
- Voting trusts, but each beneficiary is counted as a separate shareholder. (Code Sec.1361(c)(2)(A)(iv), (B)(iv); Reg §1.1361-1(h)(1)(v), (3)(i)(E))
- Testamentary trusts, for 2-years beginning with the day when stock was transferred to the trust under the testator's will. (Code Sec. 1361(c)(2)(A)(iii); Reg §1.1361-1(h)(1)(iv))
- "Qualified Subchapter S trusts" (QSSTs), if the beneficiary elects to be treated as the owner of the trust so that it is eligible to hold the S stock and is treated as the shareholder. (Code Sec. 1361(d); Reg §1.1361-1(j))
- "Electing small business trusts (ESBTs)." (Code Sec. 1361(c)(2)(A)(v); Code Sec. 1361(e); Reg §1.1361-1(m)) These trusts are subject to fewer restrictions than QSSTs but carry a heavy tax cost (see Module 3, Specialized Tax Issues).
- Tax-exempt Code Sec. 401(a) qualified plan trusts. (Code Sec. 1361(c)(6))
- Individual retirement accounts, but only to the extent of the stock held in a bank or a depository institution holding company. (Reg §1.1361-1(h)(1)(vii), Reg §1.1361-1(h)(3)(i)(G))

D. Limited Liability Company

Under the "check-the-box" entity classification rules (see below), if a limited liability company (LLC) isn't mandatorily classified as a corporation, it's an "eligible entity" that may elect to be classified for tax purposes either as a partnership or as a corporation. (Reg §301.7701-2(c)) However, a single member LLC that doesn't elect to be a corporation is treated as not having any entity status, i.e., it can't be treated as a partnership. (Reg §301.7701-2(a), Reg §301.7701-2(c)(2)(i))

If an LLC is characterized as a partnership for federal tax purposes, the limited liability company form will offer the pass-through of tax attributes, as well as limited liability. Pass-through of tax attributes and limited liability are also available to S corporations. S corporations are, however, subject to many restrictions, including restrictions on the number and kind of shareholders, which don't apply to limited liability companies.

Review Question 2

Which of the following is a true statement?

a. Both S corporations and LLCs are subject to restrictions on the number of shareholders.

b. Both S corporations and LLCs are always classified as corporations for tax purposes.

c. Both S corporations and LLCs may offer the pass-through of tax attributes.

E. "Check-the-Box" Regulations

The IRS has issued regulations that set forth a "check-the-box" system of classifying entities for federal tax purposes. These regulations allow the elective classification of unincorporated business entities, including organizations/entities that have a single owner.

Under the check-the-box regulations, "eligible entities" are allowed to elect their classification for federal tax purposes. An eligible entity with at least two members may elect to be classified as an association (and thus as a corporation), or as a partnership. An eligible entity with a single owner may elect to be classified as an association or to be disregarded as an entity separate from its owner. (Reg §301.7701-3(a))

An "eligible entity" is any business entity that isn't mandatorily classified as a corporation (see above).

Unless a domestic eligible entity elects otherwise, the following default classifications generally apply:

- The entity is a partnership if it has two or more members;
- The entity is disregarded as an entity separate from its owner if it has a single owner. (Reg §301.7701-3(b)(1))

In other words, a domestic eligible entity is classified as a partnership if it has two or more members and if it does not file an election to be classified as an association. A domestic eligible entity with only a single owner isn't treated as separate from that owner if it doesn't file an election to be treated as an association.

Review Question 3

A domestic eligible entity with two members is automatically classified as a __________ unless it elects a different classification.

a. Corporation. b. Partnership.

c. Disregarded entity.

A disregarded entity will still be treated as a separate entity for purposes of:

- federal tax liabilities of the entity for any taxable period for which the entity was not disregarded.
- federal tax liabilities of any other entity for which the entity is liable.
- federal tax refunds or credits. (Reg §301.7701-2(c)(2)(iii)(A); Reg §301.7701-2(e)(2))

An eligible entity that wishes to elect a classification other than its default classification, or any eligible entity that wishes to change its classification does so by filing Form 8832. If an eligible entity makes an election to change its classification, it may not change its classification again during the 60 months after the effective date of the election. However, IRS may permit the entity to change its classification by election within that 60-month period if more than 50% of the ownership interests in the entity as of the effective date of the later election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's earlier election. (Reg §301.7701-3(c)(1)(iv))

An election by a newly formed eligible entity that is effective on the date of its formation is not considered a change of classification for purposes of the above rules. (Reg §301.7701-3(c)(1)(iv))

An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member (Reg §301.7701-3(f)(2)), provided that the "entity" is still treated as such under local law. A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity's membership is increased to more than one member. (Reg §301.7701-3(f)(2)) Both of these classifications are changeable by election, assuming that the entity is not subject to the 60-month limitation on elections.

A change in classification, no matter how achieved, will have certain tax consequences that must be reported. For example, if an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations (see VII.D.).

Final IRS regulations treat single-owner eligible entities that are disregarded entities as *separate* entities for employment tax and related reporting requirements. They also treat these disregarded entities as separate entities for certain excise taxes reported on Forms 720, 730, 2290, and 11-C, as well as for excise tax refunds or payments claimed on Form 8849, and excise tax registration on Form 637. An owner of a disregarded entity treated as a sole proprietorship is subject to self-employment taxes. (Reg. §1.34-1; Reg. §1.1361-4)

II. Tax Accounting

Learning Objectives

After completing this section, you should be able to:

- Identify accounting periods and methods and when an entity can freely choose its tax year.
- Describe the tax rules governing accounting for inventories.

No matter what form it takes, a business (including a professional practice) reports its gross income and claims allowable deductions to compute its taxable income.

In the case of a manufacturing, merchandising, or mining taxpayer, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. (Reg §1.61-3(a)) In a professional practice or other service business, gross income typically includes fees and royalties. Special rules apply to certain types of business income. For example, gain from the sale of property used in a business may qualify for favorable capital gain treatment (see Module 1, Taxation of Individuals).

From gross income, a business taxpayer may deduct all ordinary and necessary expenses related to the business (see III.). (Code Sec. 162(a)) An expense is ordinary if it's customary or usual in the taxpayer's business. A necessary expense is one that's appropriate and helpful in developing and maintaining the taxpayer's business. Again, special rules apply to certain types of expenses. For example, capital outlays that provide long-term benefits cannot be deducted as ordinary and necessary expenses, but may be recovered over a period of time through depreciation and amortization allowances (see IV.).

Tax accounting deals with timing issues—when income must be included in gross income and when expenses can be deducted. The purpose is to match income with related expenses over an appropriate period of time.

A. Accounting Periods

Taxpayers must compute their taxable income on the basis of their tax year. (Code Sec. 441(a); Reg §1.441-1(a)) "Tax year" is the taxpayer's annual accounting period (the annual period on the basis of which the taxpayer regularly computes his or her income in keeping books) (Code Sec. 441(c)), but only if that's the calendar year or a fiscal year. (Code Sec. 441(b)(1))

The calendar year is the 12-month period ending on December 31. (Code Sec. 441(d)) A taxpayer must use the calendar year if the taxpayer keeps no books (unless it gets IRS consent to use a fiscal year (Reg §1.441-1(c)(2))), has no annual accounting period, has an annual accounting period that doesn't qualify as a fiscal year (Code Sec. 441(b)(2); Code Sec. 441(g)), or if the taxpayer hasn't established a fiscal year. (Reg §1.441-1(b)(1)(iv))

A fiscal year is any 12-month period ending on the last day of a month other than December, or the 52-53-week tax year. (Code Sec. 441(e)) A 52-53-week tax year varies from 52 to 53 weeks and always ends on the same day of the week. The day chosen must be either the day of the week that last occurs in a calendar month or the day that falls nearest to the end of the calendar month (in which case the last day of the tax year may fall in the next month). (Code Sec. 441(f)(1); Reg §1.441-2(a)(1)) A taxpayer may elect a 52-53-week tax year if it otherwise satisfies Code Sec. 441 and its regulations. (Reg §1.441-2(a)(3))

Wherever the applicability of any provision of the Code, or filing date, is expressed in terms of tax years beginning, including, or ending with reference to a specified date that's the first or last day of the month, the actual opening and closing dates of 52-53-week years are disregarded. The year is considered to begin on the first day of the calendar month beginning nearest to the first day of that tax year, and to end on the last day of the calendar month ending nearest to the last day of that tax year. (Code Sec. 441(f)(2)(A))

If a return is properly made for a period of less than 12 months, the tax year is the short tax year for which the return is made. (Code Sec. 441(b)(3)) A taxpayer must use a tax "year" of less than 12 months if:

- the taxpayer isn't in existence for what would otherwise be its full tax year (Code Sec. 443(a)(2)); or
- the taxpayer properly changes his or her annual accounting period. (Code Sec. 443(a)(1))

Review Question 4

Which of the following is correct regarding accounting periods for taxpayers?

a. Taxable income must be computed based on a calendar year for all taxpayers.

b. If a taxpayer keeps no annual accounting records, the taxpayer can choose the basis for his or her tax year.

c. If a taxpayer changes his or her annual accounting period, the taxpayer can have a short tax year.

d. A fiscal year is defined as a 12-month period ending on the last day of the month of December.

1. Required Tax Year of Personal Service Corporations and S Corporations

The tax year of a personal service corporation (PSC) or an S corporation must be a calendar year unless the corporation:

- makes a Code Section 444 election (see below),
- elects a 52-53-week tax year ending with reference to the calendar year or the year elected under Code Section 444, or
- can satisfy IRS that there's a business purpose for a different tax year. (Code Sec. 441(i)(1); Code Sec. 1378; Reg §1.441-1(b)(2)(i)(B); Reg §1.441-3(a); Reg §1.441-1(b)(2)(i)(L); Reg §1.441-(b)(2)(ii)(B))

A PSC is any corporation whose principal activity is the performance of personal services that are substantially performed by employee-owners. But for this purpose PSC doesn't include S corporations, and the term "owner-employee" includes all employees with any stock ownership in the corporation. Certain independent contractors who own stock in the corporation and perform personal services for or on behalf of it are treated as employees. (Reg §1.441-3(g)(2))

The performance of personal services is considered the corporation's principal activity if the corporation's compensation cost for a testing period for activities that are considered the performance of personal services exceeds 50% of its total compensation cost for the period. (Reg §1.441-3(e)(1)) The testing period is the preceding tax year (or, for a corporation's first tax year, the period beginning the first day of the first tax year and ending the last day of that tax year or, if earlier, the last day of the calendar year in which that tax year began). (Reg §1.441-3(c)(2))

2. Required Tax Year of Partnership

Generally speaking, a partnership must adopt:

- the "majority interest tax year" (Code Sec. 706(b)(1)(B)(i))—the tax year of one or more of the partners having an aggregate interest in partnership profits and capital of more than 50% on each testing day (the first day of the partnership's tax year as otherwise determined, or days prescribed by IRS) (Code Sec. 706(b)(4)(A));
- the tax year of all its principal (5%-or-more) partners, if there's no majority interest tax year (Code Sec. 706(b)(1)(B)(ii));
- the "least-aggregate-deferral" year, if there's no majority interest tax year and the principal partners don't have the same tax year. (Code Sec. 706(b)(1)(B)(iii); Reg §1.706-1(b)(2)(i)(C))

A partnership may have a tax year other than its required year if it makes an election under Code Sec. 444, elects to use a 52-53-week tax year that ends with reference to its required year or a tax year elected under Code Sec. 444, or establishes a business purpose for it and gets IRS approval. (Reg §1.706-1(b)(2)(ii))

3. Code Section 444 Election

An S corporation, PSC, or partnership may elect to have a tax year other than the required tax year (Code Sec. 444(a)), but only if the deferral period (number of months between beginning of elected fiscal tax year and following December 31) for the tax year elected isn't longer than three months. (Code Sec. 444(b)(1); Reg §1.444-1T(b))

A partnership or S corporation that elects has to make a "required payment" to the IRS that approximates the tax the partners or S corporation shareholders would have paid on short-period income if the election hadn't been made. (Code Sec. 7519; Reg §1.444-3T)

A PSC that elects a fiscal tax year but doesn't make required minimum distributions to its employee-owners before the end of the calendar year must postpone part or all of its corresponding deduction to its next fiscal tax year. (Code Sec. 280H)

B. Accounting Methods

Methods of tax accounting are the methods and systems by which taxpayers determine the amount of their income, gains, losses, deductions and credits, as well as the time when those items must be realized and recognized. Various methods of tax accounting are permissible, such as the cash method and the accrual method (see below), but each must be used consistently, and each must clearly reflect income.

Because a taxpayer's book accounting method determines its accounting method, a taxpayer establishes a tax accounting method by setting up books, keeping accounts, and preparing income tax returns under any of the permissible methods. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which the income or deductions are first reported, must be followed consistently after that. (Reg §1.446-1(d)(1))

The Code does impose limits on the choice of accounting methods. The accrual method is mandatory for purchases and sales (unless IRS consents to a change) where inventories must be used. (Reg §1.446-1(c)(2)(i)) Inventories must be used where the production, purchase or sale of merchandise is an income-producing factor (but see below). (Reg §1.446-1(a)(4)(i))

C corporations (other than qualified personal service corporations), and partnerships with a C corporation (other than a qualified personal service corporation) as a partner, with average annual gross receipts of more than $5 million for any prior three-tax-year period (or the period of its existence, if less) can't use the cash method. Tax shelters can't use the cash method in any event. (Code Sec. 448(a)) The limitation on the cash method doesn't apply to farming businesses (except tax shelters) (Code Sec. 448(b)(1)), but for special farm accounting rules, see Module 3, *Specialized Tax Issues*.

Review Question 5

Which of the following statements best describes the tax rules generally applicable to taxpayers required to maintain inventories?

a. The cash method must be used for all transactions.

b. The accrual method must be used for all transactions.

c. The accrual method must be used for purchases and sales.

d. The taxpayer may choose any accounting method.

Small business exemption. IRS excepts two classes of taxpayers from having to account for inventories or use an accrual method of accounting:

- $1 million or less average gross receipts. Taxpayers (other than tax shelters) with average annual gross receipts of $1 million or less do not have to account for inventories or use an accrual method of accounting. Those that qualify for this exception and do not want to use inventories must treat merchandise inventory in the same way that cash method taxpayers must treat material or supplies that are not "incidental" (i.e., include in deductible expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year).
- More than $1 million but not more than $10 million average gross receipts. A taxpayer (but not a C corporation or partnership with a C corporation partner with average gross receipts over $5 million that is barred from using the cash method) whose principal business activity is not mining, manufacturing, wholesale trade, retail trade, or information industries may use the cash method and does not have to keep inventories for all of its trades or businesses if its average annual gross receipts are more than $1 million but not more than $10 million.

Review Question 6

Lex Furniture is a partnership that maintains an inventory of supplies to manufacture wooden furniture. The company has approximately $6 million of gross receipts each year. Which of the following is correct regarding Lex Furniture's method of accounting for its inventory?

a. Lex Furniture qualifies for a small business exemption since its gross receipts are less than $10 million.

b. Lex Furniture must use the accrual method of accounting for its inventory.

Reserves for expenses. Deduction or exclusion from income isn't allowed for additions to reserves for estimated expenses or contingent liabilities, even if reserves are required by state law or by contract, unless the reserve is expressly authorized by the Code (e.g., depreciation) or is a reserve for trading stamps or coupons. (Reg §1.451-4(a))

Repayment of previously reported income. A taxpayer who must repay previously-reported income is entitled to deduct the amount repaid.

- For a cash basis taxpayer, the year of the deduction is the year the income previously reported was repaid. If the taxpayer reported the income as constructively received, the year of deduction is the year he or she had to relinquish the claim to the income. (Reg §1.1341-1(e))
- For an accrual basis taxpayer, the year of deduction is the year liability for repayment becomes fixed. Where the taxpayer received the income reported, the year of deduction is the year it's finally established the taxpayer had no unrestricted right to it. (Reg §1.1341-1(e))

A special relief provision is available for repayments in excess of $3,000. If the amount of the deduction allowed for a tax year with respect to an item reported as income in an earlier tax year is more than $3,000, and:

- that item was included in gross income in the earlier year because it appeared that the taxpayer had an unrestricted right to it then; and

- the deduction is allowed because it was shown after the close of the earlier year that taxpayer did not have an unrestricted right to all or part of that item, then the tax for the year in which the deduction is allowed is the lesser of:
    - the tax for that year computed with the deduction,
    - the tax for that year computed without the deduction, minus the decrease in tax for the earlier year that would result solely from excluding the deductible repayment. (Code Sec. 1341(a))

This relief for repayments exceeding $3,000 doesn't apply:

- where repayment is required because of a liability that arose later, as distinguished from absence of an unrestricted right to the income previously reported;
- where an item was originally included in gross income by reason of the sale or other disposition of stock-in-trade, or other property includible in inventory if on hand at close of the earlier tax year, or property held primarily for sale to customers in the ordinary course of business—i.e., it doesn't apply to sales returns and allowances and similar items (Code Sec. 1341(b)(2); Reg §1.1341-1(f));
- to deductions attributable to bad debts or to legal fees and other expenses incurred in contesting the repayment of income previously included. (Reg §1.1341-1(g); Reg §1.1341-1(h))

1. Cash Method of Accounting

Under the cash basis method of accounting, income is reported when cash or property is actually or constructively received, and deductions are taken in the year cash or property is paid or transferred.

A check issued by a solvent payor is income when received by a cash basis payee, unless there's a restriction on the payee's right to cash the check. Receipt of a check by an agent is considered receipt by the principal.

Income not actually received is constructively received and reportable if it's within the taxpayer's control. Cash basis taxpayers must report money unconditionally subject to their demand as income, even if they haven't received it.

There's no constructive receipt if the amount is available only on surrender of a valuable right, or if there are substantial limits on the right to receive it. (Reg §1.451-2(a))

Cash method taxpayers generally take deductions (if otherwise allowable) in the year the items are paid. (Reg §1.461-1(a)(1)) There's no constructive payment doctrine.

Where an expense (e.g., rent or an insurance premium) relates to a period covering more than 12 months, IRS and most courts agree that the deduction must be spread over the period to which the expense applies.

A check is payment when delivered, not when cashed, if it's honored when it's first presented for payment.

2. Accrual Method of Accounting

Income accrues and must be reported in the year all events have occurred that determine taxpayer's right to receive it, and the amount can be determined with reasonable accuracy (Reg §1.451-1(a)), even if it's received in a later year. That is, the right to receive the income must not be contingent on a future event; the amount must be reasonably susceptible of accurate estimate; and there must be a reasonable expectation that it will be received in due course.

The "nonaccrual experience method" permits taxpayers to avoid accruing income from the performance of services that, based on their experience, wouldn't be collected if, among other things, interest wasn't charged on the debt and there was no penalty for late payment. This method is available only for (1) amounts owing for services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or (2) other services, if the taxpayer's three-year average annual gross receipts don't exceed $5 million. Uncollectible amounts may be determined using specified safe-harbor methods. (Code Sec. 448(d)(5))

Contingent income and disputed liability. Where the right to income is contingent on a future event, an accrual basis taxpayer doesn't have to recognize the income until that event occurs. Where litigation is involved and liability to the taxpayer is admitted, the income must be recognized if the taxpayer can accurately estimate the amount of recovery. But if liability isn't admitted, the income accrues when the litigation is concluded or settlement reached, whichever is earlier. An offer in compromise is income when the dispute is settled or the offer is unconditionally accepted.

If an accrual method taxpayer overbills a customer due to clerical error and the customer discovers the error and disputes its liability in the following year, gross income accrues in the year of sale for the correct amount. An accrual method taxpayer does not accrue income in the year of sale if, during that year, the customer disputes its liability because incorrect goods were shipped. However, income does accrue in the year of sale if excess quantities of goods are shipped and the customer agrees to pay for them.

Advance payments. Advance payments received for services to be performed must be reported by an accrual basis taxpayer in the year received, with this exception: A taxpayer can elect to defer advance payments over the period services are performed if they are received under an agreement requiring all the services to be performed by the end of the next year. Deferral isn't allowed if any of the services may be performed later or if the agreement doesn't say when they must be performed.

Amounts received as security aren't taxable until used. A deposit that guarantees the customer's payment of amounts owed to the creditor isn't a deposit but an advance payment includible in income, while a deposit securing someone's property is a true security deposit and not an advance payment.

Advance merchandise payments and advance payments under long-term construction contracts are reported by accrual method taxpayers when the income is properly accruable under their method of accounting. But that method must be used for all tax reporting and for credit purposes. (Reg §1.451-5(b))

An accrual basis taxpayer or a taxpayer using one of the long-term contract methods (see II.B.3.) can defer reporting an advance payment received under an agreement for the sale or other disposition in a future tax year of goods held primarily for sale to customers, or for the building, installing, constructing or manufacturing of items, where the work isn't completed in the year the advance payment is received. (Reg §1.451-5(a)(1)) Deferral also applies to advance payments for services to be performed under the agreement as an integral part of the above activities, and for gift certificates. (Reg §1.451-5(a)(2) Amounts due and payable under the contract are treated as advance payments received. (Reg §1.451-5(a))

There's a limited deferral for certain inventoriable goods. Where a payment for goods is received several years before they are delivered, taxpayer can postpone reporting the advance payments for one year past the year total advance payments first equal or exceed the anticipated cost of the goods. Thereafter, all prepayments received are reported and actual or expected costs deducted. (Reg §1.451-5(c))

Timing of expense deductions. Expenses are deductible under the accrual method in the period in which all events have occurred that determine the fact of the liability (including economic performance, see below), and the amount of the liability can be determined with reasonable accuracy. (Reg §1.461-1(a)(2)) A reasonable estimate of the liability must be accrued for the tax year in which it was incurred. If there is a difference between the estimate and the amount finally determined, the difference must be added to or deducted from income when the final determination is made.

Where the accrual doesn't involve a current expense, but results in the creation of an asset having a useful life extending substantially beyond the end of the tax year, the deduction must be taken as depreciation, amortization or similar deduction. (Reg §1.461-1(a)(2))

An accrual basis taxpayer is entitled to a deduction for a properly accrued expense, regardless of whether he or she has actually paid that expense.

Economic performance. Accrual basis taxpayers won't be considered to have met the all-events test until economic performance has occurred. (Code Sec. 461(h)) Economic performance occurs when the property or service to which the accrual relates is actually provided or used. (Code Sec. 461(h)(2)(A))

Certain "recurring" expenditures may be treated as incurred in the year the all events test is otherwise met, even though economic performance doesn't occur until the following year. This applies if:

- economic performance occurs on or before the date taxpayer files a timely (including extensions) return for the tax year the expense is accrued or, if shorter, 8½ months after the close of that year; and
- the item is recurring and taxpayer consistently treats items of that kind as incurred in the tax year the all-events test (not including the economic performance test) is met; and the item is either not a material item or its accrual in the year before economic performance results in a more proper match against income than would be achieved by accruing it in the year of economic performance. (Code Sec. 461(h)(3)(A); Reg §1.461-5(b))

The IRS has provided a safe harbor procedure for accruing payroll tax liabilities for taxpayers using the recurring item exception. (Rev. Proc. 2008-25, 2008-13 IRB 686) Under the safe harbor, a taxpayer satisfies the recurring item exception for its payroll tax liability in the same tax year in which all events have occurred that establish the fact of the related compensation liability, and the amount of the related compensation liability can be determined with reasonable accuracy. The safe harbor does not apply to an employee's portion of FICA tax deducted by the employer from wages paid to the employee.

A taxpayer can adopt the recurring item exception as part of its method of accounting for any type of income for the first tax year that type of item is incurred. (Reg §1.461-5(d)(1))

If the liability of a taxpayer requires a payment to another person that arises out of a tort, economic performance occurs as the payments are made. (Code Sec. 461(h)(2)(C)) A qualified payment to a court-ordered or designated settlement fund that extinguishes a taxpayer's tort liability is economic performance with respect to the liability as the payment is made. The present or future claims against the taxpayer must arise out of personal injury, death or property damage. (Code Sec. 468B)

Contested liabilities. An otherwise deductible expense isn't allowable, as long as the taxpayer denies and contests the liability, until the contest is resolved by agreement or final court decision. However, a deduction is allowed in the year of transfer (payment) where:

- the taxpayer contests an asserted liability;
- the taxpayer transfers money or other property to satisfy the liability;
- the contest with respect to the asserted liability exists after the transfer; and
- but for the contest, a deduction would be allowed for the tax year of the transfer (or an earlier year). (Code Sec. 461(f)) The contest need not involve court proceedings.

Payments to related parties. An accrual basis taxpayer can deduct expenses and interest owed to a related cash basis taxpayer only when payment is made and the amount involved is includible in the gross income of the cash basis payee. (Code Sec. 267(a)(2)) That is, an accrual basis taxpayer is treated as on the cash method for purposes of deducting amounts owed to a related cash basis payee.

The rule applies in general to all deductible expenses if the timing of the deduction depends on the taxpayer's method of accounting or on electing to expense the item. But it doesn't apply to defer the deduction of otherwise deductible original issue discount or below-market loan interest. (Reg §1.267(a)-2T(b), Q&A-2) Nor does it apply to defer the deduction of otherwise deductible depreciation, or amortization, except as to amounts owed to a related person for interest, rent or for the performance or nonperformance of services (which amount the payor capitalized or treated as a deferred expense). (Reg §1.267(a)-2T(b), Q&A-4)

3. Long-term Contracts

Taxpayers must account for long-term contracts (except for certain home and other real property construction contracts) under the percentage-of-completion method. (Code Sec. 460)

A long-term contract is any contract for the manufacture, building, installation, or construction of property, if not completed in the tax year in which it is entered into. (Code Sec. 460(f)(1); Reg §1.460-1(b)(1)) Whether the taxpayer reasonably expected that the contract would be completed within the tax year is not relevant. But a manufacturing contract isn't long-term unless it involves manufacture of a unique item (of a type not normally included in inventory), or an item that normally requires more than 12 months to complete. (Code Sec. 460(f)(2))

Home construction contracts (specially defined) aren't limited to the percentage-of-completion method. Nor are any other real property construction contracts if originally estimated to be completed within two years of the contract start date, and if the taxpayer's average annual gross receipts for the three previous tax years don't exceed $10 million (including receipts of certain related businesses). (Code Sec. 460(e); Reg §1.460-3(b)) IRS regulations provide reporting methods for exempt contracts. (Reg §1.460-4(c))

Percentage-of-completion method. Under this method, a long-term contract's percentage of completion must be determined by comparing costs allocated to the contract and incurred before the close of the tax year, with estimated total contract costs. (Code Sec. 460(b)(1)(A)) Events that occur after the end of the tax year that are reasonably subject to estimate as of the last day of the tax year are taken into account.

Gross income recognized in a particular year under the percentage-of-completion method equals total revenue expected from the contract times the cumulative percentage of the contract completed as of the end of the tax year, less the total cumulative amount of contract revenue required to be included in gross income in all preceding tax years. (This can result in a deductible loss for a year if total estimated contract costs increase.) (Reg §1.460-4(b)(2))

If the total contract price has not been included in gross income by the completion year, the taxpayer must include the remaining portion of the total contract price in gross income for the following tax year. (Reg §1.460-4(b)(3))

For purposes of the percentage-of-completion method, a taxpayer may elect not to recognize income under the contract and not to take into account any costs allocable to the long-term contract for any tax year if, as of the end of the tax year, less than 10% of the estimated total contract costs have been incurred. (Code Sec. 460(b)(5)).

Review Question 7

Which of the following is an attribute of the cash method of accounting?

a. If cash or property is paid or transferred for a deductible item, the deduction is taken.

b. Income is recorded when the taxpayer's right to receive it is fixed and the amount can be determined accurately, even if payment has not yet been received.

c. A check received by a taxpayer's agent is not reported as income until the check is cashed by the taxpayer.

d. If an expense covers more than a 12-month period, it is deducted in the year the bill is paid.

4. Change in Accounting Methods

Taxpayers must obtain IRS's consent before changing a method of accounting for federal income tax purposes. (Code Sec. 446(e)) This is so even if the taxpayer has been using an incorrect method, or a method that doesn't clearly reflect income.

Taxpayers can't, without IRS consent, retroactively change from an erroneous to a permissible accounting method by filing amended returns, even if the time for amending the return for the first year in which the erroneous method was used hasn't expired.

There are two processes, automatic and nonautomatic consent. Some of the more commonly applicable "automatic consent" changes are those involving: nonpermissible to permissible accounting method for depreciation; uniform capitalization methods of small resellers; cash or hybrid method to accrual method; timing of incurring liabilities for employee compensation, workers' compensation, and payroll taxes; change from LIFO; retail safe harbor method (and certain other methods) for estimating inventory shrinkage; and capitalizing costs incurred in acquiring or creating intangible assets. There are generally no user fees for automatic-consent accounting method change requests.

In general, automatic consent to change an accounting method is achieved by filling out Form 3115 (Application for Change in Accounting Method) and filing it:

(1) with a timely filed (including extensions) original income tax return for the change year (file a copy with the IRS National Office), or

(2) within six months of the original tax return due date (excluding extensions) for the change year, if the taxpayer (a) timely filed (including extensions) its return for the change year; (b) files an amended return within the six-month extension period; (c) attaches the original Form 3115 to the amended return; (d) files a copy with the national office at the same time or sooner; and (e) writes "FILED PURSUANT TO Reg § 301.9100-2 " at the top of the application.

Unless IRS provides otherwise, a taxpayer not under audit who follows the automatic consent procedures generally gets both audit and ruling protection. That is, IRS will not require the taxpayer to change its method of accounting for the same item for a tax year before the change year (audit protection). It also won't require the taxpayer to change or modify the new method of accounting except in certain limited circumstances, and, if IRS makes the taxpayer change or modify the new method of accounting, the required change or modification generally won't apply retroactively (ruling protection). In other words, the taxpayer generally receives protection for the use of the new method of accounting in future years.

Review Question 8

A taxpayer that discovers it has been using an incorrect method of accounting must:

a. Immediately file amended returns to change to a correct method for prior years.

b. Immediately switch to a correct method for future years.

c. Get the IRS's permission to change methods.

d. Immediately switch to a correct method *and* file amended returns to change to a correct method for prior years.

In any year in which a taxpayer uses a different tax accounting method from the method used in the preceding year, adjustments—"Code Sec. 481(a) adjustments"—must be made to prevent items of income or expense from being duplicated or entirely omitted. (Reg §1.446-1(e)(3)(i)) The adjustments must take into account inventories, accounts receivable, accounts payable, and any other necessary items. (Reg §1.481-1(b)) The adjustments can be positive (increasing taxable income), or negative (decreasing taxable income). (Reg §1.481-1(c)) In computing the net Code Sec. 481(a) adjustment, a taxpayer must take into account all relevant accounts. For example, the Code Sec. 481(a) adjustment for a change in the proper time for deducting salary bonuses (under Code Sec. 461) should reflect any necessary adjustments for amounts of salary bonuses capitalized to inventory under the uniform inventory inclusion and capitalization rules (see III.A.2.). (Rev Proc 2009-39, 2009-38 IRB)

Generally speaking, the Code Sec. 481(a) adjustment required as a result of an accounting method change must be taken into account in the year of change—i.e., the first tax year in which the taxpayer's method of accounting is different from that used in the previous tax year. (Code Sec. 481(a); Reg §1.481-1(a)(1)) However, the Code Sec. 481(a) adjustment period for voluntary accounting method changes, including automatic consent changes is one tax year for negative adjustments and four tax years for positive adjustments beginning with the year of change. Taxpayers may elect to account for a positive adjustment in the year of change if it's less than $25,000.

A special rule applies to high-impact Code Sec. 481(a) adjustments. Where the adjustments increase taxable income of the change-over year by more than $3,000, the taxpayer can compute his or her tax for that year using whichever of these two methods produces the lower tax:

(1) *Three-year allocation*—The tax that would have resulted if one-third of the increase had been included in taxable income in each of the two preceding years and in the change-over year. (Code Sec. 481(b)(1); Reg §1.481-2(a))

(2) *Allocation of specific years under new method of accounting*—Where the taxpayer establishes his or her taxable income under the new method of accounting for one or more tax years consecutively preceding the year of change (in which the old method was actually used), the tax is reduced to the amount that would have been paid if:

a the tax for the preceding years was figured under the new method, and

b the then remaining adjustments were allocated to the change-over year. (Code Sec. 481(b)(2); Reg §1.481-2(b))

C. Inventories

Where producing, buying or selling merchandise is an income-producing factor, inventories are needed to determine the correct cost of goods sold. Inventories serve to allocate the expense of buying merchandise to the year in which that merchandise is sold.

Inventories must be used whenever IRS finds their use is needed to clearly determine a taxpayer's income. (Code Sec. 471) Generally, this is the case where the "production, purchase or sale of merchandise" is an income-producing factor. (Reg §1.471-1) A taxpayer that must use inventories also must use the accrual method of accounting with respect to its purchases and sales. (Reg §1.446-1) However, IRS has excepted non-tax shelters with average annual gross receipts of $1 million or less from having to account for inventories (see above).

Under the uniform inventory inclusion and capitalization rules (see III.A.2.), certain direct and indirect costs are either included in inventory or capitalized.

1. Goods Included in Inventory

Inventories include all merchandise that is held for sale in the ordinary course of business or that is to become a physical part of merchandise intended for sale. Inventories generally cover finished or partly finished goods as well as raw materials and supplies acquired for sale or that will physically become a part of merchandise intended for sale. For items to be included in inventory, the taxpayer must have title. (Reg §1.471-1) Prescription drugs and similar items administered by healthcare providers are not merchandise.

Merchandise shipped on approval or sold on sample is kept in the seller's inventory until its acceptance. Consigned goods or goods in the hands of others for processing (e.g., dyeing) and returnable in kind are kept in the consignor's inventory. A seller's inventory includes goods he or she has contracted to sell but not yet segregated and applied to the contract, while a buyer's inventory includes merchandise in transit or that for other reasons hasn't been reduced to possession but to which he or she has title. But a buyer does not include in inventory goods ordered for future delivery.

Containers that are to be sold with the merchandise they contain should be included in the seller's inventory, regardless of whether they are returnable. If the containers are merely leased or loaned with a deposit received to guarantee the return, they aren't included in inventory since they aren't part of the merchandise held for sale. In that case they can be inventoried at cost the same as supplies, considered as fixed assets and depreciated, or, if they have a useful life of less than a year, currently deducted.

Under the latest IRS rules, rotable spare parts (parts that can be re-serviced or repaired and used repeatedly) can be treated as depreciable assets, rather than inventory, provided certain requirements are met. The IRS has issued a revenue procedure providing a safe harbor method of accounting to treat rotable spare parts as depreciable assets. [Rev. Proc. 2007-48, 2007-29 I.R.B. 110]

Review Question 9

Which of the following items is **not** included in the seller's inventory?

a. Merchandise shipped to a buyer on approval.

b. Merchandise in transit to a buyer who has paid in full.

c. Merchandise ordered by a buyer for future delivery.

d. Consigned goods.

2. Valuing Inventory

The two most commonly recognized bases of valuing inventories are: (1) cost, and (2) cost or market, whichever is lower. (Reg §1.471-2(c)) Consistency from year to year in whatever inventory procedure is adopted is of first importance. (Reg §1.471-2(b))

Any goods in inventory that are unsaleable at normal prices or in the normal way because of damage, imperfections, style changes, etc., can at the taxpayer's option be written down—that is, valued at selling prices less direct costs of disposition, whether the cost or the lower of cost or market method is used. If the goods consist of raw materials or partly finished goods held for use or consumption, they must be valued upon a reasonable basis, considering the usability and condition of the goods, but in no case at less than scrap value. (Reg §1.471-2(c)) Selling price means the actual price at which goods are offered for sale during a period ending not later than 30 days after the date of inventory. (Reg §1.472-2(c))

Cost method. The cost of goods on hand at the start of an accounting period is the amount at which they were valued in the closing inventory of the preceding period. (Reg §1.471-3(a))

The cost of the goods purchased ordinarily is the invoice price reduced by trade or other discounts. Strictly cash discounts approximating a fair interest rate may be deducted at the option of the taxpayer if the method is consistently followed. (Reg §1.471-3(b)) To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. (Reg §1.471-3(b))

The costs of goods produced by the taxpayer include, in addition to the opening inventory, cost of raw materials and supplies entering into or consumed in manufacture, regular and overtime direct labor costs, and the indirect costs required to be included under the "full absorption" method. (Reg §1.471-3(c))

To find the cost of each item, a taxpayer may use the specific identification method by which goods are matched with their invoices (less appropriate discounts). But where it isn't possible or practicable to identify each item of inventory with its cost, an assumption must be made to determine which items were sold and which remain in inventory.

Two methods of costing intermingled merchandise are specifically approved: (1) the "first-in, first-out" (FIFO) method and (2) the "last-in, first-out" (LIFO) method. However, any method that comes within the best accounting practice of the particular business and clearly reflects income is acceptable. Two permissible cost identification methods are averaging the cost of each type or grade of goods in the inventory, and mainly relying on the taxpayer's accounting records to arrive at the correct inventory value. The base stock method (the assumption that a certain portion of inventory will be maintained from year to year and therefore need not be revalued) isn't permitted.

Under the FIFO method, the cost of goods that are so intermingled they cannot be identified with specific invoices is considered to be the cost of goods most recently purchased or produced. (Reg §1.471-2(d)) Thus, under FIFO, the first inventory purchased is treated as the first sold.

Under the LIFO method of inventory valuation, the most recently purchased merchandise is treated as the first sold. (Code Sec. 472(b)(1)) LIFO may generally be used only where inventory is valued at cost. (Reg §1.472-2(b)) If a taxpayer has written down inventory to a lower market value, the difference between that value and cost must be restored to income ratably over a three-year period (beginning with the year of the election to LIFO). (Code Sec. 472(d)) In order to use LIFO for tax purposes, the enterprise must also use LIFO in its reports to partners, stockholders, etc., and for credit purposes. (Code Sec. 472(c))

Under the "dollar value" LIFO method a taxpayer who deals in a large variety of products may value inventory by the use of the dollar value rather than natural units. The assumption is that items in the inventory are homogeneous. The taxpayer is therefore required to break up the inventory into a series of "pools"—the natural business unit pool or multiple pools. (Reg §1.472-8) Any taxpayer electing to use the dollar-value LIFO method can elect to compute an inventory price index in accordance with the Inventory Price Index Computation (IPIC) method (Reg §1.472-8(e)(3)(ii)) The IPIC method allows inventory price indexes to be computed with reference to consumer or producer price indexes published by the United States Bureau of Labor Statistics

An eligible small business may elect to use a simplified dollar-value method of pricing inventories for purposes of the LIFO method. Under the method, the cost of each grade of goods is averaged.

(Code Sec. 474(a)) An eligible small business is a taxpayer whose average annual gross receipts don't exceed $5,000,000 for the three-tax-year period ending immediately before the tax year. (Code Sec. 474(c))

Retailers can value each item of merchandise in stock at the end of the year at its retail selling price but adjusted to approximate cost by eliminating the average percent of markup. (Reg §1.471-8(a)) This retail inventory method may be used in conjunction with FIFO and specific identification methods, as well as LIFO, if the taxpayer adjusts his or her selling price for both markups and markdowns. (Reg §1.471-8(g)) Price change adjustments are determined by reference generally to U.S. Bureau of Labor Statistics price indexes. (Reg §1.472-1(k))

Lower-of-cost-or-market method. Under this method, market value on the inventory date is compared with the cost of each item. The lower of the two is the inventory value of the item. Total inventory is the aggregate of the inventory values so computed for each item in the inventory. It is not the lower of the total cost or total market value of all items. (Reg §1.471-4(c))

Market value normally means the current bid price prevailing at the inventory date for the particular merchandise in the volume usually purchased by the taxpayer. Market price is applied to: (1) goods purchased and on hand, and (2) the basic elements of cost (materials, labor and overhead) of goods in process of manufacture and of finished goods on hand. (Reg §1.471-4(a))

Market price may not be applied to goods on hand or in process if the merchandise is covered by a firm sales contract at fixed prices (i.e., not legally subject to cancellation by either buyer or seller). If, under the contract, the taxpayer is protected against actual loss, the goods must be inventoried at cost with no deduction for inventory decline. (Reg §1.471-4(a)) Moreover, goods covered by firm sales contracts at the end of the year must be valued at cost even though the contracts are cancelled after the close of the year at the customer's request. If the contract gives the seller an almost certain loss, IRS says the seller isn't allowed to write the inventory down but must value it at cost, thus taking the loss when actually realized (Reg §1.471-4(a)), but some courts disagree.

A taxpayer may write down inventory below market if in the regular course of business he or she has offered for sale such merchandise at below-market prices. (Reg §1.471-4(b))

If no market exists, or if quotations are nominal because of an inactive market, the taxpayer must use whatever evidence of a fair market price at the date or dates nearest his or her inventory date as may be available, such as specific purchases and sales made by the taxpayer or others in reasonable volume and in good faith, or compensation paid for cancellation of contracts for purchase commitments. (Reg §1.471-4(b))

Change in valuation method. A change in the method of valuing inventory, with the exception of a change to LIFO and to certain specialized LIFO methods, requires IRS approval. This includes adoption of either: (1) cost, or (2) cost or market, whichever is lower, where the taxpayer has been on a different basis, and changes to and from the various methods of determining inventory costs. (Reg §1.446-1(e)) An automatic consent procedure also applies for certain taxpayers changing from LIFO.

III. Business Expenses

Learning Objectives

After completing this section, you should be able to:

- Distinguish between ordinary and necessary business expenses and capital expenses;
- Identify expenses required to be inventoried or capitalized under the uniform capitalization rules;
- Delineate the tax treatment of business start-up and organization expenses;
- Recognize when payments, awards and reimbursement to employees qualify for deductions;
- Determine when and how to claim deductions for business rent, interest, taxes, charitable contributions, and other payments;
- List the special tax rules governing travel and entertainment expenses; and
- Apply the deduction for manufacturing/production activities.

Business taxpayers can deduct ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. (Code Sec. 162(a))

An expense is *ordinary* if it's customary or usual in the taxpayer's business. But an unusual expense may be ordinary if it's reasonably related to the taxpayer's trade or business.

A *necessary* expense is one that's appropriate and helpful in developing and maintaining the taxpayer's business. It need not be essential or indispensable. Usually the taxpayer's judgment as to what's necessary will be accepted.

To be deductible as a business expense, an item must be directly connected with or pertain to a trade or business carried on by the taxpayer. (Code Sec. 162(a); Reg §1.162-1(a)) A trade or business need not be the taxpayer's principal occupation; a sideline can qualify.

A deductible expense must be an expense of the taxpayer's business. Expenses incurred on another's behalf aren't deductible. For example, a corporation's payment of the personal expenses of its shareholders isn't deductible. Similarly, payment by a corporation of the personal expenses of its officers and employees isn't deductible, except to the extent the payment represents reasonable compensation or is made for business reasons to provide benefits to employees in general.

On the other hand, if a taxpayer pays the debts or other obligations of someone else, the payment may or may not qualify as a business expense. Deductions have been allowed where the payment of another's obligation is made for a good business reason, e.g., to preserve sales-force morale and customer goodwill; to reestablish or protect credit standing; to avoid loss of business patronage, etc.

The IRS will routinely disallow deductions for business expenses that are not substantiated. However, if a taxpayer's records or other proof aren't adequate to substantiate expense deductions, a court may allow the taxpayer to deduct an estimated amount under the Cohan rule. But the deduction may be for much less than the taxpayer spent, since the court in making an estimate may bear heavily upon a taxpayer whose inexactitude is of his or her own making. Moreover, the Cohan rule doesn't apply to deductions for certain expenses such as travel or entertainment expenses, listed property, or business gifts.

A. Ordinary vs. Capital Expenses

1. General Rules

Unlike ordinary expenses, capital expenditures generally can't be deducted except through depreciation, expensing, depletion, or amortization deductions. Capital expenses that cannot be deducted are added to the basis of property and recovered when the property is sold.

A capital expenditure differs from a deductible expense because the anticipated benefit of the capital expenditure extends beyond the tax year.

Capital expenditures include amounts paid or incurred to add to the value, or to substantially extend the useful life, of property owned by the taxpayer. (Code Sec. 263; Reg §1.263(a)-1)

Examples of capital expenditures include:

- Original cost of getting a business license that's good or renewable for an indefinite period.
- Initiation fees or initial admission fees paid for business association and similar memberships.
- Costs incurred by a corporation related to the issuance, redemption and sale of its stock.
- Installation costs of purchased machinery, equipment, etc., including labor, material and freight charges. But costs of retiring and removing old depreciable assets in connection with the installation or production of replacement assets don't have to be capitalized.
- Costs, other than interest, incurred to borrow funds and other finance costs are capital expenditures to be amortized over the life of the loan. (For capitalization of interest on produced property, see below.) This applies to commissions and other fees paid to get a loan; costs of issuing bonds, including legal fees and printing costs; and finder's fees and commissions paid by a lender to get borrowers.
- Payments made to acquire the goodwill of a business, including payments for the use of an individual's name in a business bought from him; the cost of acquiring a dealer's franchise; and the cost of acquiring customer lists.

Review Question 10

Which of the following are solely examples of costs that must be capitalized?

a. Original cost of getting a business license, cost of a trip to a customer's location, costs incurred by a corporation related to the issuance of its stock.

b. Initiation fees paid for business association, rent paid for occupancy of a business premises, interest paid on a business loan.

c. State income tax payments, payments made to acquire the goodwill of a business, cost of acquiring a dealer's franchise.

d. Installation costs of purchased machinery, commissions paid to get a business loan, costs incurred by a corporation related to the redemption of its stock.

Special uniform capitalization (UNICAP) rules apply to property produced by a taxpayer and to property acquired for resale (see below). (Code Sec. 263A(b)(2)(A)). The tax law's general capitalization requirements apply only to the extent they do not conflict with the UNICAP rules.

Some taxes and carrying charges that would normally be deducted currently or amortized may be capitalized if the taxpayer so elects. For depreciable property this has the effect of deferring the deduction to later years as depreciation. For non-depreciable property, such as unimproved real estate, the capitalized expenses increase basis and serve to reduce gain (or increase loss) on a later sale of the property. (Code Sec. 266; Reg §1.212-1(n); Reg §1.266-1) However, taxpayers can elect to capitalize interest under Code Sec. 266 only after applying the uniform capitalization rules for interest under Code Sec. 263A (see below).

2. Uniform Capitalization Rules

A taxpayer must (1) include in inventory costs the "allocable costs" of "property" that is inventory (Code Sec. 263A(a)(1)(A)), and (2) capitalize the allocable costs of any other property. (Code Sec. 263A(a)(2)(B))

The *allocable* costs are:

- the direct costs of the property (Code Sec. 263A(a)(2)(A));
- the indirect costs, to the extent of the property's proper share of that part (or all) of the costs. (Code Sec. 263A(a)(2)(B))

Allocable costs include all depreciation deductions with respect to the taxpayer's assets. Interest is an allocable cost, but only where the underlying debt was incurred or continued to finance certain produce property (see below). Taxes are allocable indirect costs. (Code Sec. 263A(a)(2)(B))

Allocable costs don't include:

- selling, marketing, advertising and distribution expenses (Reg §1.263A-1(e)(3)(iii)(A));
- any amounts allowable as a deduction under Code Sec. 174 for research and experimental expenditures (Code Sec. 263A(c)(2));
- any cost to the extent allowable as a deduction under Code Sec. 263(c) (intangible drilling and development costs), Code Sec. 616(a) (mining development expenses), or Code Sec. 617(a) (mining exploration expenses) (Code Sec. 263A(c)(3));
- any qualified creative expense incurred by a "writer," "photographer," or "artist" that would otherwise be deductible. Expenses related to printing photographic plates, motion picture films, video tapes or similar items aren't qualified creative expenses (Code Sec. 263A(h));
- "deductible service costs." (Reg §1.263A-1(e)(3)(iii)(K))

What is property? A taxpayer must include in inventory or capitalize the allocable costs with respect to:

- real or tangible personal property that the taxpayer produced (Code Sec. 263A(b)(1));
- real or personal Code Sec. 1221(1) property—inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business—that the taxpayer acquired for resale. (Code Sec. 263A(b)(2)(A))

Tangible personal property includes a film, sound recording, video tape, book or similar property. (Code Sec. 263A(b))

A taxpayer "produces" tangible property if it constructs, builds, installs, manufactures, develops or improves it. (Code Sec. 263A(g)(1)) Where a taxpayer makes progress or advance payments to a contractor, the taxpayer is treated as producing any property the contractor produces for the taxpayer under the contract to the extent of those payments (whether paid or incurred by the taxpayer under the contract or otherwise). (Code Sec. 263A(g)(2))

Property acquired for resale includes intangible as well as tangible property.

"Property" doesn't include (and therefore allocable costs don't have to be capitalized with respect to):

- Any property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit. (Code Sec. 263A(c)(1))
- Any property produced by the taxpayer under a long-term contract (Code Sec. 263A(c)(4)) except for certain home construction contracts. (Code Sec. 460(e)(1))
- Timber and certain ornamental trees. (Code Sec. 263A(c)(5)(A))
- Personal property acquired for resale by certain taxpayers with average annual gross receipts of $10,000,000 or less. (Code Sec. 263A(b)(2)(B))

Review Question 11

Which of the following costs have to be inventoried or capitalized under the uniform capitalization rules?

a. Labor costs connected with timber production.

b. Selling, marketing, advertising and distribution expenses.

c. Labor costs connected with the production of a motion picture.

d. Interest on a mortgage on a store that holds goods for resale.

Cost allocation. Allocable costs must be allocated to inventory or capitalized according to the following rules:

- Direct labor costs are generally allocated by using a specific identification ("tracing") method (Reg §1.263A-1(g)(2)), but any reasonable method may be used. (Reg §1.263A-1(f)(4))
- Indirect costs should be allocated to particular production, resale, etc., activities using either a specific identification ("tracing") method; the standard cost method; or a method using burden rates, such as ratios based on direct costs, hours, or other items, or similar formulas, so long as the method employed reasonably allocates indirect costs among activities. (Reg §1.263A-1(g)(3))

Taxpayers who acquire and hold property for resale (such as retailers and wholesalers) may elect a simplified resale method to determine the additional costs properly allocable to the resale property. (Reg §1.263A-3(d))

For the application of the uniform capitalization rules to farmers and ranchers, see Module 3, *Specialized Tax Issues.*

Review Question 12

Which of the following is **not** a true statement regarding the uniform capitalization rules?

a. Direct labor costs are generally allocated by using a specific identification ("tracing") method.

b. Allocable costs include any amounts allowable as a deduction under Code Sec. 174 for research and experimental expenditures.

c. Taxpayers who acquire and hold property for resale may elect a simplified resale method to determine the additional costs properly allocable to the resale property.

d. The uniform capitalization rules do not apply to property produced by the taxpayer under a long-term contract except for certain home construction contracts.

3. Interest Capitalization Rules

Under the uniform capitalization rules, interest that is paid or incurred during the production period of property produced by a taxpayer and that is allocable to the property must be capitalized if:

- the property has a long useful life (Code Sec. 263A(f)(1)(B)(i));
- the property has an estimated production period exceeding two years (Code Sec. 263A(f)(1)(B)(ii)); or
- the property has an estimated production period exceeding one year and a cost exceeding $1,000,000. (Code Sec. 263A(f)(1)(B)(iii); Reg §1.263A-8(b)(1))

The taxpayer must also capitalize any interest on debt allocable to an asset needed to produce the above property. (Code Sec. 263A(f)(3); Reg §1.263A-8(a)(2)) A taxpayer must capitalize interest whether the property is produced for the taxpayer's own use or for sale.

The "production period" with respect to any property begins on the date production of the property begins. (Code Sec. 263A(f)(4)(B)(i)) The production period ends the date the property is ready to be placed in service or is ready to be held for sale. (Code Sec. 263A(f)(4)(B)(ii))

Property has a "long useful life" if it is real property or property with a class life of 20 years or more. (Code Sec. 263A(f)(4)(A)(ii); Reg §1.263A-8(b)(1)(ii)(A))

Interest isn't capitalized with respect to real or personal property acquired solely for resale.

Allocating interest to produced property. Interest is allocable to property a taxpayer produces if the taxpayer incurred or continued the underlying debt to finance the construction or production of the property.

A taxpayer is treated as having incurred or continued debt to finance the production of property: (1) where the debt can be specifically traced to production expenditures, and (2) where the debt can't be so traced, but where production or construction expenditures exceed the debt that is directly traceable. (Reg §1.263A-9(a)(2))

The interest on the debt incurred or continued to finance production is allocated to the property produced as follows:

- interest (other than qualified residence interest) on a debt that is directly attributable to production expenditures with respect to the produced property is assigned to that property; (Code Sec. 263A(f)(2)(A)(i); Reg §1.263A-9(a)(2)(i)(A)), and
- interest on any other debt is assigned to the produced property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to the directly allocable debt) had not been incurred (Code Sec. 263A(f)(2)(A)(ii); Reg §1.263A-9(a)(2)(i)(B)) (that is, had the expenditures that were incurred for construction been used instead to repay the debt).

B. Start-up and Organizational Expenses

Taxpayers embarking on a new business venture frequently incur a myriad of expenses long before the business is up and running. These expenses may include start-up expenses incurred in investigating business prospects and getting the business off the ground. They may also include organizational expenses required to officially create the business.

1. Start-up Expenses

A taxpayer can elect a current deduction for up to $5,000 of start-up expenditures in the tax year in which the trade or business begins. However, this $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of startup expenditures exceeds $50,000. (Code Sec. 195(b)(1)(A)) The remainder of the start-up expenditures are deductible ratably over a 180-month period beginning with the month in which the active trade or business begins. (Code Sec. 195(b)(1)(B))

Start-up expenses are amounts paid or incurred in connection with:

- investigating the creation, acquisition, or establishment of an active trade or business (Code Sec. 195(c)(1)(A)(i));
- creating an active trade or business (Code Sec. 195(c)(1)(A)(ii)); or
- any activity engaged in for profit and for the production of income before the day the active trade or business begins in anticipation of that activity becoming an active trade or business. (Code Sec. 195(c)(1)(A)(iii))

The expenditure must be one that, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the taxpayer's new business), would be deductible for the year in which paid or incurred. (Code Sec. 195(c)(1)(B))

Common start-up expenses include:

- pre-opening advertising costs;
- salaries and wages paid to employees and their instructors for training;
- travel and related expenses incurred in the course of finding potential distributors, suppliers and customers;
- salaries and fees paid to executives and consultants, as well as for professional services.

The IRS has issued final regs that eliminate the need to make a formal election to deduct start-up expenses. Instead, taxpayers are deemed to have made the appropriate election for the year in which the active trade or business begins. A taxpayer may irrevocably choose to forgo the deemed election by clearly electing to capitalize its starts or organizational expenses on a timely filed Federal income tax return (including extensions) for the tax year in which the active trade or business begins. (Reg. §1.195-1)

Review Question 13

Which of the following is a true statement regarding the tax treatment of start-up expenses?

a. The phase-out threshold for start-up expenses is $5,000.

b. A formal election must be made with the IRS to deduct start-up expenses.

c. Pre-opening advertising expenses qualify as amortizable start-up expenses.

d. The amortization period for start-up expenses is 160 months.

2. Organization Expenses

A corporation or partnership can elect a current deduction for up to $5,000 of organizational expenditures. (Code Sec. 248(a)(1). Code Sec. 709(b)(1)) However, this $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of organizational expenditures exceeds $50,000. The remainder of the organizational expenditures can be claimed as a deduction ratably over a 15-year period. ((Code Sec. 248(a)(2)); Code Sec. 709(b)(1)(B))

In the case of a corporation, organizational expenditures are those which are: (1) directly incident to the creation of the corporation, (2) chargeable to the corporation's capital account, and (3) of a type which, if incurred to set up a limited life corporation, could be amortized over that limited life.

Corporate organizational expenditures include:

- legal services incident to the organization of the corporation, i.e., drafting the corporate charter, bylaws, minutes of organizational meetings, terms of original stock certificates;
- necessary accounting services;
- expenses of temporary directors and of organizational meetings of directors or stockholders;
- fees paid to the state of incorporation (expenses of qualifying to do business in states other than the state of incorporation, however, are deductible expenses).

In the case of a partnership, organizational expenses are costs which are: (1) incident to the creation of the partnership, (2) chargeable to capital account, and (3) of a character which, if spent incident to the creation of a partnership having an ascertainable life, would be amortized over that life.

Partnership organizational expenses include:

- legal fees for services incident to the organization of the partnership, e.g., fees for negotiation and preparation of a partnership agreement;
- accounting fees for services incident to the organization of the partnership; and
- filing fees.

The election to deduct organization expenses is made by the partnership, not by individual partners, and the $5,000 limit is applied at the partnership level. (Code Sec. 709(b)(1))

As with start-up expenses (see above), the IRS has issued regulations that eliminate the need to make a formal election to deduct organizational expenses. (Reg. §1.248-1)

Review Question 14

Which of the following is a true statement regarding the tax treatment of organization expenses?

a. No amortization is allowed for expenses incurred in organizing a partnership.

b. A corporation or partnership can elect a current deduction for up to $10,000 of organizational expenditures.

c. A corporation with $60,000 of organization expenses can currently deduct $5,000 of the expenses and amortize the other $55,000 of expenses.

d. Organization expenditures are amortizable over 15 years.

3. Unsuccessful Business Investigations

A corporation that makes expenditures in fruitlessly searching for or investigating a new venture may deduct the expenses as a loss when it abandons the effort.

A non-corporate taxpayer not engaged in the business of locating or promoting new ventures can’t deduct expenditures made in fruitlessly searching for or investigating a new venture. However, once a taxpayer has focused on the acquisition of a specific business or investment, unsuccessful start-up expenses that are related to an attempt to acquire that business or investment are deductible as business or investment losses under Code Sec. 165.

4. Expanding an Existing Business

A taxpayer can deduct certain expenditures made to expand an existing business. The taxpayer must show:

- that the business contemplated and the one already conducted are closely related or “intramural,” and
- that the expenditures are ordinary and necessary expenses of the business conducted when the expenses were incurred, and not capital expenditures.

However, expansion costs must be capitalized if they provide the taxpayer with long-term benefits, create separate and distinct assets, or relate to a change in the nature of the taxpayer’s activities (e.g., a wholesaler opening a retail outlet).

C. Compensation

Reasonable amounts that are paid or incurred in connection with a trade or business as compensation for personal services actually rendered are deductible as trade or business expenses. (Code Sec. 162(a)(1)). Deductible compensation includes amounts paid to independent contractors, as well as employees. Payments for fringe benefits are deductible as compensation, subject to some limits (see below). A parent can deduct reasonable wages paid to an unemancipated minor child for personal services actually rendered as a bona fide employee in the business.

An employer’s payment of an employee’s debts or personal expenses is compensation to the employee and deductible as compensation by the employer (if reasonable), just as if the employee had been paid directly and the employee had used the money to pay his or her debts or expenses.

No deduction is allowed for payments by the taxpayer for services rendered to someone other than the taxpayer—for example, payments by a shareholder to employees of the corporation for services to the corporation, or by a corporation to its officers for services to subsidiaries and related corporations, or by a corporation to employees of a sub. But compensation paid by a parent corporation to its own executives for supervising the operations of a sub is deductible by the parent as an expense of the parent's business.

Compensation payments that result in the acquisition of property or rights that have value or are useful to the business must be added to the basis of the property. Thus, capitalization has been required for payments for services in organizing and incorporating a company; in acquiring valuable property, or in negotiating the sale of a company.

Payments that are purportedly compensation may in reality be the purchase price of property. If so, no expense deduction is allowed. This may arise when a business or other property is bought and the former owner agrees to continue to perform services. If the payments for services are reasonable in relation to the services rendered, they are deductible. But if the payments are excessive, a part may be considered payment for the purchase price of the property.

Review Question 15

Which of the following payments are **not** currently deductible as compensation?

1. Payments to an unemancipated minor child by a parent-employer.
2. Payments by a shareholder to employees of the corporation.
3. Payments by a corporation for services rendered in helping organize a corporation.
4. Payments of an employee's debts by an employer.

a. 1 and 2 only b. 2 and 3 only
c. 3 and 4 only d. 1, 2 and 4 only

1. Reasonableness of Compensation

Compensation is deductible only to the extent it's *reasonable*. Compensation paid to employee-shareholders also must be paid purely for services, or have a purely compensatory purpose, in order to be deductible. (Code Sec. 162(a)(1))

The question of reasonableness rarely arises unless the payments are made to a person "related" to the taxpayer—that is, to the members of an employer's family, to stockholders of the employer corporation, or to members of a stockholder's family.

The unreasonable portion of compensation is nondeductible. If the recipient is a shareholder, the unreasonable portion may be treated as a dividend. (Reg §1.162-7(b)(1))

Reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises under like circumstances. (Reg §1.162-7(b)(3)) Other factors determining reasonableness include:

- duties performed by the employee;
- character and amount of responsibility;
- amount of time required;
- ability and achievements of the employee;
- volume of business handled by the employee;
- complexities of the business;
- relationship of compensation to gross and net income of the business;
- living conditions in locality;
- compensation history of the employee; and
- salary policy as to all employees.

The Seventh Circuit applies a single independent-investor test in evaluating whether a stockholder-employee's pay is reasonable (i.e., would an outside investor have paid the compensation amount based on performance). Other courts employ the independent-investor test in conjunction with an analysis of the above factors.

The test of whether compensation is reasonable is normally applied to the compensation paid to the particular individual and not to the total compensation paid to a group of employees. Services rendered in earlier years can be taken into account in determining the reasonableness of compensation paid during the current year.

Reasonableness of compensation for part-time services is determined under the usual reasonableness rules. Generally, salaries that are reasonable for an employee's full-time services aren't reasonable for his or her part-time services.

2. Year for Deducting Compensation

The employer deducts compensation in the year allowed under its cash or accrual accounting method see II.B), subject to special deduction timing rules for certain types of compensation.

If salary is paid or accrued in one year for services to be rendered in a later year, the deduction is allowed only over the period during which the services are rendered. This applies to both cash and accrual basis employers.

3. Payment in Property Other than Cash

The deduction for compensation paid in property, including a bargain sale and including restricted property, is the amount included in the income of the person who performed the services, to the extent the compensation is reasonable. (Code Sec. 83(h)) The "amount included" in income is the amount reported by the service provider on an original or amended return, or included in income as a result of an IRS audit. It includes excluded group-term life insurance and foreign income. (Reg §1.83-6(a)(1))

Under a "deemed inclusion rule," however, a deduction may be taken by an employer (service recipient) if it timely complies with the applicable information reporting requirements. Thus, an employee is deemed to have included the property received in income, and a deduction can be claimed by the employer if the employer timely satisfies the Code Sec. 6041 or Code Sec. 6041A requirements (Reg §1.83-6(a)(2) by timely reporting the transaction to the service provider and federal government on Form W-2 or Form 1099-MISC, whichever applies. If this rule isn't satisfied, an employer must demonstrate that the compensation amount deducted was actually included in the service provider's income.

The deemed inclusion rule can be used where the service provider is a corporation by issuing Form 1099-MISC even though there would otherwise be a general reporting exemption for a service provider that's a corporation. (Reg §1.83-6(a)(2))

If a transfer is less than $600 in any tax year (in which case the reporting requirements don't apply), or if the transfer is eligible for any other reporting exemption (applicable to a non-corporate service provider), no Form 1099 reporting is required in order for the service recipient to rely on the deemed inclusion rule.

In addition, to be deductible a transfer can't be a capital expenditure, a deferred expense, or part of inventory. (Reg §1.83-6(a)(4))

If payment is in employer stock, no gain or loss results. (Code Sec. 1032) If payment is in property other than the employer's stock, and the value of the property exceeds the employer's basis for the property, the excess is income to the employer (capital gain or ordinary income, depending on the character of the property used). (Reg §1.83-6(b)) The employer has a loss deduction where the basis of the property exceeds its fair market value (subject to related-taxpayer restrictions on losses).

The deduction is allowed for the tax year of the employer in which, or with which, the employee's tax year ends. (Code Sec. 83(h))

Review Question 16

XYZ Incorporated transfers outright 10 shares of stock in ABC Incorporated to John Smith, an XYZ employee, as compensation for services rendered. XYZ purchased the shares for $75 per share and the fair market value at the time of the transfer is $100 per share. Which of the following is a true statement?

a. XYZ gets no compensation deduction for the transfer.

b. XYZ recognizes no gain or loss on the transfer.

c. XYZ recognizes a $250 loss on the transfer.

d. XYZ recognizes a $250 gain on the transfer.

4. Deferred Compensation

An employer's contributions to a nonqualified deferred compensation plan are deductible in the tax year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan (Code Sec. 404(a)(5)), even if the employer is an accrual basis taxpayer.

For rules governing the inclusion of nonqualified deferred compensation in income of an employee, see Module 3, *Specialized Tax Issues*.

Benefits provided under a welfare benefit fund (Code Sec. 404(b)(2)(B)), and payments of bonuses or other amounts within 2½ months after the close of the tax year in which significant services required for payment have been performed (Reg §1.404(b)-1T, Q&A-2(c)), aren't treated as deferred compensation.

To determine whether compensation is deferred compensation, and when deferred compensation is paid, no amount is treated as paid or received until it's actually received by the employee. (Code Sec. 404(a)(11)

5. Bonuses

A cash basis employer deducts bonuses only for the year in which the bonuses are actually paid.

Bonuses by an accrual basis taxpayer are deductible in the tax year when all the events have occurred that establish the fact of liability to pay the bonus, the amount can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability (see II.B.2). (Reg §1.461-1(a)(2)(i))

To deduct a year-end bonus in the accrual year rather than the actual payment year an employer must pay the bonus within a brief period of time after the close of the employer's tax year. If an employer pays bonuses within 2½ months after the close of the tax year, then a deduction for the bonuses won't be subject to the deferred compensation rules (see above), which would bar the deduction until the bonus is included in the employee's income. (Reg §1.404(b)-1T) Payment after 2½ months is presumed to be deferred compensation, and that presumption can only be rebutted by showing that: (1) it was either administratively or economically impossible to avoid a later payment, and (2) as of the end of the employer's tax year, the impracticability was unforeseeable. (Reg §1.404(b)-1T)

6. Vacation Pay

Cash basis employers take a deduction when the vacation pay is paid in accordance with the general rules for cash basis employers (see II.B.1). For an accrual basis employer, vacation pay earned during any tax year but not paid on or before 2½ months after the end of the tax year is deductible for the tax year of the employer in which it's paid. (Code Sec. 404(a)(5))

7. Deduction Limit for Certain Compensation

A publicly held corporation can't deduct applicable employee remuneration in excess of $1,000,000 per year paid to a covered employee. (Code Sec. 162(m)(1)) Covered employees include the principal executive officer (or someone acting in that capacity) and the three highest paid officers (other than the principal executive officer or principal financial officer). (Code Sec. 162(m)(3); Reg §1.162-27(c)(2)) Applicable employee remuneration means a covered employee's aggregate remuneration for services performed (either during the deduction year or during another tax year) which would be deductible entirely for the tax year if the $1 million limit didn't apply. But it doesn't include commissions generated directly by the executive's performance. certain other performance-based compensation, certain grandfathered contracts, qualified plan contributions and certain excludable employee fringe benefits. (Code Sec. 162(m)(4))(E))

The Code Sec. 162(m) deduction limit is reduced to $500,000 for remuneration paid to covered executives (generally, CEO, CFO, and the 3 highest paid other officers) by employers receiving assistance under the Troubled Assets Relief Program (TARP) established by the Emergency Economic Stabilization Act of 2008. (Code Sec. 162(m)(5)) The $500,000 limit remains in effect as long as any obligation arising from TARP financial assistance remains outstanding (with the exception of warrants to purchase common stock); it isn't restricted to employer tax years that include any part of the TARP authorities period, which will end by October 3, 2010 (2008 Economic Stabilization Act Sec. 111(b)(1), Div. A, as amended by 2009 American Recovery and Reinvestment Act Sec. 7001)

8. Fringe Benefits

A fringe benefit is pay for the performance of services that is provided in a form other than a traditional paycheck. For example, an employer provides a fringe benefit when it gives an employee the use of a company car for personal travel or pays for an employee's parking at work.

Where the employer furnishes a non-cash fringe benefit to an employee as compensation, the employer may deduct only the costs it incurs in providing the property to its employees, not the property's value. Where the property is depreciable, the employer is entitled to a depreciation deduction. Where the property is leased by the employer, the employer is entitled to a deduction for the leasing costs as an ordinary and necessary business expense. (Reg §1.162-25T(a))

Furnishing property to an employee for his or her personal use is additional compensation and gives rise to a deduction by the employer. For example, the employer can deduct depreciation and maintenance expenses it pays on a car, house, etc., furnished for an employee's personal use and treated by the employer as compensation. (Code Sec. 274(e)(2))

In some cases, fringe benefits are eligible for favorable tax treatment to employees. See Module 3, *Specialized Tax Issues*.

In other cases, taxable fringe benefits are subject to special rules.

Stock options. In the case of a non-statutory stock option, the employer's deduction is determined under the Code Sec. 83 payment-in-property rules (see above). Therefore, the employer can deduct the amount the employee must include in income on exercise of the option, provided the option has no readily ascertainable value at grant. If the option has a readily ascertainable fair market value, the employer can generally deduct the fair market value at the time of grant under the restricted property rules of Section 83 (see Module 1, *Taxation of Individuals*). The employer isn't allowed a compensation deduction with respect to stock transferred under an incentive stock option or an employee stock purchase plan, unless the employee has income by reason of a disqualified (premature) disposition of the stock. (Code Sec. 421(a); Code Sec. 421(b)) (See Module 1, *Taxation of Individuals*.)

Life insurance, endowment, or annuity contracts. A taxpayer can't deduct premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract. (Code Sec. 264(a)(1)) However, the general bar on deduction of premiums doesn't apply to Code Sec. 72(s)(5) annuity contracts (certain qualified pension plans, retirement annuities, individual retirement annuities and qualified funding assets) or to any annuity contract to which Code Sec.72(u) (annuity contracts held by other than natural persons) applies. (Code Sec. 264(b)(2))

For contracts issued before June 9, 1997, the deduction disallowance only applies to premiums on the life of an officer, employee or any person financially interested in any trade or business carried on by the taxpayer if the taxpayer is directly or indirectly a beneficiary of any part of the policy.

Premiums are deductible as a non-cash fringe benefit where only the insured employee or his or her beneficiaries will get the proceeds.

Premiums on group term life insurance are deductible (if the employer isn't directly or indirectly a beneficiary) even though the employee isn't taxed on group term coverage of $50,000 or less. (See Module I, Taxation of Individuals.)

Health benefits. The employer's payment of health and accident insurance premiums for employees and their families, or the employer's direct payment or reimbursement of actual expenses if under a plan, is deductible. (Reg §1.162-10(a)) Reimbursements are deductible even where the employee is the spouse of a sole proprietor and the medical expenses incurred on behalf of the employee's family include those of the sole proprietor (as the employee's spouse). The IRS treats these amounts as additional compensation deductible by the employer to the extent that, when added to other compensation, the amounts are reasonable.

Welfare benefit plans. An employer's contribution to a "welfare benefit fund" is deductible only for the tax year paid, and only to the extent the contribution doesn't exceed the "qualified cost" of the plan for its tax year that relates to (ends with or within) the employer's tax year. (Code Sec. 419(a); Code Sec. 419(b)) Contributions for independent contractors are also subject to this rule. (Code Sec. 419(g)) The rule, however, doesn't apply to a ten-or-more employer plan if no employer (or related employer) normally contributes more than 10% of total contributions, unless the plan uses experience ratings to determine each employer's contribution. (Code Sec. 419A(f)(6); Reg §1.419A(f)(6)-1(b)(1))

A welfare benefit fund is a fund that is part of an employer's plan through which the employer provides welfare benefits to employees or their beneficiaries, but doesn't include amounts held under certain kinds of insurance contracts. (Code Sec. 419(e); Reg §1.419A(f)(6)-1(b)(4))

Death benefits. Payments to the surviving spouse or other beneficiaries of a deceased employee, such as continuation of the decedent's salary for a reasonable period, are deductible by the employer to the extent they qualify as a business expense. A benefit paid as a gift based on the beneficiary's need doesn't qualify as a business expense. (Reg §1.404(a)-12(b)(2))

Review Question 17

Which of the following is a true statement regarding the deductibility of employee fringe benefits?

a. Contributions to a welfare benefit plan are not deductible by the employer.

b. If an employer grants a non-statutory stock option to an employee, the employer can deduct the value of the option at the time of grant as long as the option has no readily ascertainable fair market value.

c. An employer can't deduct premiums on any life insurance policy if the employer is a beneficiary under the policy.

d. When an employer provides property to an employee as compensation, the employer can deduct the fair market value of the property, not just its cost to the employer.

D. Travel and Entertainment Expenses

Like other business expenses, travel and entertainment expenses are deductible only if they are "ordinary and necessary." However, travel and entertainment expenses are subject to special rules that limit the type and amount of expenses that can be deducted. These expenses are also subject to special substantiation requirements.

1. Travel Expenses

Ordinary and necessary expenses incurred while traveling "away from home" in pursuit of a trade or business are deductible. Those expenses include amounts (other than amounts that are lavish or extravagant) paid for meals (subject to a percentage limit, see below) and lodging. (Code Sec. 162(a)(2))

Deductible business travel expenses include baggage charges; air, rail and bus fares; costs of transporting sample cases or display materials; expenses for sample rooms; costs of maintaining or operating a car, house trailer or airplane; telephone and telegraph expenses; laundry and dry cleaning costs; taxi fares, etc., from the airport or station to the hotel and back or from one customer to another; transportation from where meals and lodging are obtained to the temporary work assignment; and reasonable tips incident to any of the above expenses. (Reg §1.162-2(a)) Travel expenses don't include expenses of the taxpayer's own entertainment.

A travel expense deduction for meals and lodging generally isn't allowed unless a trip takes the individual away from home overnight, or at least long enough to require rest or sleep. The individual need not be away from his or her tax home for an entire 24-hour day or throughout the hours from dusk to dawn if the relief from duty is long enough to get necessary sleep. A layover sufficient only for a short rest and to get a meal isn't "overnight."

Note, however, that the IRS has carved out an exception that allows deductions for local lodging under certain circumstance (see below).

Tax home. An individual's home for travel expense purposes is his or her "tax home"—the individual's principal place of business, employment station, or post of duty, regardless of where his or her family lives.

Where an individual has no principal place of business or employment but continually changes work locations (e.g., a traveling salesperson), the individual's regular residence is his or her "tax home." If a taxpayer has no regular place of abode in a real and substantial sense, he or she has no "tax home" and can't deduct travel expenses.

If an individual regularly works at two or more separate locations, the individual's tax home is the general area of his or her principal employment or business, determined on the facts of the particular case. Important factors are: (1) time spent at each location, (2) business activity at each location, and (3) financial return from each location. Income is the most significant factor. Costs of traveling to and from the minor place of employment, 50% of the cost of meals (see below) at the minor post, and the cost of lodging at the minor post are deductible travel expenses. In rare situations, an individual may have two tax homes.

Certain state legislators may elect to treat their residences in their legislative district (instead of the state capitol) as their tax home. (Code Sec. 162(h))

Assignment away from home. A temporary assignment away from home—an assignment whose termination can be foreseen within a fixed and reasonably short period—doesn't shift the "tax home." Therefore, a deduction is allowed for the necessary traveling expenses in getting to the temporary assignment and for the return trip to the individual's tax home after the temporary assignment is completed, as well as expenses for lodging and 50% of the cost of meals (see below) while the individual is in the place to which he or she is temporarily assigned. If an individual returns home on nonworking days, travel expenses home are deductible, but the travel expense deduction is limited to the amount the individual would have spent to stay at the temporary location.

An individual isn't treated as being temporarily away from home if the period of employment exceeds one year (certain federal employees on crime investigations are exempt from this rule). (Code Sec. 162(a)). The one-year rule generally isn't triggered by short intermittent assignments that span more than one year. Employment away from home at a single location for less than one year is treated as temporary, in the absence of facts and circumstances indicating otherwise. If employment away from home in a single location initially is realistically expected to last for one year or less, but later is realistically expected to exceed one year, then the employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the realistic expectation changes (at which point the employment will no longer be "temporary").

An indefinite assignment away from home shifts an individual's "tax home." No deduction is allowed for the expenses of travel, meals and lodging while in the location of the "indefinite" assignment. Employment is indefinite if it lasts for more than one year, or there is no realistic expectation that the employment will last for one year or less.

U.S. travel for both business and pleasure. Transportation costs to and from a destination are deductible only if the trip is related primarily to business. However, expenses at the destination that are allocable to business are deductible even if the expenses of getting to and from the destination are disallowed because the trip was primarily a pleasure trip. If the trip is primarily for business, but an individual extends his or her stay for personal reasons, makes side trips, or engages in other non-business activities, the deduction for certain expenses, such as lodging and 50% of the cost of meals (see below), is limited to the amount that would have been incurred if the trip had been totally for business. But no allocation is required for transportation costs to and from the business destination. (Reg §1.162-2(b)(1))

Foreign travel for both business and pleasure. As with U.S. trips, if foreign travel is primarily for pleasure, only those expenses directly allocable to business are deductible (see above). But under special rules for foreign travel, even if travel is primarily for business, a portion of the transportation cost is nondeductible if the travel also has a pleasure element. The nondeductible part is computed on a time ratio, usually based on the proportion of non-business days to all travel days.

This allocation and denial of deduction does not apply if: (1) travel is for one week or less; or (2) less than 25% of the total time is spent on non-business activity; (3) the individual traveling had no substantial control over the arranging of the trip; or (4) a personal vacation wasn't a major consideration in making the trip. (Code Sec. 274(c); Reg §1.162-2(b); Reg §1.274-4(f)(5))

As with U.S. trips, the pleasure portion of the meals and lodging costs at the destination is not deductible as a travel expense.

Local lodging. The IRS has provided an exception to the general rule that lodging is deductible only when a business traveler is away from home. Under the exception, an employee can deduct the cost of *local* lodging that is (1) temporary in nature and (2) required by the employer so that the employee can participate in or be available for a bona fide business meeting or function of the employer. If the employer pays for the lodging, it's excludible from the employee's income as a "working condition" fringe benefit [Notice 2007-47, 2007-24 I.R.B. 1393].

Review Question 18

Ann Johnson makes arrangements to fly to Europe on business. Of the total 12 days of her trip, two days are spent sightseeing. Johnson's airfare is $2,400. How much of her airfare can Johnson deduct?

a. Johnson can deduct the full $2,400 airfare.

b. Johnson gets no deduction because she had control over the trip's arrangements.

c. Johnson can deduct 50% of the total $2,400 cost, or $1,200.

Domestic conventions. Travel expenses incurred in attending a domestic convention are subject to the regular business trip rules if attendance will benefit or advance the taxpayer's business or the employee's responsibilities, as distinguished from serving some social, political, or other non-business function. (Reg §1.162-2(d))

Foreign conventions. No business expense deduction is allowed for expenses allocable to a convention, seminar, or similar meeting held outside the North American area (defined below) unless the taxpayer establishes that the meeting is directly related to the active conduct of a trade or business or to an activity relating to the production of income and that, after taking specified factors into account, it's as reasonable for the meeting to be held outside the North American area as within it. (Code Sec. 274(h)(1))

"North American area" means the U.S., its possessions, the Trust Territory of the Pacific Islands, Canada and Mexico. (Code Sec. 274(h)(3)(A)) U.S. possessions include Puerto Rico and the U.S. Virgin Islands. "North American area" also includes Bermuda, Barbados, Costa Rica, Dominica, the Dominican Republic, Grenada, Guyana, Honduras, Jamaica, St. Lucia, Trinidad and Tobago, Antigua and Barbuda.

Cruise ship conventions. A deduction of up to $2,000 per individual per year is allowed for attending business conventions, etc., held aboard a cruise ship, but only if the ship is registered in the U.S. and all ports of call of the cruise ship are located in the U.S. or its possessions. (Code Sec. 274(h)(2)) A married couple filing a joint return can deduct $4,000 if each spent at least $2,000 for attending an otherwise deductible business-related cruise ship convention.

A taxpayer claiming the deduction must attach to the return two specified written substantiation statements (including one signed by the sponsor). (Code Sec. 274(h)(5))

Travel expenses of companion. No deduction is allowed for travel expenses paid or incurred for a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) unless (Code Sec. 274(m)(3)):

- the companion is an employee of the taxpayer,
- the travel of the companion is for a bona fide business purpose, and
- the expenses would otherwise be deductible by the companion, etc.

The limits on deductions for travel companions don't apply to a companion who (1) is a business associate (see below), (2) comes along for a bona-fide business purpose, and (3) could otherwise deduct the expense if he or she incurred it. (Reg §1.274-2(g))

If a spouse accompanies an individual on a business trip and his or her expenses aren't deductible, the deductible expense for transportation and lodging is the single rate cost of similar accommodations for the individual alone. But the full rental for a car in which both spouses travel is deductible, since no part of the expense is attributable to the "extra" spouse.

Luxury water travel. The deduction allowed for travel by ocean liner, cruise ship, or other form of "luxury" water transportation is limited to twice the highest domestic per diem allowance for executive branch U.S. government employees (other than high-ranking executive personnel) multiplied by the number of days of luxury water travel. (Code Sec. 274(m)(1)(A)) If the cost includes separately stated amounts for meals and entertainment, these amounts must be reduced by 50% (see below). The per diem rule doesn't apply to expenses of a cruise-ship convention or seminar to which special rules apply (see above) (Code Sec. 274(m)(1)(B)(i)), or to:

- expenses treated as compensation paid to an employee or otherwise included in the gross income of the recipient;
- reimbursed, accounted-for expenses of the taxpayer where the services are performed for someone else, and if performed for an employer, the reimbursement hasn't been treated as compensation;
- expenses for recreational or social activities primarily for the benefit of employees;
- services and facilities made available by the taxpayer to the general public; and
- services and facilities sold to customers. (Code Sec. 274(m)(1)(B)(ii))

2. Local Transportation Expenses

Transportation expenses (but not commuting expenses) directly attributable to the conduct of a business are deductible even though an individual isn't away from home overnight. (Reg §1.162-1(a)) These expenses (sometimes called local travel expenses) include air, train, bus and cab fares and costs of operating automobiles. If an individual works at two or more places each day, the costs of getting from one place to the other are deductible.

Daily transportation between home and work site. No deduction is allowed for expenses of commuting between an individual's residence and his or her regular business location, wherever situated (Reg §1.162-2(e); Reg §1.162-2(f)), even to a remote area where there's no residential area nearby and no public transportation.

A deduction is allowed for daily transportation expenses incurred in going between an individual's residence and a temporary work location *outside* the metropolitan area where the taxpayer lives and normally works.

Daily transportation expenses incurred in going between an individual's residence and a temporary work location within the same metropolitan area are deductible if one of two conditions exist:

- The individual has one or more regular work locations away from the individual's residence; or
- The individual's residence is the individual's principal place of business.

A work location is "temporary" for purposes of deducting daily transportation costs if employment at the location is realistically expected to last (and in fact does last) for one year or less. If employment at a work location initially is realistically expected to last for one year or less, but at some later date it is realistically expected to exceed one year, that employment is temporary (absent facts and circumstances indicating otherwise) until the date that the realistic expectation changes, and is treated as not temporary after that date.

Where an assignment at a work location is expected to last for more than one year, but the individual is realistically expected to be present at that location *for no more than 35 workdays (partial or complete)* during each of the calendar years in that period, the location is temporary for a calendar year in which the individual actually works there for no more than 35 partial or complete workdays.

Automobile expenses. The expenses of operating and maintaining a car used for business purposes, such as gasoline, oil, repairs, insurance, depreciation (see IV.D. for limits on depreciation), interest on debt incurred to buy the car, taxes, licenses, garage rent, parking, fees, tolls, etc., are deductible. If an individual makes both personal and business use of a car, the expenses must be apportioned between business (deductible) and personal (nondeductible) use.

Employees or self-employed individuals can use the optional business standard mileage rate in computing the deductible costs of operating passenger automobiles owned or leased by them (including vans and pickup or panel trucks) for business purposes. An employee may use the optional business standard mileage rate in substantiating reimbursed expenses paid by an employer (see below).

For 2013, a taxpayer who uses this method multiplies the number of business miles by a rate of 56.5¢. (Notice 2012-72, 2012-50 IRB 673)

A deduction using the standard mileage rate is in lieu of deducting operating and fixed costs. Thus, a taxpayer who uses the standard mileage rate forgoes deductions for depreciation (or leasing costs), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and registration fees. But deductions for parking fees and tolls are still available.

Use of the standard mileage rate isn't available if an auto is used for hire (e.g., as a taxi) or for five or more autos that are used simultaneously, such as in fleet operations; nor is it available for a purchased car if it has previously been depreciated using any method other than the straight-line method, or if a Code Sec. 179 expensing deduction has been claimed. The standard mileage rate may be used for a leased auto only if the taxpayer uses this method for the entire lease period (including renewals).

3. Entertainment Expenses

Costs incurred for entertainment must meet strict tests in order to be deductible. A 50% deduction rule also generally limits otherwise allowable deductions for meals and entertainment.

Entertainment expenses (subject to limitations and substantiation requirements discussed below) are deductible if they are ordinary and necessary expenses of carrying on a trade or business. (Code Sec. 274(a); Code Sec. 274(e); Reg §1.162-1(a)) But no deduction is allowed unless the taxpayer can show that the entertainment expenses are: (1) "directly related" to the active conduct of a trade or business, (2) "associated with" the active conduct of a trade or business, or (3) covered by a special exception. (Code Sec. 274(a))

"Entertainment" includes any activity generally considered to be entertainment, amusement or recreation. This covers entertaining guests at night clubs, theaters, sporting events, and at entertainment facilities such as yachts, country clubs, hunting lodges, etc. If the expense involves the use of an entertainment facility special rules apply. (Reg §1.274-2(b)(1))

Expenses of entertaining customers or clients at home may be ordinary and necessary. But only the extra expense incurred because they are present is deductible. Failure to show a business purpose for entertaining bars a deduction.

A "business associate" who may be entertained is a person with whom the taxpayer could reasonably expect to engage or deal with in the active conduct of a trade or business. Examples are customers, suppliers, clients, employees, agents, partners, or professional advisors, whether established or prospective. (Reg §1.274-2(b)(2)(iii))

The cost of entertaining the host's spouse or the spouse of a business associate is deductible if there was a clear business purpose rather than a personal or social purpose for incurring the expenses. For example, a customer's spouse may join the party for the entertainment because it's impracticable, under the circumstances, to entertain the customer without the spouse. And if the host's spouse joins the party because the customer's spouse is present, the cost of the entertainment allocable to the host's spouse is also deductible. (Reg §1.274-2(d)(2); Reg §1.274-2(d)(4))

No deduction is allowed for any food or beverage expense unless—

(1) the expense isn't lavish or extravagant under the circumstances, and

(2) the taxpayer (or one of taxpayer's employees) is present when the food or beverages are furnished (Code Sec. 274(k)(1)), and

(3) the taxpayer establishes that the expenditure was directly related to the active conduct of taxpayer's business or, for an expenditure directly preceding or following a substantial and bona fide business discussion, was associated with the active conduct of the taxpayer's business. (Code Sec. 274(a); Code Sec. 274(k))

Neither the lavish or extravagant limit nor the presence test applies to any expense that is excepted from the percentage limit (see below). (Code Sec. 274(k)(2))

In determining the deduction for the cost of a ticket to an entertainment or recreation activity, the amount taken into account can't exceed the face value of the ticket (including any ticket tax). But the face value limit doesn't apply to a ticket to a charitable sporting event that's excepted from the percentage limit (see below). (Code Sec. 274(l)(1))

"Directly related" entertainment. Amounts paid for entertainment are deductible if they are directly related to the active conduct of a trade or business. This test is met if the entertainment:

- involved an active discussion aimed at getting immediate revenue;
- occurred in a clear business setting such as a hospitality room; or
- must be reported as compensation for services performed by an individual other than an employee. (Reg §1.274-2(c)(1))

Costs aren't generally considered "directly related" if entertainment occurs where there's little or no possibility of engaging in the active conduct of business, e.g., at night clubs, theaters, or sporting events. But these costs may be deductible under the "associated with" rule.

"Associated with" entertainment. Entertainment expenses that don't meet the directly related test but that are associated with the active conduct of a business are deductible if the entertainment directly precedes or follows a substantial and bona fide business discussion. (Reg §1.274-2(d)(1))

An entertainment expense is generally associated with the active conduct of a taxpayer's business if the taxpayer can show a clear business purpose in incurring the expenditure. (Reg §1.274-2(d)(2))

The portion of an otherwise deductible expense allocable to the spouse of a person who engaged in the discussion is ordinarily considered associated with the active conduct of the business. (Reg §1.274-2(d)(4))

Whether a business discussion is substantial depends on all the facts of each case. The taxpayer must show that he or she or a representative actively engaged in a discussion, meeting, negotiation, or other bona fide business transaction (other than entertainment) in order to get income or some other specific business benefit. The meeting doesn't have to be for any specific length of time, but the business discussion must be substantial in relation to the entertainment. It isn't necessary that more time be devoted to business than entertainment. (Reg §1.274-2(d)(3)(i))

Special exceptions. Certain ordinary and necessary entertainment expenses are deductible even if they aren't "directly related" to or "associated with" the active conduct of a trade or business. But they are subject to the strict substantiation requirements that apply to other entertainment expenses (see below). The exceptions are:

- Food and beverages furnished on the taxpayer's business premises primarily for the taxpayer's employees.
- The expense (other than club dues, see below) of providing recreational, social, or similar activities primarily for the benefit of the taxpayer's employees, other than highly-compensated employees.
- Goods, services, and the use of a facility, if treated as compensation and as wages by the employer for withholding tax purposes. For example, an employer rewards an employee and his wife with an expense-paid vacation trip. The employer can deduct the cost if it treats the expenses as compensation and wages subject to withholding.
- Expenses connected with meetings of directors, shareholders, employees or trade associations.
- Cost of providing entertainment or recreational facilities to the general public as a means of advertising or promoting good will in the community.

- Expense of providing entertainment, goods, and services, or use of facilities, that are sold to the public in a bona fide transaction for adequate and full consideration.
- Reimbursed and substantiated expenses or allowances of employees where the employer hasn't treated the expenses as wages subject to withholding, and reimbursed, accounted-for entertainment expenses of self-employeds reimbursed or covered with an allowance by the client or customer. (Code Sec. 274(e); Reg §1.274-2(f)(2)) In these situations, the "directly related" and "associated with" tests apply to the payor (see below).

In addition, the prohibition against deductions for entertainment expenses that are not directly related to or associated with a taxpayer's business does not apply to the extent that the expenses were treated by the taxpayer as compensation to an employee on the taxpayer's income tax return and as wages to that employee for purposes of the income tax withholding rules. (Code Sec. 274(e)(2)) In addition, the prohibition doesn't apply to the extent that the expenses are includible in the gross income of a recipient who is not an employee of the taxpayer as non-employee compensation for services rendered or as a prize or award includible in the recipient's income under Code Sec. 74. (Code Sec. 274(e)(9))

According to the Tax Court (affirmed by the Eighth Circuit) in *Sutherland Lumber-Southwest Inc*, (2000) 114 TC 197, affd (2001, CA8) 88 AFTR 2d 2001-5026, the above "compensation exceptions" to the deduction prohibition means that if the taxpayer treats an entertainment expenditure as compensation to the recipient, the taxpayer can deduct the entire cost of the entertainment, regardless of whether that cost is greater or less than the amount that the recipient must treat as income. In other words, an employer's deduction for providing an entertainment- or recreation-type "perk" to employees or independent contractors isn't limited to the amount properly charged to the employees or independent contractors as compensation income for the perk, but is allowed for the entire cost of providing the perk.

The 2004 Jobs Act overturned the Sutherland Lumber rule with respect to the costs of entertainment-, amusement- or recreation-related goods, services and facilities provided by private and publicly-held companies to officers, directors, and 10%-or-more owners. In the case of those individuals, the taxpayer's deduction is limited to the amount actually treated as compensation or includible in income. (Code Sec. 274(e)(2)(B), as amended by 2004 Jobs Act Sec. 907(a)) The deduction limitation applies to expenses incurred after October 22, 2004, the date of enactment of the 2004 Jobs Act.

Review Question 19

Which of the following entertainment expenses are taken into account in full for deduction purposes?

a. Peter Gable takes a good customer to a football game. They discuss a pending contract during halftime.

b. Joan Carson has a substantial business meeting with a customer on Monday. The following Saturday she and the customer play a round of golf at Carson's country club.

c. After a substantial business discussion in the morning, Tom Jenkins takes a good customer to a World Series baseball game in the afternoon. He purchased the tickets from a scalper for $500 each.

d. XYZ hosts a company outing for all its employees at a nearby theme park.

Entertainment facilities. No deduction is allowed for any expense paid or incurred for an entertainment facility used in conjunction with any activity that is generally considered to be entertainment, amusement or recreation. (Code Sec. 274(a)(1)(B)) Entertainment facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments, and houses located in recreational areas (e.g., beach cottages and ski lodges). Again, the disallowance rule does not apply to facilities used primarily for the benefit of the taxpayer's employees, other than highly-compensated employees. In addition, a facility isn't an entertainment facility unless it's actually used at least in part for entertainment. (Reg §1.274-2(e)(2))

The following expenditures aren't subject to the entertainment facility rules:

- Interest, taxes, and casualty losses on entertainment facilities—these are deductible subject to the regular rules that apply to these items.

- Out-of-pocket expenses for such items as food and beverages, or expenses for catering furnished during entertainment at a facility, are subject to the general entertainment deduction rules.
- Expenses for actual business (as opposed to entertainment) use of a facility, such as using a plane or car for business transportation or chartering a yacht to an unrelated person. (Reg §1.274-2(e)(3)(iii); Reg §1.274-6)

Club dues. Deductions are generally barred for the cost of membership in any club organized for business, pleasure, recreation or other social purpose (Code Sec. 274(a)(3)), such as country clubs, golf and athletic clubs, airline clubs, hotel clubs, and business luncheon clubs. (Reg §1.274-2(a)(2)(iii)(a)) However, a deduction is allowed to the extent dues are treated as compensation income to an employee. (Reg §1.132- 5(s)) Dues for membership in professional and trade associations and civic or public service organizations (e.g., Rotary, Kiwanis) are deductible. (Reg §1.274-2(a)(2)(iii)(b))

Meal and entertainment deduction limits—the 50% rule. The amount of an otherwise allowable deduction for meal or entertainment expenses (including meals while on business travel status) is reduced by 50%. This reduction applies to any expense for food or beverages, and any item with respect to entertainment, amusement, or recreation, or for a facility used for such an activity. (Code Sec. 274(n)(1))

The 50% limit doesn’t apply to:

- Expenses treated as compensation paid to an employee or otherwise included in the gross income of the recipient of the meal or entertainment. (Code Sec. 274(n)(2)(A))
- Meals and entertainment expenses that are reimbursed. (Code Sec. 274(n)(2)(A)) Instead, the percentage limit applies to the person making the reimbursement.
- Traditional recreational expenses for employees. (Code Sec. 274(n)(2)(A))
- Services and facilities made available by the taxpayer to the general public. (Code Sec.274(n)(2)(A))
- Expenses of goods, services, or use of facilities, sold by the taxpayer in a bona fide transaction (entertainment sold to customers). (Code Sec. 274(n)(2)(A))
- Food or beverage expenses that are excludable from the gross income of the recipient under the *de minimis* fringe benefit rules. (Code Sec. 274(n)(2)(B))
- An expense that is part of a package that includes a ticket to attend certain charitable sporting events. (Code Sec. 274(n)(2)(C)) The event must: (1) be organized for the primary purpose of benefiting a tax-exempt charitable organization, (2) contribute 100% of the net proceeds to the charity, and (3) use volunteers for substantially all work performed in carrying out the event. (Code Sec. 274(l)(1)(B))
- Food or beverage expenses of crews of certain drilling rigs and crews of certain commercial vessels. (Code Sec. 274(n)(2)(E))

Final IRS regulations clarify that where one party reimburses another for meal and entertainment expenses, the deduction limit applies to either the party that makes the expenditure or to the party that actually bears the expense, but not to both. (Reg. §1.274-2(f)(2)(iv)) In the case of an employee’s expenditure for meals or entertainment, the deduction limit applies to the employee to the extent the employer treats the reimbursement as compensation to the employee. On the other hand, if the reimbursement is made under an accountable reimbursement plan (see below) and is treated as excludable from the employee’s income, the employer is subject to the 50% deduction limit.

Where an employee’s deduction of unreimbursed employee business expenses is subject to the 2%-of-AGI floor (see Module I, *Taxation of Individuals*), the 50% limit is applied before the 2% floor.

The deductible percentage of meals consumed by certain transport workers (e.g., air transport employees, truck and bus drivers, railroad employees) while away from home during or incident to the period of duty subject to the hours of service limitations of the Department of Transportation is 80% for 2008 or later years. (Code Sec. 274(n)(3))

Skyboxes. Where a skybox or other private luxury box is leased for more than one sporting event, the amount allowable as a deduction for business-related entertainment use is limited to the face value of non-luxury box seat tickets. (Code Sec. 274(l)(2)) This is reduced by 50% to determine the deduction. (Code Sec. 274(n))

4. Substantiating Travel and Entertainment Expenses

In order to deduct travel and entertainment expenses, each expense must be substantiated. (Code Sec. 274(d)(1); Code Sec. 274(d)(2); Code Sec. 274(d)(3)).

Generally, proper substantiation requires "adequate records" or a taxpayer statement supported by sufficient corroborating evidence, plus documentary evidence where required. (Code Sec. 274(d)) Approximations or estimates aren't sufficient. (Reg §1.274-5T(a))

All elements of an expenditure or use must be proved. Failure to prove any one will bar the deduction. (Reg §1.274-5T(c)(1))

In the usual instance, an employee who substantiates expenses to the employer need not account for them to the IRS. However, an employee who is "related" to his or her employer (certain close relatives of an individual employer, or a more-than-10% shareholder of a corporate employer) may be asked by IRS to substantiate his or her expense accounts even though the employee has accounted to the employer. (Reg §1.274-5T(f)(5)(ii))

Simplified substantiation procedures apply to business expenses of certain federal employees.

Proving travel and transportation expenses. The taxpayer must prove all of the following elements by adequate records or by a sufficiently corroborated statement:

- The amount of each separate expenditure for traveling away from home, such as the cost of transportation or lodging. The daily cost of breakfast, lunch, and dinner and other incidental travel elements may be aggregated if they are set forth in reasonable categories, such as for meals, oil and gas, taxi fares, etc.
- The dates of the departure and return home for each trip, and the number of days spent on business away from home.
- The destinations or locality of the travel.
- The business reason for the travel or the nature of the business benefit derived or expected to be derived as a result of the travel. (Reg §1.274-5T(b)(2))

Incidental travel expenses, e.g., tips, aren't subject to these rules. Where records are incomplete and documentary proof is unavailable, the taxpayer may establish the amount of incidental travel expenses by reasonable approximations. (Reg §1.162-17(d)(3))

Substantiation by use of optional meal or incidental expenses allowance. Employees and self-employed persons who are away from home on business travel may use standard per diem amounts to compute meal expense deductions (and in some instances to claim deductions for incidental expenses) instead of keeping records to substantiate the actual amount of the expense.

Employees and self-employed individuals who don't pay or incur meal expenses for a calendar day (or partial day) of travel away from home may deduct $5 for each away-from-home calendar (or partial) day in 2012. (Notice 2012-63, 2012-42 IRB 496)

If a payor (employer, its agent, or third party) pays a per diem allowance only for meals and incidental expenses in lieu of reimbursing actual expenses incurred for travel away from home, the amount that's deemed substantiated is the lesser of the per diem allowance or the amount computed at the federal per diem (M&IE) for the locality of travel for each calendar day (or part of a day) the employee is away from home.

Using standard per diem amounts only releases the taxpayer from the duty of substantiating the actual amount. *Time, place and business purpose must still be substantiated.*

An employee may deduct an amount computed under this method only as an itemized deduction subject to the percentage limit on meal and entertainment expenses and then to the 2%-of-AGI floor on miscellaneous itemized deductions (see Module I, Taxation of Individuals). A self-employed individual deducts the amount in determining adjusted gross income. This deduction is subject to the percentage limit on meal and entertainment expenses.

Proving entertainment expenses. For entertainment expenses, all these elements must be proved:

- The amount of each separate expenditure, except that incidental items like cab fares and telephone calls may be aggregated.
- The date the entertainment took place.
- The name (if any), address or location, and the type of entertainment, such as dinner or theater, if that information isn't clear from the location.
- The reason for entertaining, or the nature of the business benefit derived or expected to be derived, and the nature of any business discussion or activity that took place.
- The occupation or other information about the person or persons entertained, including name, title or other designation, sufficient to establish the business relationship to the taxpayer. (Reg §1.274-5T(b)(3))

In the case of "associated with" entertainment, the taxpayer must substantiate the date and duration of the business discussion, where the discussion took place, the nature of the discussion, and the business reason for the entertainment or the nature of business benefit derived or expected to be derived as the result of entertaining. The persons entertained who participated in the business discussion must be identified. (Reg §1.274-5T(b)(4))

Adequate records. Adequate records of travel and entertainment expenses consist of a currently maintained account book, diary, log, statement of expenses, trip sheet, or similar record and, where necessary (see below), documentary evidence such as receipts and paid bills, which together are sufficient to establish each element of every expenditure or use that must be substantiated. Information reflected on a receipt need not be duplicated in an account book or other record so long as the account book or other record and the receipt complement each other in an orderly fashion. (Reg §1.274-5T(c)(2)(i))

Both written and computer records are adequate records. (Reg §1.274-5T(c)(2)(ii)(C)(2))

Where the business purpose of an expenditure is evident from the surrounding facts and circumstances, a written explanation of the business purpose isn't required. (Reg §1.274-5T(c)(2)(ii)(B))

Corroborated statements. Taxpayers may substantiate the elements of their expenditures and uses not only by adequate records, but also by their own statements, written or oral, if those statements are supported by sufficient corroborating evidence. (Code Sec. 274(d))

Corroborating evidence may be oral, but if so, should be from a disinterested, unrelated party who has knowledge of the expenditure or use in question. Written evidence has greater probative value, and its probative value increases if set down close to the time of the expenditure or use in question. (Reg §1.274-5T(c)(1))

A taxpayer's written or oral statement must contain specific, detailed information about the element being substantiated, and the taxpayer must present other corroborative evidence sufficient to establish that element. (Reg §1.274-5T(c)(3)(i))

Documentary evidence. Documentary evidence, such as receipts or bills marked paid, is required to support all expenditures for lodging while away from home and for any other expenditures of $75 or more. (Reg §1.274-5(c)(2)(iii))

Documentary evidence is ordinarily considered adequate to support an expenditure if it discloses the amount, date, place, and essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the name and location of the hotel, the date or dates taxpayer stayed there, and separate amounts for charges such as for lodging, meals, and telephone. A restaurant receipt is sufficient to support an expenditure for a business meal if it contains the name and location of the restaurant, the date and amount of the expenditure, and an indication that a charge (if any) is made for an item other than meals and beverages. A canceled check, together with a bill from the payee, ordinarily will establish the cost, but may not be enough to show business purpose of an item. (Reg §1.274-5(c)(2)(iii)) Documentary evidence need not be in the form of original documents. Faxes, copies, or printouts of e-mail (if they contain the necessary substantiation elements) also may qualify.

Inadequate substantiation. If a taxpayer hasn't fully substantiated a particular element of an expenditure or use, but does establish to IRS's satisfaction that he or she has substantially complied with the adequate records requirements, IRS may permit the taxpayer to establish the missing element by other evidence that it considers adequate. (Reg §1.274-5T(c)(2)(v))

Where a taxpayer establishes that, by reason of "the inherent nature of the situation," he or she was unable to get either fully adequate records or fully sufficient corroborating evidence in support of the taxpayer's own statement, he or she will be treated as satisfying the substantiation requirements if other evidence is presented that possesses the highest degree of probative value under the circumstances. (Reg §1.274-5T(c)(4))

Where a taxpayer establishes that he or she has maintained adequate records of an expenditure or use, but is unable to produce the records because they have been lost through circumstances beyond his or her control (e.g., damage by fire, flood, earthquake or other casualty), the taxpayer has a right to prove his or her entitlement to a deduction by a reasonable reconstruction of the expenditure or use in question. (Reg §1.274-5T(c)(5)) Destruction of records in marital disputes has been held to fall within this rule.

Review Question 20

Which of the following is a true statement regarding substantiation requirements for travel and entertainment expenses?

a. If an employer pays an employee a per diem rate for business travel that is not higher than the federal per diem rate, the employer is not required to substantiate the time, place, and business purpose of the employee's travel.

b. Computerized records are not sufficient for substantiating travel and entertainment expenses.

c. A less-than-50% shareholder-employee is not required to substantiate his or her expenses to the IRS if the shareholder-employee has accounted to the employer.

d. Adequate records are not the only means by which a taxpayer can substantiate travel and entertainment expenses.

5. Employee Business Expense Reimbursements

An employee doesn't pay tax on an advance, reimbursement or other expense allowance received from his or her employer (or from a third party) under an "accountable plan." (Reg §1.62-2(c)(4)) The employer or third party payor may deduct the expenses subject to the rules discussed above.

By contrast, an advance, etc., made under a "non-accountable plan," is fully taxable to the employee and subject to FICA and income tax withholding. (Reg §1.62-2(c)(5)) The employer or third party payor may deduct the amounts as compensation, subject to the reasonable compensation requirement discussed above.

An advance, reimbursement or other expense allowance is treated as made under an "accountable plan" if the following conditions are met:

- the employee receives the advance, etc., for a deductible business expense that he or she paid or incurred while performing services as an employee of his or her employer,
- the employee adequately accounts to his or her employer for the expense within a reasonable period of time, and
- the employee returns any excess reimbursement or allowance within a reasonable period of time.

An advance, etc., that doesn't satisfy all three conditions is treated as paid under a non-accountable plan—it is taxed to the employee and is subject to FICA and income tax withholding. (Code Sec. 62(c); Reg §1.62-2(c)(5))

If an employee is allowed to keep advances or reimbursements in excess of those that are substantiated, only the excess is treated as made under a non-accountable plan. (Reg §1.62-2(c)(3)(ii))

If an employer maintains an arrangement that would in part be an accountable plan and in part be a non-accountable plan if both parts were viewed separately, the arrangement is treated as two expense allowance arrangements—one, a fully accountable plan, and the other, a fully non-accountable plan. The amounts paid under the non-accountable part of the arrangement must be treated as wages or other compensation.

Business connection requirement. An arrangement satisfies the "business connection" requirement if it provides advances, allowances (including per diem or mileage allowances, or allowances for meals and incidental expenses), or reimbursements only for business expenses that are allowable as deductions, and that are paid or incurred by the employee in connection with performing services as an employee. (Reg §1.62-2(d)) For example, a reimbursement for an employee's meal eaten while away from home overnight on employer business satisfies the business connection requirement, but a reimbursement for an employee's (non-business-entertainment) meal eaten during a non-overnight trip on employer business wouldn't satisfy the requirement. An advance, reimbursement or allowance that would be treated as made partially under a non-accountable plan solely because the expense is subject to the 50% deduction limit for business meals and entertainment is treated as made under an accountable plan. (Reg §1.62-2(h)(1))

Adequate accounting. To the extent an employee business expense is the type of expense (e.g., travel, entertainment, and certain other expenses) that isn't deductible unless the substantiation requirements of Code Sec. 274(d) are met, the employee must meet those substantiation requirements within a reasonable period of time. Under these requirements, information sufficient to substantiate the requisite elements of each expense or use must be submitted to the employer.

For all other business expenses, sufficient information must be submitted to enable the person providing the reimbursement to identify the specific nature of each expense and to conclude that the expense is attributable to the employer's business activities. (Reg §1.62-2(e)(3))

The following simplified substantiation rules apply to per diem or mileage allowances paid under an arrangement that otherwise qualifies as an accountable plan:

- Mileage allowance. An employee who receives a fixed mileage allowance of not more than the optional business standard mileage rate (see above) to cover transportation expenses while traveling away from home or for local business travel expenses, is considered to have made an adequate accounting to his or her employer if the elements of time, place, and business purpose of the travel are substantiated. (Reg §1.274-5T(f))
- Per diem allowance. If a payor (i.e., the employer, its agent, or a third party) pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal and incidental expenses (M&IE) incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is treated as substantiated for each calendar day (or part of that day) is the lesser of the per diem allowance or the amount computed at the federal per diem rate for the locality of travel for that day (or part of that day). An employee who is "related" to the employer (see above) isn't considered to have accounted to his or her employer for the full federal per diem allowances for lodging, meals, and incidental expenses, and must substantiate any deductions claimed, but may use the meals-only per diem and the business standard mileage rate. For travel outside the continental U.S., a separately identified lodging expense rate and M&IE rate is available for each locality outside the continental U.S.
- Simplified (high-low) method for substantiating travel allowances. A simplified method can be used for per diem amounts paid for lodging plus meals and incidental expenses (M&IE) during travel within the continental U.S. (See, e.g. Notice 2012-63, 2012-42 IRB 496)
- Fixed and variable rate (FAVR) allowances for auto expenses. Where an employer provides a mileage allowance under a reimbursement or other expense allowance arrangement in regard to an employee owned or leased car, the substantiation requirement is satisfied as to the amount if the employer reimburses in accordance with a fixed and variable rate (FAVR) allowance. A FAVR allowance is periodic fixed payments to cover fixed costs such as depreciation, coupled with periodic variable payments to cover operating costs such as gasoline. Among other things, a FAVR allowance may be paid only to an employee who substantiates at least 5,000 miles driven in connection with the performance of services as an employee, and at least ten employees must be covered by the FAVR allowance.

Reasonable period of time. Under an accountable plan, an employee must be required to return any reimbursement in excess of substantiated business expenses within a reasonable period of time. (Reg §1.62-2(f)(1)) The definition of reasonable period of time depends on the facts and circumstances. However, under a safe-harbor rule, (1) an advance within 30 days of the time the employee has the expense, (2) an expense adequately accounted for within 60 days after it was paid or incurred, or (3) an amount returned to the employer within 120 days after the expense was paid or incurred will be treated as having occurred within a reasonable period of time. (Reg §1.62-2(g)(2)(i)) If the employee is given a periodic statement (at least quarterly) that asks the employee to either return or adequately account for outstanding reimbursements and he or she complies within 120 days of the statement, the amount is adequately accounted for or returned within a reasonable period of time. (Reg §1.62-2(g)(2))

E. Business Gifts and Employee Awards

The costs of ordinary and necessary business gifts to individuals other than employees are deductible, subject to a $25 per-year per-person limit. Gifts to employees aren't deductible as gifts, but may be deductible as compensation. Certain non-cash awards to employees are deductible.

1. Business Gifts

A deduction is allowed for the cost of ordinary and necessary business gifts of up to $25 a year to any one individual. Gift means any item that is excludable from gross income by the recipient under Code Sec. 102, but not excludable under any other Code income tax provision. (Code Sec. 274(b)) However, any item for general distribution having a cost of not more than $4 on which the giver's name is clearly and permanently imprinted, and signs, display racks, or other promotional material donated to a retailer to be used on his or her business premises, aren't classified as gifts. (Code Sec. 274(b)(1); Reg §1.274-3(b)(2))

Since no amount transferred by or for an employer to or for the benefit of an employee is excludable as a gift (under Code Sec. 102) no such amount is deductible as a gift, though it may be deductible under other rules (e.g., as compensation).

To claim a deduction for a business gift, all these elements must be proved by adequate records or a sufficiently corroborated statement:

- description of the gift,
- taxpayer's cost,
- when the gift was made,
- occupation or other information about the recipient of the gift, including the recipient's name, title, or other designation sufficient to establish his or her business relationship to the taxpayer, and
- the reason for making the gift or the nature of business benefit derived or expected. (Reg §1.274- 5T(b)(5))

2. Employee Achievement Awards

An employer can deduct the cost of employee achievement awards. (Code Sec. 274(j)) The maximum deduction for awards made to one employee is $400 per year. In the case of a qualified plan award, the maximum deduction is $1,600 (including the cost of awards that aren't qualified plan awards). (Code Sec. 274(j)(2)) The award must be given as part of a meaningful presentation under conditions and circumstances that don't create a likelihood that the payment is disguised compensation. (Code Sec. 274(j)(3))

An employee achievement award is an item of tangible personal property awarded to an employee because of length of service achievement or safety achievement. (Code Sec. 274(j)(3)) Tangible personal property doesn't include cash or any gift certificate other than a nonnegotiable gift certificate conferring only the right to receive tangible personal property. (Reg §1.274-3(b)(2)(iv))

A qualified plan award is an item awarded as part of a permanent, written, nondiscriminatory plan of the employer. (Code Sec. 274(j)(3)(B); Reg §1.274-3(d))

A length-of-service award won't qualify for deduction under these rules if given during an employee's first five years of employment or if a length-of-service award was given to the same employee during the same year or any of the earlier four years. (Code Sec. 274(j)(4)(B))

Safety achievement awards don't qualify if given to managerial, administrative, professional or clerical employees, or if such awards previously have been given to more than 10% of other employees during the year. (Code Sec. 274(j)(4)(C))

No deduction is allowed for an employee achievement award except under the above rules. (Code Sec. 274(j)(1))

F. Rent Expense

Rent paid for the use of property used in whole or in part in the taxpayer's trade, business, or profession, or for the production of income, is deductible. (Code Sec. 162(a)(3)) But rent paid for personal-use property isn't. (Code Sec. 262(a); Reg §1.262-1(b)(3))

Besides normal cash rent payable periodically, rent includes a lump sum paid as advance rental, bonus, etc.; a percentage of the tenant's receipts or profits; the tenant's payment of the expenses of maintaining the rented property (taxes, insurance, etc.), and payment in property other than money (deductible to the extent of the property's fair market value).

Rentals paid between parties who are related either as members of a family or by stock ownership may not be deductible to the extent that they exceed the rent that would have been paid in an arm's-length transaction.

A corporation may deduct fair and reasonable rentals paid to corporate shareholders or their relatives. But excessive rentals can be treated as nondeductible dividends. Reasonable rental payments by a shareholder for use of corporate property are deductible.

1. Leaseback Arrangements

A transfer by sale or gift coupled with a leaseback may be more advantageous than a mortgage loan and can create tax benefits for the transferor. The transferor may be able to raise more cash by selling than by mortgaging the property. The transferor also may be able to claim a rent deduction substantially higher than the depreciation and interest that could have been claimed if the transferor retained title and mortgaged the property. Tax advantages (including rent deduction) of a sale and leaseback arrangement may be lost if IRS treats it as a mortgage loan, a tax-free exchange, or a sham transaction.

A gift in trust with a leaseback of the property to the grantor will generally be upheld as a valid rental or royalty arrangement by the courts if: (1) the transfer is complete and irrevocable, (2) the trustee is independent, and (3) the rent is reasonable. Reasonableness of rent and the independence of the trustee are questions of fact.

2. Rent vs. Purchase

A payment is deductible as rent only if the taxpayer-lessee hasn't taken or isn't taking title to the property and has no equity interest in it. (Code Sec. 162(a)(3)) Thus, payments made under conditional sales contracts aren't deductible as rent.

A lease that contains an option permitting the lessee to buy the property may be construed as a sale so that none of the payments are deductible as rent. Whether the lease is considered to be a sale depends essentially upon the intent of the parties, as shown in the agreement, read in light of the facts and circumstances existing at the time the agreement was made. Important factors indicating sale instead of lease include a nominal option price, excessive rent, designation of part of the payment as interest, a rental plus option price equal to the property's value plus interest, or application of rent payments to the lessee's equity in the property.

3. Lease Acquisition Costs

Payments made by a lessee to get a business lease aren't currently deductible but must be amortized. (Reg §1.162-11(a)) This rule applies whether the tenant is on the cash or accrual basis and even though the tenant has an option to buy the property.

If the lease isn't renewable, lease acquisition costs are amortized over the unexpired term of the lease.

If the lease is renewable, any renewal period must be taken into account in determining the amortization period if less than 75% of the lease cost is attributable to the portion of the lease (exclusive of the renewal period) remaining on the date of acquisition of the lease.

4. Lessor's Costs

Costs incurred by a lessor in leasing property or by a lessee in subletting aren't currently deductible, but must be amortized ratably over the term of the lease.

The cost of depreciable improvements made by lessors are recoverable over the cost recovery period applicable to the leasehold improvements, regardless of the period of time the property is leased. (Code Sec. 168(i)(8)) Certain "qualified leasehold improvements property" is depreciated over a 15-year cost recovery period if placed in service before 2012 (see IV.B.)

A lessor's payments for cancellation of a lease generally must be amortized and deducted over the remaining term of the cancelled lease. However, if the payment is made in order to enter a lease with a new tenant, the payment must be amortized over the term of the new lease.

5. Deduction Timing

The tax year in which rent is paid by a cash basis taxpayer or incurred by an accrual basis taxpayer is generally the proper year for deduction. But advance rentals must be apportioned and deducted over the term of the lease or other rental period.

Deferred rental agreements. Rent and interest attributable to a deferred rental agreement must be reported and deducted as if both parties are accrual basis taxpayers. This rule applies to leases of over $250,000 that require either: (1) at least one payment for the use of property to be paid after the close of the calendar year following the calendar year of the use, or (2) increases (or decreases) in the amounts to be paid as rent. (Code Sec. 467)

For lessees, the deductible rental amount for the tax year is the sum of:

- rent deemed accrued by allocating rents in accordance with the rental agreement, taking into account the present value of rent to be paid after the close of the period, and
- interest for the year on amounts taken into account for earlier tax years, but which are as yet unpaid. (Code Sec. 467(b)(1))

Present value and interest are computed using a rate equal to 110% of the applicable federal rate. (Code Sec. 467(e)(4))

If the agreement is silent as to rent allocation, or the agreement is a disqualified leaseback or long-term agreement, then constant rental accrual applies. (Code Sec. 467(b)(2); Code Sec. 467(b)(3)) The constant rental amount is an amount paid as of the close of each lease period which would result in a total present value equal to the present value of the total payments required under the lease. (Code Sec. 467(e)(1)) A rental agreement is a disqualified leaseback or long-term agreement if:

- it is part of a leaseback transaction to any person who had an interest in the leased property within two years before the leaseback (Code Sec. 467(e)(2)), or the term of the agreement exceeds 75% of a prescribed recovery period (Code Sec. 467(b)(4)), and
- a principal purpose of the increased rents provided in the agreement is tax avoidance. (Code Sec. 467(b)(4))

An agreement isn't a disqualified leaseback or long-term agreement if it qualifies for any of various safe harbors, including the uneven rent test which is met if the rent allocated to each calendar year does not vary from the average rent allocated to all calendar years by more than 10%. (Reg §1.467-3(c))

A reasonable rent holiday won't cause an agreement to be treated as a disqualified leaseback or long-term agreement. (Code Sec. 467(b)(5)) A rent holiday of 3 months or less at the beginning of the lease term is disregarded in determining whether the rental agreement has increasing or decreasing rent. (Reg §1.467-1(c)(2)(i)(B)) A lessor's granting of an 11.5 month zero rent period in a 25-year lease was held to be a reasonable rent holiday in an area where such inducements were needed to attract lessees.

Review Question 21

Which of the following statements regarding deductions for rental expenses is **incorrect**?

a. Payments made under conditional sales contracts may be deducted as rent.

b. Payments made by a lessee to get a business lease cannot be deducted currently as rental expenses.

c. A landlord's payment to a tenant to cancel a lease in order to acquire a new tenant cannot be deducted over the remaining period of the canceled lease.

d. A corporation may deduct rental payments to a shareholder only if the amount of the payments are fair and reasonable.

G. Interest

Business-related interest is deductible if it's incurred with respect to a valid debt and is actually paid or accrued during the tax year. However, certain interest expenses must be included in inventory or capitalized (see III.A.3).

The basic rules regarding characterization of an expense as interest, who can deduct interest, and timing of the deduction parallel those for individual taxpayers. See Module I, *Taxation of Individuals*.

1. Deductible Business Interest

Provided there is a business connection, deductible interest includes the amount paid: (1) for the borrower's use of money during the term of a loan, or (2) for the borrower's detention of money after the due date for repayment. Merely designating a payment as "interest" won't make it deductible. Nor does the fact that the payment is taxable interest to the lender make it deductible by the payor-borrower.

To be deductible, the charge for interest need not be reasonable, and may even be usurious. But it must be definitely ascertainable, and be paid with respect to a valid debt.

The amount of "finance charges" imposed on the unpaid balances of charge accounts or credit cards is deductible as interest, as are credit card fees imposed for cash, check, or overdraft advances, but only to the extent the payment isn't a service charge, etc. Similarly, interest on an installment purchase that's separately stated or definitely determinable and provable is deductible as interest. On certain deferred payment sales, part of each payment is treated as interest ("unstated interest") that's treated by the buyer as interest expense.

Interest on a mortgage on real property generally is deductible. (Reg §1.163-1(b))

Business taxpayers may deduct interest on certain delinquent tax payments. For example, interest on sales, excise and similar taxes incurred in connection with taxpayer's business may be deducted. Interest on an income tax deficiency arising from an unincorporated business can't be deducted as a business expense. In addition, interest paid by an S corporation or other pass-through entity on income tax underpayments, or on debt used to pay those taxes, is nondeductible. (Reg §1.163-9T(b)(2)) A corporation cannot deduct interest on understatements with respect to certain tax shelter transactions that were required to be but were not adequately disclosed. (Code Secs. 6664(d)(2)(A); 163(m))

A penalty paid for prepaying a debt (including a mortgage) is deductible as interest, as is a late payment charge (that isn't a service charge).

2. Interest on Corporate Debt

Corporations may favor heavy debt capitalization because interest paid on debt is deductible, while dividends paid on stock aren't. But a corporation's debt obligations may be treated as equity (stock), making the "interest" paid on them a nondeductible dividend. Also, repayment of a debt isn't taxable to the lender corporation, while a stock redemption may be taxable as a dividend to the shareholder. On the other hand, from the shareholder's perspective, an equity interest may offer a tax advantage not available with debt obligations. A "qualified dividend" (see Module 1, *Taxation of Individuals*) is more favorably taxed than interest income.

The corporate issuer's characterization (at issuance) of a corporate instrument (issued after 10/24/92) as stock or debt is binding on the issuer and all holders (unless the holder discloses inconsistent treatment on his or her return), but not on IRS. (Code Sec. 385(c))

Key factors that are relevant in determinations by IRS (or with respect to instruments not described above) as to whether purported corporate debt will be treated as debt for federal tax purposes include:

- the names given to the certificates evidencing the "debt";
- the presence or absence of a fixed maturity date;
- the source of payments;
- the right to enforce payment of principal and interest;
- any resulting participation in management;
- whether the "debt" is subordinate to the corporation's other debt;
- whether the "debt" is convertible into stock;
- the intent of the parties;
- whether there is a high ratio of debt to equity;
- identity of interest between creditor and shareholder;
- the corporation's ability to get loans from outside lenders;
- the extent to which the advance was used to acquire capital assets;
- the "debtor's" failure to repay on time or to seek a postponement;
- the economic realities of the transaction; and
- the business purpose of the transaction.

Debt payable in stock. No deduction is allowed for interest paid or accrued on a disqualified debt instrument (Code Sec. 163(l)(1)), or for original issue discount (OID) on such an instrument. A disqualified debt instrument is any corporate debt (or debt issued by a partnership to the extent of its corporate partners) that's payable in equity (i.e., stock) of the issuer or a related party (under Code Sec. 267(b)). (Code Sec. 163(l)(2); Code Sec. 163(l)(4)) In the case of instruments issued after October 3, 2004, corporate debt that's payable in third-party equity held by the issuer or any related party is treated as a disqualified debt instrument. The basis of the third-party equity is increased by the disallowed deduction. (Code Sec. 163(l)(6)) Disqualified debt instruments don't include certain debt issued by dealers in securities. (Code Sec. 163(l)(5))

These rules deal only with the deduction by the issuer, generally for debt instruments issued after June 8, 1997. They don't affect the treatment of a holder of an instrument.

Corporate acquisition indebtedness. The deduction allowed to a corporation for the interest it pays or accrues during a tax year on certain "corporate acquisition indebtedness" can't exceed $5,000,000. But all or part of the excess may not be subject to disallowance if specified tests (acquisition purpose, subordination, convertibility, and debt-equity) are met. (Code Sec. 279)

Review Question 22

In which of the following situations is the payor allowed an interest deduction?

a. XYZ Inc. pays interest on a debt to a shareholder in the form of additional shares of XYZ stock.

b. Bob Black, a self-employed taxpayer, pays interest on an income tax deficiency connected with his business.

c. Jane Holland, a self-employed taxpayer, pays an annual service charge on the credit card she uses for business purposes.

d. Acme Inc. pays a penalty for prepaying its mortgage.

H. Taxes

A business expense deduction may be claimed for certain state, local, U.S. possessions, and foreign taxes, as well as some federal taxes (not income tax). Taxes that are incurred in a trade or business are generally deducted to arrive at adjusted gross income.

Only payments that are really taxes (regardless of what they are called) are deductible as taxes. Taxes are charges imposed on persons or property by governmental authority to raise funds for the support of government or for public purposes. The mere fact that a levy is called a "tax" isn't conclusive. Fees imposed primarily as charges for government services, e.g., fees for a driver's license or car inspection, or passport fees, aren't deductible as taxes.

Penalties paid to a government for violation of a law aren't taxes. (Code Sec. 162(f))

The basic rules regarding characterization of a payment as a tax, who can deduct tax payments, and timing of the deduction parallel those for individual taxpayers. See Module I, Taxation of Individuals.

Business taxpayers may deduct the following taxes:

- state, local and foreign income, war profits and excess profits taxes;
- state, local and foreign real property taxes;
- state and local personal property taxes; and
- other state, local and foreign taxes (e.g., occupational taxes) paid or accrued in business unless incurred in connection with an acquisition or disposition of property. (Code Sec. 164(a)(1))

State or local sales or use taxes paid or incurred in connection with the acquisition or disposition of property aren't deductible (buyer treats them as part of the cost, seller as a reduction in the amount realized). Other sales taxes are deductible if paid or incurred in a trade or business or for the production of income. (Code Sec. 164(a))

Taxes not included above (e.g., gasoline, diesel and other motor fuel taxes, transfer taxes on securities and real estate, Social Security (FICA) and unemployment (FUTA) taxes on employers, motor vehicle registration fees) aren't deductible as taxes (although some motor vehicle fees may qualify as personal property taxes), but may be deductible as business expenses or expenses for the production of income. (Reg §1.164-2(f))

Review Question 23

Which of the following payments are deductible as taxes by a business?

a. Penalties paid for violations of law.
b. Fees paid for car inspections.
c. Foreign real property taxes.
d. Sales taxes on machinery acquired for use in the business.

I. Bad Debts

Business bad debts are deductible as ordinary business expense deductions. They are deductible if partly worthless as well as when wholly worthless. Non-business bad debts are deducted only as short-term capital losses, and only when wholly worthless.

A business debt is either:

- a debt created or acquired in the course of taxpayer's trade or business (whether or not it was related to that business when it became worthless); or
- a debt the loss from whose worthlessness is incurred in taxpayer's trade or business. This applies if the loss is proximately related to taxpayer's business when the debt becomes worthless. A bad debt is proximately related to business if business is the dominant motivation for the debt. (Reg §1.166-5(b))

A *non-business debt* is a debt other than a business debt. (Code Sec. 166(d)(2); Reg §1.166-5(b); Reg §1.166-5(d))

The need to determine whether a debt is a business or non-business debt arises only for non-corporate taxpayers. A corporation's debts are always business debts. (Code Sec. 166(d))

A taxpayer that makes a guarantee agreement in the course of a trade or business is entitled to a business bad debt deduction for any payment of principal or interest made as guarantor. (Reg §1.166-9(a))

1. Wholly Worthless Debt

To establish that a debt is wholly worthless, a taxpayer must show the debt had value at the beginning of the year and no value at the end, and that the worthlessness occurred in the particular tax year claimed.

Worthlessness is a question of fact requiring consideration of all pertinent evidence, including the debtor's financial condition and the value of any security. (Reg §1.166-2(a)) Ordinarily, there's some identifiable event that demonstrates a debt's worthlessness, such as the debtor's bankruptcy or death, although these events may not be conclusive.

The amount deductible for a wholly worthless debt is its adjusted basis for determining loss on a sale or exchange, regardless of its face value. (Code Sec. 166(b); Reg §1.166-1(d)) The adjustments used to figure adjusted basis are generally the debtor's payments on the debt. But a deduction allowed for a debt's partial worthlessness (see below) reduces the debt's basis to that extent, whether or not the taxpayer received a tax benefit from the deduction.

If the taxpayer has no basis in the debt, there's no deduction. So there's no deduction for wages, rents, etc., that were never received, unless these items were included in income. (Reg §1.166-1(e)) Where a taxpayer reports receivables at fair market value (FMV) rather than face, the deduction can't exceed FMV. (Reg §1.166-1(d)(2))

If a debt is compromised because of inability to pay the full amount, taxpayer deducts the debt's adjusted basis minus any cash and the value of any property received. If the debt is compromised for some other reason, the taxpayer doesn't have a bad debt (but may have a loss).

2. Partially Worthless Debt

A deduction is allowed for a partially worthless debt (Code Sec. 166(a)(2)) *only if*:

- the debt is a business debt;
- the IRS is satisfied that the specific debt is recoverable only in part;
- the amount deducted was charged off on the books during the tax year; and
- the debt is not evidenced by a security. (Code Secs. 166(d)(1) and 166(e); Reg §1.166-5(b))

A taxpayer may charge off and deduct a debt for partial worthlessness as it occurs. Alternatively, the taxpayer can defer charge-off and deduction to a later year when partial worthlessness is greater, thus deducting several years' partial worthlessness in one year, or defer deduction until total worthlessness (but not beyond the year of total worthlessness). (Reg §1.166-3(b))

J. Losses

As a general rule, business taxpayers may deduct losses from a trade or business that aren't compensated for by insurance or otherwise. (Code Sec. 165(a)).

However, business losses may be subject to a number of special rules and restrictions. For example, the rules limiting losses to the amount "at-risk" apply to C corporations if more than 50% in value of the corporation's stock is owned by not more than five individuals at any time during the last half of its tax year. And a closely held C corporation cannot deduct a "passive activity loss" against portfolio income, but can deduct the loss against active business income. For a discussion of the at-risk and passive activity loss limitations, see Module 1, *Taxation of Individuals*.

1. Business Casualty and Theft Losses

Losses to property used in a trade or business from fire, storm, auto accident or other casualty, and losses from theft, are deductible.

The amount of the casualty loss generally is the lesser of: (1) the property's adjusted basis (i.e., its basis for determining loss on disposition), or (2) its decline in value (i.e., its fair market value (FMV) immediately before the casualty minus its FMV immediately afterward). However, if property used in business is totally destroyed, the amount of the loss is the property's adjusted basis in all cases. (Reg §1.165-7(b)(1))

While special deduction limitations apply in the case of losses to personal use property, no such limitations apply in the case of trade or business property.

2. Net Operating Losses

A net operating loss (NOL) sustained in one year may be used to reduce the taxable income for another year. It may be carried back to earlier years and yield tax refunds. If not exhausted in earlier years (or if taxpayer elects not to use the carryback), it may be carried forward to later years and reduce the tax for those years.

NOL defined. An NOL is the excess of business deductions (computed with certain modifications) over gross income in a particular tax year. A deduction is allowed for that loss, through an NOL carryback or carryover, in some other tax year(s) in which gross income exceeds business deductions. (Code Sec. 172(a); Reg §1.172-1(a))

An NOL deduction is allowed to individuals, corporations (Code Sec. 172), estates and trusts (Code Sec. 642(d)) (and charitable organizations with respect to the unrelated business income tax). (Code Sec. 512(b)(6))) It isn't allowed to partnerships (Code Sec. 703(a)(2)(D)), common trust funds (Code Sec. 584(g)) (but the deduction is allowed to the partners and beneficiaries), regulated investment companies (Code Sec. 852(b)(2)(B)), or S corporations (losses are passed through to shareholders). (Code Sec. 1366(a))

NOL carryover and carryback periods. As a general rule, an NOL for any tax year may be carried back two years and forward 20 years.(Code Sec. 172(b)(1)(A)).

A three-year carryback period applies to the following:

- NOLs arising from property losses of individuals due to fire, storm, shipwreck, or other casualty, or from theft.
- For a small business, or a taxpayer engaged in the trade or business of farming, NOLs attributable to Presidentially declared disasters. A small business is one whose average annual gross receipts (under Code Sec. 448(c)) are $5 million or less. (Code Sec. 172(b)(1)(F))

A special five-year carryback applies to certain farming losses. See Module 3, *Specialized Tax Issues*.

For net operating losses (NOLs) arising in tax years ending after December 31, 2007 and before January 1, 2010, any taxpayer could elect to increase the NOL carryback period from two years to three, four, or five years. (Code Sec. 172(b)(1)(H)) The election was allowed for an applicable NOL arising in 2008 or 2009 (but not both, except for certain eligible small businesses).

Election to forgo NOL carryback. A taxpayer may elect not to use the carryback period and instead only carry over the NOL for the allowed carryforward period. Once the election is made for any tax year (on a statement attached to the return or amended return), it's irrevocable for that year. (Code Sec. 172(b)(3); Reg §301.9100-12T(d))

Amount of NOL deduction. The NOL deduction in any year is the sum of all NOL carrybacks and carryovers to that year. (Code Sec. 172(a)).

If a husband and wife who make a joint return for the deduction year made a joint return for all other tax years involved in computing the NOL deduction, that deduction is computed on the basis of their joint NOLs and combined taxable incomes. (Reg §1.172-7(c)) Special rules apply if they didn't make joint returns for all applicable years. (Reg §1.172-7)

Special limits apply to the NOL deduction for alternative minimum tax purposes. See Module III, *Specialized Tax Issues*.

K. Deduction for Manufacturing/Production Activities

Business taxpayers can claim a deduction equal to a percentage of the income earned from manufacturing (and certain other production activity) undertaken in the U.S. (Code Sec. 199, as added by 2004 Jobs Act Sec. 102) Under Code Section 199 as originally enacted, the deduction did not apply to Puerto Rico. However subsequent amendments to the law provide that for tax years beginning after December 31, 2005, and before January 1, 2014, the taxpayer may treat Puerto Rico as part of the U.S. for Section 199 deduction purposes, but only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for U.S. Federal income tax purposes. (Code Sec. 199(d)(8), as amended by Sec. 401(a) of the Tax Relief and Health Care Act of 2006, by Sec. 312(a)(1)DivC of the 2008 Extenders Act, by 2010 Tax Relief Act §746(a), and by the American Taxpayer Relief Act of 2012 §318(a))

Caution: Expired or expiring provisions may be extended by Congress.

The Section 199 deduction equals the lesser of:

- a percentage of the lesser of (1) the "qualified production activities income" of the taxpayer for the tax year or (2) taxable income (modified adjusted gross income, for individual taxpayers) without regard to this deduction, for the tax year. The percentage is 6% for tax years beginning in 2007-2009, and 9% thereafter.
- 50% of W-2 wages, including elective deferrals listed in Code Sec. 6051(a)(8) (e.g., deferrals to Code Sec. 401(k) or Code Sec. 457 retirement plans for employees), paid by the taxpayer during the calendar year that ends in the tax year. For tax years beginning after May 17, 2006, W-2 wages do include any amount that is not properly allocable to domestic production gross receipts in determining qualified production activities income. (Code Sec. 199(b)(2)(B) as amended by Tax Increase Prevention Act §514(a))

"Qualified production activities income" is equal to domestic production gross receipts reduced by the sum of:

- the costs of goods sold that are allocable to such receipts;
- other deductions, expenses, or losses that are directly allocable to such receipts; and
- a ratable portion of deductions, expenses, and losses that are not directly allocable to such receipts or to another class of income.

"Domestic production gross receipts" are gross receipts of a taxpayer that are derived from:

- any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.;
- any sale, exchange or other disposition, or any lease, rental or license, of a qualified film produced by the taxpayer;
- any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.;
- construction activities performed in the U.S.; or
- engineering or architectural services performed in the U.S. for construction projects located in the U.S.

Domestic production gross receipts do not include any gross receipts derived from (1) the sale of food or beverages prepared by the taxpayer at a retail establishment; or (2) the transmission or distribution of electricity, natural gas, or potable water. Specifically excluded from the definition of domestic production gross receipts are gross receipts of the taxpayers that are derived from the lease, rental, license, sale, exchange, or other disposition of land. (Code Sec. 199(c)(4)(B)(iii))

"Qualifying production property" includes any tangible personal property, computer software and sound recordings. In order to be a "qualified film," 50% of the total compensation relating to the production of the film must be for services performed in the U.S. by actors, production personnel, directors and producers.

The deduction is available to C corporations, S corporations, partnerships, sole proprietorships, cooperatives, and estates and trusts, and, subject to an adjustment, is allowed for AMT purposes. For purposes of determining alternative minimum taxable income (AMTI) for tax years beginning in 2008 or later, a taxpayer other than a corporation can deduct 9% of the lesser of qualified production activities income (QPAI) or taxable income (AGI for an individual taxpayer) determined without regard to the Sec. 199 deduction. A corporation can deduct 9% of the lesser of QPAI or its AMTI for the tax year determined without regard to the Sec. 199 deduction. In either case, the amount of the deduction cannot exceed 50% of the taxpayer's W-2 wages for the tax year. (Code Sec. 199(d)(6); Prop. Reg. §1,199-8(c))

The 2008 Energy Act, which was included as part of the 2008 Emergency Economic Stabilization Relief Act of 2008 (P.L. 110-343, 10/3/08), reduces the otherwise-allowable domestic production activities deduction of taxpayers with oil-related qualified production activities income for tax years beginning after 2009. (Code Sec. 199(d)(9)(A) as amended by 2008 Energy Act §401(a)DivB)

Review Question 24

Which of the following is a true statement regarding the deduction for manufacturing/production activities?

a. The deduction for 2013 is 6% of "qualified production activities income," subject to certain limitations.

b. The deduction is not available to sole proprietorships.

c. The deduction cannot exceed a taxpayer's taxable income.

d. The deduction is available to taxpayers who own and operate a restaurant.

L. Miscellaneous Expenses

The test for deductibility is whether a particular expense is ordinary and necessary in a taxpayer's particular business. Therefore, a wide variety of expenses may qualify depending on the nature of a particular business. The following are examples of some common deductions.

1. Legal and Accounting Expenses

Attorney's fees, court costs and other legal expenses can qualify as deductible business expenses. Legal expenses aren't deductible if they are either capital expenditures or a personal expense of the taxpayer. (Code Sec. 162; Code Sec. 262(a); Code Sec. 263) Qualified legal expenses can include expenses incurred in litigation, for legal advice, and for the drafting of instruments, but not to acquire, perfect or defend title to property. (Reg §1.212-1(k)) A legal retainer must be capitalized if it is for legal expenses associated with the acquisition of a business.

Fees for bookkeeping and accounting work incurred in the operation of the taxpayer's business are deductible.

2. Insurance Premiums

Premiums for insurance against various types of risks, such as property damage, are generally deductible as business expenses (Code Sec. 162; Reg §1.162-1(a)).

Self-insurance reserve funds aren't deductible even if taxpayer can't get business insurance coverage for certain business risks. Neither are payments to "captive" insurance subsidiaries or other similar arrangements where there's no true risk-shifting. A limited deduction is allowed, however, for certain payments made to a medical malpractice self-insurance pool.

Premiums are nondeductible capital expenditures where paid for property insurance during construction. So are premiums for title insurance and for public liability and worker's compensation insurance paid in connection with the construction of a building.

Life insurance premiums aren't deductible if the taxpayer is directly or indirectly a beneficiary. (Code Sec. 264(a)(1); Reg §1.264-1). For example, the cost of a corporation's key person insurance isn't deductible. However, premiums on life insurance for employees may be deductible as non-cash fringe benefits (see III.C.7).

If a cash basis taxpayer pays an otherwise deductible premium for one year's coverage which applies in part to the following tax year, the entire premium is deductible in the year paid. But if premiums for several years are paid in advance, IRS and most courts require the premium to be amortized and deducted over the life of the policy.

For an accrual basis taxpayer, deductibility of an accrued liability for an insurance expense is determined under the economic performance rules—that is, when the premium is paid. But where prepaid premiums cover more than one year, an accrual basis taxpayer must prorate the premium paid in advance over the life of the policy.

3. Research and Experimental Expenditures

Taxpayers can choose to immediately deduct or to capitalize research and experimental (R&E) expenditures. (Code Sec. 174(a)(1)) If the taxpayer adopts current expense treatment, it must be used for all qualifying expenses for the year of adoption and for all later years, unless the IRS consents to a change. (Code Sec. 174(a)(3))

For research and experimental expenditures that aren't chargeable to depreciable or depletable property, instead of current deduction or capitalization the taxpayer can elect (use Form 4562) to deduct the expenditures ratably over 60 months or longer as deferred expenses, beginning with the month the taxpayer first realized benefits from the expenditures. (Code Sec. 174(b)(1); Reg §1.174-4(b)(1))

In general, expenditures that qualify as research and experimental costs are research and development costs in the experimental or laboratory sense. This includes all costs incident to the development or improvement of a product, including a pilot model, process, formula, invention, technique, patent or similar property. (Reg §1.174-2(a))

All taxpayers, including partners and S corporation shareholders, may elect to deduct all or any portion of these costs ratably over ten years. (Code Sec. 59(e)(1))

Deductions for research and experimental expenses that also qualify for the research credit or the orphan drug credit are limited (see V.A.4, V.A.6).

4. Royalty Payments

Royalty payments made for the right to use patents, copyrights and similar rights are deductible. Payments to acquire the property itself are capital expenditures.

5. Circulation Costs

Publishers of periodicals can deduct currently their expenditures to establish, maintain and increase circulation. (Code Sec. 173) Or, instead, they may elect to capitalize those costs. (Reg §1.173-1(c)) A taxpayer may elect (use Form 4562) to amortize circulation costs over three years beginning with the year the expenditure is made. (Code Sec. 59(e)(1))

6. Payments for Franchises, Trademarks, or Trade Names

In the case of a transfer of a franchise, trademark or trade name, a deduction is allowed to the transferee for serial payments contingent on the productivity, use, or disposition of the franchise, trademark or trade name transferred. (Code Sec. 1253(d)(1))

7. Civil Damages

Civil damages paid under judgments and out-of-court settlements arising out of normal business operations are deductible as business expenses if the litigation is directly connected with the taxpayer's business.

No deduction is allowed for two-thirds of treble damage or settlement payments to private parties where the taxpayer (payor) in a criminal proceeding for violation of federal antitrust law is convicted or pleads guilty or no contest. (Code Sec. 162(g); Reg §1.162-22)

8. Charitable Contributions

Business taxpayers can claim a deduction for charitable contributions to qualified charitable organizations. For rules governing deductible contributions, see Module I, Taxation of Individuals.

A C corporation's charitable deduction for a tax year can't exceed 10% of its taxable income for the year. Taxable income for this purpose is computed without deductions for charitable contributions, dividends received, or net operating loss or capital loss carrybacks to the year. (Code Sec. 170(b)(2); Reg §1.170A-11(a)) To the extent contributions in any year exceed this limit, the excess can be carried forward and deducted for up to five years. (Code Sec. 170(d)(2))

In the case of partnerships and S corporations, charitable deductions are passed through and added to the partners' or shareholders' personal contributions in determining their charitable deductions.

Charitable contribution v. business expense. Transfers to a charity that are directly related to a taxpayer's business and are made with a "reasonable expectation of financial return commensurate with" the amount transferred may be deductible as business expenses, and not as charitable contributions. But no business expense deduction is allowed for the transfer if any part of it is deductible as a charitable contribution. (Reg §1.162-15(a)(2))

Gifts of ordinary income-type appreciated property. For charitable gifts of ordinary income-type property, the amount contributed generally must be reduced by the amount which would have been recognized as gain other than long-term capital gain if the property had been sold by the donor for its then FMV. (Code Sec. 170(e)(1))

Ordinary income-type property is property which, if sold by taxpayer (donor) at its FMV on the date it was contributed, would have resulted in some amount of gain other than long-term capital gain. This includes: inventory or other property held for sale to customers; capital assets held for less than the long-term holding period; property subject to depreciation, etc., recapture; property used in taxpayer's trade or business; and art works, letters, memoranda and similar property created by or for taxpayer. (Code Sec. 170(e)(1); Reg §1.170A-4(b))

There are, however, some exceptions to the general rule.

A C corporation that contributes inventory, property held primarily for sale to customers in the ordinary course of its trade or business, or depreciable or real property used in its trade or business, makes only half the reduction described above but the resulting charitable deduction can't exceed twice the basis of the contributed property. This applies only if the contribution is to an exempt Code Sec. 501(c)(3) organization (other than certain private foundations) that uses the property solely for the care of the ill, the needy or infants, and that meets other specified requirements. (Code Sec. 170(e)(3)) The same limited reduction applies to a C corporation that contributes scientific equipment or apparatus to a higher education institution or a tax-exempt organization (but not a private foundation) that's organized and operated primarily to conduct scientific research. However, this rule applies only if the taxpayer constructed the property and the contribution is made no later than two years after the date the property was substantially completed; if the donee is the original user of the property; and if other specified requirements are met. (Code Sec. 170(e)(4))

In addition any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced above-basis deduction for donations of "apparently wholesome food' inventory. "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

For taxpayers other than C corporations, the total deduction for donations of food inventory in a tax year generally may not exceed 10% of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other entity that is not a C corporation) from which contributions of apparently wholesome food are made.

The apparently wholesome food contribution rules expires for contributions made after December 31, 2013. [IRC Sec. 170(e)(3)(C)(iv) as amended by 2010 Tax Relief Act (P.L. 111-312) and the American Taxpayer Relief Act of 2012 (P.L. 112-240)

- **Caution:** Expired or expiring provisions may be extended by Congress.

Review Question 25

XYZ Inc., a C corporation, donates an item of inventory to an exempt organization that uses the item solely for the care of the ill. XYZ's cost for the item is $500 and it has a fair market value of $1,600. How much can XYZ deduct?

a. $1,600. b. $1,000.

c. $1,050. d. $500.

Charitable donations of patents and other intellectual property. If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization after June 3, 2004, the initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property. The taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent tax years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property.

The amount of any additional charitable deduction is calculated as a sliding-scale percentage of qualified donee income received or accrued by the charitable donee that properly is allocable to the contributed property in the applicable tax year of the donor.

An additional charitable deduction is allowed only to the extent that the aggregate of the amounts that are calculated pursuant to the sliding-scale exceed the amount of the deduction claimed upon the contribution of the patent or intellectual property. No charitable deduction is permitted for any revenues or income received or accrued by the charitable donee after the expiration of the legal life of the patent or intellectual property, or after the tenth anniversary of the date the contribution was made by the donor.

The taxpayer must inform the donee at the time of the contribution that the taxpayer intends to treat the contribution as a contribution subject to the additional charitable deduction provisions. In addition, the taxpayer must obtain written substantiation from the donee of the amount of any qualified donee income properly allocable to the contributed property during the charity's tax year. The donee must file an annual information return that reports the qualified donee income and other specified information relating to the contribution.

Additional charitable deductions are not available for patents or other intellectual property contributed to a private foundation (other than a private operating foundation or certain other private foundations described in Code Sec. 170(b)(1)(E)). (Code Sec. 170(e)(1)(B); Code Sec. 170(m); and Code Sec. 6050L)

IV. Depreciation and Amortization

Learning Objectives

After completing this section, you should be able to:

- Discuss depreciation rules and the related available deductions.
- Apply the income limitations and other restrictions on the Section 179 expensing allowance.
- Recognize the restrictions on deductions for listed property.
- Identify property subject to amortization and depletion.

A taxpayer who buys business or income-producing property with a useful life of more than one year cannot deduct its full cost as an expense for that year. (Code Sec. 263(a); Reg §1.263(a)-2(a)) Instead, the cost of that property must be recovered over more than one year.

The Code allows an annual deduction of a portion of the cost or other basis of capital assets used during the year in a trade or business or held for the production of income. For most assets, this annual deduction is claimed through depreciation under the Modified Accelerated Cost Recovery System (MACRS). For certain property amortization or depletion is allowed instead of depreciation.

When depreciation is claimed for property and the property is subsequently sold or exchanged, part or all of the gain may be subject to "recapture" as ordinary income (instead of capital gain) (see Module 1, *Taxation of Individuals*).

A. Qualifying Property

Real property (except land), personal property and certain intangibles are depreciable if the property:

- is used in a trade or business, or held for the production of income (Code Sec. 167(a));
- has an exhaustible useful-life that can be determined with reasonable accuracy (Reg §1.167(a)-1(b)); and
- isn't inventory or stock in trade (Reg §1.167(a)-2).

Some courts have held that property can be depreciated even if it doesn't have a determinable useful life, but IRS disagrees and will continue to contest the issue.

Property isn't depreciable if it isn't exhaustible or subject to wear and tear, such as land (Reg §1.167(a)- 2) or radium. Natural resources such as oil, gas or minerals in the ground (Reg §1.167(a)-2) qualify for depletion, not depreciation (see IV.F.) and 15-year amortization applies to "Section 197 intangibles" (see IV.E.).

The mere fact that property diminishes in value doesn't mean that it's depreciable, if the decrease isn't the result of exhaustion, wear and tear, or obsolescence. (Reg §1.167(a)-1(a))

Property used solely for personal purposes isn't depreciable. (Reg §1.167(a)-2) Where the same property is used both for personal and for business or income-producing purposes, depreciation is deductible only to the extent of non-personal usage. Property acquired for personal use but later converted to business or income production is depreciable from the date of conversion.

1. Who Can Claim the Deduction

Ordinarily the owner of depreciable property is the person entitled to deduct depreciation. This is the equitable owner, and not the owner of bare legal title.

A lessor (landlord) deducts depreciation on property that is already on the leased premises when he or she leases out the property and on any improvements the lessor constructs during the term of the lease. (Reg §1.167(a)-4) But the lessor can't deduct depreciation where the lease requires the lessee to replace property at the lessee's expense because the lessor suffers no "depreciable" loss, i.e., wear and tear, etc.

A lessee (tenant) ordinarily depreciates the cost of improvements it makes, but the costs of acquiring a lease are amortizable, not depreciable.

Review Question 26

Which of the following can qualify for depreciation?

a. Minerals in the ground	b. Improvements to leased property
c. Inventory	d. Land

2. Depreciation Period

The depreciation period generally begins when an asset is placed in service (Reg §1.167(a)-10(b)), namely when it's in a condition or state of readiness and availability for a specifically defined function. The depreciation period ends when the asset is retired from service, its cost or other basis is fully recovered, or it's sold or disposed of—whichever occurs first. (Code Sec. 167; Code Sec. 168(d); Reg §1.167(a)-10(b); Reg §1.167(b)-0(a)) However, under MACRS these rules are subject to the certain conventions, which govern when depreciation begins and ends (see below).

B. Modified Accelerated Cost Recovery System (MACRS)

MACRS is used to recover the basis of most business and investment property placed in service after 1986. Under MACRS, recovery property is depreciated by applying to its depreciable basis a prescribed depreciation method for its prescribed recovery period.

MACRS consists of two depreciation systems, the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). Generally speaking, GDS provides for shorter recovery periods and more accelerated depreciation methods than ADS, although the straight-line depreciation method may be elected for GDS. While most businesses chose GDS, ADS is mandated for certain property.

Regardless of which system is used, the depreciation deduction is determined by applying

1. a depreciation method to,

2. the depreciable basis of the recovery property,

3. over the applicable recovery period and,

4. subject to the applicable placed-in-service conventions.

A taxpayer may be able to expense (currently deduct) part or all of the cost of MACRS property, up to a statutory dollar ceiling under Code Section 179 (see IV.C.). Special limitations apply to depreciation on "listed property" (see IV.D.).

Lessees are treated like any other owner-taxpayer for purposes of determining MACRS deductions for lessees' improvements subject to MACRS rules. Thus, a lessee's deductions for the property are determined without regard to the lease term. (Code Sec. 168(i)(8)) This means that the lessee depreciates property over its MACRS recovery period even if the lease term is shorter or longer. (Certain leasehold periods have a special MACRS recovery period; see below.)

Where the lease ends or terminates before the end of the MACRS recovery period of the lessee's improvement and the lessee doesn't retain the improvement, the lessee has a gain or loss for the remaining unrecovered basis of the property. The remaining basis of unamortized leasehold improvements that are left behind when a lease terminates is deductible as a loss. A gain would arise if, for example, the tenant is paid to terminate the lease and the payment exceeds the basis of the leasehold improvements (and lease acquisition costs, if any).

A lessor is entitled to recover the cost of depreciable leasehold improvements that it makes. If such improvements are made for the lessee (e.g., to customize the space for the lessee) and are irrevocably disposed of or abandoned by the lessor at the termination of the lease by the lessee, then for purposes of determining gain or loss, the improvement is treated as disposed of by the lessor at that time. (Code Sec. 168(i)(8)(B))

Where depreciable property is acquired in certain nontaxable transfers, the transferee-recipient must "step into the shoes" of the transferor with respect to the depreciation period and method of the transferred property. This applies to the extent that the basis of such property in the hands of the transferee equals the transferor's adjusted basis. (Code Sec. 168(i)(7))

1. MACRS Recovery Property

With certain exceptions MACRS is mandatory for recovery property placed in service during the tax year. (Code Sec. 168(a)) Recovery property is depreciable tangible property used in a trade or business or for the production of income. (Code Sec. 168(a))

MACRS recovery property is divided into various classes, e.g., 3-year property, 5-year property, etc. These classes also generally indicate the recovery period for the property under GDS.

The following property isn't depreciable under MACRS:

- Intangible property (Code Sec. 168(a));

- Property the taxpayer elects to depreciate under a depreciation method not expressed in a term of years; e.g., the unit-of-production, or income-forecast method (Code Sec. 168(f)(1));

- Public utility property for which the taxpayer doesn't use the MACRS normalization method of accounting. (Code Sec. 168(f)(2));

- Any motion picture film or video tape (Code Sec. 168(f)(3)), including videocassettes; and

- Any master sound recordings. (Code Sec. 168(f)(4))

The assignment of MACRS property to a recovery class is made by reference to that property's class life as of January 1, 1986. (Code Sec. 168(i)(1)) The class life of many types of assets is carried in Rev. Proc. 87-56, 1987-2 CB 672. The assignment to a MACRS recovery class is determined as follows (Code Sec. 168(e)(1)):

MACRS Recovery Class	Property with a Class Life (in Years) of:
3-Year	4 or less
5-Year	More than 4 but less than 10
7-Year	10 or more but less than 16
10-Year	16 or more but less than 20
15-Year	20 or more but less than 25
20-Year	25 or more

In addition, MACRS assigns certain property to specific classes as follows:

- certain water utility property is in the 25-year class;
- residential rental property is in the 27.5-year class;
- nonresidential real property placed in service before May 13, 1993 is in the 31.5-year class and nonresidential real property placed in service after May 12, 1993 is in the 39-year class; and
- any railroad grading and tunnel bore is in the 50-year class. (Code Sec. 168(c))

Following are examples of the type of properties in each recovery class:

- Three-year MACRS class: tractor units for use over-the-road; breeding hogs; special handling devices used in the manufacture of food and beverages; and special tools used in the manufacture of rubber products, finished plastic products; qualified "rent-to-own" property and all racehorses placed in service after 2008 and before 2014, racehorses more than two years old when placed in service after 2013, and other horses more than 12 when placed in service. (Code Sec. 168(e)(3)(A))
- Five-year MACRS class: information systems (computers); heavy general purpose trucks; trailers and trailer-mounted containers; breeding or dairy cattle; and certain assets used in the drilling of oil and gas wells, construction, the manufacture of textile yarns, apparel, other finished goods, and cutting timber; any automobiles or light general purpose trucks (Code Sec. 168(e)(3)(B)(i)); personal property used in connection with research and experimentation (Code Sec. 168(e)(3)(B)(v)); certain energy-related property (Code Sec. 168(e)(3)(B)); and most farming equipment and machinery (other than grain bins, cotton ginning assets, fences, or other land improvements), the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010. (Code Sec. 168(e)(3)(B)(vii))
- Seven-year MACRS class: office furniture, fixtures, and equipment; machinery and equipment used in agriculture; certain assets (except helicopters) used in air transport; certain assets used in exploration for and production of petroleum and natural gas products, the manufacture of wood products and furniture, theme and amusement parks and recreation facilities (e.g., bowling alleys), motorsports entertainment complexes placed in service after October 22, 2004 and before 2014; Alaska natural gas pipeline property placed in service after 2004; natural gas gathering lines placed in service after April 11, 2005; property that doesn't have a class life and isn't specifically assigned to any other MACRS class. (Code Sec. 168(e)(3)(C)(ii))
- Ten-year MACRS class: water transport equipment not used in marine construction; assets used in petroleum refining, manufacture of grain and grain mill products, sugar and sugar products, and vegetable oils and vegetable oil products; a single purpose agricultural or horticultural structure, any tree or vine bearing fruit or nuts; and any qualified smart electric meter or qualified smart electric grid system placed in service after October 3, 2008. (Code Sec. 168(e)(3)(D) as amended by 2008 Energy Act §306(a)DivB)
- 15-year MACRS class: land improvements (e.g., sidewalks and roads) that aren't explicitly included in another class and aren't buildings or structural improvements; assets such as service-station and car-wash buildings; concrete footings used to anchor gas station pump canopies;

initial clearing and grading land improvements relating to gas utility property, qualified leasehold improvement property placed in service before 2014 (see IV.B.7); qualified restaurant property improvements placed in service before 2014; certain electrical transmission property and natural gas distribution lines placed in service after April 11, 2005 and before 2011; and qualified retail improvement property placed in service after 2008 and before 2014. (Code Sec. 168(e)(3)(E) as amended by 2010 Tax Relief Act (P.L. 111-312) and the American Taxpayer Relief Act of 2012 (P.L. 112-240)

- 20-year MACRS class: farm buildings (other than single purpose agricultural or horticultural structures) and initial clearing and grading land improvements for electric utility transmission and distribution plants.
- *25-year MACRS class:* Water utility property and municipal sewers.

Caution: Expired or expiring provisions may be extended by Congress.

A 27.5-year class is specifically assigned to residential rental property (Code Sec. 168(c)), including manufactured homes that are residential rental property, and elevators and escalators in that type of property. A 39-year class life is specifically assigned to nonresidential real property (Code Sec. 168(c)), and to elevators and escalators in that type of property.

The depreciation for any additions to, or improvement of, any real property (whether or not recovery property) is determined in the same manner as the depreciation deduction for the real property would be determined if the real property were placed in service at the same time as the addition or improvement. (Code Sec. 168(i)(6)(A)). The applicable MACRS depreciation period for additions or improvements to real property begins on the later of: (1) the date the addition or improvement is placed in service, or (2) the date the property is placed in service. (Code Sec. 168(i)(6)(B))

The depreciation allowance for MACRS personal property placed in service or disposed of in a short year can't be determined by using the IRS optional MACRS rate tables. The depreciation allowance is instead determined by: (1) multiplying the property's depreciable basis by the applicable depreciation rate, and (2) multiplying the product obtained in step (1) by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed in service during the short year under the applicable convention (see below), and the denominator of which is 12.

When a taxpayer has a short tax year other than the first tax year in the recovery period, the MACRS depreciation allowance for that short year must account for the difference between recovery years and tax years.

2. Basis of Recovery Property

MACRS depreciation deductions are computed on the property's depreciable adjusted basis under Code Sec. 1011 for the purpose of gain or loss on a sale or other disposition. (Code Sec. 167(a); Code Sec. 168(a)) This "unrecovered basis" is adjusted (i.e., ordinarily reduced) by depreciation previously allowed or allowable. However, if the taxpayer chooses to use IRS's optional MACRS depreciation rates tables, the applicable rate from the appropriate MACRS table is applied to the property's unadjusted depreciable basis in computing the depreciation deduction for the year.

Regardless of the methodology chosen, before regular MACRS depreciation deductions are computed, the beginning basis of assets must be reduced by: the portion of basis that the taxpayer elects to expense under Code Sec. 179 (see IV.C.) and for any bonus depreciation allowance claimed for the property (see below).

3. MACRS Depreciation Methods

Under GDS, there are three depreciation methods used for MACRS property: the 200% and 150% declining balance methods with an appropriate switch to straight-line to maximize deductions, and the straight-line method. (Code Sec. 168(b))

Under the declining balance methods, the depreciation rate (in percentage terms) generally is determined by dividing the declining balance percentage (200% or 150%) by the applicable recovery period. For example, the 200% declining balance method applied to property with a 5-year recovery period results in a depreciation rate of 40% (i.e., 200% ÷ 5). This 40% rate remains constant for each tax year in which the 200% declining balance method is used.

The 200% declining balance method can be used for MACRS property in the three-, five-, seven-, and ten-year recovery classes except for any tree or vine bearing fruit or nuts, or any qualified smart electric meter or any qualified smart electric grid system in the ten-year class. (Code Sec. 168(b)(1))

The 150% declining balance method must be used for MACRS property in the 15- and 20-year classes (other than qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) (Code Sec. 168(b)(3) as amended by 2010 Tax Relief Act (P.L. 111-312)), any property used in a farming business (Code Sec. 168(b)(2)(B)), any qualified electric smart meter or qualified smart electric grid system (Code Sec. 168(b)(2)(C) as amended by 2008 Energy Act §306(c)DivB)and, if the taxpayer elects, any other property (other than that for which straight-line must be used). (Code Sec. 168(b)(2)(D))

The straight-line method must be used for all residential rental property in the 27.5-year class and for all nonresidential real property in the 39-year class. It must also be used for qualified leasehold improvement property (Code Sec. 168(b)(3)(G)), qualified restaurant property improvements (Code Sec. 168(b)(3)(H)), and qualified retail improvement property (Code Sec. 168(b)(3)(I) as amended by 2008 Extenders Act §305(c)).

For property not required to use the straight-line method, a taxpayer can elect straight-line depreciation over the same recovery period in whi`ch the property belongs. This election must be for all property within a recovery class, but can be made for any or all classes. But once made, it's irrevocable for that year. (Code Sec. 168(b)(3); Code Sec. 168(b)(5))

Review Question 27

Under MACRS, how would an office building be depreciated?

a. 150% declining-balance method over 27.5 years.

b. Straight-line method over 27.5 years.

c. 200% declining balance method over 31.5 years.

d. Straight-line method over 39 years.

4. Placed-in-Service Conventions

In the case of personal property (generally property other than residential rental or nonresidential real property), the half-year depreciation convention applies for the acquisition and disposition year. Under this rule, only a half-year of MACRS depreciation is allowed for personal property for the acquisition or disposition year. (Code Sec. 168(d)(1); Code Sec. 168(d)(4)(A))

However, there is a special exception to the half-year convention. The mid-quarter, and not the half-year, convention applies to all personal property placed in service during a tax year if more than 40% of the total basis of all personal property placed in service during that year is placed in service during the last three months of the year. Under the mid-quarter convention, depreciation for a full year is multiplied by a fraction based on the quarter it's placed in service: 87.5% for the first quarter, 62.5% for the second, 37.5% for the third, and 12.5% for the fourth.

When determining if the more-than-40% threshold has been reached, the taxpayer excludes:

- That portion of the basis of property that is expensed under Code Sec. 179 (see IV.C.). (Reg §1.168(d)-1(b)(4)(i)).
- Nonresidential real property, residential rental property, and any railroad grading or tunnel bore. (Code Sec. 168(d)(3)(B)(i))
- Property placed in service and disposed of in the same tax year. (Code Sec. 168(d)(3)(B)(ii))
- Property excluded from MACRS (Reg §1.168(d)-1(b)(1)), such as films, videotapes and sound recordings.
- The basis of a business car, if the taxpayer elects for the placed-in-service year to claim deductions using the standard mileage allowance method (see III.D.2.).
- That portion of basis attributable to the personal-use portion of mixed-use assets (e.g., a self-employed person's car used for both business and personal use). (Reg §1.168(d)-1(b)(4)(iii))

Review Question 28

A calendar year taxpayer who placed $1 million of equipment in service during the current year will use the mid-quarter convention for depreciation purposes only if more than __________ of the equipment was placed in service during the final three months of the year.

a. $250,000. b. $400,000.

c. $500,000.

A mid-month depreciation convention applies in determining MACRS depreciation deductions for the year real property in the 27.5 or 39-year class is placed in service or is disposed of. Under this rule, all realty placed in service (or disposed of) during any month is treated as placed in service (or disposed of) at the mid-point of that month in computing MACRS depreciation deductions for the acquisition and disposition years. (Code Sec. 168(d)(2))

Review Question 29

A calendar-year taxpayer placed MACRS realty in service at the end of last year and disposed of the realty on August 3 of this year. How many months of depreciation is the taxpayer entitled to for the current year?

a. 0 months. b. 6 months.

c. 7.5 months. d. 12 months.

5. Alternative Depreciation System (ADS)

ADS is a straight-line depreciation system under which there is only one depreciation period for each class of personal property and only one depreciation period for realty. (Code Sec. 168(g)(2)(C); Code Sec. 168(g)(3)(B)) ADS uses the same depreciation conventions as MACRS. (Code Sec. 168(g)(2)(B)) Depreciation deductions must be computed under ADS only for certain specified properties (see below).

However, ADS must be used for all properties including properties depreciated under MACRS for purpose of computing earnings and profits of corporations (see VII.B.1.) (Code Sec. 312(k)(3)(A)). ADS also applies for purposes of computing the depreciation tax preference for certain property under the alternative minimum tax (see VI.E.) ADS may be elected for all other properties—on a class-by-class basis for personal property and on an individual basis for residential rental and nonresidential real properties. (Code Sec. 168(g)(7)(A))

An ADS election is a year-by-year election; and, once made, it's irrevocable. (Code Sec. 168(g)(7)(B)) This election is in addition to the similar, year-by-year straight-line MACRS election, discussed above.

Property excluded from MACRS because a depreciation method not measured in term of years is elected is also excluded from ADS. (Code Sec. 168(f)(1))

Required ADS property. MACRS property that must be depreciated under ADS include:

- "Luxury" automobiles and other "listed" (i.e., mixed-use) property used 50% or more for personal purposes (see IV.D.) (Code Sec. 280F(b)(1))
- Properties used predominantly outside the U.S. (Code Sec. 168(g)(1)(A)), except certain properties listed in the Code.
- Imported business equipment from countries that discriminate against U.S. goods from the date the equipment is placed on a restricted list by Presidential Executive Order. (Code Sec. 168(g)(6))

ADS depreciation periods. Examples of the prescribed ADS straight-line depreciation period include:

- Four years: qualified rent-to-own property placed in service after August 5, 1997 (Code Sec. 168(g)(3)(B));
- Five years: automobiles, light-purpose trucks (Code Sec. 168(g)(3)(D)), and qualified technological equipment, (Code Sec. 168(g)(3)(C));
- 20 years: Code Sec. 1250 property (generally depreciable real property) which is a retail motor fuels outlet (Code Sec. 168(g)(3)(B));

- 12 years: for personal (Code Sec. 1245 class) property with no class life (Code Sec. 168(g)(2)(C));
- 40 years: nonresidential real property and for residential rental property (other than certain low or moderate income housing) and any Code Sec. 1245 real property with no ADR class life. (Code Sec. 168(g)(3)(E))

6. Optional IRS Depreciation Tables

Instead of making the MACRS computations described above for either GDS or ADS, a taxpayer can rely on tables provided by IRS) in which the applicable recovery period and placed-in-service conventions are built-in. Four important rules control the use of these optional tables:

- All the tables' rates (accelerated or straight-line) are applied to the property's unadjusted depreciable basis. This is the unadjusted depreciable basis (basis for gain or loss, not reduced by prior depreciation), after reflecting reductions in basis for: (1) personal-use percentage of the asset for the tax year; (2) any portion of the asset that is expensed under Code Sec. 179; (3) other initial basis adjustments, and (4) unless the taxpayer "elected out," the bonus first-year depreciation for certain qualified property. (Reg §1.168(k)-1T(d)(2))
- No special notice is filed with IRS to use the optional MACRS tables.
- The taxpayer must use the tables to compute the annual depreciation allowances for the entire recovery period of the property. However, a taxpayer may not continue to use the tables if there are any adjustments to the basis of the property for reasons other than: (a) depreciation allowed or allowable, or (b) an addition or an improvement to such property that is subject to depreciation as a separate item of property.
- Use of the tables is denied for a short tax year and for later tax years with respect to MACRS personal property not fully depreciated by the end of the short tax year.

7. Bonus First-year Depreciation Allowance

A bonus first-year depreciation allowance applies to "qualified property". The allowance, which is claimed in the first year that the property is placed in service by the taxpayer for use in its trade or business or for the production of income, is generally equal to 50% of the unadjusted depreciable basis of property acquired and placed in service after Dec. 31, 2007 and before Jan. 1, 2014 (Jan. 1, 2015 for certain aircraft and long-production-period property). (Code Sec. 168(k); Reg § 1.168(k)-1(d)(1)). However, 100% bonus depreciation was available for property acquired and placed in service, generally, after Sept. 8, 2010 and before Jan. 1, 2012 (Jan. 1, 2013 for certain aircraft and long-production-period property).

Caution: Expired or expiring provisions may be extended by Congress.

The adjusted basis of the property is reduced by the bonus depreciation before computing the amount otherwise allowable as a depreciation deduction for the tax year and any later tax year. (Code Sec. 168(k)(1)(B)) There is no alternative minimum tax depreciation adjustment for the entire recovery period of qualified property. (Code Sec. 168(k)(2)(G); Reg §1.168(k)-1(d)(2)(ii))

For property eligible for bonus first-year depreciation, the taxpayer may elect not to claim bonus first-year depreciation. This election-out may be made for any class of property for any tax year. (Code Sec. 168(k)(2)(D)(iii))

Qualified property. "Qualified property" eligible for bonus first-year depreciation includes most tangible personal property, "qualified leasehold improvement property" (i.e. certain interior improvements to nonresidential buildings), and most computer software. (Code Sec. 168(k)(2)(A)(i)) In addition to being of a qualifying type, the property must meet (1) original use, (2) timely acquisition, and (3) timely placed-in-service requirements. (Reg §1.168(k)-1(b)(1))

Property is ineligible for a bonus first-year depreciation allowance if it must be depreciated under the alternative depreciation system. (Code Sec. 168(k)(2)(D))

Other special allowances. A special 50% first-year bonus depreciation allowance applies to qualified cellulosic biomass ethanol plant property purchased after December 20, 2006 and placed in service after October 3, 2008 and before January 1, 2014(Code Sec. 168(l) as amended by 2008 Energy Act §308(a)DivB and the American Taxpayer Relief Act of 2012 §410(a)(1)) and qualified reuse and recycling property purchased and placed in service after August 31, 2008. (Code Sec. 168(m) as amended by 2008 Energy Act §308(a)DivB)

8. Non-MACRS Depreciation Methods

A taxpayer may elect to exclude property from MACRS if the property can properly be depreciated using the unit-of-production method or any other depreciation method not expressed in terms of years. (Code Sec. 168(f)(1)) In addition, certain property, such as motion pictures and sound recordings, are expressly excluded from MACRS and can be depreciated using the income forecast method.

Unit-of-production method. The unit-of-production method is suitable for figuring depreciation of equipment used in mining, oil wells, and timber working. Under the unit-of-production method, depreciation is based on the estimated number of units that will be produced before the asset wears out. For example, if a taxpayer estimates that a machine will produce 20,000 units before it is no longer useful and in the first year of service 2,000 units are produced, then 10% of the cost of the machine can be deducted as depreciation in that year.

Income forecast method. Taxpayers using the income forecast method compute depreciation based on the ratio of current year income to forecasted total income from the property before the close of the tenth tax year after the year the property is placed in service. (Code Sec. 167(g)) If the income in the first year is 50% of the estimated total income, then depreciation that year is 50% of the cost. If income in the second year is 25% of the estimated total, depreciation that year is 25% of cost. Expressed as a formula, any year's depreciation is computed as follows:

$$\text{cost} \times \frac{\text{current year's income from asset}}{\text{total estimated income from asset}}$$

No depreciation is allowed once the total cost of the property has been recovered. If the cost has not been fully recovered, the entire remaining basis of the property is claimed as a depreciation deduction for the tenth tax year after the property is placed in service.

Only the following property is eligible for depreciation under the income forecast method or any similar method:

- any motion picture film or video tape
- sound recordings
- copyrights
- books
- patents
- property specified in regulations. (Code Sec. 167(g)(6))

Proposed IRS regulations would extend use of the income forecast method to theatrical productions, and would authorize IRS to publish guidance designating other properties. (Prop Reg §1.167(n)-5(a)) An income forecast or similar method may not be used with respect to any amortizable Code Sec. 197 intangible (see IV.E.). (Code Sec. 167(g)(6)) Thus, the income forecast method is not applicable to property to which Code Sec. 197 applies.

In lieu of the income forecast method, a taxpayer may elect to treat the cost of any "qualified film or television production" as an expense which is not chargeable to capital account. Any cost so treated may be currently deducted. (Code Sec. 181(a)(1), as added by 2004 Jobs Act §244(a)) A qualified film or television production is any production of a motion picture (whether released theatrically or directly to videocassette or any other format); miniseries; scripted, dramatic television episode; or movie of the week if at least 75% of the total compensation expended on the production is for services performed in the U.S. The election to treat qualified film or television production costs as deductible expenses does not apply to any qualified film or television production the aggregate cost of which exceeds $15 million. (Code Sec. 181(a)(2)(A))

Review Question 30

In Year 1, a publisher acquires and publishes a copyrighted manuscript. The cost of the copyright is $10,000. The estimated income from the copyright is $100,000. In each of Years 1 and 2, the publisher earns $50,000 from the copyright. In Year 3, the publisher earns $5,000 from the copyright. What is the amount of the publisher's depreciation deduction for Year 3?

a. $0

b. $5,000

c. $10,000

C. Section 179 and Section 179D Expense Elections

Taxpayers, except trusts, estates and certain non-corporate lessors, can elect to expense up to a statutory amount per year of the cost of certain eligible personal property used in the active conduct of a trade or business.

Historically, the maximum amount that could be expensed annually was $25,000. However, in recent years, Congress has temporarily tinkered with the amount of the expensing deduction. For tax years beginning in 2010 through 2013, the maximum amount is $500,000. (Code Sec. 179(b)((1)(b)) as amended by the American Taxpayer Relief Act of 2012) However, the maximum expensing deduction is scheduled to drop to $25,000 or tax years beginning after 2013. (Code Sec. 179(b)(1) (C))

Two additional dollar limits apply to the Section 179 expense election:

- The maximum annual expensing amount generally was reduced dollar-for-dollar by the amount of section 179 property placed in service during the tax year in excess of an investment ceiling amount. For tax years beginning in 2010 and 2013, the investment ceiling limit is $2,000,000. For tax years beginning in after 2013, the investment ceiling will drop to $200,000. (Code Sec. 179(b)(2) as amended by the American Taxpayer Relief Act of 2012).
- The amount of deduction is further limited to the amount of taxable income from any of taxpayer's active trades or businesses. Taxable income, for this purpose, is computed without regard to the cost of any qualified expense property, the deduction for one-half of self-employment tax, any net operating loss carryback or carryforward, and any deductions suspended under other Code sections (e.g., passive activity rules) (Code Sec. 179(b)(3); Reg §1.179-2(c)(1)) An amount that can't be deducted because of the taxable income limit is carried over indefinitely until it can be deducted. (Code Sec. 179(b)(3)(B))

Caution: Expired or expiring provisions may be extended by Congress.

Special dollar limits apply to expensing passenger automobiles (see IV.D.2.)

Where an expense election deduction is allocated to a taxpayer from a partnership or an S corporation, the deduction limitation, the investment limitation, and the "taxable income" limitation are applied at both the partnership (or S corporation) level and the taxpayer level. (Code Sec. 179(d)(8); Reg §1.179-2(c)) However, for purposes of the investment limitation, the cost of qualifying property that the partnership or S corporation placed in service isn't attributed and allocated to the partner or shareholder. (Reg §1.179-2(b)(3))

Review Question 31

If a taxpayer placed $2,100,000 of qualifying property in service in 2013, the taxpayer's Section 179 expensing deduction for the year is limited to:

a. $0.

b. $100,000.

c. $400,000.

d. $500,000.

1. Eligible Property

Property eligible for the expense election consists of the following assets, if "purchased" for use in the active trade or business of the taxpayer:

- Tangible recovery property that's Code Sec. 1245 (personal) property.
- Off-the-shelf computer software (Code Sec. 179(d)(1))

Code Sec. 179 property *does not include* property used in the production of income (Code Sec. 212 property), air conditioning and heating units, property used for lodging, property used outside the U.S., property used by certain tax-exempt organizations, and property used by governmental units or foreign persons or entities. (Code Sec. 179(d)(1)) The election isn't available for the portion of the property's basis that's determined by reference to the basis of other property held at any time by the purchaser (e.g., trade-ins).

Property is not "purchased" (and thus no Section 179 deduction is available) when it is acquired from any person whose relationship to the purchaser would cause the disallowance of losses under Code Sec. 267 or Code Sec. 707(b). This includes (a) family members (but only spouses, ancestors and lineal descendants), (b) 50%-owned corporations, (c) grantors, fiduciaries and beneficiaries of trusts, and (d) 50%-owned partnerships. Property is also ineligible for the Section 179 deduction if its basis is determined by reference to the adjusted basis of the person from whom acquired (e.g., gifts), or if it's acquired from a decedent. (Code Sec. 179(d)(2); Reg §1.179-3(d))

2. Recapture of Section 179 Deduction

A Code Sec. 179 "recapture" is triggered when the business use of property placed in service in an earlier year is reduced to 50% or less during the recapture period. The recapture period of the expense election is the entire recovery period of the qualifying Section 179 property. (Code Sec. 179(d)(10))

The amount that must be recaptured and included in income equals the expense deduction taken minus the MACRS depreciation amount that would have been allowed on the expensed amount from the time the property was placed in service up to and including the year of recapture. (Reg §1.179-1(e)(1))

Review Question 32

Recapture of a Code Section 179 expensing deduction claimed in an earlier year will be triggered if the property' business use drops to:

a. 50% or less. b. 75%or less.

c. Any amount less than 100%.

3. Section 179D Election for Energy-efficient Commercial Buildings

Taxpayers may expense the cost of "energy efficient commercial building property" placed in service in calendar years 2006 through 2013. (Code Sec. 179D(a) as amended by 2006 Tax Relief and Health Care Act §204 and by 2008 Energy Act §303DivB) The deduction for any building for any tax year can't be more than the excess (if any) of (1) $1.80 × the square footage of the building over (2) the deductions allowed under Code Sec. 179D for prior years. (Code Sec. 179D(b))

"Energy efficient commercial building property" is property that is (1) depreciable or amortizable, (2) installed on or in a building located in the U.S. and (3) certified as being installed as part of a plan that will meet a 50% energy use reduction test described in Code Sec. 179D(c). In some situations in which the 50% test isn't satisfied, a partial deduction is permitted. (Code Sec. 179D(d)(1))

D. "Luxury" Automobiles and Other "Listed" Property

MACRS depreciation deductions and the Code Sec. 179 expense election are limited for "luxury" business autos and other "listed property."

The following restrictions on depreciation (and the Code Sec. 179 expense election) apply to listed property:

- Property may be depreciated under the accelerated MACRS rates only if it is used more than 50% for business.
- Depreciation of certain passenger autos ("luxury autos") is limited to specific dollar amounts.
- A taxpayer who leases a "luxury" auto for business must add into income an "inclusion amount."
- A taxpayer who leases listed property, other than a luxury auto, must take into income an "inclusion amount" when the property is no longer used more than 50% for business.
- Specific recapture rules apply to listed property.
- Strict substantiation rules apply to listed property expenses.

"Listed property" consists of:

- any passenger auto (except for ambulances or hearses used directly in a trade or business, taxis and other vehicles used directly for transporting people or property for pay, and trucks or vans specified by IRS regulations);
- any other property used as a means of transportation (e.g., trucks, buses, trains, boats, airplanes), except for vehicles that, by reason of their nature, aren't likely to be used more than a *de minimis* amount for personal purposes;
- any property of a type generally used for entertainment, recreation or amusement, including photographic, phonographic, communication and video recording equipment, unless the property is used either exclusively at the taxpayer's regular business establishment, or in connection with the taxpayer's principal trade or business;
- any computer or peripheral equipment except those owned or leased by the taxpayer, and used exclusively at the taxpayer's regular business establishment; and
- any other property specified by regulations. (Code Sec. 280F(d)(4); Code Sec. 280F(d)(5); Reg §1.280F-6T(b)(1))
- For tax years beginning before Jan. 1, 2010, listed property also included any cellular telepone or other similar telecommunications equipment.

Review Question 33

Which of the following is **not** listed property?

a. A cellular phone.

b. A laptop computer used for business by a traveling salesperson.

c. A business car provided to an employee.

1. Depreciation of Mixed-use Listed Property

A special limitation applies for the year listed property (including autos) is placed in service. If the property is not predominantly used in a "qualified business use," an accelerated depreciation deduction (including the Code Section 179 expense election deduction) is not allowed for the property. If, for the acquisition year, the listed property is used 50% or less in a qualified business use, it: (1) doesn't qualify for the Code Section 179 expense election (Reg §1.280F-3T(c)(1)), and (2) is depreciable only under straight-line using the ADS recovery periods (see above), (Code Sec. 168(k)(2)(E); Code Sec. 280F(b)(1))

When the more-than-50% qualified business use requirement isn't met in a post-acquisition year (during the property's normal recovery period), the listed property becomes, retroactively to the year of acquisition, straight-line ADS property. (Reg §1.280F-3T(c)(2)) Depreciation in excess of straight-line (including the expensing election and the bonus first-year depreciation allowance) previously taken is recaptured (included in income). (Code Sec. 280F(b)(2)(A); Reg §1.280F-3T(b)(2); Reg §1.280F-3T(d)(2))

"Qualified business use" generally is any use in a trade or business of the taxpayer. (Code Sec. 280F(d)(6)(B)) However, this term doesn't include Code Sec. 212 production-of-income use. (Reg §1.280F-6T(d)(2)) Thus, if an asset is used 49% in a trade or business and 51% for the production of income not in a trade or business, the asset isn't predominantly used in a qualified business use. (Reg §1.280F-6T(d)(5), Ex (1)) However, the actual deduction amount is computed by using the sum of the (1) business use percentage (qualified and nonqualified) and (2) the production-of-income use percentage, and not by the qualified business use percentage. (Reg §1.280F-6T(d)(3)(i)) Thus, in the case of a 49% business use and 51% production-of-income use, 100% of the property's basis is eligible for straight-line ADS.

Qualified business use doesn't include:

- Leasing property to any 5% owner of the taxpayer or to any person related to the taxpayer. Leasing aircraft to such persons, however, is qualified business use if business use, without counting the lease use, is at least 25% of the aircraft's total use.
- The use of listed property as compensation for services by a 5% owner or a related person.
- The use of listed property as compensation for services by any person other than a 5% owner or a related person, unless the provider of the property includes the value of the compensation in the recipient's gross income, properly reports it and, where necessary, treats it as wages subject to withholding. (Code Sec. 280F(d)(6)(C))

2. "Luxury" Auto Restrictions

Purchased autos (and certain trucks and vans) used in a trade or business normally are depreciated as 5-year MACRS property. (Code Sec. 168(b)(1); Code Sec. 168(e)(3)(B)) However, the deduction normally obtained for an auto by applying the MACRS rules for 5-year property and the Code Sec. 179 expensing rules is limited by the so-called "luxury auto dollar caps" of Code Sec. 280F. The dollar caps are periodically adjusted for inflation and vary with the placed-in-service year of the auto and the depreciation year. Thus, the maximum annual depreciation/expensing deduction for a business auto is the lesser of the otherwise allowable depreciation/expensing allowance or the applicable luxury auto dollar cap.

The following table shows annual depreciation dollar caps for vehicles that are subject to the luxury-auto limits and placed in service in calendar year 2013. Note: The tables reflect the additional first-year bonus depreciation allowable for 2013 (see above) if applicable.

If the first-year bonus depreciation rules don't apply to an auto (not a truck or van):

... $3,160 for the placed in service year;

... $5,100 for the second tax year;

... $3,050 for the third tax year; and

... $1,875 for each succeeding year.

If the bonus depreciation rules do apply to an auto (not a truck or van):

... $11,160 for the placed in service year;

... $5,100 for the second tax year;

... $3,050 for the third tax year; and

... $1,875 for each succeeding year.

If the bonus depreciation rules don't apply to a light truck or van (passenger auto built on a truck chassis, including minivan and sport-utility vehicle (SUV) built on a truck chassis):

... $3,360 for the placed in service year;

... $5,400 for the second tax year;

... $3,250 for the third tax year; and

... $1,975 for each succeeding year.

If the bonus depreciation rules do apply to a light truck or van:

... $11,360 for the placed in service year;

... $5,400 for the second tax year;

... $3,250 for the third tax year; and

... $1,975 for each succeeding year.

A passenger auto is defined as any four-wheeled vehicle which is manufactured primarily for use on public streets, roads, and highways, and is rated at an unloaded gross vehicle weight of 6,000 pounds or less. In the case of a truck or van, the above 6,000-pound weight test is applied to the truck's or van's gross (loaded) vehicle weight rather than its unloaded gross vehicle weight. (Code Sec. 280F(d)(5)(A)) Special vehicles (such as ambulances, hearses and autos used as taxis and limos) are excepted from the luxury auto rules, as are trucks or vans that are qualified non-personal use vehicles (those which, by reason of their nature are not likely to be used more than a *de minimis* amount for personal use). (Reg §1.280F-6T(c)(3)(iii))

Heavy sport-utility vehicles (SUVs) are exempt from the luxury auto dollar caps if they are rated at more than 6,000 pounds gross vehicle weight (loaded). However, as a result of the enactment of the 2004 Jobs Act, the Section 179 expense deduction for these heavy SUVs is subject to a special dollar cap. For heavy SUVs (more than 6,000 pounds and no more than 14,000 pounds), the expense deduction is limited to $25,000. This limitation applies to SUVs placed in service after October 22, 2004. (Code Sec. 179(b)(6)(A))

Lessees of listed property. Lessees of business automobiles and other listed property under leases of 30 days or more are subject to a different set of restrictions than those that apply to owners of listed property. (Code Sec. 280F(c)(2); Code Sec. 280F(c)(3))

Deductions for rental payments aren't limited. Instead, during every lease year, lessees of "luxury" autos must include in gross income an "inclusion amount," determined from IRS's tables. The "inclusion amount" for business automobiles is based on the fair market value of the automobile and the lessee's business/production-of-income use. An amount must be included in the lessee's gross income for each year the automobile is leased, whether or not it's used 100% for business/investment purposes. (Reg §1.280F-5T(d); Reg §1.280F-5T(e))

For listed property other than business automobiles, there's no annual "inclusion amount." The lessee must, however, take an "inclusion amount" into income for the first year the property ceases to be used predominantly in a qualified business use. (Reg §1.280F-5T(f))

The fair market value of the property is equal to its fair market value on the first day of the lease term. If, however, the capitalized cost of the leased property is specified in the lease, that amount is its fair market value. (Reg §1.280F-5T(h)(2))

3. Substantiation Requirements

In the case of listed property, all the relevant elements from the following list must be proved for each expenditure or business use of the property:

- The amount and date of each separate expenditure with respect to the item of listed property (for example, the cost and date of acquisition or leasing, the cost and date of maintenance and repairs, etc.).
- The amount and date of each use of the item of listed property for business or investment, based on an appropriate measure (mileage for automobiles and other property used for transportation, time for other types of property, unless IRS approves an alternative method), and the total use of the item of listed property for the tax period.

- The business purpose for each expenditure or use with respect to the item of listed property. (Reg §1.274-5T(b)(6))

E. Amortization

Taxpayers can claim a deduction for an "amortizable section 197 intangible" by amortizing the adjusted basis (for purposes of determining gain) of that intangible ratably over a 15-year period. The period begins on the later of: the first day of the month in which the intangible is acquired, or, for property held in connection with the conduct of a trade or business or a production-of-income activity, the first day of the month in which the conduct of the trade or business or the activity begins. (Code Sec. 197(a); Reg §1.197-2(f)(1)(i)) No other depreciation or amortization deduction is permitted for any amortizable section 197 intangible. (Code Sec. 197(b))

No loss deduction is permitted on the disposition of an amortizable section 197 intangible if the taxpayer retains one or more other intangibles acquired in the same transaction or series of related transactions along with the intangible disposed of. (Code Sec. 197(f)(1)(A)) On the disposition of the intangible, the bases of the other intangibles acquired in the same transaction or series of related transactions are increased by the amount of the loss barred. (Code Sec. 197(f)(1)(A)(ii)) The basis of each retained section 197 intangible is increased by the product of (1) the amount of the loss not recognized solely by reason of this rule, and (2) a fraction consisting of the basis of the intangible over the total bases of all such retained section 197 intangibles.

1. Qualifying Section 197 Intangibles

An amortizable section 197 intangible is any section 197 intangible acquired and held in connection with the conduct of a trade or business or a Code Sec. 212 production-of-income activity. (Code Sec. 197(c)(1)) An acquisition may be made in the form of a stock acquisition or redemption. Amortizable section 197 intangibles include:

- Business goodwill (Code Sec. 197(d)(1)(A); Reg §1.197-2(b)(1)),

- Going concern value (Code Sec. 197(d)(1)(B); Reg §1.197-2(b)(2)),

- Workforce in place (Code Sec. 197(d)(1)(C)(i); Reg §1.197-2(b)(3)),

- Business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers) (Code Sec. 197(d)(1)(C)(ii); Reg §1.197-2(b)(4)),

- Any patent, copyright, formula, process, design, pattern, know-how, format or similar item (but see below) (Code Sec. 197(d)(1)(C)(iii); Reg §1.197-2(b)(5)),

- Customer-based intangibles (Code Sec. 197(d)(1)(C)(iv); Reg §1.197-2(b)(6)), including the deposit base and any similar asset of a financial institution. (Code Sec. 197(d)(2)(B)) Customer-based intangibles are the composition of market, share, and any other value resulting from the future provision of goods or services out of relationships with customers (contractual or otherwise) in the ordinary course of business (Code Sec. 197(d)(2)(A)),

- Supplier-based intangibles. (Code Sec. 197(d)(1)(C)(v)) Supplier-based intangibles are the value resulting from the future acquisitions of goods or services out of relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer (Code Sec. 197(d)(3); Reg §1.197-2(b)(7)),

- Government-granted licenses, permits or other rights (Code Sec. 197(d)(1)(D); Reg §1.197-2(b)(8)), and

- Franchises, trademarks and trade names (including professional sports franchises acquired after October 22, 2004). (Code Sec. 197(d)(1)(F); former Code Sec. 197(e)(6))

Section 197 intangibles also include any other item that is similar to workforce in place, information base, know-how, customer-based intangibles or supplier-based intangibles. (Code Sec. 197(d)(1)(C)(vi))

The following intangibles are treated as section 197 intangibles only if acquired in connection with the acquisition of a business:

- Covenant not to compete or similar arrangements (Code Sec. 197(d)(1)(E); Reg §1.197-2(b)(9)),
- Computer software (any program designed to cause a computer to perform a desired function. (Code Sec. 197(e)(3)(B)) The term computer software does not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software. (Code Sec. 197(e)(3)(B))
- Films, sound recordings, video tapes and books (Code Sec. 197(e)(4)(A); Reg §1.197-2(c)(4)),
- Copyrights and patents (Code Sec. 197(e)(4)(C)),
- Rights to receive tangible property or services under a contract granted by the government (Code Sec. 197(e)(4)(B)), and
- Mortgage-servicing rights secured by residential real property. (Code Sec. 197(e)(7))

2. Non-qualifying Intangibles

The following are never treated as section 197 intangibles regardless of how acquired:

- Interests in corporations, partnerships, trusts and estates (Code Sec. 197(e)(1)(A)),
- Computer software that's readily available for purchase by the general public, is subject to a nonexclusive license, and hasn't been substantially modified. (Code Sec. 197(e)(3)(A))
- Futures, foreign currency contracts and notional principal contracts (Code Sec. 197(e)(1)(B)),
- Land (Code Sec. 197(e)(2)),
- Leases of tangible property (Code Sec. 197(e)(5)(A)),
- Debt instruments, except for deposit bases and similar items (Code Sec. 197(e)(5)(B)),
- Any fees for professional services or transaction costs incurred by parties to a transaction with respect to which any part of the gain or loss isn't recognized under the rules in Code Sec. 351 through Code Sec. 368 that govern corporate organizations and reorganizations (Code Sec. 197(e)(8)), and
- Accounts receivable.

In addition, self-created intangibles aren't subject to 15-year amortization if they are:

- created by the taxpayer (even if created by someone else under contract with the taxpayer),
- not an intangible described in Code Sec. 197(d)(1)(D), (E) or (F), i.e., not certain licenses and permits granted by a governmental unit, covenants not to compete made in connection with the acquisition of an interest in a trade or business, and franchises, trademarks and trade names, and
- not an intangible created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of one. (Code Sec. 197(c)(2); Reg §1.197-2(d)(2))

Review Question 34

Which of the following is **not** an amortizable Section 197 intangible?

a. Goodwill. b. Lease of tangible property.

c. Going concern value. d. Customer list.

3. Other Amortization

In addition to section 197, the cost of a number of special facilities and expenditures may be amortized, usually over a period of 60 months at the taxpayer's election.

Expenditures made for the following properties may be amortized over the period indicated instead of being depreciated under MACRS:

- Costs of certified pollution control facilities for older plants—60-month amortization election available.
- Costs of certain reforestation expenditures—84-month amortization election available. (An expensing deduction is also available for reforestation expenditures incurred after October 22, 2004. (Code Sec. 194(b)(1)(A))
- Research and experimental expenditures connected with a trade or business may be amortized over a 60-month period (see III.K.3.).
- Startup expenditures (see III.B.1.).
- Organization costs (see III.B.2.).
- For amounts paid or incurred in tax years beginning after August 8, 2005, geological and geophysical expenses connected with the exploration for, or development of, oil or gas within the U.S. are amortized ratably over a 24-month period. (Code Sec. 167(h)(1), as amended by 2005 Energy Tax Act §1329(a))

F. Depletion

All exhaustible natural deposits and timber qualify for cost depletion—that is, deduction of a reasonable allowance for depletion based on the taxpayer's cost or other basis of the resources. For mines and certain interests in oil or gas wells, the depletion deductions may be computed as a specified percentage of gross income if that is greater than cost depletion. (Code Sec. 613)

A taxpayer can claim percentage depletion on one property and cost depletion on another, or claim cost depletion for one year and percentage for another year on the same property. Percentage depletion for oil and gas wells (except for gas from certain domestic geothermal deposits or geopressured brine) is limited to "independent producers and royalty owners." The allowable deduction is never less than cost depletion. (Code Sec. 611; Code Sec. 612; Code Sec. 613)

The basis of the property must be reduced by the depletion deduction allowed or allowable, whichever is larger.

1. Cost Depletion

The deduction for cost depletion is based on the property's adjusted basis, the number of recoverable units of mineral at the beginning of the year and the number of units sold or for which payment is received during the year. (Reg §1.611-2(a)) Taxpayer's total cost depletion deductions can't exceed his or her basis for the mineral property.

Basis for cost depletion and gain or loss is its cost or other basis plus or minus basis adjustments. (Code Sec. 612) It doesn't include the basis of non-mineral property, such as amounts recoverable through depreciation, or the residual value of land and improvements at the end of operations. (Reg §1.612-1(b)(1)) Additional basis adjustments also apply to natural resources. (Code Sec. 1016(a))

2. Percentage Depletion

The deduction for percentage depletion is a specified percentage of the "gross income from the property" for the tax year. It can never exceed 50% (100% for oil and gas properties) of taxable income from the property before deducting depletion. (Code Sec. 613(a)) The specified percentages range from 22% for sulfur and uranium down to 5% for gravel and sand. For crude oil and natural gas production of independent producers and royalty owners, the percentage is generally 15%.

Percentage depletion, like cost depletion, reduces basis. But percentage depletion continues to be deductible as long as there is gross income from the property even after taxpayer's basis for the property has been reduced to zero.

A corporation's deductible depletion allowance for iron ore or coal (including lignite) is cut back by 20% of the otherwise allowable percentage depletion deduction in excess of the adjusted basis of the property at the close of the tax year (determined without regard to the depletion deduction for the tax year). (Code Sec. 291(a)(2))

Review Question 35

Which of the following is a true statement about depletion?

a. A taxpayer may claim either cost depletion or percentage depletion for any property eligible for depletion.

b. A taxpayer can claim cost depletion for one property and percentage depletion for another property in the same year.

c. Percentage depletion is no longer deductible once a taxpayer's basis in a property has been reduced to zero.

V. Business Tax Credits

Learning Objectives

After completing this section, you should be able to:

- Explain the operation of the general business credit.
- Apply the requirements for business tax credits.

A. General Business Credit

Certain business incentive credits are combined into one "general business credit" for purposes of determining each credit's allowance limitation for the tax year.

Among the components of the general business credit are:

- the investment credit (Code Sec. 38(b)(1)),
- the work opportunity credit (Code Sec. 38(b)(2)),
- the incremental research credit (Code Sec. 38(b)(4)),
- the disabled access credit (Code Sec. 38(b)(7)),
- the employer social security credit (Code Sec. 38(b)(11)),
- the employer-provided child care credit (Code Sec. 38(b)(15)),
- the small employer pension plan startup credit (Code Sec. 38(b)(14)),
- the energy efficient home credit (Code Sec. 38(b)(23),
- the energy efficient appliance credit (Code Sec. 38(b)(24),
- the differential wage payment credit for compensation paid to active duty military personnel (Code Sec. 38(b)(33)), and
- the small employer health insurance credit (Code Section 45R).

A credit is allowed against income tax for a particular tax year equal to the sum of: (1) the business credit carryforwards carried to the tax year, (2) the current year business credit, and (3) the business credit carrybacks carried to the tax year. (Code Sec. 38(a))

The credit allowed for any tax year is generally limited to the excess of taxpayer's "net income tax" over the greater of: (1) the tentative minimum tax for the tax year (see VI.E.), or (2) 25% of the amount of the taxpayer's "net regular tax" that exceeds $25,000. (Code Sec. 38(c)(1)). However, the limitations are applied separately to certain "specified credits" and the tentative minimum tax is treated as being zero (i.e., the credits can offset the taxpayer's alternative minimum tax). Specified credits include: (1) the alcohol fuel credit; (2) the low-income housing credit for buildings placed in service after 2007; (3) the FICA tip credit; (4) the rehabilitation investment credit for qualified rehabilitation expenditures properly taken into account after 2007; (5) the work opportunity tax credit, and (5) the small employer health insurance credit. (Code Sec. 38(c)(4)(B))

"Net income tax" is the sum of the regular tax liability and the alternative minimum tax, reduced by certain (mainly personal) credits claimed by the taxpayer (e.g., dependent care credit). (Code Sec. 38(c)(1)) There's a one-year carryback and 20-year carryforward for the unused business credit on an earliest year-first (FIFO) basis. (Code Sec. 39(a)) If any portion of a business credit hasn't been allowed after the carryover period expires, the taxpayer is generally allowed to deduct the unused portion in the first tax year after the last tax year of the carryover period (or in the tax year of cessation if earlier). (Code Sec. 196(a); Code Sec. 196(b))

Review Question 36

An unused general business credit can be carried:

a. Back three years and forward 20 years.

b. Forward 20 years only.

c. Back one year only.

d. Back one year and forward 20 years.

1. Investment Credit

The investment tax credit consists of: (1) the rehabilitation investment credit (Code Sec. 47), (2) the energy credit (Code Sec. 48(a)), (3) the qualifying advanced coal project credit (Code Sec. 48A), (4) the qualifying gasification project credit (Code Sec. 48B(e)), and (5) the advanced energy manufacturing project credit (Code Sec. 48C). Certain otherwise eligible property is denied the applicable credit if it is:

- Property used "predominantly" outside the U.S., except for property listed in Code Sec. 168(g)(4)—dealing with rolling stock, spacecraft, satellites, etc. (Code Sec. 50(b)(1))
- Property used predominantly to furnish, or in connection with the furnishing of, permanent lodging, except for certain non-lodging commercial facilities, lodging facilities used by transients, certified historic structures, and energy property. (Code Sec. 50(b)(2))
- Property used by certain tax-exempt organizations. (Code Sec. 50(b)(3))
- Property used by the U.S. or other governmental units, except for short-term lease property. (Code Sec. 50(b)(4))

Rehabilitation investment credit. The rehabilitation credit for a building is 10% (20% for a certified historic structure) of the qualified rehabilitation expenditure. (Code Sec. 47(a)) A rehabilitated building (other than a certified historic structure) is eligible for the credit only if the building was first placed in service before 1936. (Code Sec. 47(c)(1)(B))

A qualified rehabilitation expenditure is any amount charged to a capital account and incurred in connection with the rehabilitation (including reconstruction, or an addition or improvement) of a "qualified rehabilitated building" that's depreciable under Code Sec. 168 and is nonresidential real property, residential rental property, or real property with a class life of more than 12.5 years. Expenditures for which straight-line depreciation isn't used are not qualified expenditures.

In addition to owner-taxpayers of qualified property, the rehabilitation credits are available to lessees for qualified expenditures incurred by them, but only if, on the rehabilitation's completion date, the remaining term of the lease (without regard to renewal) is at least the recovery period under Code Sec. 168(c). (Code Sec. 47(c)(2)(B)(vi))

The term "qualified rehabilitated building" means any building (and its structural components) that satisfies all of the following requirements: (Code Sec. 47(c)(1))

- Except for a certified historic structure, the building was first placed in service before 1936.
- The building has been "substantially rehabilitated."
- The building was placed in service before the beginning of the rehabilitation.

- For any building other than a certified historic structure, the building retains in place (a) at least 75% of the external walls (including at least 50% as external walls), and (b) at least 75% of its internal structural framework.
- The building must be depreciable or amortizable. (Code Sec. 47(c)(1)(A))

A "substantial rehabilitation" is one in which the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the year exceed the greater of: (1) $5,000; or (2) the adjusted basis of the building and its structural components as of the first day of the 24-month period, or of the holding period (without regard to reconstruction), whichever is later. (Code Sec. 47(c)(1)(C) Rehabilitation includes reconstruction. (Code Sec. 47(c)(1)(D))

In the case of any rehabilitation that may reasonably be expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins, a 60-month (instead of 24-month) period applies. (Code Sec. 47(c)(1)(C))

Review Question 37

Which of the following is a requirement for treatment of a building (other than a certified historic structure) as a qualified rehabilitated building?

a. The building retains at least 50% of the external walls.

b. The building retains at least 50% of the internal structural framework.

c. The building retains at least 75% of the internal structural framework.

d. The building retains 100% of the external walls.

Energy investment credit. The energy credit is generally 10% (Code Sec. 48(a)(2)) of the basis of each energy property placed in service during the tax year. (Code Sec. 48(a)(1)) However, for property placed in service after 2005 and before 2017, the credit is 30% for solar energy property and qualified fuel cell property. (Code Sec. 48(a)(2)(A) as amended by 2008 Energy Act §103(a)(1)DivB) In addition, a 30% credit is allowed for small wind energy property and geothermal heat pump equipment for periods after October 3, 2008, in tax years ending after October 3, 2008. (Code Sec. 48(a)(3)(A), (a)(2)(A) as amended by 2008 Energy Act §104DivB)

"Energy property" for which the credit is allowed is: (Code Sec. 48(a)(3))

- equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat (including, in the case of property placed in service after 2005 and before 2017, solar energy equipment used to illuminate a room using fiber-optics distributed sunlight, but excluding property used to heat swimming pools).
- equipment used to produce, distribute, or use energy from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to but not including the electrical transmission stage.
- qualified fuel cell property or qualified microturbine property placed in service after 2005 and before 2017. A credit for qualified fuel cell property can't exceed $1,500 ($500 for periods before October 3, 2008) for each 0.5 kilowatt of the property's capacity. A credit for qualified microturbine property can't exceed $200 for each kilowatt of the property's capacity. (Code Sec. 48(c))
- combined heat and power system property for periods after October 3, 2008.
- qualified small wind energy property for periods after October 3, 2008.
- geothermal heat pump equipment which uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure, but only with respect to periods after October 3, 2008 and before 2017.

No credit is allowed for property unless it is depreciable or amortizable; its construction, reconstruction or erection is completed by the taxpayer or, if acquired by the taxpayer, its original use begins with the taxpayer; and it meets the official quality and performance standards in effect at the time of acquisition. (Code Sec. 48(a)(3))

In the past, no credit was allowed for public utility property (except for certain qualified microturbine property used predominantly in a telephone or telegraph service business) (Code Sec. 48(a)(3)) or for property that also qualifies for the rehabilitation credit. (Code Sec. 48(a)(2)) However, the 2008 Energy Act lifted the ban on energy credits for public utility property effective for periods after February 13, 2008, in tax years ending after February 13, 2008. (2008 Energy Act §103(f)(4)DivB)

Advanced coal and gasification projects. A credit can be claimed for investments in qualifying advanced coal projects for periods after August 8, 2005. The credit is 20% of the qualified investment for the tax year in integrated gasification combined cycle projects and 15% of the qualified investment for the tax year in projects that use other advanced coal-based generation technologies. (Code Sec. 48A(a))

A separate investment credit can also be claimed for qualified investment in qualifying gasification projects for periods after August 8, 2005. The credit is 20% (30% in the case of projects selected by the IRS) of the qualified investment for the tax year. ((Code Sec. 48B(a) as amended by 2008 Energy Act §112(a)DivB) This credit is not allowed for any qualified investment for which the above Code Sec. 48A credit is allowed.

The 2008 Energy Act creates a new 30% credit for certain advanced coal-based generation technology projects for which applications are submitted to the IRS. (Code Sec. 48A(a)(3) as amended by 2008 Energy Act §111(a)DivB)

Advanced energy manufacturing project credit. After February 17, 2009, a taxpayer can claim a 30% credit for investment in qualified property used in a qualified advanced energy manufacturing project. (Code Sec. 48C) This is a project that re-equips, expands, or establishes a manufacturing facility for the production of property designed to: (1) be used to produce energy from the sun, wind, or geothermal deposits or other renewable resources; (2) manufacture fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) manufacture electric grids to support the transmission of intermittent sources of renewable energy, including storage of that energy; (4) manufacture equipment for use for carbon capture or sequestration; or (5) refine or blend renewable fuels (but not fossil fuels), to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies). It also includes a facility for the production of new qualified plug-in electric drive motor vehicles; qualified plug-in electric vehicles; components designed specifically for these vehicles; or other advanced energy property designed to reduce green house gas emissions. (Code Sec. 48C(c)(1))

Qualified property must be depreciable (tangible) property used in a qualified advanced energy manufacturing project (Code Sec. 48C(b)(1)) and doesn't include property designed to manufacture equipment for use in the refining or blending of any transportation fuel (other than renewable fuels). (Code Sec. 48C(c)(1)(B)) The basis of qualified property must be reduced by the amount of credit received.

Recapture of investment credit. If investment credit property is disposed of or ceases to be investment credit property with respect to the taxpayer before the end of the recapture period, the credit taken in earlier years is recaptured (i.e., added to the tax liability for the recapture year). (Code Sec. 50(a)(1)) The recapture percentage is 100% during the first full year after the property is placed in service. This percentage decreases by 20 percentage points every succeeding full year. There's no recapture after the fifth full year. (Code Sec. 50(a)(1))

Recapture applies only to a credit used to reduce tax liability. If any part of it isn't used, carrybacks and carryovers of the credit must be appropriately adjusted. (Code Sec. 50(a)(3)) No recapture applies to a transfer by reason of a mere change in form of doing business. (Code Sec. 50(a)(4)(B))

2. Work Opportunity Credit

The work opportunity tax credit (WOTC) generally allows employers who hire members of certain target groups to get a credit against income tax for a percentage of wages paid to such employees. The credit is available for qualifying employees who begin work for the employer before January 1, 2014. (Code Sec. 51)

Caution: Expired or expiring provisions may be extended by Congress.

As a general rule, the credit can be claimed for a percentage of first-year wages up to $6,000 per employee ($12,000 for qualified veterans who begin work after May 25, 2007, and $3,000 for qualified summer youth employees). Where the employee is a long-term family assistance (LTFA) recipient who begins work after 2006, the credit is a percentage of first *and* second year wages, up to $10,000 per employee.

Generally, the percentage of qualifying wages is 40%, for a maximum credit of $2,400. The maximum credit is $4,800 for qualified veterans who begin work after May 25, 2007, and $1,200 for summer youth employees. The minimum employment period is 120 hours, but the credit is only 25% of wages paid to an employee who works less than 400 hours. (Code Sec. 51(i)(3)) In either case, more than half of the employee's wages must be for services in the employer's trade or business. (Code Sec. 51(f)(1))

The credit reduces the employer's wage deduction dollar-for-dollar. (Code Sec. 280C(a); Reg §1.280C-1) But the taxpayer can elect not to take the credit (Code Sec. 51(j))

Wages paid (1) for federally funded on-the-job training, (Code Sec. 51(c)(2)(A)) and (2) to an individual who performs the same or substantially similar services as those of employees participating in or affected by a strike or lockout at the employer's plant don't qualify for the credit. (Code Sec. 51(c)(3)) Creditable wages are reduced by the amount of supplementation payments made to the employer with respect to an employee under section 482(e) of the Social Security Act. (Code Sec. 51(c)(2)(B))

The target groups are:

- Qualified IV-A recipients (qualified recipients of aid to families with dependent children or successor program),
- qualified veterans,
- qualified ex-felons,
- designated community residents (individuals ages 18-39 whose principal abode is in an empowerment zone, enterprise zone, renewal community or rural renewal county),
- vocational rehabilitation referrals,
- qualified summer youth employees,
- qualified food stamp recipients,
- qualified SSI recipients, and
- long-term family assistance recipients.
- (Code Sec. 51(d))

To be eligible for the work opportunity credit, a new employee must be certified as a member of a target group by a State Employment Security Agency (SESA). The employer can either get the certification by the day the prospective employee begins work or complete a pre-screening notice for the employee by the day he or she is offered employment, and submit it to the SESA as part of a request for certification within 28 days after the employee begins work. (Code Sec. 51(d)(13)(A)(ii)(II))

No credit is allowed for employees who are related to the employer or to certain owners of the employer. (Code Sec. 51(i))

Review Question 38

An employer hires a qualified food stamp recipient who qualifies for the work opportunity credit. The employee works part-time, 7 hours a week for 52 weeks during his first year, and is paid $10 per hour. What is the maximum amount the employer can claim as a work opportunity credit with respect to the employee?

a. $3,640. b. $2,400.

c. $910.

3. Research Expense Credit

The research expense credit generally equals the sum of:

1. 20% of the excess (if any) of the qualified research expenses for the tax year over a base amount, (unless the taxpayer elects the alternative incremental credit, which would then replace this item (1)), plus
2. The "university basic research credit" (see below), plus
3. The "energy research credit" (see below). (Code Sec. 41(a))

The research expense credit is one of a group of "temporary" tax provisions commonly referred to as "extenders." The research expense credit, which had expired as of the end of 2011, was most recently extended retroactively by the American Taxpayer Relief Act of 2012 (P.L. 112-240), The credit applies for amounts paid or incurred before January 1, 2014. (Code Sec. 41(h)(1) as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240))

Caution: Expired or expiring provisions may be extended by Congress.

The base amount is a fixed-base percentage of taxpayer's average annual gross receipts (from a U.S. trade or business, net of returns and allowances) for the four tax years before the credit year, and can't be less than 50% of the year's qualified research expenses. The fixed base percentage for a non-startup company that isn't using the alternative incremental credit (see below) is the percentage (not exceeding 16%) that taxpayer's total qualified research expenses is of total gross receipts for tax years beginning after 1983 and before 1989.

The Code assigns a fixed-base percentage of 3% in making the base amount computation for each of its first five tax years beginning after 1993 in which a "startup company" has qualified research expenses. (Code Sec. 41(c)(3)(B)(ii)(I)) For the second five tax years beginning after 1993, the fixed-base percentage is not pre-set at 3%. Instead, it is a specified amount of the ratio or percentage increased annually during this second five-year period, determined by dividing qualified research expenses by gross receipts. An expense qualifies for the research credit if:

- it qualifies as a research and experimental expenditure under Code Sec. 174 (see III.K.3.);
- it relates to research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer; and
- substantially all of the activities of the research constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality. (Code Sec. 41(d)(1))

Certain activities (e.g., marketing, surveys, duplication of existing business components, post-commercial production activities) aren't qualified. (Code Sec. 41(d)(4)) Qualifying research must be intended to eliminate uncertainty about the development or improvement of a business component, and the process of experimentation must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may use existing technologies and may rely on existing principles of these sciences. (Prop Reg §1.41-4(a)(3)(i); Prop Reg §1.41-4(a)(4))

University basic research credit. The 20% university basic research credit component applies to 100% of cash expenditures by corporations (except S corporations, personal holding companies, or service organizations) for basic research over the sum of: (1) the minimum basic research amount, plus (2) the maintenance-of-effort amount. (Code Sec. 41(e); Reg §1.41-7)

The "minimum basic research amount" (Code Sec. 41(e)(4); Reg §1.41-7) is the greatest of: (1) 1% of the average amount paid for in-house and contract research expenses during the base period (the three tax years before the first tax year beginning after 1983); (Code Sec. 41(e)(7)(B)) (2) the contract research expense for the base period; or (3) 50% of the basic research payments if taxpayer wasn't in existence for a full year in the base period.

The maintenance-of-effort amount is: (1) the average charitable contribution to all educational institutions during the base period multiplied by the cost-of-living adjustment, minus (2) the charitable contributions to educational institutions for the year. (Code Sec. 41(e)(5)(A))

No deduction is allowed for that portion of the otherwise deductible qualified research expenses or basic research expenses that equals the research credit for the tax year. (Code Sec. 280C(c)(1)) If a taxpayer capitalizes rather than deducts expenses, the amount of such expenses capitalized during the year must be reduced by the excess of the credit over the amount allowable (without regard to the above disallowance) as a deduction for the tax year. (Code Sec. 280C(c)(2)) But a taxpayer may avoid this reduction for any tax year by claiming a reduced credit for the year. The election limits the taxpayer to a credit in the amount of the research credit before any reduction less the product of that credit amount times the maximum corporate tax rate. (Code Sec. 280C(c)(3))

Energy research credit. A taxpayer can claim a research expenses credit equal to 20% of the amounts paid or incurred in carrying on any trade or business of that taxpayer during the tax year (including as contributions) to an energy research consortium. (Code Sec. 41(a)(3)) Thus, a taxpayer can claim a credit equal to 20% of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.

The amount of credit claimed is determined only by reference to the expenditures by the taxpayer within the tax year. Unlike the general rule for the research credit, the 20% credit for research by an energy research consortium applies to all these expenditures, not only to those in excess of a base amount, however determined.

5. Disabled Access Credit

An "eligible small business" may elect to apply a credit against income tax of 50% of the amount of "eligible access expenditures" for the tax year that's over $250 and not more than $10,250. (Code Sec. 44(a)) Thus, the maximum amount of the credit for any tax year is $5,000, 50% of ($10,250 - $250).

For partnerships and S corporations this limitation applies at both the entity and the individual partner or shareholder levels. (Code Sec. 44(d)(3))

An "eligible small business" for any tax year is any person who either:

(1) has gross receipts that don't exceed $1 million for the tax year before the tax year in which the credit is elected, net of returns and allowances, or

(2) employed no more than 30 full-time employees in the tax year before the tax year in which the credit is elected; an employee who is employed at least 30 hours a week for 20 or more calendar weeks in the tax year is considered to be full-time. (Code Sec. 44(b); Code Sec. 44(d)(5))

Eligible access expenditures are amounts paid or incurred to enable the business to comply with the Americans With Disabilities Act of 1990 (as in effect on November 5, 1990). (Code Sec. 44(c)(1)) These expenses include only expenses that are necessary to comply with the Disabilities Act, that are paid or incurred (Code Sec. 44(c)):

- for the purpose of removing architectural, communication, physical or transportation barriers in connection with any facility first placed in service before November 6, 1990, which prevent a business from being accessible to, or usable by, individuals with disabilities;
- to provide qualified interpreters or other effective methods of making aurally delivered materials available to individuals with hearing impairments;
- to provide qualified readers, taped texts and other effective methods of making visually delivered materials available to individuals with visual impairments;
- to acquire or modify equipment or devices for individuals with disabilities; or
- to provide other similar services, modifications, materials or equipment.

6. Small Employer Health Insurance Credit

The 2010 Health Care Act added the small employer health insurance credit to the list of credits that make up the general business credit (Code Sec. 45R, Code Sec. 38(b)(33) as added by the 2010 Health Care Act). For tax years beginning after December 31, 2009, an eligible small employer can claim the tax credit for nonelective contributions to purchase health insurance for its employees.

An eligible small employer generally is an employer with no more than 25 full-time equivalent employees (FTEs) employed during the employer's tax year, and whose employees have annual full-time equivalent wages that average no more than $50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than $25,000. These wage limits will be indexed beginning in 2014.

A small employer qualifies for the credit only if the employer's health plan requires the employer to make nonelective contributions on behalf of each employee enrolled in the plan in an amount equal to not less than 50% of the premium cost of the employee's coverage.

For tax years beginning in 2010 through 2013, the maximum credit is 35% of the contributions made by the employer for health insurance premiums on behalf of employees for the tax year. However, the amount of contributions taken into account is limited to the amount the employer would have contributed if an employee had enrolled in coverage with a so-called "benchmark premium" based on the average cost in the small group market for coverage in the employer's state. The credit is reduced for employers with more than 10 full-time equivalent employees. The credit is also reduced for an employer with average annual wages of more than $25,000.

For tax years beginning in 2014 and later years, the credit percentage will rise to 50% (35% for tax-exempt employers). However, the credit will be available only to a qualified small employer that purchases health insurance coverage for its employees through a state Exchange and will be only available for a maximum coverage period of two consecutive taxable years.

7. Other Business Credits

A number of other credits make up the general business credit. Six of the more significant ones are (1) the employer's social security credit for tips, (2) the credit for employer-provided child care, (3) the small employer pension plan startup credit, (4) the energy efficient home credit for contractors, (5) the business tax credit for manufacturers of energy efficient appliances, and (6) the differential wage payment credit.

Employer's social security credit for tips. A food and beverage establishment is allowed a credit for the amount of the employer's FICA tax obligation (7.65%) attributable to employee tips received for providing, delivering, or serving food or beverages in excess of tips treated as wages for purposes of satisfying minimum wage provisions under section 6(a)(1) of the Fair Labor Standards Act of 1938. (Code Sec. 45B(a); Code Sec. 45B(b))

For example, suppose an employee worked 100 hours at the rate of $3.25 an hour and received $325 in wages for Jan.; in addition, the employee reported $440 in tips for a total of $765. The employee would have received wages of $655 if paid at the federal minimum wage. Thus, only $110 of the employee's $440 tips ($765 less $655) for January is taken into account for purposes of the credit. The other $330 of tips used to meet the minimum wage rate ($325 + $330 = $655) aren't used. The credit therefore is $110 × 7.65%, or $8.42 for Jan.

No deduction is allowed for any amount taken into account in determining the employer social security credit. (Code Sec. 45B(c))

Credit for employer-provided child care. The credit for qualifying employer-provided child care (Code Sec. 45F(a)) is equal to the sum of the following expenses for the tax year:

- 25% of qualified child care expenses, which are expenses to buy, build, rehabilitate, or expand property to be used as part of a qualified child care facility of the taxpayer (i.e., the employer), for which a deduction for depreciation (or amortization) is allowable, and which isn't part of the principal residence of the taxpayer or any of its employees. Qualifying child care expenses also include operating costs of a qualified child care facility of the taxpayer (including costs related to employee training, scholarship programs, and to providing increased compensation to employees with higher levels of child care training), and amounts paid under a contract with a qualified child care facility to provide child care services to the taxpayer's employees. (Code Sec. 45F(c)(1)(A))
- 10% of qualified child care resource and referral expenses, which are amounts paid or incurred under a contract to provide child care resource and referral services to an employee of the taxpayer.

The amount of the credit can't exceed $150,000 for any tax year. (Code Sec. 45F(b)) A taxpayer claiming a credit for acquiring, constructing, rehabilitating, or expanding a qualified child care facility must reduce its basis in the facility by the amount of the credits. (Code Sec. 45F(f)(1)(A)) Credit-recapture rules apply for the first ten years after a qualified child care facility is placed in service. (Code Sec. 45F(d))

Small employer pension plan startup credit. Eligible small employers that adopt a new qualified defined-benefit or defined-contribution plan (see Module 3, Specialized Tax Issues) may claim a credit equal to 50% of administrative and retirement-related education expenses for the plan for each of the first three plan years, with a maximum credit of $500 for each year. The first credit year is the tax year that includes the date the plan becomes effective, or, electively, the preceding tax year. (Code Sec. 45E(a), Code Sec. 45E(b), Code Sec. 45E(d)(3))

The pension plan startup credit is available only to businesses that did not employ, in the preceding year, more than 100 employees with compensation of at least $5,000. However, an employer isn't an eligible employer if, during the three-tax-year period immediately preceding the first tax year for which the credit is otherwise allowable, it established or maintained a qualified employer plan to which contributions were made, or benefits were accrued, for substantially the same employees that are in the qualified employer plan. (Code Sec. 45E(c)(2)) To be eligible for the credit, the plan must cover at least one non-highly compensated employee.

Energy efficient home credit. An eligible contractor may claim either a $2,000 or $1,000 credit for each qualified new energy efficient home that the contractor constructs and which is acquired by a person from the contractor for use as a residence before January 1, 2014. (Code Sec. 45L as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240))

Caution: Expired or expiring provisions may be extended by Congress.

For purposes of the energy efficient home credit, a qualified new energy efficient home is a dwelling unit:

- located in the U.S.,
- the construction of which is substantially completed after August 8, 2005, and
- which meets the energy saving requirements of Code Sec. 45L(c) (Code Sec. 45L(b)(2)) To meet this requirement, the dwelling must generally be certified in accordance with guidance prescribed by IRS to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30% or 50% reduction in energy usage.

Energy efficient appliance credit. A business credit is available to appliance manufacturers that produce energy efficient dishwashers, clothes washers, and refrigerators. The credit was originally available only for appliances produced before 2008, but has been extended to apply to certain appliance manufactured before 2014. The amount of the credit depends on the type of appliance and how much energy it saves. (Code Sec. 45M(b) as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240)),

Caution: Expired or expiring provisions may be extended by Congress.

Differential wage payment credit. Eligible small business employers that pay differential wages to qualifying employee can claim a credit equal to 20% of up to $20,000 of differential pay to each qualifying employee during the tax year, but only for payments after June 17, 2008, and before 2014. (Code Sec. 45P as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240))

Caution: Expired or expiring provisions may be extended by Congress.

For this purpose, the term "differential wage payment" means any payment (1) which is made by an employer to an individual for any period during which the individual is on active duty in the armed services for a period of more than 30 days, and (2) which represents all or a portion of the wages the individual would have received from the employer if the individual were performing services for the employer. (Code Sec. 3401(h)

A qualified employee is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made. (Code Sec. 45P(b)(2))

An eligible small business employer is one that: (1) employed on average less than 50 employees on business days during the tax year; and (2) under a written plan, provides eligible differential wage payments to each of its qualified employees. Taxpayers under common control are aggregated when determining if a taxpayer is an eligible small business employer. (Code Sec. 45P(b)(3))

No deduction may be taken for that part of compensation which is equal to the credit, and the amount of any other credit for compensation paid to an employee otherwise allowable must be reduced by the differential wage payment credit allowed for the employee. (Code Sec. 280C(a))

B. Foreign Tax Credit

Most U.S. taxpayers who pay income taxes to foreign governments may deduct those taxes for U.S. tax purposes or may credit them dollar-for-dollar against their U.S. income tax liability.

The foreign tax credit is elective and is allowed against U.S. income tax for income tax paid to a foreign country (or province, state, city, etc., thereof) or U.S. possession. (Code Sec. 901; Reg §1.901-1(a)) Taxpayers may choose each year between taking a credit or a deduction for foreign income taxes. (Code Sec. 27; Code Sec. 164) If a credit is claimed for any foreign income taxes, no deductions may be claimed for other foreign income taxes, but other foreign taxes otherwise deductible (e.g., foreign real property taxes) may be deducted. (Reg §1.901-1(c))

Accrual basis taxpayers take the tax as a credit in the tax year it accrues, cash basis taxpayers in the tax year it's paid. However, cash basis taxpayers can make a binding election to take the credit, for all qualified foreign taxes, in the year they accrue rather than are paid. (Code Sec. 905(a); Reg §1.905-1(a)

A foreign levy (i.e., a payment required from a person by a foreign country) qualifies as a creditable foreign tax only if: (1) it is a tax, and (2) its predominant character is that of an income tax in the U.S. sense. (Reg §1.901-2(a)(1)) Income taxes, war profits taxes and excess profits taxes paid or accrued during the tax year to a foreign country or a U.S. possession qualify for the foreign tax credit. (Code Sec. 901(b)(1)) Foreign taxes on wages, dividends, interest and royalties normally also qualify for the credit. (Reg §1.901-2(a))

The foreign tax credit is computed separately for certain categories of income (e.g., passive income). The credit for each category is the lesser of: (1) the amount of foreign taxes paid or accrued with respect to that category, or (2) the U.S. tax on the foreign income in that category. (Code Sec. 901(b); Code Sec. 904(a); Code Sec. 904(d))

VI. Taxation of C Corporations

Learning Objectives

After completing this section, you should be able to:

- Identify dividends eligible for the dividends-received deduction and estimated tax payments for corporations.
- Determine when a corporation is subject to the personal holding company tax, accumulated earnings tax, and corporate alternative minimum tax.

C corporations generally are subject to tax at graduated rates on their taxable income. A C corporation's taxable income equals its gross income less the deductions allowed by the Code. (Code Sec. 63) A C corporation's gross income doesn't include contributions to its capital. (Code Sec. 118)

A C corporation's tax is computed by applying the Code Sec. 11 rates in effect for its tax year to its taxable income for that year, and then subtracting any available tax credits. The benefits of the graduated rates phase out after taxable income reaches a specified amount. Here is the current tax rate schedule for corporations.

Taxable income over—	But not over—	The tax is:	Of the amount over—
0	$50,000	15%	0
$50,000	75,000	$7,500 + 25%	$50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	0

Certain personal service corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting are taxed at a flat 35% rate. (Code Sec. 11(b)(2))

Every corporation that is subject to federal income tax and that is in existence for any portion of a tax year must file an income tax return, regardless of the amount of its gross income or whether it has taxable income. (Code Sec 6012(a)(2); Reg. §1.6012-2(a)) Most domestic corporations file Form 1120. Form 1120, Schedule PH must be attached if the corporation is a personal holding company.

Small corporations (less than $250,000 in gross receipts and less than $250,000 in assets) don't have to complete Schedules L, M-1, and M-2 of Form 1120. Large corporations (reporting total assets of $10 million or more on Form 1120), must file Schedule M-3 instead of M-1. M-3 filers must file Schedule B reporting information about allocations, transfers of interest, cost sharing arrangements, and changes in methods of accounting.

A corporation that files at least 250 returns of any kind, including information returns, during the calendar year ending with or within the tax year, must file its income tax return electronically if it has assets of $10 million or more. Failure to file electronically when required to do so is deemed to be failure to file a return. (Reg. §301.6011-5T).

A. Dividends-received Deduction

Subject to specific disallowances, reductions, and limitations, a C corporation may deduct 70% of the dividends received or accrued from domestic corporations. (Code Sec. 243(a)(1)) The deduction is 80% for dividends received or accrued from a 20%-owned corporation (Code Sec. 243(c)(1)), i.e., any corporation at least 20% of whose stock (not counting certain preferred stock), by vote and value, is owned by the corporate shareholder. (Code Sec. 243(c)(2))

1. Taxable Income Limit

A corporation's dividends-received deduction for any tax year can't exceed the applicable percentage (below) of its taxable income. (Code Sec. 246(b)(1)) But this limit doesn't apply for any tax year for which the shareholder has a net operating loss (NOL). (Code Sec. 246(b)(2))

A corporation's dividends-received deduction is generally limited to 70% of its taxable income. But if the dividends are received only from 20%-owned corporations (i.e., the deduction is 80%), an 80%-of-taxable-income limit applies. If a corporation receives dividends from both 20%-owned and non-20%-owned corporations, the taxable income limit is applied first to the 20%-owned dividends so that their deduction can't exceed 80% of taxable income. (Code Sec. 246(b)(3)(A)) If this 80% limit isn't exceeded, a separate limit is then applied to the "non-20%-owned" dividends so that their deduction doesn't exceed 70% of taxable income (as reduced by the total amount of the "20%-owned" dividends). (Code Sec. 246(b)(3)(B))

Review Question 39

A corporation received $10,000 in dividends, none of which were from 20%-owned corporations. If the corporation's taxable income is $9,000 for the year, what is the amount of the corporation's dividends received deduction?

a. $0. b. $6,300.

c. $7,000. d. $10,000.

2. Holding Period Requirement

No dividends-received deduction is allowed for any dividend on any share of stock that's held by the corporation for 45 days or less during the 90-day period beginning on the date that is 45 days before the date on which the stock becomes ex-dividend with respect to the dividend (90 days or less out of the relevant 180-day period for any preferred stock with respect to which the corporation gets dividends that are attributable to a period or periods aggregating in excess of 366 days). (Code Sec. 246(c)) In other words, a dividends-received deduction is allowed only if the corporation's holding period for the dividend paying stock is satisfied over a period immediately before or immediately after the corporation becomes entitled to receive the dividend.

In determining how long the corporation has held the stock, the day of disposition but not the day of acquisition is taken into account. (Code Sec. 246(c)(3)(A))

The corporation's holding period for the stock is suspended (reduced) for any period during which, while holding the stock, the corporation:

- has an option to sell, is under a contractual obligation to sell, has made (and not closed) a short sale of, or is the grantor of an option to buy, substantially identical stock or securities (Code Sec. 246(c)(4)(A); Code Sec. 246(c)(4)(B); Reg §1.246-3(c)(2)), or
- has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property (i.e., the fair market values (FMV) of the stock and the property primarily reflect a single firm or enterprise and changes in the stock's FMV are reasonably expected to approximate (directly or indirectly) changes in the property's FMV), where changes in the FMVs of the stock and the positions are reasonably expected to vary inversely. (Code Sec. 246(c)(4)(C); Reg §1.246-5)

3. Other Limitations

A dividend (other than capital gain or exempt-interest dividends) from an regulated investment company (e.g., a mutual fund) is eligible for the dividends-received deduction only to the extent of the amounts the RIC received from domestic corporations that it would have been allowed to treat as dividends in computing its own dividends-received deduction if it had been a regular corporation. (Code Sec. 243(d)(2); Code Sec. 854(b)(4))

Dividends received from a public utility are eligible for the dividends-received deduction, but the deduction is reduced if the utility was entitled to a dividends-paid deduction on those dividends. (Code Sec. 244(a))

A U.S. corporation that owns at least 10% (by vote or value) of a foreign corporation's stock may deduct the applicable percentage (70% or 80%) of the U.S.-source portion of the dividends from that corporation. (Code Sec. 245(a)(1); Code Sec. 245(a)(2))

The dividends-received deduction is reduced for dividends on debt-financed portfolio stock. As reduced, the applicable percentage for deducting these dividends equals: (1) 70% (80% for dividends from 20%-owned corporations), multiplied by (2) 100% minus the "average indebtedness percentage." (Code Sec. 246A(a); Code Sec. 246A(b)) The reduction for any dividend may not exceed the interest deduction (including short sale expense) allocable to that dividend. (Code Sec. 246A(e))

B. Corporate Estimated Tax

Corporations owing $500 or more in income tax for the tax year must make estimated tax payments, or be subject to penalty. The estimated tax is paid in four equal installments—"required installments"—of its "required annual payment." (Code Sec. 6655(c)(1); Code Sec. 6655(d)(1)(A)) For a calendar year corporation, the required installments are due as follows: first, April 15; second, June 15; third, September 15; fourth, December 15. (Code Sec. 6655(c)(2)) For a fiscal year corporation, they are due on the 15th day of the corresponding months (Code Sec. 6655(i)(1)) (i.e., the fourth, sixth, ninth and 12th months).

A corporation that underpays its estimated tax must add to its income tax an amount equal to the underpayment interest rate times the amount of the underpayment, for the period of the underpayment. (Code Sec. 6655(a)) The amount of the underpayment is the excess of the required installment over the amount (if any) of the installment paid on or before the due date for the installment. (Code Sec. 6655(b)(1))

Review Question 40

No estimated tax penalty is imposed on a corporation for any tax year if the tax shown on the return for that year is less than _________.

a. $500. b. $1,000.

c. $5,000. d. $10,000.

1. Required Annual Payment

The "required annual payment" equals the lesser of:

- 100% of the tax shown on its return for the year (or if no return is filed, 100% of its tax for that year); or
- 100% of the tax shown on its return for the preceding tax year. (Code Sec. 6655(d)(1)(B))

A corporation's required annual payment can't be based on the preceding year's tax if:

- it didn't file a return for the preceding tax year showing a liability for tax (Code Sec. 6655(d)(1)) (a return showing zero tax, e.g., because of a net operating loss (NOL), isn't a return showing a liability for tax);
- the preceding tax year was less than 12 months (Code Sec. 6655(d)(1)); or
- it's a "large corporation." (Code Sec. 6655(d)(2)(A)) However, a large corporation may use its last year's tax to determine the amount of its first required installment for any tax year, but it must recapture any resulting reduction in that first installment, by increasing its next required installment by the amount of the reduction. (Code Sec. 6655(d)(2)(B))

A corporation is "large" in any tax year if it (or any predecessor corporation) had taxable income of $1,000,000 or more for any of the three immediately preceding tax years. For this purpose, taxable income doesn't include carryback or carryover of NOLs or capital losses. (Code Sec. 6655(g)(2))

2. Annualized Income Installment

A corporation may use an "annualized income installment" as its estimated tax installment, if that's less than the required installment. (Code Sec. 6655(e)(1)(A))

The annualized income installment is the excess (if any) of:

1. the applicable percentage (25%, 50%, 75%, and 100% for the first, second, third and fourth installments, respectively) of the full year's tax, computed by placing on an annualized basis, the taxable income (Code Sec. 6655(e)(4))), alternative minimum taxable income, and modified alternative minimum taxable income for the months to which the installment applies (i.e., the first three months (first and second installments), first six months (third), and first nine months (fourth)), over
2. the sum of any earlier required installments for the tax year. (Code Sec. 6655(e)(2)(A); Code Sec. 6655(e)(2)(B))

Alternatively, a corporation may elect to determine its annualized income based on its income for either: (1) the first two months (first installment), first four months (second), first seven months (third) and first ten months (fourth); or (2) the first three months (first), first five months (second), first eight months (third), and first 11 months (fourth). (Code Sec. 6655(e)(2)(C))

Any reduction in an installment resulting from using the annualization method must be made up (recaptured). This is done by increasing the amount of the next required installment that isn't determined under the annualization method, by the amount of the reduction. (Code Sec. 6655(e)(1)(B))

3. Adjusted Seasonal Installment

A corporation may use an "adjusted seasonal installment" as its estimated tax installment if it's less than the regular required installment or the annualized income installment (Code Sec. 6655(e)(1)(A)). This option is available only if the corporation's "base period percentage" for any six consecutive months of the tax year is at least 70%. (Code Sec. 6655(e)(3)(B))

A corporation computes its adjusted seasonal installment by:

1. computing the taxable income for all months during the tax year before the filing month (i.e., the month the installment is required to be paid),
2. dividing this amount by the base period percentage for those preceding months,

3. determining the tax on the result in (2),
4. multiplying that tax by the base period percentage for the filing month and all preceding months in the tax year (Code Sec. 6655(e)(3)(C); Code Sec. 6655(e)(3)(D)(ii)), and subtracting the aggregate of all earlier required installments. (Code Sec. 6655(e)(3)(A))

The "base period percentage" for any specific period of months is the average percent that the corporation's taxable income for the corresponding months in each of the three preceding tax years bears to its taxable income for those three years. (Code Sec. 6655(e)(3)(D)(i))

Any reduction in an installment resulting from the adjusted seasonal method must be made up (recaptured), by increasing the amount of the next required installment that isn't determined under the adjusted seasonal method, by the amount of the reduction. (Code Sec. 6655(e)(1)(B))

C. Personal Holding Company Tax

A closely held C corporation whose income is largely of investment character may be a "personal holding company" (PHC). This means that a penalty tax is imposed on the "personal holding company income" the corporation doesn't distribute.

The PHC tax is designed to prevent corporations from accumulating earnings rather than distributing the earnings as taxable dividends. Because qualified corporate dividends currently are taxed to non-corporate shareholders at a maximum rate of 20%, the personal holding company penalty tax rate is also 20%. (Code Sec. 541 as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240)

Review Question 41

A PHC that has undistributed PHC income of $100,000 is liable for a penalty tax of:

a. $100,000. b. $35,000.

c. $20,000. d. $5,000.

1. PHC Defined

Generally speaking, a corporation is a PHC if, for the tax year:

- at any time during the last half of the year more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals; and
- at least 60% of its adjusted ordinary gross income is PHC income. (Code Sec. 542(a))

Adjusted ordinary gross income is gross income minus all gains from the sale or other disposition of capital assets and of Code Sec. 1231 assets with certain other adjustments.

PHC income is the portion of adjusted ordinary gross income that consists of: dividends; interest; annuities; rents, mineral, oil and gas royalties; copyright, patent, etc., royalties (but not certain "active business computer software royalties"); produced film rents; compensation for more-than-25% shareholder's use of corporate property; amounts received under personal service contracts; and amounts received from estates and trusts. (Code Sec. 543(a)) Rents are excluded from PHC income if (1) adjusted income from rents is 50% or more of adjusted ordinary gross income; and (2) certain other undistributed "PHC income" (as specially defined) is 10% or less of ordinary gross income.

Certain corporations are specifically exempt from the PHC. These include:

- tax-exempt corporations (Code Sec. 542(c)(1));
- banks or domestic building and loan associations (Code Sec. 542(c)(2));
- life insurance companies (Code Sec. 542(c)(3));
- surety companies (Code Sec. 542(c)(4));
- certain active lending or finance companies (Code Sec. 542(c)(6); Code Sec. 542(d)).

2. Undistributed PHC Income

A corporation's undistributed PHC income that is subject to the PHC tax is its taxable income (Code Sec. 545(a)) adjusted as described below.

The following amounts are subtracted from taxable income:

- Federal income tax accrued during the year, and U.S. possession and foreign income taxes not deductible in computing taxable income. (Code Sec. 545(b)(1))
- Excess charitable contributions, i.e., amounts over the corporate ceiling up to the amount allowed under the individual ceiling. (Code Sec. 545(b)(2))
- Net capital gain (i.e., excess of net long-term capital gain over net short-term capital loss), minus income taxes attributable to that excess. (Code Sec. 545(b)(5))
- One-year net operating loss (NOL) carryforward, i.e., NOL from the preceding tax year. (Code Sec. 545(b)(4))
- Dividends paid during the year. (Code Sec. 545(a))

The following amounts are added to taxable income:

- Special corporate deductions, e.g., for dividends received. (Code Sec. 545(b)(3))
- NOL deduction. (Code Sec. 545(b)(4))
- Expenses and depreciation exceeding income from property (unless income was highest obtainable). (Code Sec. 545(b)(6))

A corporation may elect to treat dividends paid after the close of the tax year but within the first 2½ months of the next year ("late paid dividends") as paid on the last day of the earlier year for purposes of the PHC penalty tax. (Code Sec. 563(a); Code Sec. 563(b)) In addition, if a corporation is "determined" to be liable for a deficiency in PHC tax for any tax year, it may reduce or eliminate the deficiency (or get a refund of part or all of any deficiency paid) by making a "deficiency dividend" distribution and then claiming a deduction for it. This deduction is allowed only for purposes of determining the PHC tax for that year (but not any interest, additional amounts or assessable penalties computed with respect to the PHC tax). (Code Sec. 547(a))

D. Accumulated Earnings Tax

Every C corporation, unless specifically exempt, that accumulates earnings and profits to avoid income tax to its shareholders is subject to an annual accumulated earnings penalty tax. The tax is equal to 20% of its "accumulated taxable income" for the year. (Code Section 531 as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240))The tax is in addition to the regular corporate tax.

The accumulated earnings tax is only imposed on a corporation whose earnings and profits (E&P) were accumulated with the purpose of avoiding income tax on its shareholders. (Code Sec. 532(a)) A corporation that accumulates E&P beyond the reasonable needs of its business is considered to have done so to avoid tax on its shareholders unless it proves the contrary by the preponderance of the evidence. (Code Sec. 533(a))

The accumulated earnings tax does not apply to corporations subject to the PHC tax (see above) or to tax-exempt corporations.

A corporation's "accumulated taxable income" is its taxable income, reduced as described below, minus: (1) a deduction for dividends paid during the year and (2) the accumulated earnings credit. (Code Sec. 535(a))

The corporation's taxable income is reduced by:

- federal income and excess profits taxes accrued during the tax year (not the accumulated earnings tax or the personal holding company tax) (Code Sec. 535(b)(1));
- taxes of foreign countries and U.S. possessions accrued or deemed paid by a domestic corporation and included in the foreign tax credit (see V.B.) (Code Sec. 535(b)(1));

- charitable contributions in excess of the deduction ceiling (Code Sec. 535(b)(2));
- net capital gains (less attributable taxes) (Code Sec. 535(b)(6)(A));
- net capital losses reduced by the lesser of (1) prior net capital gain deductions not already offset against capital losses or (2) accumulated E&P at the close of the preceding tax year. (Code Sec. 535(b)(5))

1. Accumulated Earnings Credit

For corporations other than a mere holding or investment company, the accumulated earnings credit equals the greater of:

- $250,000 ($150,000 for certain service corporations) plus dividends paid during the first 2½ months of the tax year minus accumulated earnings and profits (E&P) at the end of the preceding tax year (Code Sec. 535(c)(2); Code Sec. 535(c)(4)); or
- an amount equal to that part of the E&P for the tax year that are retained for the reasonable needs of the business minus the net capital gain deduction, if any, allowed in adjusting the corporation's taxable income (see above). (Code Sec. 535(c)(1)) The E&P "retained" for a tax year is the amount in excess of the dividends-paid deduction. (Code Sec. 535(c)(4))

A mere holding or investment company's accumulated earnings credit is the amount, if any, by which $250,000 plus dividends paid in the first 2½ months of the tax year exceeds accumulated E&P at the close of the preceding year. (Code Sec. 535(c)(3); Code Sec. 535(c)(4))

2. Reasonable Needs of Business

An accumulation is in excess of the reasonable needs of a business if it exceeds the amount that a prudent business person would consider appropriate for the present purposes of the business and for its reasonably anticipated future needs. (Reg §1.537-1(a))

Accumulations for future needs of a business are justifiable if the needs are reasonably anticipated. (Code Sec. 537) There must be an indication that the future needs require the accumulation, and the corporation usually must have specific, definite and feasible plans for using the accumulations. The accumulations don't have to be used immediately, or even within a short period after the end of the tax year, but their use can't be postponed indefinitely. (Reg §1.537-1(b)(1))

Corporations facing an accumulated earnings tax may use a formula to compute the amount reasonably needed for working capital, to test their liability for the penalty. The Tax Court in *Bardahl Manufacturing Corp* held that necessary working capital should be determined by: (1) calculating a corporation's operating cycle percentage (the period of time, expressed as a percent of a year, needed to convert cash to inventory, inventory to sales and accounts receivable, and accounts receivable to cash), and then (2) multiplying that percentage times the corporation's total operating expenses for the year (cost of goods sold and other expenses). The result of this two-step Bardahl formula is the amount of liquid assets necessary to meet the ordinary operating expenses for one complete operating cycle.

E. Corporate Alternative Minimum Tax

Like individuals (see Module 1, *Taxations of Individuals)*, C corporations may be subject to an alternative minimum tax (AMT). The AMT equals the excess (if any) of the tentative minimum tax for the tax year, over the regular tax for the tax year. (Code Sec. 55(a)) For a corporation, the tentative minimum tax (Code Sec. 55(b)(1)) for the tax year is 20% (15% for certain timber gain) of alternative minimum taxable income (AMTI) for the tax year in excess of the exemption amount, reduced by the AMT foreign tax credit for the tax year. (Code Sec. 55(b)(1)(B))

For corporations, the AMT exemption amount is $40,000, less 25% of AMTI exceeding $150,000 (thus, the exemption is zero when AMTI is $310,000 or more).

Certain small corporations are exempt from the AMT. The tentative minimum tax of a corporation is zero (making the corporation exempt from AMT) for a tax year if its average annual gross receipts for all three-tax-year periods beginning after 1993 and ending before the tax year don't exceed $7,500,000. (Code Sec. 55(e)(1)(A)) However, the gross receipts test is applied by substituting $5,000,000 for $7,500,000 for the first three-tax-year period (or portion thereof) of the corporation that's taken into account under the test. (Code Sec. 55(e)(1)(B))

Review Question 42

A corporation has $190,000 of alternative minimum taxable income (AMTI) for the year. What is the corporation's AMT exemption amount for the year?

a. $0	b. $10,000
c. $30,000	d. $40,000

1. ACE Adjustment

As with individuals, a corporation's AMTI is taxable income plus or minus various "adjustments," plus tax preferences. Some of these adjustments and preferences (e.g., depreciation) apply to both the individual and corporate AMT (see Module 1, *Taxation of Individuals*). However, there is an "adjusted current earnings" (ACE) adjustment that applies to corporations only.

Under the ACE adjustment, AMTI is increased by 75% of the amount by which ACE exceeds AMTI determined without regard to this adjustment or the AMT net operating loss deduction (ATNOLD, see below)). (Code Sec. 56(c)(1); Code Sec. 56(g)(1)) If AMTI (before this adjustment and the ATNOLD) exceeds the amount of ACE, AMTI is reduced by 75% of the difference. This reduction, however, is limited to the aggregate amount of increases in AMTI under this provision in earlier years. (Code Sec. 56(g)(2))

ACE is AMTI, plus those items that are included in earnings and profits (E&P) but that never enter into the calculation of regular or alternative minimum taxable income (e.g., interest on certain tax-exempt bonds). In addition, there are numerous adjustments, including the "inside buildup" on life insurance contracts in ACE, disallowing the dividends received deduction and the use of the installment method, and providing for certain of the statutory adjustments required in calculating earnings and profits. (Code Sec. 56(g)(3); Code Sec. 56(g)(4))

2. Alternative Tax Net Operating Loss Deduction

There is an adjustment for AMT purposes under which the regular net operating loss deduction (RNOLD) isn't allowed, and, instead, an alternative tax net operating loss deduction (ATNOLD) is allowed.

The ATNOLD is the same as the RNOLD except that: (1) the amount of the ATNOLD is limited to 90% of the alternative minimum taxable income determined without regard to the ATNOLD, and (2) the ATNOLD is determined with each of the AMT adjustments and reduced by each of the items of tax preference (but only to the extent the tax preference item increased the NOL for the year). (Code Sec. 56(d)) The 90% limitation doesn't apply to carrybacks and carryovers of qualified disaster losses. (Code Sec. 56(d)(3))

For corporations, regular NOL carryforwards from tax years may be carried forward as alternative tax NOLs to the first tax year for which the AMT applies (Code Sec. 56(d)(2)(B)) and to later years until used up. (Code Sec. 56(d))

An election to forgo the regular net operating loss carryback period also applies for ATNOLD purposes. The election must be made for regular tax purposes in order to get it for AMT purposes.

VII. Corporate Transactions

Learning Objectives

After completing this section, you should be able to:

- Determine the tax consequences of incorporating a business.
- Identify stock redemptions that are considered dividend distributions and those that are considered sales or exchanges, and the tax treatment of shareholders and corporations when there is a complete or partial liquidation.
- Identify the different types of corporate reorganizations.

A. Incorporation and Capital Contributions

Incorporating a business or contributing property to a controlled corporation can be partly or wholly tax-free if technical rules are satisfied.

Ordinarily, a taxpayer who transfers property in exchange for stock (like a taxpayer who exchanges other property) recognizes gain or loss measured by the difference between the value of stock received and his or her basis in the property transferred. However, in certain cases, Code Section 351 permits tax-free transfers of property to a corporation solely in exchange for stock, if, immediately thereafter, the transferors are in "control" of the corporation. Courts have held that Code Section 351 applies even when a sole shareholder transfers property and does not receive any additional stock for the property. Issuance of additional stock to a 100% shareholder would be a meaningless gesture.

Property that may be transferred tax-free under Code Section 351 includes cash, tangible property and intangible personal property (e.g., stock, partnership interests, patent rights and working interests in oil and gas properties). However, it does not include services by a transferor to the transferee corporation. (Code Sec. 351(d)(1))

For purposes of the "solely in exchange for stock" test, "stock" doesn't include (1) stock rights, options or warrants (Reg §1.351-1(a)), or (2) nonqualified preferred stock. (Code Sec. 351(g)) Nonqualified preferred stock is preferred stock that the holder has the right to have the corporation (or a related person) redeem or purchase; the issuer (or a related person) is required to redeem or purchase; the issuer (or a related person) has the right to redeem or purchase (which on the issue date is more likely than not to be exercised); or that has a dividend rate that varies with reference to interest rates, commodity prices, or similar indices. (Code Sec. 351(g)(2)(A))

For purposes of the "control" requirement, control is defined as ownership of at least 80% of the transferee's voting stock and at least 80% of all its other classes of stock. (Code Sec. 351(a)) This requires transferors as a group to hold at least 80% of the voting power immediately after the transfer, but not every transferor has to hold voting stock. Some of the transferors can receive voting stock and others can receive nonvoting preferred as long as the combined stock ownership meets the control test. A corporate transferor's transfer of stock it receives to shareholders doesn't affect the determination of control for this purpose. (Code Sec. 351(c))

A corporation recognizes no gain or loss when it exchanges its stock for property or money. This is true whether the issue or subscription price is above or below par or stated value, and whether the stock is original issue or treasury stock. (Code Sec. 1032(a))

1. Receipt of "Boot"

When a taxpayer transfers property to a controlled corporation, the taxpayer may receive "boot" from the corporation as well as the corporation's stock. "Boot" is simply property other than "stock" (e.g., cash, nonqualified preferred stock, debt obligations including securities, tangible personal property). If a transferor receives boot in an otherwise qualifying Code Section 351 transfer, then:

- Loss isn't recognized on the transfer.
- Gain is recognized up to the amount of boot received. (Code Sec. 351(b); Code Sec. 351(g)(1)) If nonqualified preferred stock, and no other stock, is received by a transferor, Code Sec. 351 doesn't apply and gain or loss is recognized on the exchange. (Code Sec. 351(g))

Review Question 43

As part of a tax-free incorporation, a taxpayer contributes to the corporation property valued at $14,000 in which his basis was $10,000, and receives in return $13,000 worth of stock plus $1,000 of cash. How much gain will the taxpayer recognize on the exchange?

a. $0. b. $1,000.

c. $4,000. d. $14,000.

2. Assumption of Liabilities

When the corporation assumes liabilities in connection with an otherwise tax-free Code Section 351 transfer, the transfer is still tax-free, except: (Code Sec. 357(a))

- If the transferor's principal purpose for having the controlled corporation assume the liabilities is tax avoidance or isn't a bona fide business purpose, the full amount of all assumed liabilities, even those assumed for non-tax avoidance or valid business purposes, is treated as taxable boot. (Code Sec. 357(b)(1))

- If the total liabilities assumed exceed the transferor's adjusted basis in the transferred property, gain is recognized to the extent of the excess. (Code Sec. 357(c)(1))

A recourse liability is treated as having been "assumed" if, based on all the facts and circumstances, the transferee has agreed to, and is expected to, satisfy it (whether or not the transferor has been relieved of the liability). (Code Sec. 357(d)(1)(A)) A non-recourse liability is treated as having been assumed by the transferee of any asset subject to the liability, except that the amount of the liability treated as assumed must be reduced to reflect the value of any other assets subject to the same non-recourse liability that haven't been transferred to the transferee. (Code Sec. 357(d)(2))

B. Corporate Distributions

A distribution by a corporation to its shareholders is taxable to the shareholders as a dividend, but only to the extent it's out of current or accumulated earnings and profits (E&P). A distribution in excess of available earnings is considered a return of capital. As such, it's not taxable except to the extent it exceeds the shareholder's basis in his or her stock (the shareholder's cost or net capital investment) (Code Sec. 301(c)), and usually then as a capital gain. "Qualifying" dividends are taxed at the same favorable rates that apply to net capital gain (see Module 1, *Taxation of Individuals*).

1. Earnings and Profits

E&P as computed under the tax laws isn't necessarily the same as under accounting concepts (nor is it even the same as taxable income). Adjustments for specified transactions may have to be made to determine the increase or decrease in E&P for a particular tax year. Some adjustments are designed to conform E&P to economic income. (Code Sec. 312(n))

Depreciation. Deductions allowed for depreciation in computing E&P are often less than those allowed in computing taxable income (see IV.). For MACRS property (other than property expensed under Section 179), the deduction must be computed under the alternative depreciation system (ADS) even if a different system is used in computing taxable income. (Code Sec. 312(k)(3)(A)) For property expensed under Section 179, the cost is deducted ratably over five tax years. (Code Sec. 312(k)(3)(B))

Effect of distributions. With some exceptions, distributions of property reduce E&P by the sum of:

1. The amount of money distributed. (Code Sec. 312(a)(1))

2. The principal (face) amount of the corporation's obligations (i.e., its own notes, bonds, etc.) distributed without original issue discount (OID). (Code Sec. 312(a)(2))

3. The aggregate issue price of the corporation's obligations distributed with OID. (Code Sec. 312(a)(2))

4. The adjusted basis of other distributed property (Code Sec. 312(a)(3); Code Sec. 312(b)) determined for purposes of computing E&P. (Code Sec. 312(b)(1)) This may not be the same as the property's basis for regular income tax purposes, since depreciation allowances may differ for E&P and taxable income purposes (see above).

On distributions of property (other than the corporation's own obligations) whose fair market value exceeds its adjusted basis to the corporation, E&P is increased by the excess. (Code Sec. 312(b)(1))

The amount by which distributions decrease E&P is itself reduced by the sum of any liabilities assumed by the distributee and any liabilities to which the distributed property is subject. (Code Sec. 312(c))

Other adjustments to E&P. Here is how other key items are treated in computing E&P:

- Completed contract method of accounting (see II.B.3.) can't be used for E&P purposes. The percentage of completion method must be used instead. (Code Sec. 312(n)(6))
- Depletion (see IV.F. is taken into account on a cost, not percentage, basis. (Reg §1.312-6(c)(1))
- Estimated tax payments by a cash method taxpayer reduce E&P in the year paid.
- Exempt income (e.g., state or local bond interest) increases E&P. (Reg §1.312-6(b))
- Installment sale (see Module 1. Taxation of Individuals) principal amounts must be treated as received in the year of sale, i.e., as if the corporation didn't use the installment method. (Code Sec. 312(n)(5))
- Income tax liabilities reduce E&P as of the close of the tax year, for an accrual basis corporation, and according to some courts, a cash basis corporation (but IRS and other courts say a cash basis corporation reduces E&P only when the tax is paid).
- Life insurance proceeds increase E&P if the corporation is the beneficiary even if not includible in taxable income.
- Losses may be recognized though not allowed as a deduction, but the mere fact that the losses aren't allowed doesn't prevent a decrease in E&P by the disallowed amount.
- Loss carryovers and carrybacks don't reduce E&P of the year to which they are carried. Nor does a reduction of a loss carryover increase E&P in a later carryover year.
- Organization expenses must be capitalized and treated as part of the basis of the asset to which they relate even if they are amortized in computing taxable income (see III.B.2.). (Code Sec. 312(n)(3))
- Premiums paid for insuring lives of corporate officers reduce E&P even if not deductible in computing taxable income.

2. Effect of Distributions on Corporations

A corporation recognizes taxable gain when it makes a non-liquidating distribution of appreciated property (other than its own obligations) to its shareholders. It's as if the property had been sold, at the time of the distribution, to the distributee for its then fair market value. (Code Sec. 311(b)(1)) No loss is recognized on a non-liquidating distribution of property. (Code Sec. 311(a)(2))

If a corporation's non-liquidating distribution consists of property subject to a liability in excess of basis, or if a shareholder assumes a liability of the distributor corporation in connection with the distribution, then in computing the corporation's gain on the distribution, the property's fair market value (FMV) is treated as not less than the amount of those liabilities. (Code Sec. 311(b)(2)) If the liability is unsecured, it's allocated among all the distributed assets (including any asset that secures another liability) according to their relative FMVs.

C. Stock Redemptions

The acquisition by a corporation of its own stock from a shareholder in exchange for cash or property is treated as a distribution to the shareholder unless it qualifies as a redemption. If it qualifies as a redemption, the distribution is treated as payment for the stock (i.e., as a sale or exchange, for which capital gain treatment is allowed if the stock is a capital asset).

The importance of a stock redemption's status as a sale or exchange (instead of a distribution) has been significantly reduced by the enactment of favorable tax treatment for "qualified dividends." (see Module 1, *Taxation of Individuals*). Qualified dividends are taxed at the same tax rates as net capital gain.

Under the Code's stock redemption rules, if a redemption fits within any of the following categories, the distribution of cash or property to the redeeming shareholder is treated as a payment in exchange for stock and not as a distribution: (Code Sec. 302(a))

- A redemption that's "substantially disproportionate" with respect to the redeeming shareholder,
- A complete redemption of all of a shareholder's stock in the corporation,
- A redemption that is "not essentially equivalent to a dividend,"
- A redemption of stock held by a non-corporate shareholder, in partial liquidation of the distributing corporation, and
- A redemption of a decedent's stock to pay death taxes.

1. "Substantially Disproportionate" Redemptions

A redemption is "substantially disproportionate" if both of these tests are satisfied:

- 80% test. Immediately after the redemption, the ratio of the shareholder's voting stock to the corporation's total outstanding voting stock is less than 80% of that ratio immediately before the redemption. The same 80% test must also be met with regard to the corporation's common stock, voting and nonvoting. Where there's more than one class of common stock, the 80% test is based on the fair market value of the aggregate shares of the different classes. (Code Sec. 302(b)(2)(C))
- 50% test. Immediately after the redemption, the shareholder owns less than 50%, by vote, of the corporation's total voting stock. (Code Sec. 302(b)(2)(B))

For purposes of the stock redemption ownership tests, certain constructive ownership rules apply. Shareholders are treated as owning not only their own direct holdings, but also those of certain closely related taxpayers: (Code Sec. 302(c))

- Family attribution. An individual is considered as owning stock owned, directly or indirectly, by his or her spouse (unless divorced or legally separated), children (including adopted children), grandchildren and parents. (Code Sec. 318(a)(1))
- Attribution to and from S corporations, partnerships and estates. Stock owned by or for an S corporation, partnership or estate is considered as owned proportionately by its shareholders, partners, or beneficiaries. (Code Sec. 318(a)(2)(A), Code Sec. 318(a)(5)(E)) Stock owned by or for an S shareholder, partner or estate beneficiary is attributed in full to the S corporation, partnership or estate. (Code Sec. 318(a)(3)(A); Code Sec. 318(a)(5)(E))
- Attribution to and from trusts (except an exempt employee's trust). Stock owned by or for a trust is considered owned by its beneficiaries in proportion to their actuarial interest in the trust. (Code Sec. 318(a)(2)(B)(i)) Stock owned by or for a trust beneficiary is attributed in full to the trust unless the beneficiary's interest in the trust is a remote contingent interest. (Code Sec. 318(a)(3)(B)(i))
- Attribution to and from C corporations. A 50%-or-more shareholder in a C corporation is considered as owning his or her proportionate share of stock in other corporations owned by the C corporation. (Code Sec. 318(a)(2)(C)) A C corporation is considered as owning all the stock (except its own) owned by its 50%-or-more shareholder. (Code Sec. 318(a)(3)(C))
- Option attribution. The holder of an option to buy stock is treated as the owner of the stock covered by the option. (Code Sec. 318(a)(4)) This includes an option that isn't exercisable until after the lapse of a fixed time.

A redemption solely of nonvoting stock doesn't qualify as substantially disproportionate. But if voting stock is also redeemed at the same time and in a redemption that qualifies as substantially disproportionate, the redemption of nonvoting stock (other than Section 306 stock) will also qualify as substantially disproportionate. (Reg §1.302-3(a))

Review Question 44

A taxpayer owns 30% of a corporation before some of his shares are redeemed. For the redemption to qualify as "substantially disproportionate," the taxpayer's interest in the corporation must fall below:

a. 15%. b. 24%.

2. Complete Redemption

To qualify as a complete redemption, all stock owned (or treated as owned under the constructive ownership rules above) by the shareholder in the corporation must be redeemed. (Code Sec. 302(b)(3)) Thus, if a shareholder owns both common and preferred stock, the redemption of all the shares of only one of the classes doesn't qualify as a complete redemption.

A redemption on the installment basis can qualify as a complete redemption if the corporation and the shareholder are bound by a purchase agreement to complete the redemption by a certain date and for a maximum price.

Waiver of family attribution rules. In applying the complete redemption test, the family attribution rules (above) do not apply (but the other constructive ownership rules do apply) to any shareholder whose actually-owned stock is completely redeemed if the shareholder:

- immediately after the redemption has no personal financial interest in the corporation ("prohibited interest"), other than as a creditor;
- no longer serves as director, officer or employee;
- doesn't acquire any prohibited interest (except by inheritance) or position within ten years after the date of the redemption; and
- didn't acquire any of the redeemed stock from close family members, and didn't transfer any stock to them, within ten years before the redemption, except for an acquisition or transfer not principally motivated by tax avoidance. (Code Sec. 302(c)(2); Reg §1.302-4)

3. Redemption Not Essentially Equivalent to a Dividend

A redemption isn't essentially equivalent to a dividend if it results in a meaningful reduction in the redeemed shareholder's proportionate interest in the distributing corporation, without regard to how it affects the distributing corporation. (Reg §1.302-2(b)) A redemption from a sole shareholder and a redemption that's pro rata can't result in any reduction in the redeemed shareholder's proportionate interest in the distributing corporation.

A redemption from a shareholder with over 50% of the voting power usually results in a meaningful reduction if that shareholder's voting power is reduced to 50% or less. A redemption of voting stock from a substantial minority shareholder results in a meaningful reduction if, after the redemption, the number of shareholders the redeemed shareholder must act in concert with to control the corporation is increased. Any redemption of voting stock from a low percentage minority shareholder usually is treated as a meaningful reduction.

Redemptions of nonvoting preferred stock from shareholders who own no common stock and no voting stock of any class always result in a meaningful reduction. The constructive ownership rules (see above) apply in determining the redeemed shareholder's ownership of stock in the distributing corporation before and after the redemption (Code Sec. 302(c)(1)) even if no stock is actually owned after the redemption.

4. Distributions in Partial Liquidation

To be treated as made in partial liquidation, a redemption distribution must be:

- made with respect to a non-corporate shareholder,
- not essentially equivalent to a dividend (based on the effect to the distributing corporation), and
- made under a plan within the tax year in which the plan is adopted or the next tax year. (Code Sec. 302(b)(4); Code Sec. 302(e)(1))

Partial liquidations are meant to include cases involving the genuine contraction of a corporate business. (Reg §1.346-1(a)) If a corporation is engaged in two or more active trades or businesses for five years or more, a distribution in partial liquidation won't be essentially equivalent to a dividend if the corporation terminates one of the businesses, distributes all of the assets of the discontinued business (or its sales proceeds), and continues to operate the second business. (Code Sec. 302(e)(2); Code Sec. 302(e)(3))

5. Redemption to Pay Death Taxes

Distributions in redemption of stock included in a decedent's gross estate for federal estate tax purposes are treated as payment for stock up to the sum of: (1) all death taxes (federal and state), including interest, and (2) funeral and administration expenses allowable as federal estate tax deductions. (Code Sec. 303(a))

These rule applies only if these three tests are met:

- The value of the redeeming corporation's stock included in the estate must exceed 35% of the decedent's adjusted gross estate. (Code Sec. 303(b)(2)(A)) Stock in two or more corporations is treated as stock of a single corporation if 20% or more in value of the outstanding stock of each corporation is included in the estate. A surviving spouse's interest in stock held with the decedent as community property, joint tenants, tenants by the entirety or tenants in common is treated as included in the decedent's gross estate for these purposes (Code Sec. 303(b)(2)(B)), as are shares of stock transferred by gift within three years of a decedent's death.
- The redemption distribution must take place after the decedent's death and within three years and 90 days after the estate tax return is filed (or due, if filed early), or, in some cases, by later specified dates. (Code Sec. 303(b)(1))
- The redeemed shareholder must bear the burden of the taxes or expenses—i.e., his or her interest must be reduced (directly or through a binding obligation to contribute) by any payment of death taxes or funeral and administration expenses. (Code Sec. 303(b)(3))

D. Corporate Liquidations

If a corporation distributes its assets to its shareholders in complete liquidation, the shareholders generally recognize capital gain or loss on the receipt of the distributions. A corporation generally recognizes taxable gain or loss on the distribution or sale of property in liquidation.

1. Shareholder's Tax on Liquidations

Amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as made in full payment in exchange for the stock. (Code Sec. 331(a)) This means that a distribution in complete liquidation usually results in capital gain or loss to the shareholder.

Gain or loss is the total amount distributed less the shareholder's basis for his or her stock. (Reg §1.331-1(b)) The amount of the distribution is the sum of the cash plus the fair market value of any other property (reduced by any liability assumed) received by the shareholder in exchange for his or her stock. (Code Sec. 1001(b))

A shareholder who receives a series of distributions in complete liquidation of the corporation reports his or her gain only after the shareholder first recovers the cost or other basis of all the stock.

If property is received in a complete liquidation and any gain or loss is recognized on the receipt of the property, its basis in the hands of the shareholder-distributee is its fair market value at the time of the distribution. (Code Sec. 334(a))

2. Corporation's Tax on Liquidation

A liquidating corporation recognizes taxable gain or loss on distributions of property as if the property had been sold to the distributee for its fair market value (FMV). (Code Sec. 336(a)) If distributed property is subject to a liability, or if any shareholder assumes a liability of the liquidating corporation in connection with the distribution, the property's FMV is treated as not less than the amount of the liability. (Code Sec. 336(b))

Review Question 45

A corporation liquidates, distributing $100,000 in cash and land with a fair market value of $80,000 to its shareholders. The corporation had a basis of $60,000 in the land. How much gain or loss, if any, will the corporation recognize on the liquidating distribution?

a. $0. b. $20,000.
c. $80,000. d. $180,000.

E. Corporate Reorganizations

The term "reorganization" in the Code covers a wide variety of corporate transactions, including mergers, recapitalizations, and divisions. Qualifying reorganizations are generally tax-free.

The Code provisions view reorganizations as essentially continuations of the investment in another form, so that these transactions (typically involving exchanges of stock or securities for other stock or securities), which otherwise would be taxable, can be tax-free. The reorganization provisions provide tax-free treatment for corporate transactions in: acquiring another corporation; dividing corporate activities into separate corporations (which can be owned by differing shareholder groups); and recapitalizing, including passing ownership to younger management.

The Code defines several separate types of reorganizations, but certain definitions and requirements apply to all reorganizations, regardless of their type. Failure to meet any requirement may disqualify a reorganization and can result in recognized gain and/or dividend treatment.

- Plan of reorganization. There must be a "plan" of reorganization. (Code Sec. 354(a)(1)) The plan should be in writing (though not required by the Code) since the regulations require a copy of it to be filed with the returns of all corporate parties. (Reg §1.368-3)

- A party to a reorganization. The stock or securities exchanged must be those of a "party to the reorganization." (Code Sec. 354(a)(1)) A "party" includes any corporation resulting from the reorganization, such as the survivor in a merger, the consolidated company, etc., as well as the corporations merged, consolidated, etc. (Code Sec. 368(b)) A "party" also can include a parent corporation, in some cases.

- Continuity of interest. After all the exchanges and other changes under the plan, a substantial part of the value of the proprietary interests in the target corporation must be preserved. (Reg §1.368-1(b)) A proprietary interest is preserved if (1) it is exchanged for a proprietary interest in the acquiring corporation or its parent, (2) it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or (3) it otherwise continues as a proprietary interest in the target corporation. It isn't preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than its own stock, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. Continuity of interest isn't required for recapitalizations involving a single corporation (Type E reorganizations, below).

- Continuity of business enterprise. An acquiring corporation must either: (1) continue the acquired corporation's "historic business" (in general, its most recent business unless the most recent business was entered under the plan of reorganization), or (2) use in a business a significant portion of the acquired corporation's "historic business assets" (the assets it used in its historic business). (Reg §1.368-1(d)(1); Reg §1.368-1(d)(2)) An acquiring corporation is treated as holding all of the businesses and assets of all members of a "qualified group" (one or more chains of corporations connected through stock ownership, if the acquiring corporation has 80% control of at least one of them and each of the other corporations is controlled by one of the other corporations). (Reg §1.368-1(d)(4)(ii))

- Business purpose. Where there's no business purpose, the transaction isn't treated as a reorganization.

1. Types of Reorganizations

The types of reorganization are known as “Type A,” “B,” “C,” “D,” “E,” “F” and “G” (from Code Sec. 368(a)(1)(A) through (G))) and are distinguished by the form of the transaction rather than by economic effect.

Type A: merger or consolidation. A Type A reorganization is a statutory merger or consolidation effected under the laws of a state, a territory, the District of Columbia or the U.S. (Code Sec. 368(a)(1)(A))

In order for a transaction to qualify as an “A” reorganization, the following must occur simultaneously under the applicable law:

- All the assets and liabilities of each transferor corporation must become assets and liabilities of the transferee corporation. However assets may be distributed to transferor shareholders and liabilities may be satisfied or discharged. (Reg §1.368-2T(b)(1)(ii)(A))

- Each transferor corporation must cease its separate legal existence for all purposes. (Reg §1.368-2T(b)(1)(ii)(B))

The requirement that the transferor cease its existence for all purposes is satisfied even if, under applicable State (or U.S. or District of Columbia) law, after the effective time of the transaction, the transferor (or its officers directors or agents) may act or be acted against or the transferee (or its officers, directors, or agents) may act or be acted against in the name of the transferor if the actions relate to assets or obligations of the transferor that arose, or relate to activities engaged in by the transferor, before the effective time of the transaction. (Reg §1.368-2T(b)(1)ii)(B))

Type B: stock for stock. A Type B reorganization is the acquisition by one corporation of stock in a second (target) corporation in exchange solely for the acquiring corporation’s voting stock if the acquiring corporation has “control” (see below) of the target immediately after the exchange. (Code Sec. 368(a)(1)(B))

An acquiring corporation that transfers property other than voting stock in connection with a Type B reorganization plan (e.g., to non-shareholders) doesn’t violate the solely-for-voting-stock requirement as long as the target’s stock is acquired solely for voting stock.

Type C: acquisition of property of another corporation. A Type C reorganization is the acquisition by one corporation of “substantially all” of the properties of a second (target) corporation in exchange for voting stock of the acquiring corporation Except as noted below, liabilities assumed by the acquiring corporation are disregarded. (Code Sec. 368(a)(1)(C))

There’s no rule of thumb as to what is “substantially all” of the target’s properties, and how much can be safely retained by the transferor (target), although cases have held that certain percentages met (92%) or failed (61%, 68%) the requirement. For purposes of a favorable advance ruling from IRS, the target must transfer at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets that it held immediately before the transfer.

Also, the transaction won’t qualify as a C reorganization unless, under the reorganization plan, the target distributes to its shareholders (i.e., liquidates) all the stock, securities and other property so received, as well as its other properties. But IRS may waive this distribution requirement under certain conditions. (Code Sec. 368(a)(2)(G))

If the acquiring corporation pays cash or other property (“boot”) as part of the deal, it must receive at least 80% of the value of all the target properties in exchange solely for its voting stock. If any cash or other property is transferred, liabilities assumed with respect to acquired properties are treated as cash. (Code Sec. 368(a)(2)(B)) Preexisting ownership by an acquiring corporation of a portion of the target’s stock does not, in and of itself, prevent the solely-for-voting-stock requirement from being satisfied. (Reg §1.368-2(d)(4))

Type D: transfer of assets to a subsidiary. A Type D reorganization is the transfer by one corporation of all or part of its assets to a second corporation, if

- immediately after the transfer the transferor and/or its shareholders are in "control" (see below) of the transferee corporation, and
- the transferor either:
  - under the plan of reorganization, distributes all of its assets (including stock and securities of the transferee) to its shareholders as a part of the transferor's liquidation ("acquisitive" or "non-divisive" D); or
  - distributes the stock and securities of the transferee in a tax-free spin-off, split-off or split-up (see VII.F.). (Code Sec. 368(a)(1)(D))

Type E: recapitalization. A Type E reorganization is a "recapitalization" or change in the capital structure of a single corporation. (Code Sec. 368(a)(1)(E)) Recapitalizations include:

- issuance of preferred stock in discharge of outstanding bonds;
- exchanging one class of common for another class of common, or preferred for common, or vice versa; (Reg §1.368-2(e))
- exchanging old bonds for new bonds with a different face value, interest rate or the like;
- changes in stock or securities effected by a change in the corporate charter.

Type F: change in identity. Type F reorganization is limited to a change in identity, form or place of organization of one corporation (Code Sec. 368(a)(1)(F)), but may include a reincorporation as part of a plan that includes a public stock offering, a merger, or a C reorganization.

Type G: bankruptcy. A Type G reorganization is the transfer by a corporation of all or part of its assets to another corporation under a court-approved reorganization plan in a Title 11 or similar case (e.g., bankruptcy, receivership, or foreclosure). (Code Sec. 368(a)(1)(G))

Review Question 46

A "Type B" reorganization is also known as a:

a. Statutory merger. b. Stock-for-stock reorganization.
c. Recapitalization. d. Bankruptcy reorganization.

2. Control

For purposes of the rules for reorganizations, "control" is generally the ownership of:

- stock possessing at least 80% of the total combined voting power of all voting stock, and
- at least 80% of the total number of shares of each class of nonvoting stock. (Code Sec. 368(c))

For non-divisive Type Ds, "control" is defined as 50%, rather than 80%, ownership. (Code Sec.368(a)(2)(H)(i))

3. How Shareholders Are Taxed

If under a plan of reorganization, the holder of stock or securities receives in the exchange only stock in a corporation that's a party to the reorganization, the holder recognizes no gain or loss. Non-recognition also applies when securities of a corporate party to the reorganization are received in exchange for other securities, if the principal (face) amount of the securities received isn't more than the face amount given up. (Code Sec. 354(a)(1)) Nonqualified preferred stock (see VII.A.)) received for stock that isn't nonqualified preferred stock isn't stock or securities for this purpose unless it's received in a recapitalization of a family-owned corporation. (Code Sec. 354(a)(2)(C))

The non-recognition rule doesn't apply to D or G reorganizations unless the transferee corporation receives substantially all of the transferor's assets, and the stock, securities and other property received by the transferor, as well as its remaining assets, are distributed by the transferor under the reorganization plan. (Code Sec. 354(b))

If "boot" (see VII.A.1.) is received, then any gain realized by the recipient on the exchange is recognized up to the amount of boot (Code Sec. 356(a)(1)) as a dividend to the extent the exchange has the effect of a dividend distribution. The balance, if any, is taxed like gain from the exchange of property. (Code Sec. 356(a)(2)) In determining if dividend treatment applies, the redemption tests (see VII.C.), are applied to the transaction, as though the consideration paid in the reorganization were entirely in the form of acquirer stock, and as though, after the reorganization, the boot had been distributed in redemption of a portion of that stock.

4. How Corporations Are Taxed

No gain or loss is recognized by a corporation that is a party to a reorganization that exchanges property solely for stock or securities of another corporation that is also a party to that reorganization. (Code Sec. 361(a))

If the corporation receives "boot" (see VII.A.1.) in addition to stock or securities, then:

1. If the recipient distributes all the boot, it generally doesn't recognize gain on the exchange.
2. If any part of the boot isn't distributed, gain is recognized on the exchange but only to the extent of the undistributed boot. (Code Sec. 361(b))

Gain or loss isn't recognized on the distribution of "qualified property" received under the plan of reorganization. "Qualified property" is stock (or the right to acquire stock) in the distributing corporation, and stock or obligations of another party to the reorganization that are received in the reorganization exchange. Gain (but not loss) is recognized on the distribution of property that isn't qualified property. (Code Sec. 361(c))

F. Spin-offs, Split-offs and Split-ups

Spin-offs, split-offs and split-ups accomplish a tax-free separation of one corporation (P) into two or more corporations (S) with the same shareholders owning the separate corporations directly (though not necessarily in the same proportion).

Spin-off: Corporation P has carried on one or more businesses for five years or more. P transfers part of the business assets to S, a newly created corporation, in exchange for S's stock, and then distributes the S stock to its (P's) shareholders. Or P, previously owning all the S stock for at least five years, decides to distribute the S stock to its (P's) shareholders, pro rata. P's shareholders don't surrender any of their P stock, so they end up holding the stock of P and S in the same proportion. If certain requirements are met, the transaction is partially or wholly tax-free to P's shareholders (and to P).

Split-off: This is the same as a spin-off except that P's shareholders exchange part of their P stock for the S stock they receive from P. A split-off doesn't have to be pro rata.

Split-up: In addition to transferring part of one business or a separate business to S for S's stock, P transfers the remainder of its business (or businesses) to X Corp, also newly incorporated, for X's stock. P (left without a business) distributes the S and X stock to its shareholders in exchange for their P stock. P liquidates and disappears.

1. Non-recognition Requirements

The requirements for a tax-free spin-off, split-off or split-up are as follows:

- The distributing corporation (P) must distribute to its shareholders with respect to their stock, or to its security holders in exchange for their securities, solely stock or securities in a corporation (S) that it "controls" (see above) immediately before the distribution. (Code Sec. 355(a)(1)) Nonqualified preferred stock received in exchange for other than nonqualified preferred stock is not stock or securities for this purpose. (Code Sec. 355(a)(3)(D))

- The transaction must not be used principally as a device for distributing earnings and profits (E&P) of either P or S. (Code Sec. 355(a)(1)(B)) The IRS regulations specify "device factors" (whose presence are evidence of a device) and non-device factors, and certain distributions that ordinarily aren't considered to have been used principally as a device even though device factors are present. (Reg §1.355-2(d))

- There must be a "continuity of interest" (see above). The pre-distribution shareholders of P must end up with an amount of stock which establishes a continuity of interest in both P and S, though not necessarily proportionately. (Reg §1.355-2(c)(1))

- Both P and S (or each controlled subsidiary) must be engaged immediately after the distribution in the active conduct of a trade or business (Code Sec. 355(b)(1)(A)), i.e., each performing active and substantial management and operational functions (not holding investments or owning and operating real or personal property unless performing significant services). (Reg §1.355-3(b)(2)(iii)) However, if immediately before the distribution P has no (or *de minimis*) assets except stock or securities in its subs, then only the subs must meet the post-distribution active business requirement. (Code Sec. 355(b)(1)(B); Reg §1.355-3(a)) These trades or businesses must have been actively conducted throughout the five-year period ending on the date the sub's stock is distributed. (Code Sec. 355(b)(2)(B))

- The active trade or business (above) must not have been acquired during the above five-year period in a transaction in which gain or loss was recognized. (Code Sec. 355(b)(2)(C))

- P must distribute either all its stock or securities in S, or at least an amount of S stock that's treated as "control." The distributions don't have to be pro rata, or under a plan of reorganization. But if P retains any stock or securities in S, tax avoidance must not be a principal purpose for the retention. (Code Sec. 355(a)(1)(D), Code Sec. 355(a)(2))

Even if all the above requirements are met, there must be one or more corporate business purposes for the transaction for it to be tax-free. (Reg §1.355-2(b)) IRS has established ruling guidelines for various corporate business purposes.

The receipt of boot (cash and property other than stock or securities) in a spin-off (where no stock is surrendered) is a fully taxable ordinary dividend to the extent of E&P, and any excess is a nontaxable return of capital. (Code Sec. 356(b))

Boot in a split-off or split-up (where stock in P is surrendered) is taxable to the extent of gain, either as a dividend if the distribution has the effect of one, or as capital gain. (Code Sec. 356(a))

2. How Distributing Corporation Is Taxed

No gain or loss is recognized by a corporation (P) on its distribution of stock or securities of S in a tax-free corporate separation (Code Sec. 355(c)(1); Code Sec. 361) unless

- the distribution is "disqualified," in which case P recognizes gain (but not loss) as if the property were sold for its fair market value, (but not less than the amount of any liability on it that is assumed in connection with the distribution) (Code Sec. 355(c)(2); Code Sec. 355(d)(1) et seq.), or

- pursuant to a plan or series of related transactions (Reg §1.355-7T) there is an acquisition (direct or indirect) of a 50% or greater interest in either the controlled or distributing corporation following the distribution, in which case the distributing corporation generally must recognize gain as if it had sold the stock or securities of the controlled corporation to the distributee for fair market value immediately before the distribution. (Code Sec. 355(e))

A distribution is generally "disqualified" (Reg §1.355-6(c)(4)(i))) if:

- immediately after the distribution any shareholder (or any two or more shareholders acting under a plan (Reg §1.355-6(b)(3))) holds (actually or constructively) at least 50% of the stock of P or of S, and

- that stock was purchased (or similarly acquired) within the immediately preceding five-year period (but absent contrary knowledge, less than 5% shareholders can be presumed not to have acquired stock within the five-year period (Reg §1.355-6(f)(4))), or was received as a distribution on P stock that was purchased, etc., within that period. (Code Sec. 355(c); Code Sec. 355(d))

VIII. S Corporations

Learning Objectives

After completing this section, you should be able to:

- Determine the eligibility of a corporation to elect S corporation status.
- Demonstrate an understanding of the tax treatment of an S corporation and its shareholders.

If a corporation is eligible (see I.C.) and elects to be treated as an S corporation, it is generally exempt from federal income taxes. (Code Sec. 1363(a)) Instead, the corporation's income is passed through, and taxed, to its shareholders. But some S corporations may be subject to a tax on recognized built-in gains, a tax on excess net passive income and a tax on LIFO recapture (see below).

S corporations may have 80%-or-more owned C ("regular") corporation subsidiaries and wholly owned S corporation subsidiaries. (Code Sec. 1361(b))

A C corporation subsidiary is treated as a separate taxpayer. If it operates profitably, it pays tax on its income. If it operates at a loss, it cannot pass the loss through to the S corporation.

An S corporation cannot have a corporate shareholder. (Code Sec. 1361(b)(1)(B); Reg §1.1361-1(f)) This rule ordinarily prevents a subsidiary from being an S corporation. However, an S corporation can have an S corporation subsidiary if it owns 100% of the subsidiary's stock, the sub is not an ineligible corporation, and the S corporation parent elects to treat the subsidiary as a qualified subchapter S subsidiary (QSub). (Code Sec. 1361(b)(3)(B); Reg §1.1361-2; Reg §1.1361-3)

A QSub isn't treated as a separate corporation for federal tax purposes; rather, its assets, liabilities, and items of income, deduction, and credit are treated as those of the parent S corporation. (Code Sec. 1361(b)(3)(A); Reg §1.1361-4))

A. Electing S Corporation Status

The S election is made by the corporation (Code Sec. 1362(a)(1)) by filing a Form 2553 signed by its authorized officer. All shareholders owning stock in the corporation on the day it elects S status must consent to the election. (Code Sec. 1362(a)(2); Reg §1.1362-6(b)(2)(i))

An S election for a tax year may be made during the preceding tax year, or by the 15th day of the third month of the tax year for which it's to be effective. (Code Sec. 1362(b)(1)) If this first tax year is less than two months and 15 days, the election must be made no later than two months and 15 days after the first day of that year. (Code Sec. 1362(b)(4))

An S election will be effective retroactively to the first day of a tax year only if:

- on all days in the tax year before the day the election is made, the corporation would have been eligible to elect (Code Sec. 1362(b)(2)(B)(i)), and
- all persons who were shareholders at any time during the tax year before the day of the election, but who aren't shareholders on that date, consent (along with persons who are shareholders). (Code Sec. 1362(b)(2)(B)(ii))

If either of the above conditions isn't met, the election is treated as made for the next tax year. (Code Sec. 1362(b)(2))

If an S election is made after the required date for making it, or if no election is made, and IRS determines there was reasonable cause for the failure to timely elect, IRS can treat the election as timely made. (Code Sec. 1362(b)(5))

Unless a taxpayer qualifies for automatic relief, it must get a private letter ruling to obtain relief. Automatic relief arises where the corporation did not qualify as an S corporation because it failed to file a Form 2553 if the due date for the tax return of the corporation (excluding extensions) for the first tax year the corporation intended to be an S corporation has not passed, the corporation has reasonable cause for its failure to make a timely election, and it takes certain steps. To qualify for relief, a completed election form must be filed within 12 months of the original due date for the election and by the due date of the tax return (excluding extensions) for the first year the corporation intended to be an S corporation.

The IRS is also authorized to waive inadvertently invalid QSub elections (Code Sec. 1362(f)(1)(A)) or terminations of such elections. (Code Sec. 1362(f)(1)(B))

Review Question 47

The minimum percentage of shares needed to vote in favor for a corporation to elect S status is:

a. 51%. b. 75%.

c. 100%.

B. Taxation of S Corporation Shareholders

An S corporation's income is taxed directly to its shareholders by allocating the corporation's items of income, loss, deduction and credit for each day in its tax year pro rata among the persons who were shareholders on that day. (Code Sec. 1366(a)(1); Reg §1.1366-1(a); Code Sec. 1377(a)(1))

Items of income, loss, deduction and credit are separately allocated to each shareholder whenever separate treatment could affect the tax liability of a shareholder. (Code Sec. 1366(a)(1)(A); Reg §1.1366-1(a)) Under IRS regulations, the following S corporation items must be taken into account separately:

- The combined net amount of gains and losses from sales or exchanges of capital assets grouped by applicable holding periods, Code Sec. 1(h) tax rates, and by any other classification that may be relevant in determining the shareholder's tax liability.
- The combined net amount of gains and losses from sales or exchanges of Code Sec. 1231 property grouped by applicable holding periods, Code Sec. 1(h) tax rates, and by any other classification that may be relevant in determining the shareholder's tax liability.
- The charitable contributions, grouped by the Code Sec. 170(b) percentage limitations (see Module 1, Taxation of Individuals), paid by the corporation within its tax year.
- The foreign taxes paid (or accrued) by the corporation.
- Each of separate items involved in determining credits, except credits for certain uses of gasoline and special fuels.
- Each of these separate items: Code Sec. 165(d) gains and losses from wagering transactions; Code Sec. 175 soil and water conservation expenditures, Code Sec. 179 expense election deductions; Code Sec. 213 medical, dental, etc., expenses, additional itemized deductions for individuals under Code Sec. 212 et seq.; and any other deductions subject to the Code Sec. 67 or Code Sec. 68 limitations on itemized deductions (see Module 1, Taxation of Individuals).
- Any of the corporation's items of portfolio income or loss, and related expenses, as defined in the regulations under Code Sec. 469 (limitation on passive activity losses).
- The corporation's tax-exempt income, i.e., income that is permanently excludible from gross income.
- The corporation's alternative minimum tax adjustments described in Code Sec. 56 and Code Sec. 58, and tax preference items described in Code Sec. 57; and
- Any item identified in IRS guidance (including forms and instructions) as an item required to be separately stated. (Reg §1.1366-1(a)(2))

The character of any item in the shareholder's hands is determined as if the item had been realized directly from the source from which the corporation realized it, or as if it had been incurred in the same manner as incurred by the corporation. (Code Sec. 1366(b); Reg §1.1366-1(b)) A shareholder's share of an S corporation's items is taken into account in his or her tax year that includes the last day of the corporation's tax year. (Code Sec. 1366(a)(1); Reg §1.1366-1(a)(1))

If a shareholder sells all of his or her S corporation stock during the corporation's tax year and if all affected shareholders (all terminating shareholders and their transferees) consent (by attaching a specified statement to the corporation's tax return for the tax year during which the shareholder's entire interest is terminated), the corporation's tax year can be split into two tax years, the first of which ends on the date the seller's interest in the S corporation is terminated. Items will be allocated between those tax years according to the books. (Code Sec. 1377(a)(2); Reg §1.1377-1(b))

If a shareholder dies (or a trust terminates) before the end of an S corporation tax year, his or her (or its) pro rata part of the corporation's items is reported on the shareholder's final return. (Code Sec. 1366(a)(1))

An S corporation files Form 1120S, which must show information on actual and constructive distributions to shareholders. (Code Sec. 6037(a); Reg. §1.6012-2(h)). The corporation uses Form 1120S, Schedule K-1, to furnish information to anyone who was a shareholder during the tax year. (Code Sec. 6037(b))

1. Limitation on Shareholder's Deductions and Losses

All deductions and losses of an S corporation (e.g., capital losses and NOLs) are passed through to and (except as otherwise limited by the Code) are deductible by the shareholders. However, a shareholder may deduct his or her pro rata share of these passed-through items only to the extent of the shareholder's adjusted basis in the S corporation stock plus the amount of any debt owed by the corporation to the shareholder. (Code Sec. 1366(d)(1))

Any deduction or loss that can't be deducted (for lack of basis) may be carried over to be used whenever the shareholder has basis to apply against all or part of the amount the shareholder carried over. (Code Sec. 1366(d)(2); Reg §1.1366-2(a)(2)) Special rules apply where the S corporation is in bankruptcy or is insolvent. (Code Sec. 108(d)(7)(B))

If an S corporation's stock, or the debt it owes to a shareholder, becomes worthless in any tax year of the corporation or shareholder, the corporate items for that year will be taken into account by the shareholders, and the adjustments to basis of stock or debt will be made, before the worthlessness is taken into account. (Code Sec. 1367(b)(3))

Review Question 48

An S corporation shareholder who has loaned $10,000 to the corporation has a $15,000 basis in his stock (after taking into account basis increases for his share of corporation income items for the year). The maximum loss the shareholder can deduct from the corporation is:

a. $3,000.   b. $10,000.

c. $15,000.   d. $25,000.

2. Shareholder's Basis

A shareholder's original basis in stock (or debt) is determined in the same manner as the basis of stock (or debt) in a C corporation. The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the following items that is attributable to the share determined on a per-share per-day basis:

- separately computed income items (see above),
- non-separately computed income, and

- the excess of depletion deductions over the basis of property subject to depletion (not including the depletion deduction from oil or gas property). (Reg §1.1367-1(b))

The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the following items:

- corporate distributions that weren't included in the shareholder's income. (see below)
- items of separately computed loss or deduction,
- any non-separately computed loss,
- any corporate expense not deductible in computing its taxable income and not properly chargeable to a capital account, and
- the sum of the shareholders' deductions for depletion for any oil or gas property held by the S corporation to the extent the deduction doesn't exceed the proportionate share of adjusted basis of the property allocated to the shareholder. (Reg §1.1367-1(c)))

In the case of contributions made in tax years beginning after 2005 and before 2014, the decrease in a shareholder's basis in S corporation stock by reason of a charitable contribution of property made by the S corporation equals the shareholder's pro rata share of the adjusted basis of the contributed property. (Code Sec. 1367(a)(2) as amended by the American Taxpayer Relief Act of 2012 (P.L. 112-240)) For earlier and later years, the shareholder's basis is reduced by his or her pro rata share of the contribution (i.e., the fair market value of the property).

Caution: Expired or expiring provisions may be extended by Congress.

C. Taxation of Distributions

The amount of a distribution from an S corporation to a shareholder equals the amount of cash distributed plus the fair market value (at distribution) of any other property distributed. (Code Sec. 301(c); Code Sec. 1368(a))

If an S corporation was never a C corporation or has no accumulated earnings and profits (E&P) from its period as a C corporation, a distribution is nontaxable to the extent of the shareholder's basis in his or her stock. The basis is reduced by the amount of the distribution. If the amount of the distribution exceeds the basis, the excess is treated as payment in exchange for the stock (Code Sec. 1368(b)(2)), i.e., as capital gain.

If an S corporation has accumulated E&P from its period as a C corporation, its distributions are treated as follows: (Code Sec. 1368(c))

1. The portion of the distribution that doesn't exceed the accumulated adjustments account (see below) is taxed the same as a distribution from an S corporation with no accumulated E&P (above). (Code Sec. 1368(c)(1))
2. The portion of the distribution that remains after applying (1) is treated as a dividend to the extent it doesn't exceed the S corporation's accumulated E&P. (Code Sec. 1368(c)(2))
3. Any portion of the distribution remaining after applying (2) is treated the same as a distribution by an S corporation with no accumulated E&P. (Code Sec. 1368(c)(3))

Note, however, that the 2007 Small Business Act provides that a corporation that was an S corporation for any tax year beginning before January 1, 1983 and was not an S corporation for its first tax year beginning after December 31, 1996 reduces its accumulated E&P (for the first tax year beginning after May 25, 2007) by an amount equal to the portion (if any) of the accumulated E&P that was accumulated in any pre-1983 S corporation years. (2007 Small Business Act §8235)

The tax effects of an S corporation's distributions to shareholders with respect to stock are determined only after taking into account:

- adjustments that increase the basis of the shareholder's stock, and
- adjustments to the accumulated adjustments account other than for distributions to shareholders and without regard to any net negative adjustments, for the S corporation's tax year. (Code Sec. 1368(d); Reg §1.1368-1(e)(2))

Accumulated adjustments account. An S corporation's accumulated adjustments account (AAA) is increased each tax year by:

- Separately computed items of income. (other than tax-exempt interest).
- Non-separately computed income.
- The excess of deductions for depletion over the basis of property subject to depletion. (Code Sec. 1368(e)(1); Reg §1.1368-2(a)(2))

The AAA is decreased each tax year by:

- Items of separately computed loss and deduction.
- Non-separately computed loss.
- Nondeductible expenses (other than expenses chargeable to capital account) unless related to tax-exempt income.
- The amount of the shareholder's deduction for depletion under Code Sec. 611 with respect to oil and gas wells.
- Distributions from an S corporation that has no E&P and distributions that are made out of the AAA.

If the total distributions made by an S corporation during a tax year exceeds the amount in its AAA at the end of the year, the balance in the AAA must be allocated among the distributions in proportion to their size. (Code Sec. 1368(c); Reg §1.1368-2(b)(1))

D. Special S Corporation Taxes

As noted previously, for each tax year the S election remains in effect, the corporation is generally exempt from all federal income taxes—normal tax, capital gains tax, minimum tax, accumulated earnings tax and the tax on undistributed personal holding company income. (Code Sec. 1363) However, there are several exceptions.

- Built-in gains tax. An S corporation is subject to a corporate-level built-in gains tax in any tax year beginning in the "recognition period" in which it has a "net recognized built-in gain." (Code Sec. 1374(a)) But the tax is imposed only on S corporations that were formerly C corporations. (Code Sec. 1374(c)(1)) The recognition period is the ten-year period beginning on the first day of the corporation's first S tax year. (Code Sec. 1374(d)(7)) The American Recovery and Reinvestment Act of 2009 provides that, for S corporation tax years beginning in 2009 and 2010, no tax is imposed on the net unrecognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded the 2009 and 2010 tax years. (Code Sec. 1374(d)(7)(B) as amended by the American Recovery and Reinvestment Act of 2009 (P.L. 111-5)) Under the Small Business Jobs Act of 2010, no tax is imposed on the recognized built-in gain during the tax year beginning in 2011 if the fifth year in the recognition period (measured in calendar years) precedes the tax year beginning in 2011. The net recognized built-in gain for any tax year in the recognition period is the lesser of: (1) the amount that would be the S corporation's taxable income for that year if only "recognized built-in gains" and recognized built-in losses are taken into account, or (2) the taxable income for that year determined without taking into account NOL carryovers or special corporate deductions, e.g., for dividends received. (Code Sec. 1374(d)(2)(A)) "Recognized built-in gain" means any gain recognized (and certain related amounts taken into account) during the recognition period on the disposition of any asset held on the first day of the corporation's first S tax year, but only to the extent the gain doesn't exceed the excess (if any) of the asset's fair market value over its adjusted basis, on that first day. (Code Sec. 1374(d)(3); Reg §1.1374-4)
- LIFO recapture amount: A C corporation that used LIFO (see II.C.2.) for its last tax year before the first tax year its S election is effective must include a "LIFO recapture amount" in its income for that last C year. (Code Sec. 1363(d)(1)) Any resulting increase in tax is payable in four equal installments over four tax years. The first installment is payable with the final return as a C

corporation. (Code Sec. 1363(d)(2)) The "LIFO recapture amount" is the excess (if any) of the inventory amount under FIFO over the inventory amount under LIFO, at the close of the last C tax year. (Code Sec. 1363(d)(3))

Tax on excess net passive income. A corporate-level tax is imposed on an S corporation's "excess net passive income" (for any tax year in which it has: (1) accumulated earnings and profits from a year it was taxed as a C corporation) at the close of the tax year, and (2) passive investment income that exceeds 25% of gross receipts (Code Sec. 1375(a)) "Net passive income" is passive investment income reduced by deductions directly connected with the production of that income. (Code Sec. 1375(b)(2)) "Excess net passive income" means that amount that bears the same ratio to the total net passive income for the year as: (1) the amount by which the passive investment income for the tax year exceeds 25% of gross receipts for the year ("excess passive investment income"), bears to (2) the total passive investment income for the tax year. (Code Sec. 1375(b)(1))

IX. Partnerships

Learning Objectives

After completing this section, you should be able to:

- Determine the tax treatment of contributions to a partnership.
- Recognize how partnership income and deductions are treated for tax purposed by the partnership and the individual partners.

A "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through, or by means of which, any business, financial operation or venture is carried on if it isn't, within the meaning of the Code, a corporation, trust or estate. (Code Sec. 761(a))

Under the "check-the-box" entity classification regulations, a partnership is a business entity, with two or more members, that isn't mandatorily classified as a corporation, and that has elected, or defaulted to, partnership tax status. (Reg §301.7701-2(c)) However, certain husband and wife joint ventures are not treated as partnerships. (See I.E).

Partnerships are "pass-through entities"—that is, their income is subject to tax only once, at the partner level. They share this characteristic with S corporations, but not C corporations (whose income is taxed twice, at the corporate and again at the shareholder level).

Partnerships must generally file Form 1065 to report gross income and deductions for their tax year. (Code Sec. 6031(a), Reg. §1.6031(a)-1(a)) Every partnership required to file a return must furnish Form 1065, Schedule K-1 containing information from the return, to every person who was a partner at anytime during the partnership's tax year.

Partnerships with more than 100 partners must file Form 1065 and Schedule K-1 electronically, unless they are excepted from this requirement by IRS procedures. (Reg. §301.6011-3)

A. Contributions to a Partnership

Whether contributions to a partnership's capital are made on formation of the partnership or later no gain or loss is ordinarily recognized to the partners or the partnership. (Code Sec. 721; Reg §1.721-1)

1. Contributions of Property

Property received by a partnership from a contributing partner takes the same basis in the partnership's hands as it had in the contributing partner's hands at the time of the contribution. (Code Sec. 723; Reg §1.723-1) And the partner's basis in his or her partnership interest will be the basis he had in the contributed property, increased by cash contributed or reduced by cash received. (Code Sec. 722; Code Sec. 705; Reg §1.722-1)

A partnership's holding period for property contributed to it includes the contributing partner's holding period. (Code Sec. 1223(2); Reg §1.723-1)

When a partner contributes what was an unrealized receivable in his or her hands to a partnership, the partnership's gain or loss on disposition of the item will still be ordinary income or loss. (Code Sec. 724(a)) The same rule applies to contributed inventory, but in this case, ordinary income or loss will result only if the assets are disposed of by the partnership within five years of the contribution. (Code Sec. 724(b))

If a partner contributes a capital asset with a basis higher than its fair market value, and the partnership disposes of it within five years of the contribution, the partnership's loss will be a capital loss to the extent of the basis/value variance upon contribution. (Code Sec. 724(c))

If any of the above property is disposed of by the partnership in a nontaxable disposition, the above rules apply to the substituted basis property that results. (Code Sec. 724(d)(3))

2. Contribution of Services

Where a taxpayer receives a capital interest in a partnership in exchange for services, that interest is taxable compensation income to the taxpayer. When the income must be recognized depends on the facts and circumstances, including whether there are any restrictions on the taxpayer's right to withdraw from the partnership or otherwise dispose of the partnership interest. (Reg §1.721-1(b)(1))

Where a taxpayer receives a profits interest in a partnership (even if substantially unvested) in exchange for services, the IRS won't treat the transaction as giving rise to compensation income, unless: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets; (2) the partner disposes of the profits interest within two years; or (3) the profits interest is a limited partnership interest in a publicly traded partnership.

Review Question 49

Which of the following is a true statement regarding contributions to a partnership in exchange for interests in the partnership?

a. Contributions to a partnership must be made in cash or property.

b. If a partner contributes property with a basis higher than its fair market value, the partnership's basis in the property is equal to the fair market value of the property at the time of the contribution.

c. If a partner contributes services to a partnership in exchange for a partnership, the value of the partnership interest is taxable to the partner.

d. If a partner contributes inventory to a partnership, any gain or loss on eventual sale of the inventory will be ordinary gain or loss.

B. Partnership Income and Deductions

A partnership is essentially a conduit which passes through to each partner his or her share of income and deductions generated by the partnership.

The partners, not the partnership, are taxed on the partnership's income. (Code Sec. 701) The partnership only files an information return (Form 1065) showing each partner's distributive share of the partnership income, gains, losses, etc. Each partner includes his or her share of these items on his or her own return. (Code Sec. 702)

Partnership taxable income is computed the same as an individual's except the following deductions aren't allowed:

- standard deduction (Code Sec. 63(c)(6)(D));
- personal exemptions;
- charitable contributions;
- non-business expenses, medical expenses, alimony, retirement savings under Code Sec. 219, and taxes and interest paid to cooperative housing corporations;
- capital loss carryovers;
- net operating loss deduction;

- taxes paid to a foreign country or U.S. possession that can be taken as a credit or as a deduction (income and similar taxes); and
- oil and gas well depletion. (Code Sec. 703(a)(2); Reg §1.703-1(a)(2))

Subject to exceptions specified in IRS regulations, elections affecting partnership taxable income are made by the partnership, not the individual partners. (Reg §1.703-1(b)(2))

Review Question 50

Which of the following deductions is allowed in computing a partnership's taxable income?

a. Net operating loss deduction b. Depreciation

c. Capital loss carryovers d. Charitable contributions

Partnerships are required to "state separately"—that is, to compute as separate items—certain classes of income and deductions. These are then directly "passed through" to the partnership's partners, who take them into account for tax purposes by including their distributive shares of each of the classes as separate items on their tax returns. (Code Sec. 702(a))

Key items that must be separately stated are:

- charitable contributions;
- dividends for which a dividends-received deduction is allowed or qualified dividend income eligible for capital gains treatment;
- foreign and U.S. possessions taxes eligible for the foreign tax credit;
- income, gains and losses from the sale or exchange of unrealized receivables and substantially appreciated inventory;
- income, gain, loss, deduction or credit items that are specially allocated under the partnership agreement;
- intangible drilling and development expenses;
- long-term capital gains and losses;
- 28% rate gains and losses;
- mining exploration expenditures;
- non-business production of income expenses;
- recoveries of tax benefit items;
- Code Sec. 1231 gains and losses;
- short-term capital gains and losses; and
- soil and water conservation expenses.

Partnerships must also separately state—and partners must separately take into account their distributive shares of—any partnership item, if separately stating that item would result in a tax liability for any partner different from that partner's tax liability if the item weren't separately stated. (Reg §1.702-1(a)(8)(ii))

After determining which of its items of income, gains, losses, deductions and credits must be separately stated, a partnership computes its taxable income or loss based on items that don't have to be separately stated. The partnership's partners, in computing their income tax liabilities, take into account their distributive shares of the partnership's non-separately stated income or loss, as well as their distributive shares of each separately stated item. (Code Sec. 702(a)(8); Reg §1.702-1(a)(9))

Each item passed through to the partners and separately stated on their returns has the same character as if realized or incurred directly by the partnership. (Code Sec. 702(b); Reg §1.702-1(b))

A partner must, on his or her own return, treat a partnership item in a manner that's consistent with the treatment of that item on the partnership's return. (Code Sec. 6222(a)) A partner that treats a partnership item differently must notify IRS of the inconsistency on Form 8082. (Code Sec. 6222(b)) This consistency rule doesn't apply to certain small partnerships that aren't covered by unified audit and review procedures for partnerships. (Code Sec. 6231(a)(1)(B))

Each partner reports his or her distributive share of the partnership income, deductions and other items (including guaranteed salary and interest payments) for a partnership tax year on his or her individual return for the tax year within or with which the partnership tax year ends. (Code Sec. 706(a); Reg §1.706-1(a))

If two partnership tax years end within a partner's individual tax year, the partner must report in that year his or her share of the partnership income for both partnership years.

C. Partnership Allocations

A partner's distributive share of income, gain, loss, deduction or credit is controlled by the partnership agreement. (Code Sec. 704(a)) However, if there is no partnership agreement or the allocation in the agreement has no substantial economic effect, the allocation is made in accordance with the partner's interest in the partnership. (Code Sec. 704(b)(1)) If the partnership agreement does make allocations of partnership items, these will be respected for tax purposes if:

- they have substantial economic effect; or
- they are in accord with the partners' interests in the partnership; or
- they are treated as being in accord with the partners' interests in the partnership. (Code Sec. 704(b); Reg §1.704-1(b)(1))

Retroactive allocations—that is, allocations that give particular partners shares of partnership items of income, expense, etc., that were paid or accrued before these partners joined the partnership—aren't permitted. (Code Sec. 706(d)(1))

An allocation of partnership income, gain, loss, deduction or credit among partners has substantial economic effect if it passes a two-part test applied as of the end of the partnership year to which the allocation relates.

First, the allocation must have economic effect. (Reg §1.704-1(b)(2)(i)) This means that it must be consistent with the underlying economic arrangement of the partners. An allocation will be treated as having economic effect only if throughout the full term of the partnership, the partnership agreement provides that:

- the partners' capital accounts are to be determined and maintained according to rules set forth in the regulations;
- when the partnership liquidates, or a partner's interest is liquidated, liquidating distributions are to be made according to the partners' positive capital account balances; and
- a partner with a deficit balance in his or her capital account after the liquidation of the partner's partnership interest is unconditionally obligated to restore the amount of the deficit to the partnership. (Reg §1.704-1(b)(2)(ii))

Second, the economic effect of the allocation must be substantial. (Reg §1.704-1(b)(2)(i)) The economic effect of an allocation is substantial if there's a reasonable possibility that it will affect substantially the dollar amounts to be received by the partners from the partnership, independent of the tax consequences. (Reg §1.704-1(b)(2)(iii))

For partner capital accounts to be determined and maintained properly for purposes of the economic effect rules, each partner's account must be increased by cash contributed by the partner (including cash treated as contributed when the partner assumes partnership liabilities) and by the fair market value of property contributed by the partner (net of liabilities secured by the property). The account must also be increased by the partner's allocable share of partnership income and gain, including tax-exempt income, book income (not tax income) for property whose book value differs from basis, and unrealized income with respect to accounts receivable and certain other accrued but unpaid items.

Each account must be decreased by cash distributed to the partner (including cash treated as distributed when the partnership assumes partner liabilities) and by the fair market value of property distributed to the partner (net of liabilities secured by the property). The account must also be decreased by the partner's allocable share of partnership expenditures that are neither deductible nor capitalizable and by the partner's share of partnership loss and deduction, including book (not tax) loss for property whose book value differs from basis and unrealized deductions for accounts payable and certain other accrued but unpaid items.

Capital account adjustments may also be required when partnership property is revalued or distributed, and on the transfer of a partnership interest. For example, partnership property may be revalued (and capital accounts adjusted) if property is contributed by, or distributed to, a partner in exchange for a partnership interest. Revaluation is also allowed (after May 5, 2004) where a partnership interest is granted as payment for services.

D. Limitations on a Partner's Deductible Loss

A partner's deduction for partnership losses may not exceed the basis of his or her interest in the partnership. However, partners (but not partnerships) are allowed loss carrybacks and carryovers. A partner can deduct his or her distributive share of partnership losses only up to the amount of the adjusted basis of the partner's interest in the partnership at the end of the partnership's loss year. (Code Sec. 704(d))

Where a partnership has more than one class of losses (e.g., capital losses, Code Sec. 1231 losses, and operating losses) in the same year and a partner's total share of those losses exceeds the adjusted basis of his or her partnership interest, the limitation is allocated proportionately to each type of loss. (Reg §1.704-1(d))

Excess losses disallowed to a partner in any year are carried over, and are deductible by the partner at the end of the partnership year in which the adjusted basis of the partner's interest at the end of the year exceeds zero (before reduction by that year's loss). (Reg §1.704-1(d)(4))

A carryover or carryback of net operating losses isn't allowed to a partnership, but a partner may carry back or carry over his or her share of the partnership's net business loss for any year to the extent it can't be used by that partner in the year it's passed through to the partner. (Code Sec. 702)

E. Distributions to a Partner

A partnership generally doesn't recognize gain or loss on a distribution to a partner, but the partner often will recognize gain or loss.

As a general rule, gain or loss isn't recognized to a partner on receipt of a current or liquidating distribution from a partnership.

However, gain is recognized to the extent that money (including marketable securities) distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. (Code Sec. 731(a)) This amount is treated as a gain from sale or exchange of the partner's interest. (Reg §1.731-1(a)(3))

A reduction in a partner's liabilities (due either to the partnership's assumption of them or a reduction in the partner's share of partnership liabilities) is treated as a money distribution. (Code Sec. 752(b))

Loss is recognized to the extent the adjusted basis of the partner's interest exceeds the sum of any money, and the basis to the partner of any unrealized receivables and inventories received if the distribution is in liquidation of the partner's interest in the partnership and no other property is distributed. This amount is treated as a loss from sale or exchange of the partner's interest in the partnership. (Code Sec. 731(a))

A partner's holding period for property distributed to the partner in kind includes the period the partnership held the property. (Code Sec. 735(b)) If the property was contributed to the partnership by a partner, the recipient partner's holding period also includes the period that the property was held by the contributing partner before contribution. (Reg §1.735-1(b))

The basis to a partner of property distributed to the partner in kind, other than in liquidation of his or her partnership interest, is the same as the property's adjusted basis to the partnership immediately before the distribution. But the basis of the property to the partner may not exceed the adjusted basis of his or her interest in the partnership reduced by any money distributed to the partner in the same transaction. (Code Sec. 732(a); Reg §1.732-1(a))

A partner's basis for property distributed in liquidation of a partner's partnership interest is the same as the adjusted basis for his or her partnership interest reduced by any money distributed to the partner in the same transaction. (Code Sec. 732(b); Reg §1.732-1(b))

1. Built-in Gain or Loss Property Contributed by a Partner

If the basis of property contributed to a partnership by a partner is different from the property's fair market value at the time of contribution (i.e., there is built-in gain or loss), then the following rules apply when the property is distributed.

If the partnership distributes the property to a partner or partners other than the contributing partner within seven years (five years for property contributed before June 9, 1997) of the contribution, then the distributed property is treated as sold by the partnership for its fair market value at the time of the distribution. The contributing partner must recognize any gain or loss from this constructive sale in an amount equal to the amount of gain or loss that would have been allocated to the partner if the property had actually been sold by the partnership at the time of the distribution. (Code Sec. 704(c)(1)(B); Reg §1.704-4(a)(5), Ex (1))

If property is distributed to the partner who contributed the property, the partner will recognize as gain the lesser of (a) the excess of the fair market value of the property over the adjusted basis of the partner's interest in the partnership immediately before the distribution (reduced, but not below zero, by any money also received, including marketable securities), or (b) the partner's net pre-contribution gain, i.e., the gain that would have been recognized by the distributee partner under the rules discussed, above, if all property held by the partnership immediately before the distribution that had been contributed to it by the distributee partner within seven years (five years for property contributed before June 9, 1997) of the distribution was distributed to another partner. (Code Sec. 737(a), (b); Code Sec. 737(d)(1))

Special rules apply if the partnership distributes to the contributing partner property that's of "like kind" to the contributed property to limit recognition of gain by the contributing partner. (Code Sec. 704(c)(2))

2. Disproportionate Distributions

A disproportionate distribution of partnership assets to a partner is treated as a sale or exchange that may result in recognition of gain or loss to the partner and the partnership. The rule applies to all distributions, both liquidating and non-liquidating, except for: (1) a distribution of contributed property to the same partner who contributed it (see above); and (2) liquidation payments to a retiring or deceased partner that are treated as ordinary income (see below). (Code Sec. 751(b))

A distribution is "disproportionate" if a partner receives more than his or her proportionate share of "hot assets"—unrealized receivables and substantially appreciated inventory items and less than the partner's proportionate share of other property (including money), or vice versa.

In such a case, a partner, in effect, sells or exchanges part or all of his or her share in property of one category for property of the other category. The general rules on partnership distributions apply to the balance of the distribution not treated as a sale or exchange. (Reg §1.751-1(b))

F. Liabilities of Partnerships and Partners

Changes in partners' shares of partnership liabilities are treated as cash contributions to or distributions by the partnership. Partners' shares of partnership liabilities depend on whether the liability is recourse or non-recourse.

If a partner's share of the partnership liabilities increases, or if the partner assumes any partnership liabilities, it's treated as a contribution of money from the partner to the partnership. (Code Sec. 752(a); Reg §1.752-1(b))

If a partner's share of the partnership liabilities decreases, or if the partnership assumes any of his or her liabilities, it's treated as a distribution of money to the partner. (Code Sec. 752(b); Reg §1.752-1(c))

A partnership debt is a recourse liability to the extent that any partner bears the economic risk of loss for the liability. A partner's share of a recourse liability is the part of the economic risk of loss for the liability the partner bears. (Reg §1.752-1(a)(1)) Generally, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or a related person) would be obligated to pay the creditor or contribute to the partnership (and wouldn't be entitled to reimbursement) in case of a constructive liquidation. (Reg §1.752-2(b)(1))

If no partner bears the economic risk of loss for a partnership liability (e.g., unassumed mortgages), the liability is non-recourse. (Reg §1.752-1(a)(2)) Non-recourse liabilities of a partnership are first allocated among all the partners to reflect their shares of:

- "partnership minimum gain" (gain on the disposition of property subject to a non-recourse liability that exceeds its adjusted basis); and
- the gain that would be allocated to the partners under Code Sec. 704(c), or under similar principles in connection with a revaluation of partnership property, if, in a taxable transaction, the partnership disposed of all property subject to a non-recourse liability in satisfaction of those liabilities and for no other consideration.

Any excess is allocated among the partners in proportion to their interests in partnership profits. The partnership agreement may specify the partners' profit interests as long as those interests are reasonably consistent with allocations (which have substantial economic effect) of some significant item of partnership income or gain among the partners. Alternatively, the excess may be allocated in accordance with the manner in which it's expected that the deductions attributable to the non-recourse debt will be allocated. In addition, for liabilities incurred or assumed by a partnership after October 30, 2000 (or before October 31, 2000 in tax years ending after October 30, 2000, if the taxpayer chooses) the excess may be allocated based on the excess gain attributable to the property securing the liability. (Reg §1.752-3(a))

G. Partner's Dealings with Partnership

If a partner provides services for or transfers property to his or her partnership, the partner may be treated as dealing with the partnership either as a member or as an outsider. If there's a related allocation and distribution of partnership income (direct or indirect), and the transaction on the whole is properly characterized as a sale or exchange between a partnership and an outsider, it will be treated in that way. (Code Sec. 707(a)(2)(A); Code Sec. 707(a)(2)(B)).

Guaranteed payments are payments to a partner for services or capital without regard to partnership income. Guaranteed payments for a partner's services or capital are treated like salary payments to employees or interest payments to creditors, not like partnership distributions. (Code Sec. 707(c); Reg §1.707-1(c))

For a guaranteed payment to be deductible as a business expense by the partnership, it must meet the business expense tests as if the payment had been made to a person who wasn't a member of the partnership. (Code Sec. 707(c)) In determining whether a partnership can deduct or must capitalize a guaranteed payment, the regular capital expenditure rules apply. (Code Sec. 707(c))

No deduction is allowed for losses from sales or exchanges between:

- a partnership and a person owning, directly or indirectly, over 50% of the capital interest, or profits interest, in the partnership; or
- two partnerships in which the same persons own over 50% of the capital or profits interests.

If property on which a loss was disallowed under the above rule is later sold by the transferee at a gain, the gain is taxable only to the extent it exceeds the loss previously disallowed. (Code Sec. 707(b)(1); Reg §1.707-1(b)(1))

The character of the property in the hands of the transferee, immediately after the transfer, determines the character of a gain to the transferor on a direct or indirect sale or exchange of property between:

- a partnership and a person owning, directly or indirectly, over 50% of the capital interest, or profits interest, in the partnership; or
- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interest or profits interest in each. (Code Sec. 707(b)(2); Reg §1.707-1(b)(2))

In determining the percentage of ownership of partnership interests for purposes of these rules, the constructive ownership rules for stock under Code Sec. 267(c) apply (substituting "capital or profits interest" for "stock"), except that a partner isn't considered as owning the interest of his or her partners (unless they are relatives, etc.). (Code Sec. 707(b)(3))

H. Transfer and Liquidation of Partnership Interest

The transfer or liquidation of a partnership interest, while generally resulting in capital gain or loss, is subject to special rules that may turn part of the gain or loss from capital to ordinary.

Withdrawal of a partner from a partnership ordinarily may be accomplished either by a retiring partner's sale or liquidation of his or her interest in the partnership.

Where a partner sells his or her interest, payments to the partner that exceed the basis for his or her interest are capital gain except to the extent of payments attributable to unrealized receivables and inventory items. (Code Sec. 741; Reg §1.741-1) Gain attributable to unrealized receivables and inventory is treated as ordinary income (Code Sec. 741; Code Sec. 751(a); Code Sec. 751(c))

The capital gain or loss is the difference between:

- the amount realized reduced by the portion attributable to unrealized receivables and inventory; and
- the transferor-partner's adjusted basis for the partnership interest transferred reduced by the portion attributable to unrealized receivables and inventory. (Reg §1.741-1(a))

If the partnership interest has been held for more than one-year, a portion of the capital gain may be treated as collectibles gain or section 1250 gain, with the remainder treated as residual long-term capital gain (see Module I: Taxation of Individuals). (Reg §1.1(h)-1(a)) The partner's collectibles gain is the amount that would be allocated to the partner if the partnership had sold all of its collectibles for fair market value in a fully taxable transaction immediately before the sale of the interest in the partnership. (Reg §1.1(h)-1(b)(2)(ii)) The seller must take into account under Code Sec. 1(h)(6)(A)(i) in determining his or her unrecaptured section 1250 gain, the amount of "section 1250 capital gain" that would be allocated to the seller if the partnership had sold all of its section 1250 property in a fully taxable transaction immediately before the transfer of the partnership interest. (Reg §1.1(h)-1(b)(3)(ii))

Where all of the old partners sell out, whether the transaction is a sale of the partnership interests or a sale of the partnership assets generally depends on whether what was actually transferred was a going business or simply assets.

I. Payments after Partner's Death or Retirement

When a partner either retires or dies and payments are made in liquidation of his or her partnership interest, the payments are broken down into several categories, which are treated as ordinary income or capital gains.

Liquidation payments received by a retiring partner, a partner expelled from a partnership, or by a deceased partner's successor in interest are treated as distributions taxable under the rules for regular distributions (see IX.E) if they are for the partner's interest in partnership property. (Code Sec. 736(b)(1)) Payments for substantially appreciated inventory may result in ordinary income under the rules governing disproportionate distributions (see IX.E.2). (Reg §1.736-1(b)(1))

Liquidation payments that aren't in exchange for partnership property are treated either as distributive shares of partnership income (if the amount is determined with regard to partnership income) or as guaranteed payments (if the amount is determined without regard to partnership income). (Code Sec. 736(a); Reg §1.736-1(a)(3))

Payments for partnership property don't include payments to a retiring or deceased general partner in a partnership in which capital isn't a material income-producing factor for (i) unrealized receivables (which for this purpose includes only accounts receivable and unbilled amounts) or (ii) goodwill (unless the partnership agreement provides for payment with respect to goodwill). (Code Sec. 736(b)(2); Code Sec. 736(b)(3))

A retiring partner must pick up his or her distributive share of the partnership income for the partnership year in which the partner retires. His or her share of the partnership income for the year is allocable to the partner only for the portion of the year he or she was a member of the partnership. (Reg §1.736-1(a)(4))

The tax year of a partnership closes with respect to a deceased partner on the date of his or her death. Thus, partnership items for the short partnership tax year that closes on the partner's death are included in his or her final return. (Code Sec. 706(c)(2))

A retiring partner or a deceased partner's successor in interest who receives retirement or death payments is regarded as a partner until the retiring or deceased partner's entire interest in the partnership is liquidated. Thus, even a two-person partnership isn't terminated until the retiring or deceased partner's interest is liquidated. (Reg §1.708-1(b)(1)(i); Reg §1.736-1(a)(6))

J. Partnership Terminations

A partnership terminates for tax purposes (whether or not it has terminated under applicable local law) when:

- it stops doing business as a partnership, or
- 50% or more of the total interest in partnership capital and profits changes hands by sale or exchange (or by distribution, unless excepted by regulations) within 12 consecutive months. (Code Sec. 708; Code Sec. 761(e); Reg §1.708-1(b)(1))

When a partnership terminates as a result of a sale or exchange, the partnership is deemed to transfer all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership, and immediately after that, the terminated partnership is deemed to distribute interests in the new partnership to the purchasing partner and the remaining partners in liquidation of the terminated partnership, either for the continuation of the business of the new partnership or for its dissolution and winding up. (Reg §1.708-1(b)(4))

The sale may be made to an existing partner or an outsider. It may be made by one or more persons. A gift, bequest, or inheritance or liquidation of a partnership interest doesn't count; nor does a contribution of property to a partnership in exchange for a partnership interest, even if this produces a 50% or more change. (Reg §1.708-1(b)(2))

If a partnership splits up into two or more partnerships, a resulting partnership is considered a continuation of the old partnership as long as the members of the resulting partnership had more than a 50% interest in the capital and profits of the old partnership. A resulting partnership whose members had an interest of only 50% or less in the old partnership is treated as a new partnership.

If the members of none of the resulting partnerships had more than a 50% interest in the old partnership, the old partnership is considered terminated as of the date of the division, and all the resulting partnerships are treated as new partnerships. (Code Sec. 708(b)(2)(B); Reg §1.708-1(d)(2))

Any members of the original partnership who do not become members of a resulting partnership that is treated as a continuation of the original partnership are considered to have had their partnership interests liquidated as of the date of the division. (Reg §1.708-1(d)(1))

For divisions after January 3, 2001 (and, after January 10, 2000, if elected) the resulting partnership that is treated as the divided partnership must file a return for the tax year of the partnership that has been divided and must retain the employer identification number (EIN) of the prior partnership. All other resulting partnerships that are regarded as continuing and new partnerships must file separate returns for the tax year beginning on the day after the date of the division with new EINs for each partnership. (Reg §1.708-1(d)(2))

Solutions to Module 2 Review Questions

1. a. Incorrect. A corporation can't elect S status if it has more than 100 shareholders. However, all members of the same family have a special election in S corporations. (Code Sec. 1361(b)(1)(A))

   b. Incorrect. Family members are not required to elect to be treated as a single shareholder. (Code Sec. 1361(c)(1)(A)(ii))

   c. Correct. All members of the same family are treated as one shareholder for purposes of the 100-shareholder limit. Therefore, the corporation satisfies the 100 shareholder limit because it is treated as having 83 shareholders (80 individual shareholders and 3 families).

2. a. Incorrect. S corporations are subject to restrictions on the number of shareholders, which do not apply to LLCs.

   b. Incorrect. If an LLC isn't mandatorily classified as a corporation, it's an "eligible entity" that may elect to be classified for tax purposes either as a partnership or as a corporation.

   c. Correct. If an LLC is characterized as a partnership for federal tax purposes, the limited liability company form will offer the pass-through of tax attributes, which is also available to S corporations.

3. a. Incorrect. Corporation status is not the default classification for a domestic eligible entity with two members.

   b. Correct. A domestic eligible entity is classified as a partnership if it has two or more members and does not file an election to be classified as an association.

   c. Incorrect. A domestic eligible entity with only a single owner isn't treated as separate from that owner if it doesn't file an election to be treated as an association. However, that is not the default classification for a domestic eligible entity with two or more members. (Reg §301.7701-3(b)(1))

4. a. Incorrect. Taxpayers must compute their taxable income on the basis of their tax year, not the calendar year. (Code Sec. 441 (a))

   b. Incorrect. A taxpayer must use the calendar year if the taxpayer keeps no books, has no annual accounting period, has an annual accounting period that doesn't qualify as a fiscal year, of if the taxpayer hasn't established a fiscal year. (Code Sec. 441)

   c. Correct. If the taxpayer properly changes his or her annual accounting period, the tax year is the short year and a return is properly made for a period of less than 12 months. (Code Sec. 441 (b)(3))

   d. Incorrect. If the year ends on the last day of December, it is considered a calendar year. A fiscal year is any 12-month period ending on the last day of a month other than December, or the 52-53- week tax year. (Code Sec. 441(e))

5. a. Incorrect. A taxpayer required to use inventories generally cannot use the cash method of accounting for all transactions. The accounting method is restricted when an inventory is involved.

   b. Incorrect. A taxpayer required to use inventories generally is required to use accrual accounting only for specific transactions as stated in Reg §1.446-1(a)(4)(i).

   c. Correct. A taxpayer required to maintain inventories is required to use the accrual method of accounting for sales and purchases. (Reg §1.446-1(a)(4)(i))

   d. Incorrect. A taxpayer required to maintain inventories generally is required to use a particular method of accounting for specific transactions. (Reg §1.446-1(a)(4)(i))

6. a. Incorrect. Lex Furniture does not qualify for the small business exemption, even though its receipts are less than $10 million, because its principal business activity is manufacturing.

   b. Correct. Lex Furniture will have to use the accrual method of accounting for its inventory since it will not qualify for the small business exemption for inventory.

7. a. Correct. Under the cash basis of accounting, a deduction is taken in the year that cash or property is paid or transferred.

   b. Incorrect. Under the cash basis of accounting, income is reported only when cash or property is actually or constructively received. Under the accrual method of accounting, income accrues and must be reported in the year all events have occurred that determine taxpayer's right to receive it and the amount can be determined with reasonable accuracy. (Reg §1.461-1(a))

   c. Incorrect. A check issued by a solvent payor is income when received by a cash basis payee, unless there is a restriction on the payee's right to cash the check. Receipt of a check by an agent is considered receipt by the principal.

   d. Incorrect. When an expense relates to a period covering more than 12 months, the IRS and most courts agree that the deduction must be spread over the period to which the expense applies.

8. a. Incorrect. Retroactively changing from an erroneous to a permissible accounting method by filing amended returns is not the correct solution per Code Sec. 446(e).

   b. Incorrect. Prospectively changing from an erroneous to a permissible accounting method is not how a taxpayer should correct the issue per Code Sec. 446(e).

   c. Correct. Generally, once a taxpayer has adopted an accounting method, he must continue to use it until the IRS requires him to change the method, or the taxpayer requests, and receives, IRS permission to change. This is so even if the taxpayer has been using an incorrect method, or a method that doesn't clearly reflect income. (Code Sec. 446(e))

   d. Incorrect. Changing accounting methods retroactively and prospectively is not how the IRS mandates a change per Code Sec. 446(e).

9. a. Incorrect. Merchandise shipped on approval is kept in the seller's inventory until its acceptance.

   b. Correct. A buyer's inventory includes merchandise in transit to him or that for other reasons hasn't been reduced to possession but to which he has title.

   c. Incorrect. Goods ordered by a buyer for future delivery remain in the seller's inventory.

   d. Incorrect. Consigned goods are kept in the consignor's inventory, not the Seller's.

10. a. Incorrect. The cost of a trip to a customer's location is an ordinary and necessary business expense and does not have to be capitalized.

    b. Incorrect. Rent paid for occupancy of business premises and interest paid on a business loan are generally currently deductible.

    c. Incorrect. State income tax payments do not have to be capitalized.

    d. Correct. Installation costs of purchased machinery, commissions paid to get a business loan, and costs incurred by a corporation related to the redemption of its stock are all generally costs that must be capitalized, per Code Sec. 263.

11. a. Incorrect. For purposes of the uniform capitalization rules, "property" does not include timber. (Code Sec. 263A(c)(5)(A))

    b. Incorrect. Selling, marketing, advertising and distribution expenses are not "allocable" costs. (Reg §1.263A-1(e)(3)(iii)(A))

    c. Correct. While creative expenses are exempt from the uniform capitalization rules, costs related to motion pictures must be inventoried or capitalized under UNICAP. (Code Sec. 263A(h))

    d. Incorrect. Interest is an "allocable" cost only where the underlying debt was incurred or continued to finance certain produced property. (Code Sec. 263A(a)(2)(B))

12. a. Incorrect. This is a true statement. Direct labor costs are generally allocated by using a specific identification ("tracing") method. (Reg §1.263A-1(f)(4))

    b. Correct. This statement is not true. Under the uniform capitalization rules, allocable costs do not include any amounts allowable as a deduction under Code Sec. 174 for research and experimental expenditures. (Code Sec. 263A(c)(2))

    c. Incorrect. This is a true statement. IRS regulations provide a simplified resale method to determine the additional costs properly allocable to the resale property. (Reg §1.263A-1(g)(3))

    d. Incorrect. This is a true statement. For purposes of the uniform capitalization rules, "property" doesn't include property produced by a taxpayer under a long-term contract except for certain home construction contracts. (Code Sec. 460(e)(1))

13. a. Incorrect. The maximum deduction for start-up expenses is $5,000; the phase-out threshold is $50,000. (Code Sec. 195(b)(3))

    b. Incorrect. The IRS has issued final, temporary and proposed regs that eliminate the need to make a formal election to deduct start-up expenses.

    c. Correct. Pre-opening advertising expenses are amortizable start-up expenses. (Code Sec. 195(b)(1)(B))

    d. Incorrect. The amortization period for start-up expenses is 180 months. (Code Sec. 195(b)(1)(B))

14. a. Incorrect. Partnership organization expenses are eligible for amortization. (Code Sec. 248(a)(1))

    b. Incorrect. A corporation or partnership can elect a current deduction for up to $5,000 of organizational expenditures. (Code Sec. 248(a)(1))

    c. Incorrect. The $5,000 expensing amount is reduced by the amount by which the cumulative cost of organizational expenditures exceeds $50,000. Thus, the corporation with $60,000 of organizational expenses is not allowed to expense any amount. (Code Sec. 248(a)(1))

    d. Correct. Organization expenditures that are not currently deductible may be deducted ratably over a 15-year amortization period. (Code Sec. 248(a)(2))

15. a. Incorrect. The payments in (1) are deductible. A parent can deduct reasonable wages paid to an unemancipated minor child for personal services actually rendered as a bona fide employee in the business. (Code Sec. 162(a)(1))

    b. Correct. No deduction is allowed for payments by a taxpayer for services rendered to someone other than the taxpayer. And capitalization is required for payments for services in organizing and incorporating a company. (Code Sec. 162(a)(1))

    c. Incorrect. The payments in (4) are deductible. An employer's payment of an employee's debts or personal expenses is compensation to the employee and deductible as compensation by the employer (if reasonable). (Code Sec. 162(a)(1))

    d. Incorrect. The payments in (1) and (4) are deductible. A parent can deduct reasonable wages paid to an unemancipated minor child for personal services actually rendered as a bona fide employee in the business. And an employer's payment of an employee's debts or personal expenses is compensation to the employee and deductible as compensation by the employer (if reasonable). (Code Sec. 162(a)(1))

16. a. Incorrect. XYZ can claim a compensation deduction to the extent the transfer is included in Smith's income (presumably the $1,000 fair market value of the stock).

    b. Incorrect. Nonrecognition of gain or loss applies only if XYZ transfers its own stock to Smith.

    c. Incorrect. A loss deduction is allowed only if XYZ's basis for the stock ($750) exceeded the fair market value at the time of the transfer ($1,000).

    d. Correct. XYZ must recognize gain to the extent the fair market value of the stock ($1,000) exceeds XYZ's basis for the property ($750).

17. a. Incorrect. An employer's contribution to a welfare benefit fund is deductible to the extent the contribution doesn't exceed the qualified cost of the plan for the tax year. (Code Sec. 419(a))

    b. Incorrect. If the option has no readily ascertainable fair market value, no deduction is allowed until the employee recognizes income on exercise of the option.

    c. Correct. An employer can't deduct premiums on any life insurance policy, or endowment or annuity contract, if the employer is directly or indirectly a beneficiary under the policy or contract. (Code Sec. 264(a)(1))

    d. Incorrect. Where an employer furnishes a noncash fringe benefit to an employee as compensation, the employer may deduct only the costs it incurs in providing the property to its employees, not the property's value. (Reg §1.62-25T(a))

18. a. Correct. Because less than 25% of Johnson's total travel time is spent on nonbusiness activity, the allocation rules do not apply to her airfare. Since the primary purpose of her trip is business, the full cost of the airfare is deductible. (Code Sec. 274(c))

    b. Incorrect. Even though Johnson has control over her travel arrangements, she is still exempt from the allocation rules because less than 25% of her total travel time is spent on nonbusiness activity. (Code Sec. 274(c))

    c. Incorrect. The 50% deduction limitation applies to meals, not to airfare.

19. a. Incorrect. Costs aren't generally considered "directly related" if entertainment occurs where there's little or no possibility of engaging in the active conduct of business, e.g., at night clubs, theaters, or sporting events. The entertainment is not considered "associated with" business because the business discussion is not "substantial" in relation to the entertainment.

    b. Incorrect. Entertainment is "associated with" business only if it "immediately" precedes or follows a substantial business discussion.

    c. Incorrect. The cost of the tickets is not taken into account in full. In determining the deduction for the cost of a ticket to an entertainment or recreation activity, the amount taken into account can't exceed the face value of the ticket (including any ticket tax).

    d. Correct. The "directly related" and "associated with" requirements do not apply to expenses (other than club dues) of providing recreational, social, or similar activities primarily for the benefit of the taxpayer's employees, other than highly-compensated employees.

20. a. Incorrect. Using standard per diem amounts only releases the employer from the duty of substantiating the actual amount of an expense. Time, place and business purpose must still be substantiated.

    b. Incorrect. Both written and computer records are "adequate" records. (Reg. 1.274-5T(c)(2)(i))

    c. Incorrect. A more than 10% shareholder of a corporate employer may be asked by IRS to substantiate his or her expense accounts even though he or she has accounted to his employer. (Reg. 1.274-5T(c)(2)(i))

    d. Correct. Taxpayers may substantiate the elements of their expenditures not only by adequate records, but also by their own statements, written or oral, if those statements are supported by sufficient corroborating evidence. (Code Sec. 274(d))

21. a. Correct. This is not a true statement. Payments made under conditional sales contracts cannot be deducted as rent per Code Sec. 612(a)(3)).

    b. Incorrect. This is a true statement. Payments made by a lessee to get a business lease aren't currently deductible but must be amortized. (Reg §1.62-11(a))

    c. Incorrect. This is a true statement. A lessor's cancellation payments made in order to enter a lease with a new tenant must be amortized over the term of the new lease.

    d. Incorrect. This is a true statement. Excessive rent payments to a shareholder are treated as nondeductible dividends.

22. a. Incorrect. No deduction is allowed for interest paid or accrued on a "disqualified debt instrument." A disqualified debt instrument includes any corporate debt that's payable in equity (i.e., stock) of the issuer. (Code Sec. 163(1)(1))

    b. Incorrect. Interest on an income tax deficiency arising from an unincorporated business can't be deducted as a business expense. (Reg §1.63-9T(b)(2))

    c. Incorrect. The amount of finance charges imposed on the unpaid balances of credit cards is deductible as interest, but only to the extent the payment isn't a service charge.

    d. Correct. A penalty paid for prepaying a debt (including a mortgage) is deductible as interest.

23. a. Incorrect. Penalties paid to a government for violation of a law aren't taxes. (Code Sec. 162(f))

    b. Incorrect. Fees imposed primarily as charges for government services, such as car inspection fees, aren't deductible as taxes. (Reg §1.64-2(f))

    c. Correct. Business taxpayers may deduct state, local and foreign real property taxes. (Code Sec. 164(a)(1))

    d. Incorrect. State or local sales or use taxes paid or incurred in connection with the acquisition or disposition of property aren't deductible. Instead, the buyer treats them as part of the cost. (Code Sec. 164(a))

24. a. Incorrect. The deduction percentage is 6% for tax years beginning in 2007-2009, and 9% thereafter.

    b. Incorrect. The deduction is available to C corporations, S corporations, partnerships, sole proprietorships, cooperatives, and estates and trusts.

    c. Correct. The deduction cannot exceed a taxpayer's taxable income. The deduction is equal to the lesser of:

       - a percentage of the lesser of (1) the "qualified production activities income" of the taxpayer for the tax year or (2) taxable income (modified adjusted gross income, for individual taxpayers) without regard to this deduction, for the tax year. The percentage is 3% for tax years beginning in 2005 and 2006, 6% for tax years beginning in 2007-2009, and 9% thereafter.

       - 50% of the sum of (a) wages paid by the taxpayer and (b) the elective deferrals listed in Code Sec. 6051(a)(8) (e.g., deferrals to Code Sec. 401(k) or Code Sec. 457 retirement plans for employees) that are made by the taxpayer during the calendar year that ends in the tax year.

    d. Incorrect. For purposes of computing the deduction, "domestic production gross receipts" do not include any gross receipts derived from the sale of food or beverages prepared by the taxpayer at a retail establishment. (Code Sec. 199(c)(4)(B)(iii))

25. a. Incorrect. Taxpayers, including C corporations, cannot deduct the full fair market value of charitable gifts of ordinary income-type property.

    b. Correct. A C corporation that contributes inventory, must reduce its deduction by one-half of the amount that would be ordinary income on a sale, but the resulting charitable deduction can't exceed twice the basis of the contributed property. In XYZ's case, its deduction is limited to twice its basis ($1,000) because that is less than a deduction reduced by one-half of the ordinary income ($1,050).

    c. Incorrect. A C corporation's deduction for gifts of ordinary income-type property cannot exceed twice its basis for the property.

    d. Incorrect. Unlike individuals, C corporations do not have to reduce their deduction for inventory donations by the full amount of potential ordinary income if the donations are used for the care of the ill, the needy or infants.

26. a. Incorrect. Natural resources such as oil, gas or minerals in the ground qualify for depletion, not depreciation. (Reg §1.167(a)-2)

    b. Correct. A lessor deducts depreciation on any improvements the lessor constructs during the term of the lease. A lessee ordinarily depreciates the cost of improvements it makes.

    c. Incorrect. Inventory or stock in trade does not qualify as depreciable property. (Reg §1.167(a)-2)

    d. Incorrect. Property isn't depreciable if it isn't exhaustible or subject to wear and tear, such as land. (Reg §1.167(a)-1(b))

27. a. Incorrect. The 150% declining-balance method is used for 15- and 20-year personalty. (Code Sec. 168(b)(3))

    b. Incorrect. The 27.5 year recovery period applies only to residential rental realty. (Code Sec. 168 (c))

    c. Incorrect. The 200% declining balance method is used for 3-, 5-, 7-, and 10-year personalty. (Code Sec. 168(b)(1))

    d. Correct. Realty other than residential realty is depreciable on a straight-line basis using a 39-year recovery period. (Code Sec. 168(b)(3)(G))

28. a. Incorrect. Based on these facts, the half-year convention will apply if $250,000 of the equipment is placed in service during the final three months of the year. Any amount under $399,999 will cause the half-year convention to apply.

    b. Correct. Based on these facts, under the 40% test, the mid-quarter convention applies if more than $400,000 of equipment is placed in service during the final three months of the year.

    c. Incorrect. Based on these facts, the threshold for application of the mid-quarter convention is less than $500,000.

29. a. Incorrect. Depreciation is allowed for the year property is disposed of.

    b. Incorrect. This answer assumes the mid-year convention applies. However, that convention does not apply to real estate.

    c. Correct. Under the mid-month convention applicable to real estate, the taxpayer will be treated as disposing of the property on August 15, thus allowing for 7.5 months of depreciation for the year.

    d. Incorrect. A full year of depreciation is not allowed for the year in which the property is disposed of.

30. a. Correct. Using the income forecast method, the publisher was eligible to depreciate $5,000 of the cost in each of Years 1 and 2 ($50,000 current year income/$100,000 total estimated income x $10,000 cost = $5,000 depreciation deduction). Consequently, the entire $10,000 cost was fully depreciated at the end of Year 2. No further depreciation deductions may be claimed in year 3.

    b. Incorrect. $5,000 is the income from the copyright in Year 3, it is not the amount of the depreciation deduction for the year.

    c. Incorrect. $10,000 is the total cost of the copyright, it is not the amount of the depreciation deduction for the year.

31. a. Incorrect. The maximum Section 179 expensing deduction is reduced if more than $2 million of qualifying property is placed in service in 2013, but not always eliminated completely.

    b. Incorrect. This answer computes the maximum Section 179 expensing deduction as the amount of qualifying property above $2 million placed in service in 2013, which is not the correct application of the rule.

    c. Correct. The maximum Section 179 expensing deduction of $500,000 for 2013 is reduced dollar-for-dollar for qualifying property over $2 million placed in service in 2012. Here, $500,000 minus $100,000 equals $400,000.

    d. Incorrect. This answer incorrectly assumes that the full amount of property up to the maximum expensing deduction can be expensed.

32. a. Correct. Recapture is required when the business use of property falls to 50% or less during the recapture period. (Code Sec. 179(d)(10)

    b. Incorrect. Recapture is not required when business use of the property falls to 75% during the recapture period.

    c. Incorrect. Reduction of business use below 100% does not always trigger recapture.

33. a. Correct. Cell phones were removed from the definition of listed property under IRC Sec. 280F, for tax years beginning after December 31, 2009 by the Small Business Jobs Act of 2010.

    b. Incorrect. Listed property includes any computer or peripheral equipment except those owned or leased by the taxpayer, and used exclusively at the taxpayer's regular business establishment.

    c. Incorrect. Listed property includes any passenger auto (except for ambulances or hearses used directly in a trade or business, taxis and other vehicles used directly for transporting people or property for pay, and trucks or vans specified by IRS regulations).

34. a. Incorrect. Amortizable Section 197 intangibles include goodwill. (Code Sec. 197(d)(1)(A))

    b. Correct. Leases of tangible property are not treated as Section 197 intangibles. (Code Sec. 197(e)(5)(A))

    c. Incorrect. Amortizable Section 197 intangibles include going concern value. (Code Sec. 197(d)(1)(B))

    d. Incorrect. Amortizable Section 197 intangibles include customer lists. (Code Sec. 197(d)(1)(C)(iv))

35. a. Incorrect. All exhaustible natural deposits and timber qualify for cost depletion. However, only mines and certain interests in oil or gas wells qualify for percentage depletion.

    b. Correct. A taxpayer can claim percentage depletion on one property and cost depletion on another in the same year per the Internal Revenue Code.

    c. Incorrect. Percentage depletion continues to be deductible as long as there is gross income from the property even after taxpayer's basis for the property has been reduced to zero.

36. a. Incorrect. An unused general business credit can be carried forward 20 years; however, the carryback period is not three years.

    b. Incorrect. An unused general business credit can be carried forward 20 years; however, there is also a carryback.

    c. Incorrect. An unused general business credit can be carried back one year; however, there is also a carryforward.

    d. Correct. An unused general business credit can be carried back one year and forward 20 years. (Code Sec. 39(a))

37. a. Incorrect. Any building other than a certified historic structure must retain in place more than 50% of the external walls.

    b. Incorrect. Any building other than a certified historic structure must retain in place more than 50% of the internal structural framework.

    c. Correct. Any building other than a certified historic structure must retain in place (a) at least 75% of the external walls (including at least 50% as external walls), and (b) at least 75% of its internal structural framework. (Code Sec. 47(c)(1))

    d. Incorrect. A building other than a certified historic structure need not retain in place 100% of the external walls.

38. a. Incorrect. This answer incorrectly assumes that the employer's credit is equal to the full amount of wages paid to the employee during the year.

    b. Incorrect. $2,400 is the maximum annual credit for a qualified food stamp recipient; however, the employer is not eligible for the maximum credit with respect to this employee.

    c. Correct. Because the employee worked less than 400 hours during the year, the employer is entitled to a credit of 25% of the employee's first-year wages up to a maximum of $6,000. In this case, the employee earned $3,640, so the maximum credit is $910. (Code Sec. 51(i)(3))

39. a. Incorrect. On these facts, the corporation's dividends received deduction is reduced, but not to zero.

    b. Correct. The dividends-received deduction is limited to 70% of taxable income in this situation, which is $6,300 (70% of $9,000). (Code Sec. 246(b)(3)(B))

    c. Incorrect. This answer incorrectly computes the corporation's dividends received deduction as 70% of dividends received.

    d. Incorrect. A corporation's dividends received deduction cannot exceed a percentage of its taxable income for the year.

40. a. Correct. Corporations owing less than $500 for the year are not required to make estimated tax payments. (Code Sec. 6655(c)(1))

    b. Incorrect. The threshold amount of tax requiring a corporation to make estimated tax payments is not $1,000. Corporations with a certain amount of income tax liability must make payments.

    c. Incorrect. The threshold amount of tax requiring a corporation to make estimated tax payments is less than $5,000.

    d. Incorrect. The threshold amount of tax requiring a corporation to make estimated tax payments is less than $10,000.

41. a. Incorrect. The PHC tax is equal to a percentage of undistributed PHC income, not the entire amount.

    b. Incorrect. The PHC tax rate is less than 35%.

    c. Correct. The PHC tax rate is 20%, therefore the PHC owes a penalty tax of $20,000.

    d. Incorrect. The PHC tax rate is higher than 5%.

42. a. Incorrect. The basic AMT exemption amount of $40,000 for corporations is reduced if a corporation's AMTI exceeds $150,000. However, a corporation's exemption amount is not reduced by the full amount of the excess.

    b. Incorrect. The basic AMT exemption amount of $40,000 for corporations is reduced if a corporation's AMTI exceeds $150,000. However, the exemption is not limited to 25% of the excess AMTI.

    c. Correct. For corporations, the AMT exemption amount is $40,000, less 25% of AMTI exceeding $150,000. Thus, the corporation's exemption amount is $40,000 – $10,000 (25% x ($190,000 – $150,000).

    d. Incorrect. This answer assumes the corporation is entitled to the full AMT exemption amount of $40,000 for corporations. However, a corporation's AMT exemption is reduced if the corporation's AMTI exceeds $150,000.

43. a. Incorrect. When a taxpayer realizes gain on a tax-free reorganization, some gain will be recognized if "boot" is received.

    b. Correct. When a taxpayer realizes gain on a tax-free reorganization, gain is recognized to the extent of the boot received. Here, the realized gain is $4,000 ($14,000 amount realized less $10,000 basis), which is recognized to the extent of the $1,000 cash boot received. (Code Sec. 351(b))

    c. Incorrect. Although the taxpayer has $4,000 of realized gain ($14,000 amount realized less $10,000 basis), the full amount of gain is not recognized in this situation.

    d. Incorrect. The taxpayer's amount realized on the exchange is $14,000; however, that is not the amount of taxable gain.

44. a. Incorrect. The redemption can qualify as substantially disproportionate if the taxpayer retains an interest higher than 15%.

    b. Correct. The redemption will qualify as substantially disproportionate if the taxpayer's interest is reduced below 24%; that is, his interest must be less than 80% of his interest before the redemption (30% × 80% = 24%). (Code Sec. 302(b)(2)(C))

45. a. Incorrect. A liquidating corporation generally recognizes gain or loss on distributions of property.

    b. Correct. A liquidating corporation recognizes gain or loss on distributions of property as if the property had been sold for its fair market value. Since the fair market value of the property distributed was $80,000 and the basis to the corporation was $60,000, the recognized gain is $20,000. (Code Sec. 336(a))

    c. Incorrect. This answer determines the recognized gain to be equal to the fair market value of the property distributed, which is not a correct application of the rules.

    d. Incorrect. This answer determines the recognized gain to be equal to the amount of cash distributed plus the fair market value of the property distributed, which is not a correct application of the rules.

46. a. Incorrect. A statutory merger is a Type A reorganization. (Code Sec. 368(a)(1)(A))

    b. Correct. A Type B reorganization is also known as a stock-for-stock reorganization. (Code Sec. 368(a)(1)(B))

    c. Incorrect. A recapitalization is a Type E reorganization. (Code Sec. 368(a)(1)(E))

    d. Incorrect. A bankruptcy reorganization is a Type G reorganization. (Code Sec. 368(a)(1)(G))

47. a. Incorrect. S corporation status may not be elected based on a simple majority vote.

    b. Incorrect. More than 75% of the shares of a corporation must approve the corporation's S election.

    c. Correct. All shareholders owning stock in the corporation on the day it elects S status must consent to the election. (Code Sec. 1362(a)(2))

48. a. Incorrect. A limitation applies to the amount of S corporation loss a shareholder can deduct, but it is higher than $3,000 in these circumstances.

    b. Incorrect. A limitation applies to the amount of S corporation loss a shareholder can deduct, but it is not based solely on the amount of debt ($10,000) owed to the shareholder as this answer suggests.

    c. Incorrect. A limitation applies to the amount of S corporation loss a shareholder can deduct but it is not based solely on the shareholder's basis in his stock ($15,000) as this answer suggests.

    d. Correct. The maximum amount of loss an S corporation shareholder can deduct is equal to the basis in his stock ($15,000) plus any debt owed to him by the corporation ($10,000)—for a total here of $25,000. (Code Sec. 1366(d)(1))

49. a. Incorrect. A partner may receive a capital interest in a partnership in exchange for services. (Reg §1.721-1(b)(1))

    b. Incorrect. Property received by a partnership from a contributing partner takes the same basis in the partnership's hands as it had in the contributing partner's hands at the time of the contribution.

    c. Correct. Where a taxpayer receives a capital interest in a partnership in exchange for services, that interest is taxable compensation income to the taxpayer. (Reg §1.721-1(b)(1))

    d. Incorrect. In the case of contributed inventory, ordinary income or loss will result only if the assets are disposed of by the partnership within five years of the contribution.

50. a. Incorrect. The net operating loss deduction is not allowed in computing a partnership's taxable income. (Code Sec. 703)

    b. Correct. Depreciation deductions are allowed in computing a partnership's taxable income. (Code Sec. 703)

    c. Incorrect. Capital loss carryovers are not allowed in computing a partnership's taxable income. (Code Sec. 703)

    d. Incorrect. Charitable contribution deductions are not allowed in computing a partnership's taxable income. (Code Sec. 703)

Module 2 Glossary

401(K) PLAN**.** A qualified employment-based defined-contribution plan that allows employees to make tax-deferred contributions.

ACCRUAL METHOD. Accounting method in which items are recognized and reported when all events have occurred to fix the right to receipt of the income or to establish the fact of liability.

ADJUSTED GROSS INCOME (AGI). All taxable income of an individual filer from whatever sources derived less certain deductions allowed as defined in IRC Sec. 62. AGI is used as a threshold in individual income taxation to calculate eligibility (or phase-out of eligibility) for many deductions, credits, or taxability of specific types of income.

AMORTIZATION. Similar to depreciation and typically used in connection with intangible costs. Using amortization, a taxpayer can recover the cost or basis in property proportionately over a specific number of years or months.

AMOUNT REALIZED. The total of all money received plus the fair market value of all property or services received from a sale or exchange. The amount realized also includes any liabilities assumed by the buyer and any liabilities to which the property transferred is subject.

ALTERNATIVE MINIMUM TAX (AMT). A tax imposed as a backup to regular tax originally intended to ensure that higher income taxpayers paid their fair share of tax. AMT is separate from, but parallel to, regular tax, and a taxpayer pays the greater of regular tax or AMT.

ALTERNATIVE MINIMUM TAXABLE INCOME (AMTI). Taxable income plus or minus alternative minimum tax adjustments, plus alternative minimum tax preferences. It is used to determine AMT.

BASIS. A measure of a taxpayer's investment in property that is used for computing gain or loss on the sale of the property and for other tax purposes.

BELOW-MARKET LOAN. A demand loan (on which interest is payable at a rate below the applicable federal rate, or a term loan where the amount loaned is more than the present value of all payments due under the loan.

CAPITALIZATION. Recording an expenditure as an asset because of its long-term character or benefit, often followed by deductions to record the using up (depletion, depreciation or amortization) of the asset over a period of time.

CASH METHOD. An accounting method under which income is reported in the year in which it is actually or constructively received. Expenses are generally deducted in the year they are paid.

COMPENSATION. Income received as payment for services rendered.

DEFERRAL. Recognizing and reporting items in a time period subsequent to the period of realization.

DEPENDENT. A qualifying child or qualifying relative of the taxpayer for whom the taxpayer may claim an exemption.

DEPRECIATION. Loss in the value of tangible property over the time the property is being used. Deductions can be claimed for this loss if property is used in a trade or business or held for the production of income.

FAMILY LIMITED PARTNERSHIP (FLP). A business structure that is a tax-effective means of shifting wealth to other family members.

FIRST IN FIRST OUT (FIFO). A method of valuing inventory under which the first inventory purchased is treated as the first sold.

GROSS INCOME. All income from all sources (other than tax-exempt income) that must be included on a taxpayer's tax return.

LAST IN FIRST OUT (LIFO). A method for valuing inventory such that the cost of inventory at the close of a period is calculated assuming that the inventory removed for the period was removed at current costs. This method, during a period of rising costs, results in a lower ending inventory and a higher cost of goods sold.

LISTED PROPERTY. Passenger autos, computers, cell phones and certain other properties that are subject to certain depreciation limitations under the Internal Revenue Code.

MODIFIED COST RECOVERY SYSTEM (MACRS). Simplified depreciation system that is mandated by the Internal Revenue Code for most tangible property used in a trade or business or held for the production of income.

PASSIVE ACTIVITY. Passive activity is (1) any trade or business or income-producing activity in which the taxpayer does not materially participate and (2) all rental activities (subject to certain exceptions).

PHASE-OUT RANGES. Income ranges in which certain deductions, credits, and personal exemptions are reduced and eventually eliminated altogether.

RECAPTURE. An inclusion in income of an amount allowed as a deduction in a prior year.

TAX YEAR. The time period covered by a tax return. Usually this is January 1 to December 31, a calendar year, but taxpayers can elect fiscal tax year with different beginning and ending dates.

TAXABLE INCOME. AGI less the greater of the standard deduction or total itemized deductions, less personal and dependency exemptions.

UNRELATED BUSINESS TAXABLE INCOME (UBTI). Income generated by a tax-exempt organization when it conducts a business activity not substantially related to its tax-exempt purpose. UBTI is subject to income tax.

WASH SALE. A sale of stock or securities at a loss within 30 days before or after the stock is acquired. Loss is disallowed for tax purposes.

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RIA's 2014 Federal Tax Review Course

Module 2 (QZN145)

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RIA's 2014 Federal Tax Review Course Examination for Module 2, Taxation of Businesses

Section I: Forms of Business Organization

1. A __________ conducted by a husband and wife who file a joint return for the tax year is not treated as a partnership for tax purposes.

   a. Sole proprietorship b. Qualified domestic entity

   c. Qualified joint venture d. Disregarded entity

2. Which of the following is **not** an advantage that the partnership form of doing business has over the S corporation form?

   a. There are no limitations on who may be a partner, unlike an S corporation, which is subject to limitations on who may be a shareholder.

   b. There is far greater flexibility in allocating the business's profits, losses and credits among partners of a partnership than among shareholders of an S corporation.

   c. A partner's basis in his partnership interest, unlike a shareholder's basis in S corporation shares, includes the partner's share of partnership liabilities.

   d. A partnership and its partners avoid the double income tax that S corporations and their shareholders are subject to.

3. The IRS's _________ regulations allow the elective classification of unincorporated business entities.

   a. Eligible entity b. Disregarded entity

   c. Check-the-box d. Unincorporated business

Section II: Tax Accounting

4. A (an) _______ and a ________ must generally use the calendar tax year unless a Code Section 444 election is made or there is a business purpose for a different tax year.

   a. S corporation, C corporation

   b. S corporation, personal service corporation

   c. General partnership, limited partnership

   d. Partnership, personal service corporation

5. Which of the following is a true statement regarding the cash method of accounting?

   a. A check does not constitute "payment" until it's cashed.

   b. Receipt of a check by the taxpayer's agent is considered receipt by the taxpayer.

   c. If a taxpayer can unconditionally demand income from another party, it's not taxed to the taxpayer until demand is made.

   d. Cash basis taxpayers generally take deductions in the year items are actually or "constructively" paid.

6. The nonaccrual experience method is available to:

   1. Taxpayers providing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.
   2. Taxpayers (other than tax shelters) with average annual gross receipts of $1 million or less.
   3. Taxpayers providing services, if the taxpayer's three-year average annual gross receipts don't exceed $5 million.
   4. A taxpayer whose principal business activity is not mining, manufacturing, wholesale trade, retail trade, or information industries and whose average annual gross receipts do not exceed $10 million.

   a. 1 and 3 only b. 2 and 4 only

   c. 1, 2, and 3 only d. 1 and 4 only

7. Which of the following statements regarding the accrual method of accounting is **incorrect**?

   a. Amounts received as security aren't taxable until used.

   b. Expenses are not deductible until all events have occurred that determine the fact of the liability (including economic performance).

   c. Where the right to income is contingent on a future event, an accrual basis taxpayer doesn't have to recognize the income until that event occurs.

   d. An accrual basis taxpayer can deduct expenses owed to a related cash basis taxpayer as soon as the expenses are properly accrued even though the payment is not made until a subsequent tax year.

8. Which of the following goods held for sale are **not** included in the seller's inventory?

   a. Goods shipped on approval that have been accepted.

   b. Raw materials and supplies on hand that will become part of goods held for sale.

   c. Containers to be sold with the goods they contain.

   d. Do not select this answer choice.

Section III: Business Expenses

9. Which of the following items do **not** have to be capitalized?

   a. Costs of acquiring customer lists.

   b. Costs of removing old depreciable assets in order to install new replacement assets.

   c. Cost of obtaining a business license that's renewable for an indefinite period.

   d. Commissions paid to obtain a business loan.

10. Which of the following is considered an "allocable cost" for purposes of the uniform capitalization rules?

    a. Interest paid to produce property that has an estimated production period of more than two years.

    b. Expenses connected with property produced under a long-term contract.

    c. Marketing expenses.

    d. Research and experimental expenditures.

11. A corporation or partnership can elect a current deduction for up to _____ of organizational expenditures.

    a. $2,000 b. $4,000

    c. $5,000 d. $10,000

12. Which of the following is **not** taken into account in determining whether a corporation's payments to a shareholder-employee constitute "reasonable" compensation?

    a. Volume of business handled by the shareholder-employee's corporation.

    b. Compensation history of the shareholder-employee.

    c. Duties performed by the shareholder-employee.

    d. Number of shares owned by the shareholder-employee.

13. Bonuses paid within ________ after the close of the tax year are not treated as deferred compensation.

    a. 30 days

    b. 2 ½ months

    c. 6 months

    d. One year

14. In determining the location of the "tax home" for a taxpayer with more than one business location, which of the following factors is **not** taken into account?

    a. Time spent at each business location.

    b. Business activity at each business location.

    c. Distance between residence and each business location.

    d. Financial return from each business location.

15. For purposes of the deductibility of local transportation expenses, a worksite is considered temporary if employment at the site is realistically expected to last (and in fact does last) for no more than ______.

    a. 30 days

    b. 6 months

    c. One year

    d. Two years

16. Which of the following entertainment expenses are deductible even if they are not "directly related" or "associated with" the active conduct of a trade or business?

    1. An outing on a boat for the officers of a corporation.

    2. Entertainment provided to employees that is treated as wages by the employer for withholding tax purposes.

    3. Expenses connected with shareholder meetings.

    4. A summer picnic for rank-and-file employees.

    a. 2, 3 and 4

    b. 1, 2, and 4

    c. 3 and 4

    d. 1, 2, and 3

17. The amount of an otherwise allowable deduction for meal or entertainment expenses must be reduced by ____ %.

    a. 50

    b. 40

    c. 20

    d. 10

18. Which of the following is a true statement regarding employee business expense reimbursements?

    a. Under an accountable plan, an employee must be required to return any reimbursement in excess of substantiated business expenses within seven days.

    b. Under the simplified (high-low) method for substantiating travel allowances, an employee is not required to substantiate the business purpose of the travel.

    c. A reimbursement for an employee's meal eaten during a non-overnight trip on employer business satisfies the business connection requirement for an accountable plan.

    d. If an employee is allowed to keep advances or reimbursements in excess of those that are substantiated, only the excess is treated as made under a nonaccountable plan.

19. The maximum deduction for employee achievement awards made to one employee is $_______ per year.

    a. 200 b. 400

    c. 600 d. 1,000

20. For purposes of the deduction for manufacturing/production activities, _______ are specifically excluded from the definition of "domestic production gross receipts."

    a. Receipts from the lease or sale of land.

    b. Receipts from engineering or architectural services.

    c. Receipts from the sale of electricity or natural gas.

    d. Receipts from the rental or license of films.

Section IV: Depreciation and Amortization

21. For which of the following business properties may depreciation deductions be claimed?

    a. Land b. "Section 197 intangibles"

    c. Property converted from personal use to business use d. Mineral deposits

22. Which of the following is a true statement regarding the depreciation of leasehold improvements?

    a. Only the lessor can claim depreciation on leasehold improvements.

    b. Leasehold improvements are depreciated over the term of the lease (including renewals).

    c. When a lessee makes an improvement but doesn't retain the improvement at the end of the lease, the lessee may recognize gain or loss.

    d. A lessee may claim depreciation on an improvement only if the lease term is longer than the MACRS recovery period.

23. Which of the following properties is depreciable under MACRS?

    a. Intangible property.

    b. Real property (other than land).

    c. Property for which the taxpayer elects the unit-of-production depreciation method.

    d. Motion pictures.

24. Which of the following items are **not** included in the five-year MACRS class?

    a. Office furniture b. Automobiles

    c. Dairy cattle d. Heavy general purpose trucks

25. Under MACRS's General Depreciation System, property in the three-, five-, seven-, and ten-year recovery classes are generally depreciated under which method?

    a. Straight-line b. 150% declining balance

    c. 200% declining balance d. Sum-of-the-digits

26. Which of the following is eligible for expensing under Code Section 179?

    a. An air conditioning unit

    b. Accounting software purchased at a retail store

    c. Used office furniture purchased from the taxpayer's father

    d. New mattresses purchased for a motel

27. XYZ Inc. placed $840,000 of expensing-eligible property into service in 2013. What is the maximum amount XYZ may expense under Code Section 179?

    a. $25,000 b. $125,000

    c. $250,000 d. $500,000

28. Which of the following is a true statement regarding "listed" property?

a. Taxis are considered listed property.

b. If a taxpayer uses an automobile 40% for business driving and 60% for personal driving, his or her Section 179 expensing allowance is limited to 40% of the regular maximum allowance.

c. Lessees of luxury business autos must include in gross income an "inclusion amount."

d. No depreciation deductions may be claimed on a corporate-owned automobile to the extent that it is used by a more-than-5% shareholder.

29. Which of the following is **not** a Section 197 intangible if acquired in connection with the acquisition of a business?

a. Accounts receivable

b. Covenant not to compete

c. Patents and copyrights

d. Goodwill

Section V. Business Tax Credits

30. Which of the following is **not** a component of the general business credit?

a. The investment credit.

b. The employer-provided child care credit.

c. The foreign tax credit.

d. The small employer health insurance credit.

31. The tax credit for rehabilitation of a certified historic structure is _______ of qualified rehabilitation expenditures.

a. 10%

b. 20%

c. 40%

d. 50%

32. If investment credit property is disposed of during the second full year after the property is placed in service, ___________ of the investment credit will be recaptured.

a. 100%

b. 90%

c. 80%

d. 70%

33. For 2013, the maximum small employer health insurance credit is equal to ____ of the contributions made by the employer for health insurance premiums on behalf of employees for the tax year.

a. 10%

b. 20%

c. 35%

d. 50%

Section VI. Taxation of C Corporations

34. X Corporation has $100,000 of taxable income for the year. X Corporation receives a dividend of $10,000 from publicly traded stock and a dividend of $15,000 from a corporation that is 30% owned by X Corporation. What is the amount of X Corporation's dividends received deduction?

a. $25,000

b. $20,000

c. $19,000

d. $17,500

35. A corporation uses a fiscal year beginning March 1. What is the normal due date of the corporation's second required installment of corporate estimated tax?

a. May 15

b. June 15

c. September 15

d. August 15

36. Which of the following does the accumulated earnings tax apply to?

a. Personal holding companies
b. Foreign personal holding companies
c. S corporations
d. C corporations

37. A corporation has $200,000 of alternative minimum taxable income (AMTI). What is the amount of the corporation's AMT exemption?

a. $0
b. $27,500
c. $40,000
d. $52,500

Section VII: Corporate Transactions

38. A corporation distributes property with a basis of $8,000 and a fair market value of $5,000 to a shareholder as a nonliquidating distribution. The corporation recognizes:

a. No gain or loss
b. A $3,000 loss
c. a $3,000 gain
d. A $5,000 loss

39. A corporation's only stock is 10,000 shares of common stock, all of which is voting stock. Taxpayer owns 6,000 shares of the outstanding stock. No portion of the corporation's stock is owned by individuals related to the taxpayer or other entities. What is the minimum number of shares of the taxpayer's stock that the corporation must redeem for the redemption to qualify as "substantially disproportionate"?

a. 4,800
b. 3,000
c. 2,000
d. 1,201

40. A husband, wife and son own stock in a corporation which they each acquired by purchase. The corporation redeems all of the stock owned by the husband. The husband no longer has any personal financial interest in the corporation, and no longer serves as a director, officer or employee. However, the wife and son continue to own their stock in the corporation. The husband will qualify for a waiver of the family attribution rules and the redemption will qualify as a complete redemption if he does not acquire any prohibited interest (except by inheritance) or position with the corporation for ____ years after the date of the redemption.

a. 5
b. 10
c. 20
d. 25

41. The acquisition by one corporation of stock in a second (target) corporation in exchange solely for the acquiring corporation's voting stock, where the acquiring corporation has control of the target immediately after the exchange is a:

a. Type A reorganization
b. Type B reorganization
c. Type C reorganization
d. Type D reorganization

42. P Corporation transfers part of its business to new Corporation A in exchange for stock and transfers the remainder of its business to new Corporation B in exchange for stock. P distributes the A and B stock to its shareholders in exchange for their P stock. P liquidates. P's transaction is a:

a. Spin-off
b. Split-off
c. Split-up
d. Liquidation

Section VIII: Taxation of S Corporations

43. An S corporation can have an S corporation subsidiary if it owns _______ of the subsidiary's stock.

a. 50%
b. 75%
c. 80%
d. 100%

44. When does an S corporation shareholder take into account his share of the corporation’s items?

    a. In his first full tax year following the close of the corporation’s tax year.

    b. In his tax year in which the majority of the items were incurred by the corporation.

    c. In his tax year that includes the last day of the corporation’s tax year.

    d. In his tax year that includes the first day of the corporation’s tax year.

45. If an S corporation shareholder cannot deduct a passed-through loss from the corporation because he or she has insufficient basis in the corporation, the loss generally can be carried over _______.

    a. For five years

    b. For 20 years

    c. For 25 years

    d. Indefinitely

46. A shareholder in an S corporation that has no accumulated E&P has a $5,000 basis in his stock and receives a cash distribution of $7,000. How is the distribution taxed?

    a. No taxable income or gain

    b. $2,000 capital gain

    c. $5,000 dividend

    d. $7,000 dividend

Section IX: Taxation of Partnerships

47. If a partner contributes a capital asset with a basis higher than its fair market value, and the partnership disposes of it within five years of the contribution,

    a. Only the contributing partner recognizes gains or loss upon the asset’s disposition.

    b. The partnership does not recognize gain or loss on the disposition.

    c. Any gain recognized on the disposition is ordinary income.

    d. The partnership’s loss on disposition is a capital loss to the extent of the difference between basis and value upon contribution.

48. Property received by a partnership from a contributing partner:

    a. Takes a basis of zero in the partnership’s hands.

    b. Takes a basis equal to the property’s fair market value on the date of the contribution.

    c. Takes a stepped-up basis in the partnership’s hands.

    d. Takes the same basis in the partnership’s hands as it had in the contributing partner’s hands at the time of the contribution.

49. Taxpayer is a 10% partner and has a basis of $6,000 in his partnership interest at the end of the year. The partnership has a loss of $100,000 for the year and allocates $10,000 of it to the taxpayer. How much can the taxpayer deduct on his individual return?

    a. $0

    b. $6,000

    c. $4,000

    d. $10,000

50. A partner with a $20,000 basis in his partnership interest receives a current distribution of $8,000 cash and land worth $35,000. The partnership’s basis in the land was $25,000. The partner’s basis for the land will be:

    a. $20,000

    b. $12,000

    c. $25,000

    d. $35,000

INTRODUCTION

RIA's 2014 Federal Tax Review Course Module 3 is an interactive self-study CPE course which addresses specialized tax situations. There is a charge for grading and processing your answer sheet for this course module. To obtain credit, your **Examination for CPE Credit Answer Sheet(s)** must be submitted for grading by **November 30, 2014**.

Taking the Course

You are asked to read the material and, during the course, test your comprehension of each of the learning objectives by answering self-study quiz questions. After answering each quiz question, you can evaluate your progress by comparing your answer to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied you understand the material, answer the examination questions. You may either record your answer choices on the printed Examination for CPE Answer Sheet or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

This RIA self-study course is part of Thomson Reuters Tax & Accounting, Learning Solutions, self-study offerings. PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. Credit hours for CPE courses vary in length. Credit hours for this course are listed on the "Overview" page.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

After completing this course, you can receive CPE credit by logging on to our Online Grading System at cl.thomsonreuters.com. Click the purchase link and a list of exams will appear. You may search for the exam using the acronym QZN146. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading System, please refer to the Test Instructions located at the beginning of the examination. If you prefer, you may continue to mail your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters Tax & Accounting for grading. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. The examination contains instructions for obtaining CPE credit. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher. Please take a few minutes to complete the **Course Evaluation** and return it to us so that we can provide you with the best possible CPE.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

Express Grading: An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information.

Obtaining EA and RTRP Credit

To receive EA and RTRP credit, you must provide your PTIN to Thomson Reuters in one of two ways. Log on to cl.thomsonreuters.com, select the Settings tab, and then Edit My Membership Information. Select IRS PTIN (EA and RTRP) and input your PTIN. Alternatively, if you are submitting your exam for print grading, write your PTIN in the space provided on your answer sheet.

Retaining CPE Records

For all scores of 70% or higher, you will receive a Certificate of Completion. You should retain it and a copy of these materials for at least five years.

In-firm Training

PPC also offers a number of in-firm training classes that provide up to eight hours of PCE credit. Please call our Sales Department at (800) 323-8724 for more information.

RIA's 2014 Federal Tax Review Course

OVERVIEW

COURSE DESCRIPTION: **RIA's 2014 Federal Tax Review Course Module 3** is a general refresher course in Federal taxation of specialized tax issues. It is designed to reinforce basic tax law interpretations while keeping practitioners up to date on the latest and most important changes. The course has been updated to reflect the latest in tax legislation through the American Taxpayer Relief Act of 2012.

PUBLICATION/REVISION DATE: November 2013

RECOMMENDED FOR: Users of RIA's Federal Tax Handbook

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of federal taxation

CPE CREDIT: 9 QAS Hours, 9 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours.

This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

CTEC CREDIT: 9 Federal Tax Update Hours

EA CREDIT: 9 Federal Tax Law/Tax Related Matters Hours

RTRP CREDIT: 9 Federal Update Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmarked by **November 30, 2014**

KNOWLEDGE LEVEL: Update

After completing Course Module 3, you should be able to:

- Identify the income items of a trust or estate and the amounts deductible from income by a trust or estate.
- Recognize types of trusts and their treatment for tax purposes and identify income that is and is not included in a decedent's final income tax return.
- Determine which organizations qualify for tax exemption under Code Sec. 501(a) and recognize the restrictions that apply to private foundations.
- Differentiate between the accounting methods available to farmers.
- Recognize the depreciation and income averaging rules that apply to farmers.
- Recognize the benefits that can be offered under an employer's cafeteria plan and qualifying events under COBRA.
- Calculate excludable educational assistance under Code Sec. 127(a)(1).
- Identify the different types of qualified retirement plans and apply the applicable rules governing qualified retirement plan contributions and benefits.
- Determine the tax treatment of required minimum distributions and premature distributions.
- Identify amounts includible in and deductible from a decedent's gross estate and apply the unified estate and gift tax credit.
- Differentiate between taxable and nontaxable gifts.
- Differentiate between different types of tax audits and explain the tax assessment and collection process.
- Determine when interest and penalties will be imposed by the IRS.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet(s), Course Evaluation(s), and payment to:

Thomson Reuters Tax & Accounting
QZN146 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and compliant resolutions, dial (800) 323-8724, select the option for Customer Service, and your questions or concerns will be promptly addressed.

RIA’S 2014 FEDERAL TAX REVIEW COURSE

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MODULE 3: SPECIALIZED TAX ISSUES

I. Taxation of Trusts, Estates, and Decedents

Learning Objectives

After completing this section, you should be able to:

- Identify the income items of a trust or estate and the amounts deductible from income by a trust or estate.
- Recognize types of trusts and their treatment for tax purposes and identify income that is and is not included in a decedent's final income tax return.

Trusts and estates are generally treated as separate taxpayers and, with some important qualifications, are taxed in the same way as individuals.

Trust and estate income is normally taxed to the fiduciary (that is, to the trust or estate itself) if retained by the trust or estate, or to the beneficiary if distributed. Thus, if the fiduciary passes on income to the beneficiary, the trust or estate deducts the distributed income which then becomes taxable to the beneficiary. A special yardstick called "distributable net income" (DNI) is used to limit both the amount deducted by the trust or estate as a distribution and the amount taxed to the beneficiary. (Code Sec. 643, Code Sec. 651, Code Sec. 652, Code Sec. 661, Code Sec. 662)

The income that's passed on to the beneficiary has the same tax attributes in the beneficiary's hands as when received by the fiduciary.

Trusts and estates compute their tax under a separate, unfavorable tax rate schedule that has five brackets and that quickly reaches the top marginal rate. (Code Sec. 1(e)) Trusts and estates can't use the tax tables to figure their tax. (Code Sec. 3(b)(2))

A foreign trust or estate is taxed as if it were a nonresident alien individual who isn't present in the U.S. at any time, subject to special rules for trusts. (Code Sec. 641(b))

Beneficiaries must report items consistently with the entity's return or notify IRS of the inconsistency. (Code Sec. 6034A(c))

If a grantor creates several or "multiple" trusts, each trust is treated as a separate taxpayer. Several separate trusts may be created even though there is only one trust instrument and only one trustee. Two or more trusts are treated as one if: (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of the trusts is avoidance of federal income tax. (Code Sec. 643(f))

An election can be made to have an individual's revocable trust treated as part of his or her estate for income tax purposes. (Code Sec. 645) The election period begins on the date of death and terminates on the earlier of (1) the day on which both the electing trust and related estate have distributed all their assets, or (2) the day before the "applicable date." (Reg §1.645-1(f)(1)) The applicable date varies depending on whether an estate tax return is required. If no return is required, the date is two years after death; if one is required, it's the date that's six months after final determination of estate tax liability, or the day that is two years after the date of death (if later). (Reg §1.645-1(f)(2))

A related issue to the taxation of estates and beneficiaries is the taxation of a decedent—what is reported on the decedent's final return. A cash basis decedent's final return includes only the income he or she actually or constructively received before death. An accrual basis decedent's return includes income and deductions properly accruable at death (but not solely by reason of death). After-death income and deductions "in respect of a decedent" must be reported by the decedent's estate or others who acquire his or her rights or obligations.

A. Income of Trusts and Estates

What would be gross income in the hands of an individual is gross income when received by a trust or estate—dividends, interest, rents, royalties, capital gains, ordinary gains, etc. (Reg §1.641(a)-2) Gross income includes income accumulated or held for future distribution under the terms of a will or trust, income that's currently distributable, income received by a deceased's estate during administration or settlement, and income that, in the fiduciary's discretion, may be either accumulated or distributed. (Code Sec. 641(a))

1. Income from Real Estate

When under local law, real property is subject to an estate's administration, the income from it is that of the estate for the period that the estate is under administration. However, when local law vests legal title to decedent's real estate upon his or her death directly in heirs, devisees, or other beneficiaries, income from it is taxed to the beneficiaries and not the estate. (Reg §1.661(a)-2(e))

When because of insufficiency of funds to pay the deceased's debts, property is sold at the direction of the court, the gain realized upon the sale is, for tax purposes, divided between the heirs and the estate in proportion to the amount of the proceeds received by each.

2. Gain or Loss on Distribution of Property

A trust or estate ordinarily doesn't recognize gain or loss on the distribution of property in kind to a beneficiary. However, if the distribution is in satisfaction of the beneficiary's right to receive a specific dollar amount or specific property other than that distributed, the trust or estate will recognize gain determined as if the property were sold for its fair market value. (Reg §1.661(a)-2(f)(1)) And a trust or estate can irrevocably elect to recognize gain or loss as if the property had been sold to the beneficiary for its fair market value. (Code Sec. 643(e)(3)) If made, the election applies to all distributions made by the estate or trust during the tax year (Code Sec. 643(e)) except:

- gifts or bequests of a specific sum of money or of specific property that under the terms of the will or trust are paid to the beneficiary in three or fewer installments;
- charitable contributions qualifying for deduction as amounts paid or permanently set aside for qualified charities;
- amounts distributed in the current tax year for which a distributions deduction was allowed in an earlier tax year. (Code Sec. 643(e)(4), Code Sec. 663(a))

Trusts and estates may not deduct a loss on property to which a Code Sec. 643(e)(3) election applies because of the rule barring loss deductions on sales between related parties.

Review Question 1

An estate distributes land worth $100,000 to a beneficiary to satisfy a $100,000 bequest. The estate's basis in the land was $96,000. How much gain will the estate recognize on the distribution?

a. $0. b. $4,000.

c. $96,000. d. $100,000.

B. Deductions and Credits of Trusts and Estates

Deductions and credits of trusts and estates are basically those allowed to individuals (see Module 1, *Taxation of Individuals*) except for the special deduction rules discussed below. (Code Sec. 641(b); Reg §1.641(b)-1)

The adjusted gross income of a trust or estate is computed the same as for an individual, with some exceptions. In computing adjusted gross income, the trust's or estate's personal exemptions and the deduction for distributions to beneficiaries (see I.C.) are allowed as deductions in arriving at adjusted gross income. In addition, costs paid or incurred in connection with the administration of the trust or estate that wouldn't have been incurred if the property weren't held in the trust or estate are not treated as miscellaneous itemized expenses. Instead, they are also allowed as deductions in arriving at adjusted gross income. (Code Sec. 67(e))

1. Charitable Contributions

An estate or trust may deduct any amount of gross income, without limitation, that, under the terms of the governing instrument is paid during the tax year for a charitable purpose. (Code Sec. 642(c)(1); Reg §1.642(c)-1(a)).

Estates are allowed to deduct any amount of gross income, without limit, which under the terms of the governing instrument is, during the tax year, permanently set aside for a charitable purpose. (Code Sec. 642(c)(2); Reg §1.642(c)-2(a), Reg §1.642(c)-2(b)) Trusts are denied the set-aside deduction, except for pooled income funds. (Code Sec. 642(c)(2), Code Sec. 642(c)(3); Reg §1.642(c)-2(b), Reg §1.642(c)-2(c))

Contributions made out of tax-exempt income, such as state or municipal bond interest, aren't deductible. (Reg §1.642(c)-3(b), Reg §1.643(a)-5(b))

A fiduciary of a trust or estate can elect to treat a contribution actually paid in one tax year as paid in the preceding tax year. (Code Sec. 642(c)(1)) The election to accelerate the deduction must be made not later than the time, including extensions, prescribed for filing the income tax return for the tax year *following the tax year* to which the deductions are pushed back. The election is made by attaching a statement to the return or amended return for the year to which the deductions are pushed back. (Reg §1.642(c)-1(b))

Review Question 2

An estate pays out $50,000 to charity during a tax year and permanently sets aside $75,000 for charitable purposes during the same year. What is the amount of the estate's charitable deduction for the year?

a. $50,000.

b. $75,000.

c. $125,000.

2. Personal Exemption and Standard Deduction

An estate is entitled to a deduction for a personal exemption of $600. (Code Sec. 642(b)) A trust that's required to distribute all of its income currently has a $300 exemption (even for a year in which it makes a corpus distribution or a charitable contribution). All other trusts deduct $100. (Code Sec. 642(b); Reg §1.642(b)-1)

An estate or trust gets no benefit from an exemption on its final return, because all income will have been distributed to beneficiaries.

The standard deduction of a trust or estate is zero. (Code Sec. 63(c)(6)(D))

Review Question 3

For 2013, an estate is entitled to a personal exemption deduction of ____________.

a. $100.

b. $300.

c. $600.

d. $3,900.

3. Depreciation and Depletion

Depreciation and depletion deductions of trust or estate property must be apportioned as follows:

- For a *trust*, these deductions are generally apportioned between the beneficiaries and the trustee on the basis of the trust income allocable to each. (Code Sec. 167(d), Code Sec. 611(b)(3), Code Sec. 642(e)) But if the trustee is required or permitted by the trust instrument or local law to maintain a reserve for the deduction, the deduction belongs to the trust to the extent that income is actually set aside for the reserve. Apart from this, the IRS regulations bar any deduction by the trust or a beneficiary that exceeds the trust's or beneficiary's allocable share of trust income. (Reg §1.167(h)-1(b), Reg §1.611-1(c)(4))

- For an *estate*, the deductions are apportioned between the estate and the heirs, legatees and devisees on the basis of the estate income allocable to each, regardless of the terms of the will. (Code Sec.167(d), Code Sec. 611(b)(4))

4. Other Deductions

Special rules apply to a number of other deductions of trusts and estates.

Administration expenses. Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and litigation expenses, that are ordinary and necessary in the performance of duties of administration are deductible. (Reg §1.212-1(i)) Deductible items include commissions and legal fees, whether allocable to corpus or income.

The U.S. Supreme Court has ruled that investment advisory fees paid by a trust are not deductible as "above-the-line" administration expenses. The court held that they are not the type of expenses that "would not have been incurred" if the property were held by an individual (see I.B.). Instead, a trust's investment advisory expenses must be deducted as miscellaneous expenses, which are deductible only to the extent that they exceed 2% of adjusted gross income. (Knight v. Comm (S Ct 1/16/2008), 101 AFTR 2d ¶2008-380)

Interest deductions. An estate or trust may deduct interest to the same extent as an individual. Thus, an estate or trust is subject to the bar on the deduction of "personal" interest. Interest on estate tax deferred because of a closely held business interest isn't deductible. (Code Sec. 163(k))

Net operating loss. Trusts and estates are entitled to the net operating loss (NOL) deduction. (Code Sec. 642(d)) In computing the NOL, the charitable deduction and the deduction for distributions are disregarded. (Reg §1.642(d)-1)

5. Deductions for Income or Estate Tax Purposes

Administration expenses, including commissions and other selling expenses, and casualty and theft losses during administration may be taken either: (1) as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the estate's taxable income for income tax purposes, or (2) as a deduction in computing the decedent's taxable estate for estate tax purposes, but not both. (Code Sec. 642(g))

To take the income tax deduction, the executor should file in duplicate (a) a statement that the amount involved hasn't already been taken as a deduction for federal estate tax purposes, and (b) a waiver of the right to take it as an estate tax deduction. (Reg §1.642(g)-1)

One item or portion of an item can be deducted for income tax purposes if the statement and waiver are filed, while a similar item or different portion of the same item can be taken for estate tax purposes. (Reg §1.642(g)-2)

The rule barring deductions for both income tax and estate tax purposes doesn't apply to obligations of the decedent for interest, taxes and expenses that are allowable as deductions "in respect of a decedent" (Reg §1.642(g)-2), or items that qualify for deduction on the estate tax return as claims against the estate, such as divorce settlement payments.

Review Question 4

An estate's administration costs are:

a. Not deductible.

b. Deductible only on the estate's income tax return.

c. Deductible either on the estate's income tax return or the decedent's final income tax return.

d. Deductible either on the estate's income tax return or the estate tax return.

C. Distribution Deduction

In addition to the deductions outlined above, a deduction is allowed to trusts and estates for distributions to beneficiaries up to the "distributable net income" (DNI) for the tax year. (Code Sec. 651(b), Code Sec. 661(a)) The distribution deduction of a trust depends upon whether the trust is a simple trust or a complex trust.

A "simple" trust is one that makes no distribution other than of current income and the terms of which require all of its income to be distributed currently and do not provide for charitable or similar contributions. A "complex" trust permits accumulation of income or charitable contributions or distributes principal.

A trust may shift its character from simple to complex and vice versa. (Reg §1.651(a)-1, Reg §1.661(a)-1)

1. Distributions from Simple Trust

The deduction for a simple trust is the amount of its income for the tax year that's required to be distributed currently, up to the ceiling of its DNI for the year. (Code Sec. 651(b)) Tax-exempt income is excluded both from accounting income and DNI in figuring the deduction. (Reg §1.651(b)-1) In computing DNI, the starting point is taxable income, i.e., gross income minus deductions). These adjustments are then made to taxable income:

1. Add back the deduction for personal exemption and any deduction for distributions. (Code Sec. 643(a)(1), Code Sec. 643(a)(2); Reg §1.643(a)-1, Reg §1.643(a)-2)
2. Subtract any extraordinary dividends (in cash or property) and taxable stock dividends that the trustee doesn't pay or credit because he or she determines they are allocable to principal. (Code Sec. 643(a)(4); Reg §1.643(a)-4)
3. Subtract any capital gains that are allocated to principal and aren't paid, credited or required to be distributed during the tax year. Also add back any capital losses, except to the extent they are taken into account in computing capital gains that are paid, credited or required to be distributed during the tax year. (Code Sec. 643(a)(3); Reg §1.643(a)-3(b))

2. Distributions from Complex Trust or Estate

A complex trust or estate deducts, up to its DNI ceiling for the year, the sum of:

1. any income for the tax year required to be distributed currently; and
2. any other amounts, whether income or principal, properly paid or credited or required to be distributed for that tax year. (Code Sec. 661(a); Reg §1.661(a)-2(a))

No distributions deduction may be taken for any portion of DNI that represents an item, such as tax-exempt interest, that isn't included in the gross income of the trust or estate. (Code Sec. 661(c); Reg §1.661(c)-1) Unless the instrument or local law requires another allocation, the distribution is considered to contain the same proportion of tax-exempt items entering into DNI as the total tax-exempt income bears to total DNI. (Code Sec. 661(b); Reg §1.661(b)-1)

The DNI of a complex trust or an estate is its taxable income with these adjustments:

- No deduction for distributions or personal exemption is allowed.
- Capital gains are excluded unless:
  - allocated to income;
  - allocated to principal and actually distributed during the year;
  - used in determining the amount distributed or required to be distributed; or
  - allowed as a charitable deduction.

- Capital losses are excluded except to the extent they enter into a determination of any capital gains paid, credited or required to be distributed to a beneficiary during the tax year.
- Tax-exempt interest, reduced by allocable, nondeductible expenses, is included except to the extent allocable to the charitable deduction. (Code Sec. 643(a))

"Income required to be distributed currently." This means accounting income of the trust or estate determined under the trust instrument or will and applicable local law. It doesn't include items of gross income that the fiduciary allocates to corpus. (Code Sec. 643(b))

A distribution required to be made out of income or corpus, such as an annuity, is considered to be out of currently distributable income to the extent it's paid out of income for the tax year. (Code Sec. 661(a)(1); Reg §1.661(a)-2(b))

Currently distributable income is deductible for the tax year of the trust or estate in which it is received even though, as a matter of practical necessity, it isn't distributed until after the end of that year. (Reg §1.651(a)-2(a), Reg §1.651(a)-2(b))

"Other amounts properly paid or credited or required to be distributed." These amounts must be actually distributed or at least made available on demand by the beneficiary. Even though designated by the fiduciary as a payment of principal of the trust or estate, a distribution actually paid or made available is deductible by the fiduciary as a distribution of "other amounts." It isn't necessary that the distribution actually be made out of income. (Code Sec. 661(a); Reg §1.661(a)-2(c)) An amount that a trust has elected to treat as an estimated tax payment by a beneficiary (see I.H.) is a deductible distribution. (Code Sec. 643(g))

Distributions of property. Distributions of property in kind qualify for deduction as other amounts paid. (Reg §1.661(a)-2(c)) If the trust or estate elects to recognize gain or loss, the property distributed is taken into account at its fair market value for purposes of the distribution deduction. If the election isn't made, the property is taken into account only to the extent of the lesser of the basis of the property in the hands of the beneficiary or the fair market value of the property. (Code Sec. 643(e)(2), Code Sec. 643(e)(3))

Family support allowances. Family support allowances (for a decedent's widow or dependent) paid by an estate under a court order or decree, or under local law, are treated as estate distributions deductible by the estate, subject to the regular DNI deduction ceiling. (Reg §1.661(a)-2(e), Reg §1.662(a)-2(c))

Nonqualifying distributions. No distributions deduction is allowed for:

- distributions to charity (Reg §1.663(a)-2);
- the value of any interest in real estate, title to which passes directly from decedent to his or her heirs and devisees (Reg §1.661(a)-2(e));
- a gift or bequest of specific property or of a specific sum of money that is paid or credited all at once or in not more than three installments—an amount that can be paid only from income isn't considered a gift or bequest of a specific sum of money and is therefore includible in the distributions deduction (Code Sec. 663(a)(1));
- any amount reported as a distribution in an earlier year's return because it was credited or required to be distributed in the earlier year (Code Sec. 663(a)(3); Reg §1.663(a)-3);
- any amount paid or credited within the first 65 days of the current year which the fiduciary elected to treat as paid or credited in the preceding year (see below).

Late-paid distributions. The fiduciary of a complex trust and the executor of an estate can elect to treat an amount properly paid or credited within the first 65 days of any tax year of the trust as paid or credited on the last day of the preceding tax year. (Code Sec. 663(b)) This gives the trustee or executor time to determine income earned by the trust for the year, and the opportunity to deduct distributions of that income on the return for the year earned.

The amount to which the election applies can't exceed the greater of: (1) the entity's accounting income for the year for which the election is made, or (2) its DNI for that year, in each case reduced by any amounts paid, credited, or required to be distributed in that year other than amounts considered paid or credited in a preceding tax year by reason of the "65-day" rule. (Reg §1.663(b)-1(a))

D. Taxation of Beneficiaries

Current distributions (amounts required to be distributed currently) are taxed to the beneficiary when they are required to be distributed even though not actually distributed. Other distributions are taxed to a beneficiary when they are made or credited, or required to be made. (Code Sec. 652(a), Code Sec. 662(a); Reg §1.662(a)-3(a))

If a beneficiary's tax year is different from that of the estate or trust, the beneficiary includes his or her share of required current distributions on the return for the tax year in which the tax year of the trust or estate ends. (Code Sec. 652(c), Code Sec. 662(c))

Upon termination of an estate (see I.G.), a beneficiary must include in his or her calendar year return income received from the estate during both the estate's fiscal year and final short year where both years end within his or her calendar year.

Where the 65-day rule (see above) is elected, the beneficiary is considered as receiving the distribution in his or her tax year that includes the close of the trust's or estate's tax year in which the distribution is considered made. (Reg §1.663(b)-1(a)(2)(ii))

A beneficiary isn't taxed on any amount paid or credited as a gift or bequest of specific property or of a specific sum of money, and that is paid or credited all at once or in not more than three installments. But an amount that can be paid only from income isn't excludable. (Code Sec. 663(a)(1); Reg §1.102-1(c))

1. Beneficiary of Simple Trust

The beneficiary of a simple trust is generally taxed on the lower of these two items:

- the amount of trust income for the tax year of the trust required to be distributed to the beneficiary currently whether distributed or not; or
- the beneficiary's proportionate share of the trust's DNI. (Code Sec. 652(a); Reg §1.652(a)-1)

DNI is computed as explained above except that for this purpose it includes tax-exempt interest minus allocable deductions. (Code Sec. 643(a)(5)) Tax-exempt income items, however, aren't taxable to the beneficiary.

2. Beneficiary of Complex Trusts and Estates

The beneficiary of a complex trust or of an estate includes in gross income the sum of the following amounts, subject to the DNI ceiling and the elimination of tax-exempt items.

- income required to be distributed to the beneficiary currently (though not actually distributed), which includes an annuity or other amount required to be paid out of income or corpus, to the extent it is paid out of income for the tax year; and
- all other amounts (whether from income or principal) properly paid, credited or required to be distributed to the beneficiary for the tax year (Code Sec. 662(a)) including income from property distributed in-kind. (Reg §1.662(a)-3(b))

DNI ceiling. A beneficiary of a complex trust or an estate need not report as income more than his or her share of DNI, so that the total amount of income reported by all beneficiaries cannot exceed the total DNI of the trust or estate for the tax year. For this purpose, the beneficiaries are divided into two groups or "tiers."

The first tier is composed of beneficiaries entitled to income distributions currently, that is "income required to be distributed currently." The second tier is composed of beneficiaries receiving or entitled to receive other "noncurrent" distributions. (Code Sec. 662(a); Reg §1.662(a)-3(c))

- *First-tier beneficiaries report*, in the aggregate, the amount of their current distributions, up to the amount of DNI for the tax year of the trust or estate, as explained above, without any charitable deduction. Thus, if the total of first-tier distributions is equal to or less than DNI (without charitable deduction), each first-tier beneficiary reports his or her full share of the distributions. (Code Sec. 662(a)(1)) But if the total of first-tier distributions exceeds DNI (without charitable deduction) each beneficiary reports an amount equal to his or her pro rata share of DNI (without charitable deduction). (Code Sec. 662(a)(1); Reg §1.662(a)-2(b))
- *Second-tier beneficiaries report,* in the aggregate, the amount of their second-tier distributions up to the DNI of the trust or estate as reduced for first-tier distributions of current income. For this purpose, DNI is computed with allowance of any charitable deduction. If the total of second-tier distributions equals or is less than the ceiling (DNI as reduced for first-tier distributions), each second-tier beneficiary reports his or her full share of the second-tier distributions. But, if the total of second-tier distributions exceeds the ceiling, each second-tier beneficiary reports only his or her pro rata share of the ceiling amount. (Code Sec. 662(a)(2); Reg §1.662(a)-3(c))

Beneficiaries' separate shares. If a complex trust accumulates income for one beneficiary and distributes principal to another beneficiary, the normal tax rules would impose a tax burden on the recipient of principal since he or she in effect must pay tax on income accumulated for the other beneficiary. To prevent this, the "separate share rule" treats substantially separate and independent shares of different beneficiaries of a single trust as though each share represented a separate trust. This applies only in computing DNI as a ceiling on the amount deductible by the trust and taxable to the beneficiaries(Code Sec. 663(c); Reg §1.663(c)-1(b)), applies only to complex trusts, and is mandatory. (Reg §1.663(c)-1(d))

A similar separate share rule applies to beneficiaries of estates. (Code Sec. 663(c), Reg §1.663(c)-1(a)) A surviving spouse's elective share is a separate share. A pecuniary formula bequest is also a separate share unless it's not entitled to income or to share in appreciation or depreciation and it can be paid or credited in more than three installments. (Reg §1.663(c)-4(b))

3. Character of Income

For simple trusts, complex trusts and estates, the amounts taxable to the beneficiaries have the same character (e.g., as tax-exempt income) in the hands of the beneficiaries as the amounts had when received by the trust or estate. (Code Sec. 652(b), Code Sec. 662(b); Reg §1.652(b)-1, Reg §1.662(b)-1)

Unless the instrument specifically allocates different classes of income to different beneficiaries, amounts distributed are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI of the trust or estate. (Code Sec. 652(b); Code Sec. 662(b); Reg §1.652(b)-1, Reg §1.662(b)-1)

Allocation of deductions. Deductions that enter into the computation of DNI are allocated among the various classes as follows:

1. Deductions directly attributable to a particular class of income (interest, rents, dividends, capital gains, etc.) are allocated to that class.
2. If deductions directly attributable to a class of income exceed that class, the excess may be allocated to any other class (including capital gains) included in DNI in the manner shown in (3) below. However excess deductions directly attributable to tax-exempt income cannot be used to reduce any other class of income.
3. Deductions not directly attributable to a specific class of income can be allocated to any item of income (including capital gains) included in DNI, but a part must be allocated proportionately to tax-exempt income. Examples of these "neutral" deductions are trustees' commissions (both income and corpus), and state income and personal property taxes. (Reg §1.652(b)-3)

A *charitable deduction* by an estate or complex trust is allocated just before the other deductions. Allocation follows the terms of the instrument or local law, but if these are silent, the charitable deduction is allocated to each class of income items in the proportion the total that each class bears to the total of all classes. (Reg §1.643(a)-5(b), Reg §1.662(b)-2)

4. Distributions in Kind

For property distributed in kind, the amount taken into account for purposes of determining the amount includible in the beneficiary's income depends on whether the estate or trust elected to recognize gain or loss on the distribution (see I.A.2.).

- If the estate or trust elects, the property is taken into account at its fair market value. (Code Sec. 643(e)(3))
- If the estate or trust doesn't elect, the property is taken into account only to the extent of the lesser of: (1) the fair market value of the property, or (2) its basis in the hands of the beneficiary. (Code Sec. 643(e)(2))

The beneficiary's basis for property distributed in kind is the adjusted basis of the property in the hands of the estate or trust immediately before the distribution, adjusted for any gain or loss recognized by the estate or trust on the distribution. (Code Sec. 643(e)(1))

5. Distributions of Accumulated Income

Under the "throwback rules," beneficiaries are taxed on distributions of income accumulated by the trust before the year of distribution as though the income had been distributed currently to the beneficiaries in the years received by the trust. (Reg §1.665(a)-0A(a)(1))

While once important, the throwback rules now have limited application. They apply only to foreign trusts, domestic trusts previously treated as foreign trusts (except as provided in regulations), and certain domestic trusts created before March 1, 1984. (Code Sec. 665(c))

The throwback rules generally apply only to complex trusts. Estates aren't subject to the throwback rules. (Code Sec. 666; Reg §1.665(a)-0A(d))

In addition, these distributions are exempt from the throwback rules:

- Distributions of income accumulated before birth of beneficiary or before beneficiary reaches age 21. (Code Sec. 665(b))
- Distributions not exceeding accounting income. (Code Sec. 665(b))

E. Grantor Trusts

A trust grantor or another person with certain powers or rights with regard to the trust or its property (see below) may be taxed directly on its income as the "owner" of the trust (in which case, the fiduciary is not taxed on the income). These grantor trust rules don't apply to charitable remainder trusts or pooled income funds. (Reg §1.671-1(d) and they generally apply only to the extent they result in amounts being currently taken into account in computing the income of a U.S. citizen, resident or domestic corporation. (Code Sec. 672(f); Reg §1.672(f)-1, Reg §1.672(f)-2, Reg §1.672(f)-3)

For purposes of the grantor trust rules, a grantor includes any person who creates a trust, or directly or indirectly makes a gratuitous transfer of property, including cash, to a trust. (Reg §1.671-2(e)) These rules may be applicable to the entire trust or, where appropriate, to only a specific portion of a trust. (Reg §1.671-3(a)) If a grantor or other person is considered to be the owner of the entire trust, he or she computes personal income tax by taking into account all trust income, deductions and credits, as though the trust didn't exist. (Reg §1.671-3(a)(1)) But, where a grantor is treated as owner solely because of his or her interest in trust income, the grantor takes into account only his or her share of trust items that would be reported by a current income beneficiary. (Reg §1.671-3(c))

For purposes of taxing the grantor as the owner of a trust, the grantor is treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of the power or the interest, or who became the spouse of the grantor after the creation, but only for periods after the individual became the spouse. (Code Sec. 672(e)(1))

1. Power to Revoke

If the grantor of a trust reserves the power to take back title to the trust funds, he or she is considered the owner of the trust, whether or not the power is actually exercised. (Code Sec. 671, Code Sec. 676) The power to get back the trust funds may be a power to revoke, terminate, alter or amend, or to appoint. (Reg §1.676(a)-1)

The grantor is taxed if he or she can exercise the power alone, if it can be exercised only by another who is regarded as a nonadverse party, or if it can be exercised by both the grantor and a nonadverse party together. (Code Sec. 676(a)) The grantor is not taxed if the power can be exercised only by or with consent of an adverse party. (Code Sec. 672(a), Code Sec. 676(a); Reg §1.676(a)-1)

An "adverse party" is any person with a substantial beneficial interest in the trust (including a general power of appointment over trust property) which would be adversely affected by the exercise or nonexercise of his or her power with regards to the trust. (Code Sec. 672(a)) A beneficiary is ordinarily an adverse party. (Reg §1.672(a)-1(b)) A "nonadverse party" has either no beneficial interest, or one that is not substantial, or one which would not be adversely affected by the exercise of his or her power with regard to the trust. (Code Sec. 672(b); Reg §1.672(b)-1)

2. Income for Grantor, Spouse or Dependent

The grantor of a trust is treated as its owner and taxed on its income, if the trust income is:

- distributed actually or constructively to the grantor or his or her spouse;
- held or accumulated for future distribution to the grantor or his or her spouse; or
- applied to pay premiums on life insurance policies taken out on the life of the grantor or his or her spouse (and not irrevocably payable to charities). (Code Sec. 677(a))

The income isn't taxable to the grantor if the application of the income to any of these purposes requires the approval of an adverse party. (Reg §1.677(a)-1(b))

If trust income is actually used to support a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support, such as a minor child of the grantor, the grantor is taxable on that income. But the mere fact that trust income may be so used doesn't make the grantor taxable, unless the use is discretionary with the grantor as an individual (not trustee). (Reg §1.677(b)-1(d), Reg §1.677(b)-1(e), Reg §1.677(b)-1(f))

3. Reversionary Interests

The grantor of a trust is generally taxable as the owner on its income if he or she has a reversionary interest in the corpus or income and, as of the inception of the trust, the value of that interest is more than 5% of the value of the trust. (Code Sec. 673(a)) The value of the reversionary interest must be determined by assuming the maximum exercise of discretion in favor of the grantor. (Code Sec. 673(c)) But the possibility that an interest may return to the grantor solely by intestacy is disregarded in determining whether there's a more than 5% interest.

Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest is treated as a new transfer in trust starting with the date the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period isn't included in income of the grantor by reason of this rule if it wouldn't be includible in the absence of the postponement. (Code Sec. 673(d))

The grantor isn't treated as the owner where the reversionary interest takes effect only upon the death of a beneficiary before the beneficiary reaches age 21, if the beneficiary: (1) is a lineal descendant of the grantor, and (2) holds all present interests in the trust. (Code Sec. 673(b))

Review Question 5

A trust will be a grantor trust if the grantor or the grantor's spouse holds a reversionary interest in trust corpus or income worth more than __________% of the value of the trust.

a. 10. b. 5.

4. Power to Control Beneficial Enjoyment

Trust income is generally taxable to the grantor as the owner of the trust property if the beneficial enjoyment of trust corpus or income is subject to a power of disposition that may be exercised by him or her personally, or by a nonadverse party, or both, and requires no consent or approval of an adverse party. (Code Sec. 674)

Similarly, the grantor will be taxed if he or she retains certain administrative powers, such as borrowing powers and powers to deal with the trust for less than full consideration. (Code Sec. 675) But certain relatively broad powers to shift benefits may be given to "independent" trustees without causing the grantor to be taxed on the income as owner. These so called "sprinkling" and "spray" powers permit the trustee to distribute, apportion or accumulate income, or to pay out corpus to or among beneficiaries (Code Sec. 674(c)), but not to add beneficiaries except to include after-born or after-adopted children. These powers vested solely in trustees won't cause the grantor to be taxed as the owner of the trust if the grantor isn't eligible as a trustee or co-trustee and no more than half the trustees vested with the power are related or subordinate parties subservient to the wishes of the grantor. (Code Sec. 674(c), Code Sec. 674(d); Reg §1.674(d)-2(b))

Also, a power to distribute, apportion or accumulate income won't subject the grantor to tax if the grantor and his or her spouse are ineligible to exercise the power as trustee or co-trustee and the power is limited by a reasonably definite external standard set forth in the trust instrument, such as needs for education, sickness, support in an accustomed manner, etc. (Code Sec. 674(d); Reg §1.674(d)-1)

5. Other Persons as Trust Owner

A trustee, beneficiary, or some other person may be taxable on the trust income as the owner, if that person:

- has a power exercisable solely by that person to vest the corpus, or income from it, in himself or herself; or
- has previously modified or released such a power and afterward retains sufficient control which would make the grantor taxable under the rules discussed above (Code Sec. 678)

IRS says a beneficiary of a "Crummey" power (noncumulative right to withdraw a specified amount of property transferred to a trust within a specified period) will be treated as the owner under the above rule.

F. Charitable Remainder Trusts

Charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs) are two methods approved by the tax law for creating a split-interest trust with the income going to a noncharitable beneficiary and the remainder to charity. (Code Sec. 664, Code Sec. 170(f)(2)) Contributions to CRATs and CRUTs are deductible to the extent allocable to the charitable beneficiary.

A trust that qualifies as either CRAT or a CRUT is tax-exempt as to any undistributed income for each of its taxable years (except years in which it has "unrelated business taxable income (UBTI); see II.C. (Code Sec. 664(c); Reg §1.664-1(c))

1. Qualification Requirements for CRATs

For tax purposes, a CRAT must provide that one or more noncharitable income beneficiaries are to receive a fixed sum amounting to not less than 5% of the initial principal—at least annually—for a term of not more than 20 years or for the life or lives of the beneficiaries. (Code Sec. 664(d)(1)(A)).

However, a trust does not qualify as a CRAT if the annuity amount for a year is greater than 50% of the initial fair market value of the trust's assets. (Code Sec. 664(d)(1)(A)) Nor does a trust qualify as a CRAT unless the value of the charitable remainder with respect to any transfer to the trust is at least 10% of the initial net fair market value of all property transferred to the trust. (Code Sec. 664(d)(1)(D))

The sum certain to be paid each year as the annuity amount must be 15% or less of the initial net fair market value of the property irrevocably passing in trust. (Reg §1.664-2(a)(1)(i)(b))

2. Qualification Requirements for CRUTs

A CRUT is one which provides that a fixed percentage (FP) of not less than 5% of the net fair market value of the total fund, valued annually, is to be paid at least annually to one or more noncharitable income beneficiaries for a term of not more than 20 years or for the life or lives of the income beneficiaries.

A trust cannot be a CRUT if the required payout is greater than 50% of the annual value of the trusts assets. Nor does a trust qualify as a CRUT unless the value of the charitable remainder with respect to each transfer to the trust is at least 10% of the net fair market value of the property transferred to the trust. (Code Sec. 664(d)(2)(D))

A CRUT may provide that if the trust income is less than the required FP of net fair market value, only the trust income for the year must be paid over. No invasions of corpus are required to make good an income deficiency. (Code Sec. 664(d)(3)(A); Reg §1.664-3(a)(1)(i)(b)(1)) The trust may also provide that if less than the FP is paid because of an income deficiency, the deficit must be made good in later years if income exceeds the required amount. (Code Sec. 664(d)(3)(B); Reg §1.664-3(a)(1)(i)(b)(2))

3. Taxation of Income Beneficiaries

Distributions from charitable remainder trusts (CRTs) to income beneficiaries are not treated under the normal trust rules. There is a four-tier ordering rule for characterizing distributions from CRTs to income beneficiaries which is as follows:

- *First,* as ordinary income up to the trust's ordinary income for the year and any undistributed ordinary income for prior years. (Reg §1.664-1(d)(1)(i)(a))
- *Second,* as capital gain to the extent of the trust's capital gain for the year and undistributed capital gain for prior years. (Code Sec. 664(b)(2); Reg §1.664-1(d)(1)(i)(b))
- *Third,* as other income, including tax-exempt income, to the extent of the trust's other income for the year and undistributed other income for prior years. (Code Sec. 664(b)(3); Reg §1.664-1(d)(1)(i)(c))
- *Fourth,* as nontaxable distributions of trust corpus. (Code Sec. 664(b)(4))

Within the first two categories (i.e., ordinary income and capital gain), items are assigned to different classes to reflect tax rate differences (e.g., qualified dividends and different capital gain classes). (Reg §1.664-1(d)(1)(i)(b))

G. Terminations of Trusts and Estates

When a trust terminates, it ends as a separate tax entity and no longer reports gross income or claims the deductions, credits, etc. (Reg §1.641(b)-3(d)) Though the duration of a trust may depend on the occurrence of a particular event under the trust instrument, e.g., the life beneficiary reaching a specified age, for tax purposes, the trust will nevertheless continue for a reasonable period beyond this time to allow for the orderly completion of administration. (Reg §1.641(b)-3(b))

An estate's status as a separate taxpayer exists only during the period of administration and settlement of the estate. (Code Sec. 641(a)(3)) This period starts with the deceased's death and generally extends for the entire time actually required to perform the ordinary duties of administration, such as collecting assets and paying legacies and debts. If estate administration is unduly prolonged, IRS considers the estate terminated for tax purposes after expiration of a reasonable period (considering the estate's assets) for performance by the executor of all the duties of administration. (Reg §1.641(b)-3(a))

Beneficiaries who succeed to property of a trust or estate on its termination can deduct as a miscellaneous itemized deduction the unused deductions in excess of gross income for the last tax year of the trust or estate, other than the personal exemption and charitable contributions. The deduction by the beneficiary is allowed only for his or her tax year in which the trust or estate terminates. (Code Sec. 642(h); Reg §1.642(h)-2(a))

H. Estimated Tax Of Trusts and Estates

All trusts and certain estates must make estimated income tax payments under rules similar to those that apply to individuals, with certain adjustments (see Module 1, Taxation of Individuals). (Code Sec. 6654(l)(1)) Trusts and estates generally have 45 days to compute their estimated tax payments under the annualization rules. (Code Sec. 6654(l)(4))

Estates and grantor trusts that receive the residue of a probate estate are exempt from making estimated tax payments for their first two tax years after the date of decedent's death. (Code Sec. 6654(l)(2))

A trust or estate with a short tax year must pay estimated tax installments on or before the 15th day of the 4th, 6th and 9th month of such tax year, and the 15th day of the first month of the following year. For a short tax year in which the trust or estate terminates, installments due before the last day of the short year must be paid, and a final installment must be paid by the 15th day of the first month following the month the short year ends.

A trustee may elect to treat any part of the trust's estimated tax payments as paid by a beneficiary. Any amount so treated is considered paid or credited to the beneficiary on the last day of the trust's tax year and is considered an estimated tax payment made by the beneficiary on January 15, following the trust's tax year. (Code Sec. 643(g)(1))

This election is available to an estate if a tax year is reasonably expected to be its last tax year. (Code Sec. 643(g)(3))

The election must be made on or before the *65th day* after the end of the tax year. (Code Sec. 643(g)(2))

I. Income Taxation of Decedents

The last tax year of a decedent ends with the day of his or her death. (Reg §1.451-1(b))

For a *cash basis* decedent, the final return includes only the income received, actually or constructively, up to the end of the day of death (Code Sec. 691(a); Reg §1.451-1(b)(1), Reg §1.691(a)-1(b)), and expenses are generally deductible only to the extent paid before death (an exception applies to certain medical expenses paid within one year after death).

For an *accrual basis* decedent, income and deductions are computed on the accrual method. But an amount of income or deduction accrued solely by reason of death isn't includible on the final return. (Code Sec. 451(b), Code Sec. 461(b))

A decedent's unrecovered investment in an annuity contract is an itemized deduction (not subject to the 2%-of-AGI floor) (Code Sec. 67(b)(10)) for the decedent's last tax year, if the annuity payments cease by reason of his or her death. (Code Sec. 72(b)(3)(A))

Review Question 6

If annuity payments cease as a result of the annuitant's death, the decedent's unrecovered investment in the annuity contract is:

a. Not taken into account for tax purposes.

b. An itemized deduction for the decedent's last tax year that is not subject to the 2%-of-AGI floor.

c. An itemized deduction for the decedent's last tax year that is subject to the 2%-of-AGI floor.

d. An itemized deduction of the decedent's estate.

1. Income in Respect of a Decedent (IRD)

Income in respect of a decedent (IRD) covers income (including capital gain) which a decedent had a right to receive but that: (1) wasn't actually or constructively received by a cash basis decedent, or (2) wasn't accrued by an accrual basis decedent. IRD includes insurance renewal commissions, a monthly pension paid to deceased employee's widow or widower, taxable distributions from a qualified employee plan or IRA, partnership income of a deceased partner (Reg §1.742-1) and S corporation income of a deceased shareholder. (Code Sec. 1374(b)(4))

A decedent's income in respect of a decedent not includible on his or her last return must be reported, for the tax year when received, by:

- the decedent's estate, if it acquired the right to receive the item of income from the decedent;
- the person who, by reason of the decedent's death, acquires the right to the income whenever this right isn't acquired by the decedent's estate from the decedent; or
- the person who acquires the right from the decedent by bequest, devise or inheritance, if the amount is received after distribution by the decedent's estate of the right to the income. (Code Sec. 691(a)(1))

The character of income in respect of a decedent is the same as it would have been in the hands of the decedent, if he or she had lived and received the income. (Code Sec. 691(a)(3); Reg §1.691(a)-3(a))

2. Deductions Connected with IRD

Deductions for a decedent's Code Sec. 162 business expenses, Code Sec. 212 expenses for the production of income, interest, taxes, depletion and the credit for foreign taxes are available to the decedent's estate if the estate is liable for the obligation giving rise to the deduction or credit and it isn't allowable in the decedent's final (or any previous) return. If not available to the estate, the deduction or credit may be taken by the person who acquires an interest in the decedent's property from the decedent by reason of the decedent's death, or by bequest, devise or inheritance, subject to the obligation to which the deduction or credit relates. (Code Sec. 691(b))

Deduction for estate tax. The decedent's right to income in respect of a decedent is frequently included in his or her gross estate for federal estate and generation-skipping tax purposes although it's taxed as income to the recipient. As a relief provision, the recipient of the income can deduct the estate and generation-skipping tax attributable to inclusion of the right to income in the gross estate. (Code Sec. 691(c)(1); Reg §1.691(c)-1(a)) This relief is available to an individual only if he or she itemizes deductions but the deduction isn't subject to the 2%-of-AGI floor. (Code Sec. 67(b)(8))

Annuity payments received by the surviving annuitant of a joint and survivor annuity are income in respect of a decedent of the deceased annuitant to the extent that the payments are includible in gross income of the survivor. The portion of the estate tax attributable to the survivor's annuity is allowable as a deduction to the survivor over his or her life expectancy (determined under IRS tables). (Code Sec. 691(d); Reg §1.691(d)-1(c))

II. Exempt Organizations

Learning Objectives

After completing this section, you should be able to:

- Determine which organizations qualify for tax exemption under Code Sec. 501(a) and recognize the restrictions that apply to private foundations.

An exemption from income taxes is allowed to certain organizations that may generally be described as nonprofit organizations. (Code Sec. 501(a)). The exemption applies to the types of organizations described in Code Sec. 501(c) and Code Sec. 501(d) and to employee pension, profit-sharing and stock bonus plans qualified under Code Sec. 401(a) (see V.A.).

Determination letters or rulings may be issued to organizations claiming exemption under Code Sec. 501 in advance of operations under certain conditions. However, where the IRS considers it warranted, a record of actual operations may be required before a determination is issued. An exemption, once granted, continues in force, unless revoked because of changes in the organization's character or operation or substantive changes in the law, or for other good cause, such as a misstatement on the exemption application.

Organizations claiming to be tax-exempt charities must also notify IRS to that effect. (Code Sec. 508(a)) Most exempt charities are deemed "private foundations" unless they notify IRS that they claim to be "public charities." (Code Sec. 508(b))

In general, every organization that's exempt from tax, or whose exemption application is pending, must file an annual information return (Form 990 series) and keep the records and make sworn statements as required by IRS. (Code Sec. 6033; Reg §1.6033-2) For tax years beginning on or after Jan. 1, 2010, IRS allows an exempt organization (other than a private foundation or Code Sec. 509(a)(3) supporting organization) whose annual gross receipts aren't normally in excess of $50,000 to electronically file the simpler Form 990-N (the e-Postcard) instead of Form 990. There is no monetary penalty for failure to file Form 990-N. (Code Sec. 6652(c)(1)(E))

The filing requirement does not apply to an organization, other than a private foundation, whose gross receipts in each tax year are normally not more than $25,000. However, organizations exempted under this rule must file annual notices with IRS effective for notices and returns for annual periods beginning after 2006. (Code Sec. 6033(i))

For returns and notices for annual periods beginning after 2006, an exempt organization's failure to file the required information return or notice for three consecutive years will result in the revocation of its exempt status. (Code Sec. 6033(j))

A. Qualifying Organizations

An organization that fulfills the requirements of any one of the subdivisions of Code Sec. 501(c), or of Code Sec. 501(d), is generally exempt. The particular category under which a given organization seeks exemption usually depends on the nature of the organization and on its purposes. It should also be noted that deductibility of contributions to an organization depends, in part, on the organization's purposes and certain other qualifications.

An organization that fails to meet all the requirements of a given category may sometimes fit into another, somewhat similar, category. For instance, a charitable organization that engages in forbidden legislative activity may sometimes qualify for exemption as a social welfare organization.

The categories of exempt organizations include:

- U.S. corporate instrumentalities organized under an Act of Congress (Code Sec. 501(c)(1));
- corporations exclusively holding title to property, and collecting and remitting the income from it (less expenses) to an exempt organization (Code Sec. 501(c)(2));
- religious, charitable, scientific, literary and educational organizations, organizations testing for public safety, organizations that foster national or international amateur sports competition, those organized and operated for preventing cruelty to children or animals, (Code Sec. 501(c)(3)), qualified charitable risk pools, (Code Sec. 501(n)) cooperative hospitals (Code Sec. 501(e)) and educational organizations (Code Sec. 501(f));
- religious and apostolic organizations;
- nonprofit civic organizations operated exclusively for social welfare, and local employees' associations whose net earnings are used solely for charitable, educational or recreational purposes (Code Sec. 501(c)(4));
- labor, agricultural or horticultural organizations (Code Sec. 501(c)(5), Code Sec. 501(g));
- chambers of commerce, business leagues, real estate boards, boards of trade or professional football leagues not organized for profit or private benefit (Code Sec. 501(c)(6));
- social clubs organized for pleasure, recreation and other nonprofitable purposes (Code Sec. 501(c)(7));

- fraternal beneficiary societies, orders or associations operating under the lodge system and providing life, sick, accident or other benefits to members and their dependents (Code Sec. 501(c)(8));
- domestic fraternal societies operating under the lodge system that don't provide payment of benefits, if their net earnings are devoted exclusively to religious, charitable, etc., and fraternal purposes (Code Sec. 501(c)(10));
- voluntary employees' beneficiary associations (VEBAs) providing benefit payments to members and their dependents, if no part of the VEBA's earnings (other than benefit payments) goes to benefit a private shareholder or individual (Code Sec. 501(c)(9));
- local teachers' retirement fund associations (Code Sec. 501(c)(11));
- local benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies or like organizations, 85% or more of whose income is collected from members solely to meet losses and expenses (Code Sec. 501(c)(12));
- nonprofit cemetery companies and burial corporations (Code Sec. 501(c)(13));
- credit unions without capital stock that are organized and operated for mutual purposes without profit, and certain corporations or associations without capital stock organized before September 1, 1957 to provide reserve funds and insure shares or deposits in building and loan associations, cooperative banks or mutual savings banks (Code Sec. 501(c)(14));
- nonlife insurance companies or associations whose net written premiums (or direct written premiums, if greater) for the tax year don't exceed $350,000 (Code Sec. 501(c)(15));
- farmers' cooperatives that are crop financing corporations (Code Sec. 501(c)(16));
- supplemental unemployment benefit plans (SUBs) (Code Sec. 501(c)(17));
- certain domestic veterans' organizations, if no part of net earnings benefits any private shareholder or individual. The membership base must consist of (1) at least 75% of past or present members of the U.S. Armed Forces and (2) "substantially all of the remaining members" must be cadets or spouses, widows, ancestors, or lineal descendants of past or present members of the U.S. Armed Forces or cadets so that at least 97.5% of the total organization's members consist of members in categories (1) and (2) (Code Sec. 501(c)(19));
- any association organized before 1880, if more than 75% of its members are present or past members of the U.S. armed forces, and its principal purpose is to provide insurance and other benefits to veterans or their dependents (Code Sec. 501(c)(23));
- trusts established by the Pension Benefit Guaranty Corporation (PBGC) in connection with a terminated plan (Code Sec. 501(c)(24));
- pooled real estate investment funds of exempt organizations, i.e., corporations or trusts with no more than 35 (exempt) shareholders or beneficiaries and one class of stock or beneficial interest, organized exclusively for acquiring, holding title to, and collecting income from, real property, and remitting that income (less expenses) to those shareholders, etc. (Code Sec. 501(c)(25));
- certain trusts created before June 25, 1959, to pay benefits under a pension plan funded only by employee contributions (Code Sec. 501(c)(18));
- black lung benefit trusts (Code Sec. 501(c)(21));
- state sponsored workmen's compensation reinsurance organizations established before June 1, 1996 (Code Sec. 501(c)(27)(A));
- organizations (including mutual insurance companies) providing worker's compensation and related coverage (Code Sec. 501(c)(27)(B));
- state sponsored high-risk health coverage organizations (Code Sec. 501(c)(26)); and
- qualified state tuition programs. (Code Sec. 529)

An organization operated for the primary purpose of carrying on a business for profit (not just holding title to property) is taxable on all its income, even if all its profits are payable to exempt organizations. (Code Sec. 502(a); Reg §1.502-1(a)) But this type of "feeder" organization is exempt if it's controlled by and furnishes its services solely to: a single exempt organization, an exempt parent organization and its exempt subs, or exempt subs having a common parent. (Reg §1.502-1(b))

"Businesses" that make a feeder organization taxable don't include:

- any business (1) in which substantially all the work is performed for the organization without compensation, or (2) that is the selling of merchandise substantially all of which has been received by the organization as gifts or contributions; or
- deriving rents that wouldn't be unrelated business income.

1. Religious, Charitable and Educational and Similar Organizations

A corporation, community chest, fund, foundation, or other organization is exempt if:

- it's both organized and operated exclusively for: religious, charitable, scientific, literary or educational (including certain child care) purposes; public safety testing; prevention of cruelty to children or animals; or fostering national or international amateur sports competition (even if it has local or regional membership); (Code Sec. 501(c)(3); Reg §1.501(c)(3)-1(a))
- no part of its net earnings inures to benefit of any private shareholder or individual; and
- no substantial part of its activities consists of carrying on propaganda or otherwise attempting to influence legislation, i.e., lobbying or intervening in any political campaign for or against any candidate.

These organizations are often referred to as "501(c)(3)" organizations.

Review Question 7

What percentage of an organization's net earnings may inure to a private individual or shareholder without causing the organization to fail to qualify as an exempt 501(c)(3) organization?

a. 10%. b. 0%.

Political and lobbying expenditures. A 501(c)(3) organization is subject to a two-tier excise tax on its *political expenditures*. An initial tax of 10% of the expenditure is imposed on the organization, and an initial 2 ½% tax (up to $5,000 per expenditure) is imposed on any organization manager who willfully and without reasonable cause agreed to the expenditure. (Code Sec. 4955(a), Code Sec. 4955(c)(2); Reg §53.4955-1(b)) Additional taxes are imposed on both the organization (100%) and management (50%, up to $10,000 per expenditure) if the expenditure isn't corrected within a reasonable time. (Code Sec. 4955(b), Code Sec. 4955(c)(2)

A 501(c)(3) organization (other than an organization making the lobbying expense election below, a private foundation or a church-related organization) whose *lobbying expenditures* for a tax year cause it to lose its tax exemption is subject to a 5% tax on those disqualifying amounts. The 5% tax also is imposed on any organization manager who agreed to the expenditure knowing that disqualification could result. (Code Sec. 4912) IRS may also seek to enjoin a Code Sec. 501(c)(3) organization from engaging in flagrant political activities. (Code Sec. 7409(a); Reg §301.7409-1(a))

Lobbying expense election. A 501(c)(3) organization (other than a church-related organization or private foundation) may elect to make limited lobbying expenditures without losing its exempt status. (Code Sec. 501(h)) The election is effective for all tax years that end after it's made, and that begin before it's revoked. (Code Sec. 501(h)(6))

An electing organization's permissible lobbying expenditures for any tax year can't exceed ("general limit") the *lesser of:* (1) $1,000,000, or (2) the sum of 20% of the first $500,000 it paid or incurred for exempt purposes (including related administrative costs) for the year, plus 15% of the second $500,000, plus 10% of the third $500,000, plus 5% of any additional such expenditures. (Code Sec. 4911(c)(2); Reg §56.4911-1(c)(1)) Also, only 25% of this lobbying amount may go to influencing legislation ("grass roots expenditures"). (Code Sec. 4911(c)(4); Reg §56.4911-1(c)(2)) Organizations must keep records of these expenditures (and show them on their annual returns). (Reg §56.4911-6)

In any tax year an electing organization's lobbying expenditures exceed either the general or the grass roots limit, a 25% excise tax is imposed on that excess. If both limits are exceeded, the tax is imposed on the greater excess. (Code Sec. 4911(a), Code Sec. 4911(b)) Also, an electing organization can lose its tax exemption if its lobbying expenditures over a four-year period exceed 150% of either limit. (Code Sec. 501(h)(1), Code Sec. 501(h)(2))

Religious and apostolic organizations. Even if an organization carries on business activities so that it can't be exempt under Code Sec. 501(c)(3) (as exclusively for exempt purposes), it still can be exempt as a religious or apostolic association. The organization may thus be exempt if it has a common or community treasury, and if its income (whether or not distributed) is taxed pro rata to its members, as a dividend received, for the organization's tax year ending with or within the member's tax year. (Code Sec. 501(d); Reg §1.501(d)-1)

Excess benefit transactions. Penalty excise taxes are imposed on disqualified persons and organization managers who benefit from an excess benefit transaction with a 501(c)(3) organization (other than a private foundation), or an organization that was a 501(c)(3) organization at any time within five years before the transaction. (Code Sec. 4958(a); Reg §53.4958-1) An excess benefit transaction is one in which the exempt organization provides a benefit directly or indirectly to or for the use of a disqualified person (any person in a position to exercise substantial influence over the organization at any time during the five years before the transaction (Code Sec. 4958(f); Reg §53.4958-4), or certain related parties, that exceeds the value of the consideration, including services, received in exchange. (Code Sec. 4958(c))

The disqualified person is liable for a tax of 25% of the excess benefit (200% if the transaction is not corrected by the time a deficiency notice is mailed or the tax is assessed). (Code Sec. 4958(a); Reg §53.4958-1) An organization manager (officer, director, trustee, etc.) who knowingly participates in an excess benefit transaction is liable for a tax of the lesser of (1) $20,000 or (2) 10% of the excess benefit. (Code Sec. 4958(b)) IRS may abate the first-tier taxes for reasonable cause. (Code Sec. 4962(b))

2. Civic Leagues for Social Welfare

A civic league is exempt if:

- it isn't organized or operated for profit;
- it is operated exclusively for the promotion of social welfare;
- no part of its net earnings inures to the benefit of any private shareholder or individual; (Code Sec. 501(c)(4)) and
- no substantial part of its activities consists of providing commercial-type insurance. (Code Sec. 501(m)(1))

These organizations are also subject to the penalty tax on excess benefit transactions (see above).

3. Social Clubs

For a social club to be exempt, it must be organized and operated substantially for pleasure, recreation or other nonprofit purposes; its governing instruments or written policies can't provide for discrimination based on color, race or religion; and no part of its earnings may benefit any private shareholder. (Code Sec. 501(c)(7))

Up to 35% of a social club's gross receipts (including investment income) may be from sources outside of its membership. Within this 35%, not more than 15% of gross receipts may be from the general public's (i.e., not members or their guests) use of the club's facilities or services.

If the club fails the 35% or 15% tests (and a "facts and circumstances" test) in any tax year, all of its income, even amounts (reduced by allocable costs) received from members, is subject to tax in that year. (Code Sec. 277)

4. Political Organizations

A political organization is a party, committee, association, fund (including certain newsletter funds) or other organization (whether or not incorporated) that's organized and operated primarily to accept contributions and/or make expenditures for an "exempt function," e.g., influencing or attempting to influence the selection, nomination, election or appointment of any individual to public office. (Code Sec. 527(e)(1), Code Sec. 527(e)(2), Code Sec. 527(g))

Subject to exceptions, political organizations must:

- give notice of status electronically,
- provide periodic reports of contributions and expenditures, and
- file annual returns.

Although generally tax-exempt (Code Sec. 527(a)), a political organization is taxed, at the highest corporate rate, on income (minus connected expenses) that isn't from its exempt function. (Code Sec. 527(b)(1), Code Sec. 527(c))

B. Disclosure Requirements

Certain exempt organizations are subject to special disclosure requirements.

- Organizations that aren't eligible to receive deductible contributions must expressly state that fact (in a conspicuous and easily recognizable format) in every fund-raising solicitation. (Code Sec. 6113)
- Organizations that are eligible to receive deductible contributions must, in connection with soliciting or receiving a "quid pro quo" contribution in excess of $75, inform the donor in writing that his or her charitable deduction is limited to the excess of the contribution over the value of the goods or services provided by the charity (with a good faith estimate, made by using any reasonable method, of the value of those goods and services). (Code Sec. 6115; Reg §1.6115-1)

  A Code Sec. 501(c) or Code Sec. 501(d) organization must make a copy of its annual returns for the last three years and its exempt status application and supporting documents available for inspection during business hours. (Code Sec. 6104(a), Code Sec. 6104(b), Code Sec. 6104(d); Reg §301.6104(d)-3) The organization must provide a copy of the application without charge, except for reasonable reproduction and mailing costs, to any individual who requests it. Copies must be provided within 30 days, for written requests, or immediately for in-person requests. (Code Sec. 6104(d)(1); Reg §301.6104(d)-3) Requests don't have to be honored if the information has been made widely available or if the request is determined by the IRS to be part of a harassment campaign. (Code Sec. 6104(d)(4); Reg §301.6104(d)-2, Reg §301.6104(d)-3) These requirements apply to annual information returns of private foundations (see below). (Reg §301.6104(d)-1(b)(4)(ii)) Prior to the Pension Protection Act of 2006 (P.L.109-280) the disclosure requirements for annual returns did not include Form 990-T, *Exempt Organization Business Income Tax Return,* the form used to report unrelated business income (see below). The Pension Protection Act generally provides for the disclosure of Form 990-T in the case of returns filed after August 17, 2006. Schedules, attachments, and supporting documents filed with Form 990-T, that don't relate to the imposition of unrelated business income tax don't have to be made available for public inspection and copying. (Notice 2008-49, 2008-20 IRB 979)

C. Tax on Unrelated Business Income

Many, but not all, exempt organizations are taxed under Code Sec. 511 on net income from any unrelated trade or business. Those subject to the tax include: churches, civic leagues, social clubs, fraternal benefit societies, employees' beneficiary associations, benevolent life insurance companies, mutual irrigation companies, mutual telephone companies, credit unions, cemetery companies, farmers' cooperatives financing crop operations, and certain small mutual insurance companies. Being taxable on unrelated business income doesn't mean an organization is or is not exempt from regular income tax. That is determined by its overall activities.

Exempt organizations (other than trusts) are taxed at corporate tax rates on their unrelated business taxable income. (Code Sec. 511(a)) The unrelated business taxable income of charitable trusts is taxed at the tax rates for trusts (Code Sec. 511(b))

1. Unrelated Business

An "unrelated business" is a trade or business (i.e., an activity carried on for the production of income, whether or not profit results) "regularly carried on" by the organization, that isn't "substantially related" to the exercise or performance of its exempt purpose or function. (Code Sec. 513(a), Code Sec. 513(c); Reg §1.513-1)

To determine whether business is "regularly carried on," the frequency and continuity with which the activities productive of income are conducted and manner in which they are pursued must be taken into account. Specific business activities will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable activities of nonexempt organizations.

Substantially related. For an activity to be "substantially related" to an exempt purpose, it must contribute importantly to the accomplishment of the exempt purpose. If the activity does contribute importantly, profits it produces remain tax-free. If it doesn't contribute importantly to the exempt purpose (except to raise funds), its profits are unrelated business taxable income. In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function they purport to serve. (Reg §1.513-1(d))

Ordinarily, income from the sale of a product that results from performance of exempt functions doesn't constitute income from conduct of unrelated business, if the product is sold in substantially the same state it's in on completion of the exempt functions. However, if a product resulting from an exempt function is utilized or exploited in further business endeavors beyond that reasonably appropriate or necessary for exempt functions, the income derived is from the conduct of an unrelated business. (Reg §1.513-(d)(4)(ii))

When activities carried on by an organization in the performance of exempt functions may generate goodwill or other intangibles that are capable of being exploited in commercial endeavors, the mere fact that resultant income depends in part on an exempt function of the organization doesn't make it income from a related trade or business. Unless commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is income from conduct of an unrelated business. (Reg §1.513-1(d)(4)(iv))

Corporate sponsorships. IRS regulations describe when a sponsor's payment is unrelated business income because advertising services are performed by the exempt organization. It defines advertising in a way that draws a distinction between advertising and an acknowledgement, which just recognizes a sponsor. (Reg §1.513-4(b), (c)). The difference between the two is generally determined by the nature of the service the exempt organization provides the sponsor

The regulations define advertising to include any activity undertaken in exchange for remuneration that promotes or markets any company, service, facility, or product. (Reg §1.513-4(c)(2)(v)) Acknowledgments may identify but not promote the sponsor.

Hospital services. A hospital isn't engaged in an unrelated business simply because it provides services to other hospitals if those services could have been provided, on a tax-free basis, by a cooperative organization consisting of several tax-exempt hospitals. The exclusion from the unrelated business tax applies only when the services are provided to other tax-exempt hospitals, each one with facilities to serve not more than 100 inpatients and the services would be consistent with the recipient hospital's exempt purpose. The services must be provided at a fee or charge that doesn't exceed their actual cost. The cost can include straight-line depreciation and a reasonable amount for return on capital goods used to provide the services. (Code Sec. 513(e); Reg §1.513-6)

Distribution of low cost items. The term "unrelated trade or business" of a tax-exempt organization doesn't include activities relating to the distribution of low cost items incidental to soliciting contributions. (Code Sec. 513(h)) An article is considered low cost if all items distributed to a single taxpayer cost, in the aggregate, not more than a specified amount (adjusted annually for inflation). The inflation adjusted amount for 2012 is $9.90.

Bingo games. Tax-exempts and political organizations aren't subject to the unrelated business income tax on the proceeds of bingo games when state or local law permits the games to be carried on by nonprofit organizations and these organizations don't compete with taxable entities. This also applies to bingo games regularly carried on with paid workers. But, bingo games must not be an activity ordinarily carried out on a commercial basis in the state in which the organization operates and the conduct of the games must not violate state or local law. (Code Sec. 513(f); Reg §1.513-5)

A bingo game is an unrelated business if state or local law prohibits all forms of gambling activity, including bingo, regardless of the degree to which the law is enforced. (Reg §1.513-5(c)(3), example (2).) If conducting bingo games is a primary activity of an organization, the organization may not qualify for tax-exemption. However, the mere fact that an organization's principal source of funding is from bingo games and that its members devote substantial manhours to the operation of bingo games, won't jeopardize the organization's tax exemption. (Code Sec. 513(f))

Travel tour activities. Travel tour activities may constitute an unrelated business. Whether travel tour activities conducted by an organization are substantially related to the organization's exempt purpose is determined by looking at all relevant facts and circumstances, including, but not limited to, how a travel tour is developed, promoted and operated. (Reg §1.513-7(a)) IRS regulations do not enumerate any specific factors for determining whether travel and tour activities are related to exempt purposes. The regulations provide examples that apply the facts and circumstances test in determining whether travel tour activities conducted by an organization are substantially related to the organization's exempt purpose.

2. Unrelated Business Taxable Income

Unrelated business taxable income (UBTI) is the gross income derived from any unrelated trade or business, less directly connected allowable deductions, but with certain exceptions (below), additions and limitations (Code Sec. 512(a), Code Sec. 512(b)), including a specific deduction of $1,000. (Code Sec. 512(b)(12))

Dividends (except certain insurance income received from a controlled foreign corporation (Code Sec. 512(b)(17))), interest, rents, royalties, annuities, payments with respect to securities loans, loan commitment fees, and gains or losses from property dispositions are excluded from UBTI. Also excluded are gains or losses from the lapse or termination of options to buy or sell securities or real property, or from the forfeiture of good-faith deposits to buy, sell, or lease real property in connection with the organization's investment activities, (Code Sec. 512(b)) and annual dues of up to $148 for 2011 per member received by agricultural or horticultural organizations. (Code Sec. 512(d))

But to the extent the dividends, etc., are attributable to property acquired through debt financing, they are included in UBTI. The includible portion (computed separately for each property) equals a percentage (not over 100%) of the dividends, etc., derived from the property during the tax year, based on the ratio of: (1) the average acquisition indebtedness, to (2) the average adjusted basis of debt-financed property, for the year. (Code Sec. 514(a)(1)) This same percentage also is used to compute the allowable deductions for that property (other than capital loss carryovers or depreciation). (Code Sec. 514(a)(2), Code Sec. 514(a)(3))

Review Question 8

In determining the unrelated business taxable income (UBTI) of an exempt organization, a specific deduction of ___________ is allowed.

a. $1,000.   b. $1,250.

D. Private Foundations

Private foundations are generally exempt from income tax, but are subject to excise taxes, notification requirements and other restrictions.

A private foundation is any domestic or foreign religious, scientific, charitable, etc., organization described in Code Sec. 501(c)(3) other than organizations that:

- are "50% charities" (see Module 1, Taxation of Individuals), except operating foundations and membership organizations (Code Sec. 509(a)(1));
- meet detailed public support tests (Code Sec. 509(a)(2), Code Sec. 509(d));
- operate exclusively for the benefit of one or more of the above organizations, and aren't controlled by disqualified persons, other than foundation managers); (Code Sec. 509(a)(3))
- are organized and operated exclusively for testing for public safety. (Code Sec. 509(a)(4))

Organizations will be excluded from private foundation status if they meet the ⅓ support test under Code Sec. 509(a)(2)(A) and the "not more than ⅓ support" test under Code Sec. 509(a)(2)(B). These tests are designed to insure that an excluded organization is responsive to the general public, rather than to private interests. (Code Sec. 509(a)(2); Reg §1.509(a)-3(a)(1) and Reg §1.509(a)-3(a)(4))

Generally, an organization meets the ⅓ support test if it "normally" receives more than ⅓ of its support in each taxable year from any combination of:

- gifts, grants, contributions, or membership fees, and
- gross receipts from:
- admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity other than an unrelated trade or business,
- permitted sources (governmental units, most "50% charities" and persons who are not disqualified persons).

However, in computing the amount of support received from permitted sources, gross receipts from related activities received from any person or governmental bureau are limited in any taxable year to the greater of $5,000 or 1% of the organization's support in that taxable year.) (Reg §1.509(a)-3(a)(2), and Reg §1.509(a)-3(b))

An organization meets the "not more than ⅓ support" test if it normally receives no more than ⅓ of its support in each taxable year from the sum of gross investment income and the amount of unrelated business taxable income in excess of the UBTI tax. (Code Sec. 509(a)(2)(B). Reg §1.509(a)-3(a)(3))

The support tests are based on an organization's "normal" sources of support. Generally, an organization is considered as "normally" receiving ⅓ of its support from permitted sources (subject to the $5,000/1% limitation described above) and not more than ⅓ of its support from investment and unrelated business sources for its current taxable year and the next year if, for the four taxable years immediately preceding the current taxable year, the organization has met both support tests.

Different computation periods apply to new organizations and organizations with substantial and material changes in support (other than changes arising from unusual grants.

A 501(c)(3) organization (other than a church or an organization whose annual gross receipts don't exceed $5,000) is presumed to be a private foundation unless it notifies IRS to the contrary (Code Sec. 508(b), Code Sec. 508(c)) within 15 months from the end of the month it was organized. (Reg §1.508-1(b)(2))

Certain charitable trusts and split interest trusts, and foreign organizations meeting the private foundation definition may be subject to the private foundation excise taxes (see below), but not the notification requirements. (Code Sec. 4947, Code Sec. 4948)

1. Excise Taxes

Private foundations may be subject to a number of excise taxes.

Net investment income. An exempt private foundation is liable for an excise tax of 2% on its net investment income for the tax year. (Code Sec. 4940(a); Reg §53.4940-1) The tax is reduced to 1% if the foundation makes certain charitable distributions (Code Sec. 4940(e)) and is eliminated altogether for certain operating foundations. (Code Sec. 4940(d))

Self-dealing. An excise tax is imposed when a disqualified person (substantial contributors, foundation managers, and specified owners, family members and related entities of these, as well as government officials) (Code Sec. 4946(a)(1)) engages in any of these acts of self-dealing with a private foundation:

- selling, exchanging or leasing property;
- lending money or other extension of credit;
- furnishing goods, services or facilities;
- paying compensation (including compensatory indemnification, e.g., for penalties) or reimbursing expenses;
- transfer of the foundation's income or assets to or for the use of a disqualified person; or
- agreement by a foundation to pay any money or property to a government official. (Code Sec. 4941(d)(1); Reg §53.4941(d)-2(f))

For each act of self-dealing (Code Sec. 4941(a), Code Sec. 4941(b)); the disqualified person (except foundation managers) is subject to an initial tax of 10% on the amount (not exceeding the amount he or she actually benefits) involved (Code Sec. 4941(a)(1); Reg §53.4941(a)-1(a)) and a 200% additional tax if the self-dealing isn't timely corrected. (Code Sec. 4941(b)(1)) Any foundation manager who knowingly participates in the act is subject to an initial 5% tax (Code Sec. 4941(a)(2)) and, if he or she refuses to agree with all or part of the correction, an additional 50% tax. (Code Sec. 4941(b)(2)) Managers may be jointly and severally liable, but their maximum liability for any one act is $20,000 in initial tax and $20,000 in additional tax. (Code Sec. 4941(c))

Failure to distribute income. A foundation (other than an operating foundation) that fails to distribute its income for a tax year by the end of the next year is subject to an initial tax equal to 30% of the income (based on a minimum investment return) (Code Sec. 4942(a); Reg §53.4942(a)-1(a)), which IRS may abate for reasonable cause (Code Sec. 4962(a)) In addition, there is a 100% tax if the foundation fails to distribute the income by the date the initial tax is assessed or IRS issues a 90-day letter for it. (Code Sec. 4942(b))

Excess business holdings. A foundation that has any excess business holdings is subject to an initial tax (which IRS may abate for reasonable cause) equal to 10% of those excess holdings, based on their value on the day during the tax year when those holdings were the greatest. (Code Sec. 4943(a), Code Sec. 4962) If the foundation fails to timely correct its holdings, an additional 200% tax is imposed. (Code Sec. 4943(b))

Investments that jeopardize a foundation's charitable purpose. An excise tax is imposed if a foundation makes investments that jeopardize its charitable purpose. An initial tax of 10% of the amount invested is imposed on the foundation and on any foundation manager who knowingly participated in the investment. (Code Sec. 4944(a)) Additional taxes are imposed on the foundation (25%) if the investment is not timely removed from jeopardy (Code Sec. 4944(b)(1)) and on any manager (5%) who refuses to agree to removing the investment from jeopardy. (Code Sec. 4944(b)(2)). Foundation managers may be jointly and severally liable for these taxes, but the initial tax on management with respect to any one investment is limited to $10,000, and the additional tax to $20,000. (Code Sec. 4944(d))

Propaganda, legislative activities and other taxable expenditures. An excise tax is imposed for engaging in propaganda or legislative activities or for making other taxable expenditures. An initial tax equal to 10% of the amount of the taxable expenditure is imposed on the foundation, and a 2½% initial tax is imposed on any foundation manager who willfully agreed to the expenditure. (Code Sec. 4945(a)) An additional tax is imposed on the foundation (100%) if the expenditure isn't timely corrected, and on any foundation manager (50%) who refuses to agree to part or all of the correction. (Code Sec. 4945(b)) Foundation managers may be jointly and severally liable, but the maximum tax that may be imposed on them for any one taxable expenditure is $5,000 of initial tax and $10,000 of additional tax. (Code Sec. 4945(c)) These taxes don't apply if the political expenditures tax (see II.A.1.) applies. (Code Sec. 4955(e))

Prohibited tax shelter transactions. Generally effective for tax years ending after May 17, 2006, with respect to transactions entered into before, on, or after that date, excise taxes are imposed on (1) certain tax-exempt entities that are parties to "prohibited tax shelter transactions" (Code Sec. 4965(a)(1)) and (2) "entity managers" of tax-exempt entities who approve the entity as a party (or otherwise cause the entity to be a party) to a prohibited tax shelter transaction and know or have reason to know that the transaction is a prohibited tax shelter transaction. (Code Sec. 4965(a)(2))

The amount of tax depends on whether the entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time it became a party to the transaction:

If it did not know (and did not have reason to know), the tax is the highest rate of tax under Code Sec. 11 (currently 35%) multiplied by the greater of: (1) the entity's net income with respect to the prohibited tax shelter transaction (after taking into account any other applicable taxes with respect to such transaction) for the tax year or (2i) 75% of the proceeds received by the entity for the tax year that are attributable to such transaction. (Code Sec. 4965(b)(1)(A))

If the entity knew or had reason to know, the tax is the greater of (1) 100% of the entity's net income with respect to the transaction (after taking into account any other applicable taxes with respect to such transaction) for the tax year or (2) 75% of the proceeds received by the entity for the tax year that are attributable to such transaction. (Code Sec. 4965(b)(1)(B))

2. Termination

An organization's status as a private foundation will terminate if it:

- notifies IRS of its intent to terminate or
- is guilty of willful repeated acts or omissions, or of a willful and flagrant act or omission, resulting in liability for an excise tax and IRS notifies the organization that it's liable for a termination tax. (Code Sec. 507(a))

The organization must pay a tax on termination of its private foundation status. Unless abated by IRS, the tax equals the lesser of: (1) the aggregate tax benefit (as adequately substantiated by the foundation) resulting from its Code Sec. 501(c)(3) status, or (2) the value of its net assets. (Code Sec. 507(c), Code Sec. 507(g))

In certain cases, a private foundation may terminate without having to provide notice to the IRS or incurring a termination tax. If a private foundation transfers all of its net assets to one or more "50% charities," the foundation is exempt from the termination tax and notice requirement as long as the receiving organizations have been in existence for at least 60 months [Reg. 1.507-2(a)(1)].

If at least one receiving organization has not been a "50% charity" for 60 months, the private foundation must give notice to the IRS if it wishes to terminate. However, the foundation will owe no termination tax if it has no net assets (i.e., the assets have already been transferred to the receiving organizations) on the date it provides notice.

Review Question 9

Which of the following is correct regarding private foundations?

a. Private foundations are exempt from excise tax.

b. An organization must pay a tax on termination of its private foundation status.

c. An organization that is operated exclusively for public safety qualifies as a private foundation.

d. An exempt private foundation is required to pay excise tax of 2% on net investment income.

III. Taxation of Farming

Learning Objectives

After completing this section, you should be able to:

- Differentiate between the accounting methods available to farmers.
- Recognize the depreciation and income averaging rules that apply to farmers.

Farmers get tax benefits not generally available to other taxpayers. These include: three-year income averaging, a generally longer net operating loss (NOL) carryback period, favorable accounting and inventory methods, income deferrals, capital gain-ordinary loss treatment, and the deduction of items normally capitalized.

A farmer's gross income includes cash and the fair market value of goods received ("barter income") from crops, produce, poultry and livestock. (Reg §1.61-4(c)) The value of produce consumed by the farmer and his or her family aren't included, but expenses incurred in raising that produce can't be deducted.

Farmers may deduct the ordinary and necessary expenses of operating a farm for profit—e.g., rent, labor, feed, fertilizer. (Reg §1.162-12(a)). Where farming isn't engaged in for profit, see Module 2, *Taxation of Businesses*.

A. Accounting Methods

Farmers, unless otherwise prohibited, may use the cash method, the accrual method, the crop method, or a "hybrid" method combining any of these methods if it clearly reflects income (Reg §1.61-4, Reg §1.446-1(c), Reg §1.471-6(a))

While most taxpayers who produce, buy or sell merchandise must maintain inventories and use the accrual method, farmers may choose not to, except to the extent they are subject to the uniform capitalization rules (see III.B.7.). (Reg §1.471-6(a)) A farmer who does use inventories must use the accrual method at least for purchases and sales. However, the IRS has excepted the following from having to account for inventories or use an accrual method of accounting:

- any business with average annual gross receipts of $1 million or less; and
- taxpayers whose principal business activity is not mining, manufacturing, wholesale trade, retail trade, or information industries, for all of their trades or businesses, if average annual gross receipts are $10 million ($5 million for C corporations) or less. (See Module 2, *Taxation of Businesses*.)

1. Cash Method Farmers

Cash method farmers include income in the year actually or constructively received, whichever is earlier. Gross income includes receipts of:

- proceeds from sales of *raised* livestock or produce;
- profits from the sale of any *purchased* property, including livestock,
- breeding fees,
- fees from renting teams, machinery or land,
- taxable subsidy and conservation payments,
- crop insurance proceeds, and
- all other gross income. (Reg §1.61-4(a)). For deferral of insurance proceeds and forced livestock sales, see below.

Expenses are ordinarily deductible in the year paid (other than the cost of animals and plants bought for resale). (Reg §1.61-4(a)).

Purchased animals and plants. Cash method farmers generally deduct the costs of animals and plants bought for resale only in the year the animals or plants are disposed of. (Reg §1.61-4(a)) But for these animals and plants, a farmer may elect to deduct the costs either for the year they are purchased or for the year they are sold, if the method chosen clearly reflects income:

- baby chicks and pullets bought for raising and resale;
- hens bought for commercial egg production;
- seeds and young plants (other than Christmas trees, orchards and timber) bought for further development and cultivation before sale. (Reg §1.162-12)

The farmer makes the election by deducting the cost for the first year in which he or she buys the items. Once the farmer elects this option—which is a method of accounting—he must use it consistently until IRS consents to a change.

Disaster payments. A cash method farmer can elect to defer reporting certain insurance proceeds and federal disaster payments until the tax year after the year of the destruction or damage to, or inability to plant, the crops, if the farmer shows that under his or her practice, the income from the crops would be reported in a later year. (Code Sec. 451(d); Reg §1.451-6)

One-year deferral also may be elected for income from livestock sold on account of a drought, flood or other weather-related condition so severe the sale had to take place in an earlier year than normal. (Code Sec. 451(e); Reg §1.451-7(g))

2. Accrual Method Farmers

Accrual method farmers include farm income for the year earned, regardless of when payment is received, and deduct farm expenses for the year the "all events test" is met (see Module 2, Taxation of Businesses). Inventories must be used. (Code Sec. 461(h); Reg §1.61-4(b); Reg §1.446-1(c))

An accrual farmer's gross income for a tax year is the sum of:

1. the sales price of all livestock and other products held for sale that are sold during the year,
2. the inventory value of the livestock, etc. (i.e., the proceeds from the disposition of livestock, etc., during the year, plus the inventory value of livestock, etc., not sold at the end of the year, reduced by the inventory value of livestock, etc., on hand at the start of the year, and by the cost of any livestock, etc., bought during the year and included in inventory),
3. miscellaneous farm receipts, e.g., fees from breeding or from renting teams,
4. all subsidy and conservation payments includible that year, plus
5. gross income from all other sources. Crop shares are included in the year they are reduced to money or its equivalent. (Reg §1.61-4(b))

Mandatory accrual. Corporations (except as noted below) and any partnership in which a corporation is a partner must use the accrual method of accounting to compute their taxable income from farming (as must tax shelters, which include farm syndicates, see III.D.4.). Raisers and harvesters of nut and fruit trees are covered by this rule, but nurseries, sod farms and raisers and harvesters of other types of trees aren't. (Code Sec. 447(a))

The mandatory accrual rule *doesn't* apply to:

- S corporations. (Code Sec. 447(c)(1))
- A "family corporation" (where members of the same family own at least 50% of (a) the total combined voting power of all voting stock, and (b) the total number of shares of all other classes of stock) other than one whose gross receipts exceed $25 million for any tax year. (Code Sec. 447(c)(2) Code Sec. 447(d)(2)) Two- or three-family corporations must meet special ownership tests, and must have been engaged in farming since October 4, 1976. (Code Sec. 447(h))

- A corporation whose gross receipts (or any predecessor's) don't exceed $1 million for any tax year. (Code Sec. 447(c)(2), Code Sec. 447(d)(1))
- Certain corporations (and partnerships having a corporate partner) engaged in growing sugar cane, that used "annual accrual" accounting methods for that business for a ten-year period ending with its first tax year starting after 1975. (Code Sec. 447(g))

Review Question 10

Which of the following corporations must use the accrual method of accounting to compute taxable income from farming?

a. An S corporation.

b. A C corporation that is wholly owned by one family and that has annual gross receipts of more than $1 million.

c. A C corporation that is owned by unrelated individuals and that has gross receipts of more than $1 million from fruit trees.

d. A C corporation owned by unrelated individuals that has gross receipts of more than $1 million from a sod farm.

3. Crop Method

A farmer may, with IRS consent, use the crop method to report income from crops (other than timber) for which the process of planting, harvesting and sale isn't completed within the same tax year. (Reg §1.61-4(c)) Under this method, all expenses of the crop (including expenses of seed or young plants) are charged, and all crop receipts are credited, to a crop account. Profit (or loss) is realized and included in income (or loss deducted) only in the year the crop is harvested and disposed of. The profit (or loss) is all the receipts less all the expenses. (Reg §1.61-4(c), Reg §1.162-12(a))

4. Farmers' Inventories

A farmer using inventories *must* inventory:

- all livestock and poultry, raised or purchased, held primarily for sale (Reg §1.61-4(b));
- all harvested and purchased farm products held for sale, feed, or seed, such as grain, hay ensilage, concentrates, cotton, tobacco;
- supplies, unless only small amounts are on hand;
- if in the hatchery business, eggs in incubation and growing and pre-market chickens. (Inventories *may* be used for hens primarily held for egg production which are also held for sale after their egg-producing life.)

Livestock held for dairy, breeding, sporting or draft purposes may be inventoried at the taxpayer's election. But raised livestock must be inventoried by farmers using the unit-livestock-price method. (Reg §1.61-4(b), Reg §1.471-6(f))

Review Question 11

Which of the following *must* be inventoried by any farmer using inventories?

a. Livestock held for breeding.

b. Hens held primarily for egg production that are also held for sale after their egg producing life.

c. Raised hens held primarily for sale.

d. Dairy cows.

Inventory valuation. Methods that farmers use to value inventory include:

- *Cost method.* (Reg §1.471-3)
- *Lower-of-cost-or-market method*. (Reg §1.471-4)
- *Farm price method.* Each item, raised or purchased, is valued at its market price less estimated direct cost of disposition. A farmer using this method must use it for all his or her inventory, but may use the unit-livestock-price method for livestock. (Reg §1.471-6(d))
- *Unit-livestock-price method.* Livestock is reasonably classified according to kind and age. A standard unit price is used for each animal within a class. The unit prices must reflect any costs required to be capitalized under the uniform capitalization rules (see below). Once established, the accounting methods used to determine unit prices and to classify animals must be consistently applied in all future tax years. Users of this method must annually reevaluate their unit prices and adjust them either up to reflect increases, or down to reflect decreases, in the costs of raising livestock. IRS consent isn't required for these adjustments; however it is required for other changes in classification or unit prices. (Reg §1.471-6(f))

B. Farming Deductions

1. Feed

The cost of feed is a deductible business expense. (Reg §1.162-12(a)) A cash method farmer may deduct in the year paid, the cost of feed his or her livestock will consume that year. Payments for feed to be used in the next tax year ("pre-paid feed") generally aren't deductible until the year of consumption. However, the farmer may deduct pre-paid feed expenses in the payment year if:

- the payment represents a purchase and not a deposit,
- the advance payment is for a business purpose and not merely for tax avoidance, and
- deduction in the payment year doesn't materially distort income.

2. Fertilizer

The cost of acquiring fertilizer, lime, marl, and other materials used to enrich, neutralize, or condition farmland, and the costs of applying them, are deductible in the year the costs are paid or incurred if the benefit doesn't last beyond one year. If the benefit lasts substantially more than a year (so the costs would have to be capitalized), the taxpayer may either capitalize the costs or elect to deduct them in the year paid or incurred (Code Sec. 180(a)) by deducting them on his or her return for that year. (Code Sec. 180(c); Reg §1.180-2) The election to deduct isn't allowable for costs of preparing land not previously used for farming by the taxpayer or his or her tenant. (Code Sec. 180(b); Reg §1.180-1(b))

If fertilizer expenses are capitalized, the taxpayer may deduct a portion of the capitalized amounts for each year the benefits last. The portion deducted each year need not be the same if benefits are clearly greater in the early years.

Review Question 12

A farmer applies fertilizer to a field that has been continuously used for farming for several years. The fertilizer is expected to enrich the field for many years to come, although the benefits will be greater in the early years. Which of the following is a correct statement?

a. The farmer must capitalize the cost of the fertilizer because the benefit will last substantially more than year.

b. The farmer must deduct the cost in the year paid or incurred.

c. If the expenses are capitalized, the farmer must deduct an equal portion of the cost for each year the benefit lasts.

d. The farmer may either capitalize the costs or deduct the costs currently.

3. Pre-paid Expenses

A cash method taxpayer's current deduction for pre-paid farm expenses (i.e., for feed, seed, fertilizer, and similar farm supplies that won't be used until a later tax year) is limited to one-half of his or her other deductible farming expenses for the year (for a special rule for feed, see above). The "excess" part (i.e., over that one-half amount) isn't deductible until the year the supplies are used. (Code Sec. 464(f)(1), Code Sec. 464(f)(2)) This rule also applies to farming syndicates (required to use the accrual method (see III.A.2.). (Code Sec. 464(a))

But this limit doesn't apply if the taxpayer's (or a family member's) principal home is a farm or his or her principal business is farming, and if:

- for the three preceding tax years, the taxpayer's total pre-paid farm expenses are less than 50% of his or her total other deductible farm expenses, or
- for the current year, the taxpayer's pre-paid farm expenses are more than 50% of his or her other farm expenses because of a change in business operations attributable to extraordinary circumstances. (Code Sec. 464(f)(3))

4. Pre-productive Period Expenses

The taxpayer has the option to either deduct or capitalize certain costs of developing and operating his or her farm and crops (e.g., taxes, interest, upkeep) during its pre-productive period (Reg §1.162-12(a)) (subject to the uniform capitalization rules). But the taxpayer can't deduct any capital expenditures. The pre-productive period begins when the farmer first acquires the seed or plant, and ends when the plant produces marketable quantities or is reasonably expected to be sold or otherwise disposed of. (Code Sec. 263A(e)(3))

5. Conservation Expenses

Farmers may deduct currently, as business expenses, certain outlays for soil and water conservation or erosion prevention that are incurred to maintain the farm and preserve its normal productivity, and not to increase its value or convert it to a new use. Costs that result in the acquisition of depreciable property must be capitalized.

But a farmer may elect to deduct certain nondepreciable expenditures for conservation, etc. with respect to land he or she uses for farming (Code Sec. 175(a)) if the expenditures are consistent with a federal or state approved conservation plan. (Code Sec. 175(c)(3))

Qualifying expenditures include:

- treating or moving earth (e.g., leveling, terracing or restoring fertility);
- constructing and protecting diversion channels, drainage ditches, earthen dams; eradicating brush; planting windbreaks;
- producing vegetation primarily to conserve soil or water, or prevent soil erosion; and
- expenses incurred after 2008 for endangered species recovery, including site-specific management actions under the Endangered Species Act of 1973. (Code Sec. 175(c); Reg §1.175-2(a), Reg §1.175-2(b)(2))

Costs of draining or filling wetlands or for center pivot irrigation systems don't qualify. (Code Sec. 175(c)(3)(B)) Nor does the election apply to depreciable assets. (Reg §1.175-1)

The amount of conservation, etc., expenses a farmer may deduct in any tax year under this election can't exceed 25% of his or her gross income from farming for the year. Any excess may be carried over to and deducted in the next tax year (subject to that year's 25% ceiling). (Code Sec. 175(b); Reg §1.175-5(b))

The election is made by deducting the expenses on the return for the first tax year they are incurred. (Reg §1.175-6(a)) IRS consent is needed to elect for a year other than that first year. (Code Sec. 175(d)(2)) Once the election is made, a farmer must continue to deduct all qualifying expenditures (subject to the 25% ceiling) unless IRS consents to a change. (Code Sec. 175(e))

A farmer must recapture as ordinary income part of the conservation, etc., expenses if the farm land is disposed of after being held for less than 10 years. (Code Sec. 1252)

6. Depreciation

A farmer is entitled to take depreciation deductions on property used in a farming business (Code Sec. 168(b)(2)(B)), including:

- farm buildings (except his or her dwelling);
- farm machinery;
- other physical property (not including land);
- orchards (trees and vines bearing fruits or nuts);
- draft, breeding, sporting or dairy livestock (unless inventoried). (Reg §1.167(a)-6(b))

Most farm property is depreciated under the Modified Accelerated Cost Recovery System (MACRS; see Module 2, *Taxation of Businesses*) using the 150% declining balance method (switching to straight-line for the first tax year for which that method would give a larger allowance). However, nonresidential real property, and trees or vines bearing fruits or nuts are depreciated straight-line. (Code Sec. 168(b)(1)(B), Code Sec. 168(b)(2)(B), Code Sec. 168(b)(3)(A), Code Sec. 168(b)(3)(B))

The cost of purchased dairy, etc., livestock may be recovered under MACRS. The cost of raised livestock may be either deducted (but costs so deducted can't be included in depreciable basis) (Reg §1.61-4(a), Reg §1.162-12(a)) or capitalized as the taxpayer chooses. But accrual method farmers using inventories can't depreciate any purchased dairy, etc., livestock that's inventoried. (Reg §1.167(a)-6)

Under a special rule enacted by the Heartland, Habitat, Harvest, and Horticulture Act of 2008 (Title XV P.L.110-246), any race horse, regardless of age, will have a 3-year recovery period if it is placed in service after December 31, 2008, and before January 1, 2014. After 2013, as under prior law, the 3-year recovery period will apply only to race horses that are more than two years old when placed in service.

7. Uniform Capitalization Rules

Farmers and ranchers are subject to the uniform capitalization rules for taxpayers generally (see Module 2, *Taxation of Businesses*) with respect to the production, growing, or raising of property that:

- is produced by a farmer required to use the accrual method, (Code Sec. 263A(a), Code Sec. 263A(d)(1); Reg §1.263A-4(a), Reg §1.263A-4(b)) or
- has a pre-productive period, of more than two years. (Code Sec. 263A(d)(1)(A)(ii))

For taxpayers not required to use the accrual method, the uniform capitalization rules don't apply to costs related to any animal, or any plant with a pre-productive period of two years or less, which is produced by a taxpayer in a farming business. (Code Sec. 263A(d)(1)(A); Reg §1.263A-4(a)(2) The pre-productive period is:

- the period before the first marketable crop or yield, for plants that have more than one crop or yield (e.g., the orange tree);
- the period before a crop or yield is disposed of, for the crop or yield of a plant that will have more than one crop or yield (e.g., the orange); or,
- for any other plant, the period before it is disposed of. (Reg §1.263A-4(b)(2))

If required to use the accrual method, the uniform capitalization rules apply, however long the pre-productive period. (Code Sec. 263A(d)(1)(B)) The IRS has published a non-inclusive list of plants with pre-productive periods in excess of 2 years.

Certain replanting costs. The uniform capitalization rules don't apply to costs incurred for the replanting, cultivation, maintenance and development of plants bearing an edible crop for human consumption (including citrus or almond) that were lost or damaged (while in the taxpayer's hands) by freezing temperatures, disease, drought, pests, or casualty (replanting costs). (Code Sec. 263A(d)(2)(A); Reg §1.263A-4(e)(1), Reg §1.263A-4(e)(4))

This casualty exception generally applies to the costs of the person owning ("owner") the plants at the time of the loss or damage. But costs paid or incurred by another person (payor) in any tax year also may qualify if in that year:

- the owner has a more-than-50% equity interest in the plants, and
- the payor owns any of the remaining equity interest in them and materially participates in their planting, maintenance, cultivation or development. (Code Sec. 263A(d)(2)(B); Reg §1.263A-4(e)(2))

Electing out of uniform capitalization rules. Except as noted below, a farmer may elect to have the uniform capitalization rules not apply to any plant produced in his or her farm business (Code Sec. 263A(d)(3)(A)), so the farmer may currently deduct all otherwise deductible pre-productive costs.

If the taxpayer or any related person (as specially defined) makes the election, he or she must use the Code Sec. 168(g)(2) alternative (i.e., straight-line) depreciation for all property used predominantly in the farming business that was placed in service in any tax year during which the election is in effect (Code Sec. 263A(e)(2)(A); Reg §1.263A-4(d)(4)(ii)) and follow other requirements in the IRS regulations. (Reg §1.263A-4(d)(4))

If the election is made, any plant with respect to which amounts would have been capitalized *but for* the election is treated as Code Sec. 1245 property (if it's not otherwise Code Sec. 1245 property; see Module 2, *Taxation of Business*). (Code Sec. 263A(e)(1)(A)(i); Reg §1.263A-4(d)(4)(i)) Deductible amounts that *but for* the election would have been capitalized are treated as depreciation deductions for Code Sec. 1245 purposes (Code Sec. 263A(e)(1)(A)(ii), Code Sec. 263A(e)(1)(B)) so that they are recaptured as ordinary income when the product is disposed of.

The election can't be made with respect to any item attributable to the planting, maintenance or development of any citrus or almond grove (or part of a grove) that's incurred before the close of the fourth tax year beginning with the tax year the trees were planted. For this purpose, the portion of a grove planted in one tax year must be treated separately from the portion planted in another tax year. (Code Sec. 263A(d)(3)(C); Reg §1.263A-4(d)(2))

The election out of the uniform capitalization rules is made by not applying the rules to determine the capitalized costs of plants produced in a farming business for the first tax year capitalization is required. For partnerships or S corporations, the election must be made by the partner, shareholder, or member. (Code Sec. 263A(d)(3)(D); Reg §1.263A-4(d)(3)(i)) A taxpayer that does not make the automatic election described above must get IRS consent to change accounting methods. (Reg §1.263A-4(d)(3)(ii))

The election can't be made by farmers who are required to use the accrual method of accounting. (Code Sec. 263A(d)(3)(B))

C. Sales and Exchanges

Special rules apply to certain sales and exchanges of farm property. For example, gain on the disposition of land used for farming that is converted wetland or highly erodible cropland is ordinary income. Loss is long-term capital loss. (Code Sec. 1257) And the trading of livestock may qualify as a tax-free like-kind exchange if the exchanged animals are the same sex. (Code Sec. 1031(e); Reg §1.1031(e)-1)

1. Unharvested Crops Sold with Land

Gain or loss on an unharvested crops sold, exchanged, or compulsorily or involuntarily converted with the underlying land qualifies under the capital gain-ordinary loss rule of Code Sec. 1231 (see Module 2, *Taxation of Businesses*), if:

- the land was used in the taxpayer's trade or business and was held for the long-term capital gain holding period, and
- the land and crops are sold at the same time and to the same person. (Code Sec. 1231(b)(4)) It doesn't matter how long the crops were held, or their state of maturity. (Reg §1.1231-1(f))

2. Disposition of Livestock

Gains and losses from the sale, exchange, or involuntary conversion of animals held for draft, breeding, dairy, or sporting purposes qualify for capital gain-ordinary loss treatment under Code Sec. 1231 as follows:

- cattle and horses held for 24 months or more from the date of acquisition;
- other livestock (except poultry) held for 12 months or more from the date of acquisition. (Code Sec. 1231(a), Code Sec. 1231(b)(3); Reg §1.1231-2(a))

Inventorying the livestock doesn't preclude Code Sec. 1231 treatment if the animal is held for the required purposes and relevant period and not for sale to customers.

D. Other Special Rules for Farming

1. Income Averaging

An individual (including a partner in a partnership and a shareholder of an S corporation engaged in a farming business, but not including an estate or trust) engaged in a farming business may elect three-year averaging of "elected farm income" for regular income tax (not AMT or employment tax) purposes.

If the election is made, tax for the year is equal to the sum of

1. tax computed on taxable income reduced by elected farm income, and
2. the increase in tax that would result if taxable income for the three prior tax years were increased by an amount equal to one-third of the elected farm income. Any adjustment under this provision for any tax year is taken into account in applying this provision for any later tax year. (Code Sec. 1301(a); Code Sec. 1301(b)(3); Reg §1.1301-1(b))

Taxable income for prior years can be less than zero, but in that case any amount that may provide a benefit in another tax year (such as an NOL) is added back in determining base year taxable income. (Reg§1.1301-1(d)(2))

"Elected farm income" means the amount of taxable income for the tax year attributable to any farming business that's specified in the election to average farm income (Code Sec. 1301(b)(1)(A)) including farm wages paid to an S corporation shareholder (Reg §1.1301-1(e)(1)) and certain crop-share income. (Reg §1.1301-1(b)(2))

Gain from the sale or other disposition of property (other than land) regularly used by the taxpayer in a farming business for a substantial period is treated as attributable to that farming business. (Code Sec. 1301(b)(1)(B); Reg §1.1301-1(e)(1)(ii)(A)) A landlord is engaged in a farming business for farm income averaging purposes for rental income based on a share of production (not fixed rent) from a tenant's farming business determined under a written agreement entered into before the tenant begins significant activities.

2. Conservation Programs

Unless the taxpayer elects out (Code Sec. 126(c)), gross income doesn't include the excludable part of payments received under certain conservation programs specified in Code Sec. 126(a)(1) to Code Sec. 126(a)(8) or received under Code Sec. 126(a)(9) Agriculture Department programs affecting small watersheds found by IRS to be similar to those programs. (Code Sec. 126(b)) For example, cost-sharing payments (not rental and incentive payments) received under the Conservation Reserve Program (CRP) qualify under the later provision, as do cost-share payments under the Soil and Water Conservation Assistance (SWCA) and the Agricultural Management Assistance (AMA) programs.

3. Net Operating Losses

Although net operating losses (NOLs) generally may be carried back only two years, a taxpayer engaged in the business of farming generally gets a three-year carryback for NOLs attributable to Presidentially declared disasters. (Code Sec. 172(b)(1)(F)(ii)(III)) But "farming losses" (any NOL attributable to the income and deductions of a farming business, but not in excess of the taxpayer's NOL for the year) may be carried back five years (Code Sec. 172(b)(1)(G)) (and forward for the regular 20-year period).

Farmers may elect (by the due date, including extensions, for the loss year, or, if a timely return was filed, on an amended return within six months of the original return due date) not to have the five-year carryback apply, in which case the regular NOL rules apply. Once made, the election is irrevocable for that year. (Code Sec. 172(i)(3))

Review Question 13

To the extent a farmer's net operating loss is attributable to his or her farming business, it may generally be carried back __________years.

a. Two.	b. Three.
c. Five.	d. 20.

4. Tax Shelters and Farming Syndicates

All tax shelters, including farming syndicates, must use the accrual method of accounting. (Code Sec. 448(a)(3))

A farming syndicate is a partnership or any other enterprise (including an S corporation, but not any other corporation) that is engaged in farming and has listed its securities with any federal or state securities agency before offering them for sale. The term also includes a similar unlisted enterprise that allocates more than 35% of its losses to limited partners or limited entrepreneurs. A limited entrepreneur is a person who has an interest in an enterprise (other than as a limited partner) and who does not actively participate in the management of the enterprise. (Code Sec. 464(c)(1), Code Sec. (e)(2))

A person is not treated as a limited partner or a limited entrepreneur, and therefore is not subject to these rules, if he or she:

1. has actively participated in managing the farm enterprise (or its predecessor) for at least five years;
2. lives on the farm where the farming business is carried on;
3. actively manages a farm that raises livestock (or is treated as actively managing under one of the first two exceptions) and participates in the further processing of such livestock; or
4. is a member of the family (brother, sister, spouse, ancestor, lineal descendant or a spouse of any such member) or a grandparent of an individual who would be excepted under any of the three cases above, and whose interest is attributable to the active participation of such person. (Code Sec. 464(c)(2))

5. Limitation on Deduction for Farm Losses

For tax years beginning after 2009, the farming loss of a taxpayer, other than a C corporation, is limited for any tax year in which any applicable subsidies are received. The losses are limited to the greater of (a) $300,000 ($150,000 for a married person filing separately), or (b) the taxpayer's total net farm income for the prior five tax years.

Applicable subsidies are (1) any direct or counter-cyclical payments under title I of the Food, Conservation, and Energy Act of 2008 (or any payment elected in lieu of any such payment), or (2) any Commodity Credit Corporation (CCC) loan.

Total net farm income is an aggregation of all income and loss from farming businesses for the prior five tax years. Any loss that is disallowed in a particular year is carried forward to the next tax year and treated as a deduction attributable to farming businesses in that year. Farming losses arising because of fire, storm, or other casualty, or by reason of disease or drought, are disregarded for purposes of calculating the limitation. (Code Sec. 461(j))

For partnerships and S corporations, the limit is applied at the partner or shareholder level. (Code Sec. 461(j)(5))

IV. Employee Benefit Plans

Learning Objectives

After completing this section, you should be able to:

- Recognize the benefits that can be offered under an employer's cafeteria plan and qualifying events under COBRA.
- Calculate excludable educational assistance under Code Sec. 127(a)(1).

An employee benefit is pay for the performance of services that is provided in a form other than a traditional paycheck. As a general rule, benefits provided by an employer are included in an employee's gross income (See Module 1, *Taxation of Individuals*) and are deductible as compensation by the employer (see Module 2, *Taxation of Businesses*). However, certain employee benefits are eligible for favorable tax treatment to employees. In addition, certain types of employee benefit plans must comply with nondiscrimination and other requirements specified in the Code.

Employee benefits subject to special tax rules include:

- adoption assistance
- educational assistance
- dependent care assistance
- medical care coverage, including accident and health insurance
- group-term life insurance

A. Cafeteria Plans

Employees have different benefit needs. One employee may need dependent care assistance, another may need health insurance, and yet another may prefer cash compensation in lieu of benefits. One way to address these differing needs is through a "cafeteria plan." A cafeteria plan (also referred to as a flexible benefit plan) is a written plan under which participants (all employees) may choose their own "menu" of benefits consisting of "cash" and "qualified benefits." (Code Sec. 125(d))

No amount is included in the gross income of the participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. (Code Sec. 125(a)) Cafeteria plans are generally the sole method of employers providing nontaxable benefits where employees can elect between taxable compensation and nontaxable benefits. (Prop Reg §1.125-1(b)(1))

For purposes of cafeteria plans, cash means cash from current compensation (including salary reduction), payment for annual leave, sick leave, or other paid time off, severance pay, property, and certain after-tax employee contributions; distributions from qualified retirement plans are not cash. (Prop Reg §1.125-1(a)(2)) "Qualified benefits" (see below) generally must be excludable from employees' gross income under a specific Code section and must not defer compensation (with some exceptions). (Code Sec. 125(d)(2))

In the case of a "highly compensated participant," the exclusion won't apply to any benefit attributable to a plan year for which the plan discriminates in favor of highly compensated participants as to contributions, benefits or eligibility to participate. (Code Sec. 125(b)(1)) An individual is a "highly compensated participant" if he is an officer or more-than-5% shareholder of the employer, a highly compensated employee or a spouse or dependent of such a person. (Code Sec. 125(e)(1))

In the case of a key employee (defined in Code Sec. 416(i)(1)), the exclusion won't apply to any plan year if the qualified benefits provided to key employees under the plan exceed 25% of the total of such benefits provided for all employees under the plan. (Code Sec. 125(b)(2))

Qualified benefits that may be offered under a cafeteria plan include:

- group-term life insurance, including amounts that aren't excludable because the dollar coverage limit is exceeded (see IV.E.);
- coverage under an accident or health plan under Code Sec. 106 (see IV.F.);
- dependent care assistance programs under Code Sec. 129 (see IV.C.);
- adoption assistance under a program that meets the Code Sec. 137 requirements (see IV.B.);
- qualified cash or deferred arrangements (see V.D.)
- employer contributions to a health savings account (HSA) under Code Sec. 106(d) (see IV.F.2.); or
- vacation days if the plan precludes any participant from using, or receiving cash in a later plan year for any vacation days remaining unused at the end of the current plan year. (Code Sec. 125(f); Prop Reg §1.125-1(a)(2); Prop Reg §1.125-1(o)(4)(i))

The following benefits are not qualified benefits for purposes of the cafeteria plan rules:

- scholarships or fellowships under Code Sec. 117 (see IV.D.3);
- educational assistance programs under Code Sec. 127 (see IV.D.1.);
- no-additional-cost services, qualified employee discounts, working condition fringes, and *de minimis* fringes under Code Sec. 132 (Code Sec. 125(f)) (see Module 1, *Taxation of Individuals*);
- meals and lodging furnished for the employer's convenience under Code Sec. 119 (Prop Reg §1.125-1(q)(1)) (see Module 1, *Taxation of Individuals*);
- any product that's advertised, marketed, or offered as long-term care insurance, for contracts issued after 1996 (Code Sec. 125(f)) (see IV.F.4); and
- employer contributions to an Archer medical savings account (Archer MSA) under Code Sec. 106(b) (see IV.F.1.). A high deductible health plan can be provided as part of a cafeteria plan, and can be used in conjunction with an Archer MSA, but the Archer MSA must be established outside the cafeteria plan.

Although long-term care insurance is not a qualified benefit and may not be offered in a cafeteria plan (see above), a cafeteria plan *is* permitted to offer a health savings account (HSA) as a qualified benefit, and funds from the HSA may be used to pay eligible long-term care premiums on a qualified long-term care insurance contract for qualified long-term care services. (Prop Reg §1.125-1(q)(3)

Flexible spending accounts. A cafeteria plan also can include one or more "flexible spending accounts" (FSAs). An FSA is a benefit designed to reimburse employees for expenses incurred for certain qualified benefits, up to a maximum amount not substantially in excess of the salary reduction and employer flex-credits allocated for the benefit. The maximum amount of reimbursement reasonably available must be less than five times the value of the coverage. (Prop Reg §1.125-5(a)) Employer flex-credits are non-elective contributions that an employer makes available for every employee eligible to participate in the cafeteria plan, to be used at the employee's election only for one or more qualified benefits (but not as cash or other taxable benefits). (Prop Reg §1.125-5(b)) The three types of FSAs are dependent care assistance, adoption assistance and medical care reimbursements (health FSA).

A health FSA may be limited to a subset of permitted Code Sec. 213(d) medical expenses, or it may be a health saving account (HSA) compatible limited-purpose health FSA or post-deductible health FSA. (Prop Reg §1.125-5(m)) A health FSA may not reimburse premiums for accident and health insurance or long-term care insurance. (Code Sec. 125(f))

Historically, there has been no dollar limit on the amount that can be contributed to an employee's health FSA for a plan year, although overfunding of an FSA is discouraged by the use-it-or-lose it rule that requires forfeiture of unspent amounts (see below). Effective for plan years beginning after 2012, the 2010 Health Care Act imposes a $2,500 limit on annual salary reduction contributions to a health FSA. {I.R.C. §125(i) as added by 2010 Health Care Act; IRS Notice 2012-40, 2012-25 IRB 1046}. The $2,500 limit is a structural requirement. A cafeteria plan that does not include this limitation starting in 2013 will not qualify as a cafeteria plan.

An employer may reimburse a terminated employee's qualified dependent care expenses incurred after termination through a dependent care FSA, if all other Code Sec. 129 requirements are otherwise satisfied. (Prop Reg §1.125-6(a)(4)(v))

Use-it-or-lose-it rule. Unused cafeteria plan amounts left over at the end of a plan year generally have to be forfeited (use-it-or-lose-it rule). But a cafeteria plan can provide an optional grace period immediately following the end of each plan year, extending the period for incurring expenses for qualified benefits to the 15th day of the third month after the end of the plan year. It may apply to one or more qualified benefits but can't apply to paid time off or elective contributions to Code Sec. 401(k) plans. Unused benefits or contributions for one qualified benefit may only be used to reimburse expenses incurred during the grace period for that same qualified benefit. Benefits or contributions not used as of the end of the grace period are forfeited. (Prop Reg §1.125-1(e)) An exception for qualified reservist distributions allows FSAs to make distributions of all or part of unused health FSA benefits to military reservists who are called to active duty for a period exceeding 179 days (or an indefinite period). The distribution must be made during the period beginning with the call to active duty and ending on the last day of the coverage period of the FSA that includes the date of the call to active duty. (Code Sec. 125(h))

SIMPLE cafeteria plan. Cafeteria plans are subject to strict nondiscrimination rules to prevent benefits provided under the plan from favoring highly compensated employees (see above). In addition, separate nondiscrimination rules apply to specific qualified benefits offered under a cafeteria plan.

A SIMPLE cafeteria plan is a safe-harbor plan, created by the 2010 Health Care Act, that will automatically satisfy the overall cafeteria plan nondiscrimination rules as well as the nondiscrimination rules that apply separately to specified qualified benefits provided under the plan. (Code Sec. 125(j) as added by 2010 Health Care Act) An eligible small employer may establish a SIMPLE cafeteria plan for plan years beginning after December 31, 2010.

A SIMPLE cafeteria plan must meet two requirements:

1. A minimum eligibility and participation requirement, and
2. A minimum contribution requirement.

A plan that satisfies both requirements for a plan year will be treated as meeting any of the following applicable nondiscrimination requirements for the year:

- the cafeteria plan nondiscrimination requirements specified in Code Section 125(b);
- the nondiscrimination requirements for employer-provided group term life insurance specified in the Code Section 79(d);
- the nondiscrimination requirements for dependent care assistance programs under Code Section 129(d); and
- the health benefit nondiscrimination requirements in Code Section 105(h).

An employer qualifies to establish or maintain a SIMPLE cafeteria plan for a year if the employer employed an average of 100 or fewer employees on business days during either of the two preceding years. (Code Sec. 125(j)(5)) Once an employer qualifies as an eligible small employer and maintains a SIMPLE cafeteria plan for any year, the employer can continue to maintain a SIMPLE cafeteria plan for employees (including new employees) of the same trade or business until the year following the year in which the employer employs an average of 200 or more employees.

An eligible employer will satisfy the minimum eligibility and participation requirement if:

1. All employees with at least 1,000 hours of service for the preceding plan year are eligible to participate, and
2. Each employee eligible to participate may elect any benefit available under the plan (subject to terms and conditions that apply to all participants).

To meet the minimum contribution requirement, the plan must require the employer to make a minimum contribution to provide benefits under the plan on behalf of each qualified employee, regardless of whether the employee makes salary reduction contributions to the plan. [I.R.C. §125(j)(3)] The minimum contribution on behalf of each qualified employee can be calculated under either a nonelective contribution method or a matching contribution method, but the same method must be used for all qualified employees.

Under the nonelective contribution method, the minimum contribution on behalf of each qualified employee must equal a uniform percentage (not less than two percent) of the eligible employee's compensation for the plan year, determined without regard to whether the employee makes any salary reduction contribution under the cafeteria plan.

Under the matching contribution method, the minimum contribution is the lesser of (1) 100 percent of the amount of the salary reduction contributions elected to be made by the qualified employee for the plan year or (2) six percent of the qualified employee's compensation for the plan year.

Review Question 14

Which of the following are considered qualified benefits for cafeteria plan purposes?

I. Educational assistance programs.

II. Dependent care assistance programs.

III. Meals and lodging furnished for the employer's convenience.

IV. Employer contributions to a health savings account

a. I and II only

b. III and IV only

c. I and III only

d. II and IV only

B. Adoption Assistance

An employee may exclude amounts paid or expenses incurred by an employer for qualified adoption expenses connected with the employee's adoption of a child, if the amounts are furnished under an adoption assistance program in existence (and known to the employee) before the expenses are incurred. For 2013, the maximum exclusion for employer-provided adoption assistance is $12,970 per child (for both non-special needs and special needs adoptions). (Code Sec. 137) The excludable amount is phased out for taxpayers with adjusted gross income (AGI, as specially computed) over $194,480 in 2013 and is fully eliminated when AGI reaches $234,580. (Code Sec. 137(b)(2))

For most adoptions, the exclusion is limited to the amount of qualified adoption expenses actually paid or incurred by the employee. However, in the case of an adoption of a child with special needs the exclusion applies regardless of whether the employee has qualified adoption expenses.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to and the principal purpose of which is the legal adoption of an eligible child. (Code Sec. 23(d)(1)(A))

Amounts are excludable in the year in which the employer pays for qualified adoption expenses of an eligible child who is a U.S. citizen or resident when the adoption is commenced. If the eligible child isn't a U.S. citizen or resident, the exclusion is available only if the adoption becomes final, and only in the year in which it is finalized. Where expenses of a foreign eligible child are paid in a year before the adoption becomes final, the employee includes the employer's assistance in income for that year, and claims the otherwise available exclusion in the year the adoption becomes final. A taxpayer may claim both an adoption expense credit (see Module 1, Taxation of Individuals) and an exclusion for the adoption of an eligible child, but cannot claim a credit and an exclusion for the same expense.

Qualified adoption expenses paid under an employer's adoption assistance program aren't wages subject to income tax withholding.

C. Dependent Care Assistance

Payments incurred by an employer for dependent care assistance under a written plan are excluded from an employee's gross income. (Code Sec. 129(a)(1))

The amount an employee can exclude (computed on Form 2441 with Form 1040 or Form 1040A) can't exceed the employee's earned income (excluding employer dependent care assistance payments) or, for married employees, the earned income of the lower earning spouse. (Code Sec. 129(b)) The aggregate exclusion is further limited to $5,000 ($2,500 for a married individual filing separately). (Code Sec. 129(a)(2)(A)) Any excess is includible in income for the tax year the dependent care services are provided. (Code Sec. 129(a)(2)(B))

Dependent care assistance is the payment for or provision of services that if paid for by the employee would be considered employment-related expenses under the child care credit rules (see Module 1, *Taxation of Individuals*). (Code Sec. 129(e)(1)) An employee includes a self-employed individual who can be covered under a self-employed retirement plan. An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer. A partnership is treated as the employer of each partner who is eligible to be included in a self-employed retirement plan. (Code Sec. 129(e)(3), Code Sec. 129(e)(4))

No amount is excludable unless the name, address and (except in the case of a tax-exempt service provider) taxpayer identifying number (TIN) of the person providing the dependent care services are included on the employee's return. The employee can use Form W-10 to ask for this information from the service provider. Failure to provide this information is excused if the employee exercised due diligence in trying to do so. (Code Sec. 129(e)(9))

A dependent care assistance plan cannot discriminate in favor of highly compensated employees (see V.B.2.) and must meet certain other requirements. (Code Sec. 129(d)) If an otherwise qualified program fails to meet these requirements, the program will be a dependent care assistance program under which expenses are still excludable for non-highly compensated employees. (Code Sec. 129(d)(1))

Payments made under a dependent care assistance program are not treated as wages subject to withholding if it is reasonable to believe that the employee can exclude the payments. (Code Sec. 3401(a)(18))

D. Educational Assistance

An employee may exclude from income the value of educational benefits provided by an employer if the benefit is provided under an educational assistance program of the employer or is for job-related education that qualifies as a working condition fringe benefit. Qualified tuition reductions provided to employees of educational institutions and qualifying scholarships and fellowships also are excludable.

1. Educational Assistance Programs

An employee's gross income doesn't include amounts paid or expenses incurred by the employer for educational assistance to the employee under an employer's qualified educational assistance program. (Code Sec. 127(a)(1)) The maximum amount of educational assistance that an employee can receive tax-free under an educational assistance plan during any calendar year is $5,250. The education received need not be job-related. (Code Sec. 127(a)(2)) No deduction or credit can be taken by the employee for any amount excluded from income. (Code Sec. 127(c)(7))

"Educational assistance" means the employer's payment for or provision of tuition, fees, books, supplies and equipment under an educational assistance program, including amounts for graduate-level courses. It doesn't include meals, lodging, transportation, or tools or supplies (other than textbooks) that may be retained after the course ends. (Code Sec. 127(c)(1); Reg §1.127-2(c)(3))

Eligibility requirements can't discriminate in favor of "highly compensated employees" (see V.B.2.) (Code Sec. 127(d)) Payments made under a qualified educational assistance program are not treated as wages subject to withholding if it is reasonable to believe that the employee can exclude the payments. (Code Sec. 3401(a)(18))

2. Job-related Education

Any employer-provided educational expense that an employer pays on behalf of an employee is excludable from the employee's gross income as a working condition fringe benefit to the extent that if the employee paid for the benefit, the amount paid could have qualified as a deductible employee business expense. (Reg §1.132-1(f); Reg §1.132-5(a)(2)) (See Module 1, Taxation of Individuals)

No exclusion is allowed for expenses incurred to:

(1) meet minimum job qualifications, or

(2) qualify for a new trade or business.

3. Scholarships and Fellowships

A scholarship or fellowship isn't taxable, to the extent it's a "qualified scholarship" granted to a degree candidate at an educational organization and isn't a stipend. (Code Sec. 117(a)), (c)) A "qualified scholarship" is any amount received as a scholarship and used for tuition and fees required for enrollment at an educational organization, and for required fees, books, supplies and equipment. (Code Sec. 117(b)(2)) An "educational organization" is one that normally maintains a regular faculty, curriculum and regularly enrolled student body in attendance. (Code Sec. 117(b)(2)(A))

The exclusion for qualified scholarships doesn't apply to any amount received that represents payment for teaching, research or other services performed by the student as a condition for receiving the qualified benefit. (Code Sec. 117(c)(1)) However, this no-payment-for-services rule doesn't apply to amounts received under certain health professions scholarship programs. (Code Sec. 117(c)(2)).

Because of the employment relationship, a scholarship granted by an employer to an employee (or to an employee's child) will generally indicate that the scholarship isn't excludable because it is payment for services. However, employer-sponsored scholarships granted by private foundations may be excluded by employees under Code Sec. 117 if the grants are made outside the pattern of employment.

A scholarship grant will be considered outside the pattern of employment if the following conditions are met:

- The program is not used to recruit employees or to induce them to continue their employment or otherwise follow a course of action sought by the employer.
- Selection of recipients is done by an independent committee.
- The program imposes identifiable minimum requirements for grant eligibility.

- Selection of grant recipients is based solely on substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business.
- A grant will not be terminated because the recipient or his or her parent terminates employment with the employer after the award.
- The courses of study for which grants are available are not limited to those that would be of particular benefit to the employer or to the foundation.
- The terms of the grant meet all other requirements of Code Sec. 117 and its regulations, and are consistent with a disinterested purpose of enabling recipients to obtain an education for their personal benefit.
- The program meets the percentage test explained below.

In the case of a program that awards grants to employees of a particular employer, the program meets the percentage test if the number of grants awarded in any year to such employees doesn't exceed 10% of the number of eligible employees who were applicants for the grants and were considered by the selection committee. In the case of a program that awards grants to children of employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such children doesn't exceed (a) 25% of the number of eligible children who applied for the grants and were considered by the selection committee or (b) 10% of eligible children. (Rev. Proc. 76-47, 1976-2 CB 670)

4. Qualified Tuition Reductions

Qualified tuition reductions for employees of educational institutions are excluded from the recipient's gross income. (Code Sec. 117(d)) A "qualified tuition reduction" is the amount of tuition reduction provided to an employee of an educational organization for below-graduate-level education at that or a similar institution, for the employee (whether active, retired, or disabled), or the employee's spouse or dependent children. (Code Sec. 117(d)(2)) The exclusion generally does not apply to graduate-level education, but a tuition reduction for a graduate student engaged in teaching or research can qualify. (Code Sec. 117(d)(5))

A qualified tuition reduction provided with respect to a highly compensated employee (see V.B.2.) is excludable only if it's available to all employees on a nondiscriminatory basis. (Code Sec. 117(d)(3))

Review Question 15

Which of the following is a true statement regarding employer-provided educational assistance?

a. A scholarship provided by an employer to a employee's dependent is excludable from income as long as the dependent is not also an employee.
b. Benefits received under a Code Sec. 127 educational assistance program are not excludable from an employee's income if the education qualifies the employee for a new trade or business.
c. There is an annual limit on the amount that may be excludable from an employee's income under a Code Sec. 127 educational assistance program.
d. The exclusion for qualified tuition reductions for employees of educational institutions is generally available for both undergraduate and graduate education.

E. Group-term Life Insurance

An employee isn't taxed on premiums paid by the employer on insurance covering the employee's life under a group-term life insurance policy if the employee's total coverage under all such plans of all his or her employers doesn't exceed $50,000. If the total coverage does exceed $50,000, the employee is taxed on the "cost" of coverage over $50,000 minus the amount paid by the employee. (Code Sec. 79(a))

A disabled terminated employee isn't taxed on group term coverage even if it exceeds $50,000. (Code Sec. 79(b)(1))

Retired employees (except certain employees who reached 55 or retired before January 2, 1984) are treated the same as other employees. (Code Sec. 79(e))

The exclusion doesn't apply to any insurance protection in excess of the maximum allowed by state law for employee group insurance. (Reg §1.79-1(e))

The exclusion is available to a key employee only if the plan doesn't discriminate in favor of key employees (at any time in the key employee's tax year) (Reg §1.79-4T, Q&A-11) as to eligibility to participate and in the type and amount of benefits available. (Code Sec. 79(d)) If the plan is discriminatory, each key employee must include the greater of (a) the actual cost of the insurance (determined by apportioning the net premium allocable to the group-term coverage during the key employee's tax year among the covered employees (Reg §1.79-4T, Q&A-6(b)), or (b) the cost determined from IRS's premium table. (Code Sec. 79(d)(1)(B))

The employer must compute the "cost" of taxable group-term coverage and notify the employee on Form W-2 of the amount included in his or her income. The employee computes the cost only if he or she has two or more employers who provide coverage.

The cost of group-term life insurance is determined on the basis of uniform premiums (computed on the basis of five-year age brackets) prescribed by IRS. (Code Sec. 79(c)) The cost for each month of coverage is the number of thousands of dollars of coverage over $50,000 (to the nearest tenth) times the amount in IRS's table below for the employee's attained age on the last day of the employee's tax year. (Reg §1.79-3(d)(2))

COST PER $1,000 OF PROTECTION PER MONTH

AGE	*COST*
Under 25	5 cents
25 through 29	6 cents
30 through 34	8 cents
35 through 39	9 cents
40 through 44	10 cents
45 through 49	15 cents
50 through 54	23 cents
55 through 59	43 cents
60 through 64	66 cents
65 through 69	$1.27
70 and older	$2.06

If the employee contributes to the plan, the employee's contributions for the tax year are considered made for that part of the coverage over $50,000. (Code Sec. 79(a)(2))

Group-permanent insurance premiums that an employer pays on an employee's life are included in the employee's income. Where a group term policy provides permanent benefits, the amount included in income for the permanent benefits is computed under a formula. (Reg §1.79-1(d))

Premiums paid by an employer for group term insurance on an employee's life are not wages subject to withholding. (Code Sec. 3401(a)(14))

The cost of group-term life insurance on the life of an individual other than an employee (e.g., the employee's spouse or dependent) provided in connection with the performance of services by the employee is includable in the employee's gross income. (Reg §1.61-2(d)(2)(ii)(b)) If, however, the face amount of employer-provided group-term insurance payable on the death of an employee's spouse or dependent doesn't exceed $2,000, it's an excludable *de minimis* fringe benefit.

Review Question 16

Karen Kimble, reached age 29 in November of Year 1 and is an employee of XYZ Inc., On January 1 of Year 2 Kimble becomes covered by XYZ's qualifying group-term life insurance plan. Kimble has a $100,000 death benefit and makes no contribution to the premium payments. How much additional income must Kimble report in Year 2 as a result of the group-term life insurance coverage?

a. $4.00.	b. $36.00.
c. $48.00.	d. $96.00.

F. Health and Accident Coverage

An employer's payments of health and accident insurance premiums for employees and their families, or the employer's direct payments or reimbursements of actual expenses if under a plan, are deductible by the employer. (Reg §1.162-10(a)) Reimbursements are deductible even where the employee is the spouse of a sole proprietor, and the medical expenses incurred on behalf of the employee's family include those of the sole proprietor (as the employee's spouse). The IRS treats these amounts as additional compensation deductible by the employer to the extent that the amounts, when added to other compensation, are reasonable.

An employee excludes from gross income the cost (i.e., premiums paid) of employer-provided coverage under an accident or health plan. (Code Sec. 106) However, if the employer-provided policy, trust, etc., provides other benefits, only the portion of the employer contributions for the accident and health coverage is excludable. (Reg §1.106-1)

Insurance premiums paid for partners and more-than-2% S corporation shareholders (who are treated as partners) are not excludable.

An employee can also exclude from gross income amounts received from his or her employer, directly or indirectly, as reimbursement for expenses for the medical care of the employee, the employee's spouse, and the employee's dependents. (These amounts are excludable even where a sole proprietor employer is the employee's spouse, and the amounts received are for the employer-spouse's medical care.) However, a reimbursement is includible in an employee's income to the extent it exceeds medical expenses or is attributable to medical expense deductions claimed by the employee in a previous year. (Code Sec. 105(b); Reg §1.105-2)

Highly compensated individuals who benefit from an employer's "self-insured" medical reimbursement plan that discriminates in favor of "highly compensated employees" (see V.B.2) must include "excess reimbursements" (reimbursements for benefits not available to other plan participants) in income. (Code Sec. 105(h))

Lump sum or installment amounts received under an employer's plan as payment for permanent loss or loss of use of a member or function of the body, or permanent disfigurement, of the employee or the employee's spouse or dependent are tax-free, but only if the payment is based on the nature of the injury without regard to the period the employee is absent from work. (Code Sec. 105(c))

Employer provided accident and health benefits are exempt from income tax withholding to the extent they are excludable from employees' incomes. Medical care reimbursements made for the benefit of an employee under a self-insured medical reimbursement plan are also exempt. (Code Sec. 3401(a)(20))

Traditionally, the exclusions from gross income for employer-provided accident and health coverage and medical expense reimbursements have applied only to qualifying child and qualifying relative dependents as defined in Code Section 152 (i.e., children under age 19 or children under age 24 who are full-time students and other individuals who meet gross income and support tests). However, a provision added by the 2010 Health Care Act (P.L. 111-148 as amended by P.L. 111-152) requires health plans that provide dependent coverage to make that coverage available to an employee's adult child until the child reaches age 26 (Code Sec. 9815). A corresponding change extends the exclusion for reimbursements for medical care to any child who has not reached age 27 as of the end of the tax year. (Code Sec. 105(b)) This change also applies to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such child. (Notice 2010-38, 2010-20 I.R.B. 682)

1. Archer Medical Savings Account (MSA)

A medical savings account (MSA), referred to formally in the Code as an Archer MSA, allows eligible individuals or their employers to make deductible contributions to a savings account set up in tandem with a "high deductible" health insurance plan. (See Module 1, *Taxation of Individuals*)

Eligible small employers or their employees (but not both) and self-employed individuals can, subject to statutory limits (see below), make contributions to an MSA (Code Sec. 106, Code Sec. 220) Employer-sponsored plans generally are treated as employer provided coverage for medical expenses under an accident or health plan (Code Sec. 106(b)(1)) and thus employer contributions (within statutory limits) are deductible by the employer. Otherwise allowable employer contributions are deductible only in the year they are paid. (Code Sec. 106(b)(3)) An eligible self-employed individual claims deductions for MSA contributions above the line, to arrive at adjusted gross income. (Code Sec. 62(a)(16)) Employer contributions to an MSA are excludable from the employee's income and qualifying distributions for medical expenses are tax-free.

If an employer provides high deductible health plan coverage coupled with an MSA and makes employer contributions, the employer must make available the same contribution on behalf of all employees with comparable coverage during the same period. A 35% penalty applies for failure to meet the comparability rule. (Code Sec. 4980E)

Distributions from MSAs used to pay qualified medical expenses of the account holder and/or spouse and dependents aren't taxable. Distributions not used for these expenses are taxable and also are subject to a penalty tax (on Form 8853) unless paid after the individual attains age 65, or on account of death or disability. The penalty tax is 20% for distributions in tax years beginning after December 31, 2010. (Code Sec. 220(f) as amended by 2010 Health Care Act)

A small employer is one that employed on average no more than 50 employees during either of the two preceding years. If the 50-employee limit is exceeded in a succeeding year, the employer can continue to establish and make contributions to MSAs until the year after the first year in which the employer has more than 200 employees. (Code Sec. 220(c)(4))

For tax years beginning in 2013, a "high deductible" health plan means, in the case of self-only coverage, a plan where the annual deductible is not less than $2,150 and not more than $3,200, and under which annual non-premium out-of-pocket expenses required to be paid doesn't exceed $4,300. In case of family coverage, the annual deductible cannot be less than $4,300, nor more than $6,450, and under which the annual non-premium out-of-pocket expenses required to be paid doesn't exceed $7,850. (Code Sec. 220(c)(2))

The maximum annual contribution for individual coverage is 65% of the deductible under the high deductible plan (75% for family coverage). A self-employed's deduction for contributions to an MSA can't exceed his or her earned income from the trade or business that established the high deductible plan (Code Sec. 220(b)(4)(B) and an employee's contributions to an MSA can't exceed his or her compensation from the employer that set up the plan. (Code Sec. 220(b)(4)(A))

Employer contributions to a medical savings account for an employee are not treated as wages subject to withholding if it reasonable to believe the contributions are excludable from the employee's income. (Code Sec. 3401(a)(21))

Expiration date. No new contributions may be made to MSAs after 2007, except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. (Code Sec. 220(i))

2. Health Savings Account (HSA)

Like an MSA, a health savings account (HSA) works in tandem with a high-deductible health plan. (See Module 1, *Taxation of Individuals*) However, HSAs are not restricted to small employers and their employees.

Employer contributions to an HSA of the employee are treated as employer-provided coverage for medical expenses under an accident or health plan to the extent the amounts don't exceed the statutory limits applicable to the employee for the tax year. (Code Sec. 106(d)(2) Employer contributions to an HSA on behalf of an eligible individual are excludable from income. Employer contributions to an HSA must be reported on the employee's Form W-2, Box 12.

There is no constructive receipt of income solely because the employee may choose between employer contributions to an HSA and to another health plan. (Code Sec. 106(d)(2)) An HSA may be offered as part of a cafeteria plan. (Code Sec. 125(d)(2)) Employer contributions to an HSA are excludable if made at the employee's election under a salary reduction arrangement in a cafeteria plan (see IV.A.).

If an employer provides high deductible health plan coverage coupled with an HSA and makes employer contributions, the employer must make available the same contribution on behalf of all employees with comparable coverage during the same period. A 35% penalty applies for failure to meet the comparability rule. (Code Sec. 4980G) However, a law change made by the 2006 Tax Relief and Health Care Act carves out an exception to the comparability rule enabling employers to make larger HSA contributions for nonhighly compensated employees (non-HCEs) than for highly compensated employees (HCEs). The 2006 Tax Relief and Health Care Act provides that HCEs (as defined in Code Sec. 414(q)) are not treated as "comparable participating employees" for purposes of applying the comparability rule to an employer's contribution to a non-HCE's HSA. (Code Sec. 4980G(d) as amended by 2006 Tax Relief and Health Care Act §306(a))

Distributions from HSAs used to pay qualified medical expenses of the account holder and/or spouse and dependents aren't taxable. Distributions not used for these expenses are taxable and are generally subject to a 20% penalty tax for tax years beginning after December 31, 2010. (Code Sec. 223(f) as amended by 2010 Health Care Act)

For calendar year 2013, a high deductible health plan has an annual deductible that is not less than $1,250 for self-only coverage or $2,500 for family coverage. The annual limit for out-of-pocket expenses is $6,250 for self-only coverage or $12,500 for family coverage. (Code Sec. 223(c)(2)) For 2014, the minimum annual deductible is $1,250 for self-only coverage and $2,500 for family coverage. The 2014 limit on out-of-pocket expenses is $6,350 for self-only coverage and $12,700 for family coverage.

The maximum annual contribution to an HSA is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. For this purpose, the monthly limit is 1/12 of an indexed annual limit. For 2013, the annual limit is $3,250 for self-only coverage and $6,450 for family coverage. For 2014, the annual contribution limit is $3,300 for self-only coverage and $6,550 for family coverage. The maximum HSA contribution is increased by an additional catch-up contribution amount (computed on a monthly basis) for individuals age 55 or older as of the last day of the calendar year who are not enrolled in Medicare. The catch-up contribution amount is $1,000 for 2009 and later years. (Code Sec. 223(b))

Under this "full contribution" rule, a taxpayer who is an eligible individual during the last month of a tax year is treated as having been an eligible individual during every month of the tax year for purposes of computing the annual HSA contribution. Thus, the individual can make contributions for months before he or she was enrolled in a high deductible health plan. (Code Sec. 223(b)(8))

Employer contributions to health savings accounts are not treated as wages subject to withholding if it reasonable to believe the contributions are excludable from the employee's income. (Code Sec. 3401(a)(22))

Review Question 17

Which of the following statements is correct regarding the differences between Archer MSAs and HSAs?

a. Only an employer can contribute to an Archer MSA while both an employer and employee can contribute to an HSA.

b. Self-employeds can make contributions to an HSA, but self-employeds are not allowed to contribute to an Archer MSA.

c. A penalty tax applies to distributions from Archer MSAs used for non-medical purposes, but there is no corresponding penalty for distributions from HSAs.

d. HSAs, but not Archer MSAs, permit contributions of up to 100% of the deductible of the high-deductible insurance plan.

3. Health Reimbursement Arrangement (HRA)

Amounts received by an employee under a health reimbursement arrangement (HRA) are excluded from gross income as amounts received under an accident and health plan. An HRA is a type of employee benefit plan that reimburses employees for medical expenses not covered by other forms of insurance. Benefits are paid up to a specific dollar amount from funds provided exclusively by the employer (and not through a salary reduction or otherwise under a cafeteria plan). Balances remaining in the employee's account at the end of a coverage period may be carried forward if the plan so provides.

4. Long-term Care Insurance

Qualified long-term care insurance contracts issued after 1996 are treated as accident and health insurance contracts (Code Sec. 7702B(a)(1)). Pre-1997 contracts that met applicable state long-term care insurance requirements also qualify. (Prop Reg §1.7702B-2) Therefore, premiums for group long-term care insurance are deductible by the employer and excludable from the employee's income.

Amounts (other than policyholder dividends, as defined in Code Sec. 808 or premium refunds) received from such contracts are treated as amounts received for personal injury or sickness and as reimbursement for expenses actually incurred for medical care, and are excludable, subject to a per diem limit.

Qualified long-term care insurance contracts must provide only coverage of qualified long-term care services, must not pay or reimburse expenses to the extent the expenses are reimbursable under Medicare (or would be but for a deductible or coinsurance amount), must be guaranteed renewable, and must meet other detailed requirements. (Code Sec. 7702B(b))

5. Group Health Plan Requirements

Group health plans must satisfy specific requirements relating to coverage and benefits provided under the plan. Under rules in effect prior to enactment of the 2010 Health Care Act, these requirements include:

- portability, through limits on pre-existing condition exclusions (Code Sec. 9801, Reg §54.9801-1T)
- prohibition on discrimination based on health status (Code Sec. 9802, Reg §54.9802-1T)
- guaranteed renewability in multiemployer plans and multiple employer welfare arrangements (Code Sec. 9803)
- standards relating to benefits for mothers and newborns (Code Sec. 9811)
- parity in mental health and substance abuse disorder benefits (Code Sec. 9812)
- coverage of dependent students on medically necessary leaves of absence (Code Sec. 9813)

The 2010 Health Care Act imposes extensive new requirements on group health plans, but does not negate the requirements of prior law. However, the Act provides that to the extent there is a conflict between the existing provisions of the Code and the requirements of the 2010 Health Care Act, the latter requirements apply. (Code Sec. 9815 as added by 2010 Health Care Act)

In some cases, the group health plan requirements added by the 2010 Health Reform Act are effective immediately, while other requirements carry delayed effective dates. Moreover, some requirements do not apply to grandfathered plans in effect on the date of enactment (March 23, 2010); others apply to all covered group health plans, including grandfathered plans.

The new requirements imposed by the 2010 Health Reform Act include:

- Prohibition of pre-existing condition exclusions (effective for children under age 19 for plan years beginning after September 23, 2010 and for other plan participants for plan years beginning after 2013; applies to grandfathered plans)
- Prohibition on rescission health coverage (effective for plan years beginning after September 23, 2010; applies to grandfathered plans)
- Prohibition of lifetime limits on coverage for essential health benefits (effective for plan years beginning after September 23, 2010; applies to grandfathered plans)
- Restriction of annual limits on coverage for essential health benefits before 2014, prohibition of annual limits after 2013 (effective for plan years beginning after September 23, 2010; applies to grandfathered plans)
- Extension of dependent coverage to adult children up to age 26 (effective for plan years beginning after September 23, 2010; generally applies to grandfathered health plans)
- Prohibition of discrimination in favor of highly compensated employees (effective for plan years beginning after September 23, 2010)
- Required coverage of preventive health services (effective for plan years beginning after September 23, 2010)
- Limitation on waiting periods for coverage (effective for plan years beginning after 2013; applies to grandfathered plans)
- Enhanced prohibitions on discrimination based on health status (effective for plan years beginning after 2013)
- Cost-sharing limitations (effective for plan years beginning after 2013)

An excise tax is imposed on any failure to meet these requirements. (Code Sec. 4980D) The excise tax is $100 per day per individual violation for each day of the noncompliance period, which begins on the date the violation first occurs and ends on the date the violation is corrected.

6. Group Health Plan Continuation Coverage (COBRA)

A group health plan (of or contributed to by an employer) must provide that each qualified beneficiary who would lose coverage under the plan as a result of a qualifying event is entitled to elect continuation (COBRA) coverage under the plan within a specified at-least-60-day election period. (Code Sec. 4980B(f)(1))

The "qualified beneficiaries" are the covered employee, a spouse or dependent child of a covered employee, a deceased employee's surviving spouse in certain cases, and a child born to or placed for adoption with the covered employee during the COBRA coverage period. (Code Sec. 4980B(g)(1))

The "qualifying events" that entitle an employee to continuation coverage include: death of the covered employee; termination or reduction of hours of the covered employee's employment; divorce or legal separation from the covered employee; cessation of a child's dependency; and the employee's entitlement to certain Medicare benefits. (Code Sec. 4980B(f)(3))

The continuation coverage must be identical to coverage provided under the plan to similarly situated beneficiaries who haven't had a qualifying event. (Code Sec. 4980B(f)(2)(A)) Coverage for a qualified beneficiary must begin on the date of the qualifying event and end not earlier than: a statutory maximum period, the end of the plan, the beneficiary's failure to pay a premium, or the beneficiary's eligibility for other group health plan coverage or Medicare.

Employers (or in the case of a multiemployer plan, the plan) and certain responsible persons are liable for an excise tax (Code Sec. 4980B(e)) if, with certain exceptions, a group health plan fails to provide the required continuation coverage. (Code Sec. 4980B(a)

A plan can charge a qualified beneficiary a premium for COBRA coverage of up to 102% of the cost of coverage. (Code Sec. 4980B(f)(2)(C))

V. Employee Retirement Plans

Learning Objectives

After completing this section, you should be able to:

- Identify the different types of qualified retirement plans and apply the applicable rules governing qualified retirement plan contributions and benefits.
- Determine the tax treatment of required minimum distributions and premature distributions.

Employee retirement plans fall into two basic categories: qualified and nonqualified. Qualified plans typically covered a broad segment of a business's employees. They must meet stringent regulations, including a requirement that they not discriminate in favor of highly-paid employees. In return, qualified plans enjoy favorable tax treatment: the employer's contributions to the plan are deductible when made; income from plan investments is exempt from tax; and plan benefits are not taxable to employees until received, even though they may become vested (nonforfeitable) at some earlier point in time.

Nonqualified retirement plans, on the other hand, are usually deferred compensation arrangements set up for the benefit of selected key employees. They don't have to meet nondiscrimination or other requirements that apply to qualified plans. However, by the same token, they don't enjoy the same tax advantages as qualified plans. While the employee's tax on benefits may be deferred, the employer's deduction for contributions is also postponed until benefits are included in the employee's income. And, if the plan is funded, income from plan investments is taxed to either the employer or the employee, depending on the structure of the plan. In addition, for amounts deferred after 2004, special rules govern when deferral of the employee's income tax is permitted. Under these special rules, arrangements that allow participants inappropriate levels of control or access to deferred amounts will not result in deferral of income inclusion.

A. Types of Qualified Plans

Qualified retirement plans are usually structured around a tax-exempt trust, although a qualified plan may use a custodial account or annuity contract as its investment vehicle rather than a trust. (Code Sec. 401(f))

There are a number of different types of qualified retirement plans.

- *Pension plan.* A qualified pension plan provides systematically for the payment of definitely determinable benefits to employees (and their beneficiaries) after retirement over a period of years, usually for life. Retirement benefits are generally measured by such factors as years of the employee's service and compensation received. (Reg §1.401-1(b)(1)(i)) Benefits under a defined benefit plan are "definitely determinable" if they are determined actuarially, on a basis that precludes employer discretion. (Code Sec. 401(a)(25)) A money-purchase plan, in which contributions are geared to a fixed formula (e.g., 10% of compensation) rather than to profits, is a pension plan if the plan "designates" its intent to be a money purchase pension plan. (Code Sec. 401(a)(27)(B); Reg §1.401-1(b)(1)(i))

- *Profit-sharing plan.* A qualified profit-sharing plan must have a definite, predetermined formula for allocating contributions made under the plan among the participants, and for distributing the funds accumulated under the plan only after a fixed number of years, the attainment of a stated age or upon the occurrence of some event (such as disability, retirement, death or severance from employment). (Reg §1.401-1(b)(1)(ii)) Contributions can be made to a qualified profit-sharing plan whether or not the employer has current or accumulated profits, and whether or not the employer is a tax-exempt organization. (Code Sec. 401(a)(27)(A))

- *Age-weighted profit-sharing plan.* These are profit-sharing plans in which each employee is given points based on age, service and compensation. The plan needn't grant points for both age and service (but must grant points for one of them) or for compensation. Each employee must get the same number of points for each year of age, service, and unit (not more than $200) of compensation. Employer contributions and forfeitures are then allocated in proportion to each employee's total points. (Reg §1.401(a)(4)-2(b)(3))

- *Stock bonus plan.* A qualified stock bonus plan provides benefits in the form of the employer corporation's own stock. Stock bonus plans must generally satisfy the qualification requirements that apply to profit sharing plans, plus some additional requirements.

- *Employee stock ownership plan (ESOP).* An ESOP is a qualified defined contribution plan (defined below) that is either a stock bonus plan, or a combination stock bonus and money purchase plan, that invests primarily in employer securities (Code Sec. 4975(e)(7)), and is formally designated as an ESOP.

- *Thrift plan and savings plan.* A thrift plan is in the nature of a profit-sharing plan and provides for the contribution by the participants of a specified percentage (the same for all participants) of their salaries. This employee contribution is then matched by the employer, either dollar for dollar or in some other specified manner, out of profits. A savings plan permits employees to make voluntary employee contributions which aren't limited to any specific percentage of compensation. These plans may allow withdrawal of the voluntary employee contributions (plus earnings) before retirement or termination.

- *Annuity plans.* The tax advantages of a qualified plan can be obtained without a trust by using contributions to buy retirement annuities directly from an insurance company. (Code Sec. 403(a)(1), Code Sec. 404(a)(2)) For Code Sec. 403(b) "tax-sheltered annuities" for employees of tax-exempt organizations and public schools, see V.E.

- *SEP and SIMPLE Plans.* Simplified employee pension (SEP) plans and savings incentive match plans for employees (SIMPLE) are simplified versions of qualified plans designed for small employers.

A "401(k) plan" (also known as a cash or deferred arrangement or CODA) is a popular feature of profit-sharing and stock bonus plans. It allows an employee to choose whether the employer should pay a certain amount directly to the employee in cash, or should instead pay that amount on the employee's behalf to a qualified trust under a profit-sharing or stock bonus plan. (Code Sec. 401(k))

A person who is a "self-employed individual," i.e., derives "earned income" from a business or profession that he or she owns or conducts, or who has earned income from a partnership in which he or she is a partner, or has other self-employment income (such as director's fees), can establish and be covered by a qualified retirement plan, sometimes called a Keogh plan. (Code Sec. 401(c)(1)). Earned income for this purpose consists essentially of earnings attributable to personal services, whether from a sole proprietorship, partnership or other unincorporated venture, derived from the trade or business with respect to which the plan is established. (Code Sec. 401(c)(2), Code Sec. 401(d))

Besides the plan types outlined above, there is another way to categorize qualified retirement plans: "defined benefit" and "defined contribution" plans. Certain rules governing qualified plans specifically apply either to "defined contribution plans" or to "defined benefit plans."

A defined contribution plan provides for individual accounts for participants and for benefits based on those accounts. (Code Sec. 414(i)) Included are money purchase pension plans, profit-sharing plans and stock bonus plans.

A defined benefit plan is a pension plan other than a defined contribution plan. (Code Sec. 414(j)) It provides for the payments of definitely determinable benefits to the employee over a period of years, usually for life, after retirement. (Reg §1.401-1(b)(1)(i))

Review Question 18

A plan that provides for the payment of definitely determinable benefits to employees (and their beneficiaries) after retirement over a period of years, usually for life, is a ______________.

a. Profit-sharing plan.

b. Pension plan.

c. 401(k) plan.

d. Stock bonus plan.

B. Qualification Requirements

The chief requirements for tax qualification of an employee retirement plan and tax-exempt trust are:

- The plan must be a definite written program that's communicated to the employees. (Reg §1.401-1(a)(2))
- The plan must be established by the employer for the exclusive benefit of the employees or their beneficiaries. (Code Sec. 401(a)(1))
- The plan must generally provide that benefits can't be assigned, except for transfers under a qualified domestic relations order (QDRO) and judgments or settlements for certain crimes and violations of the Employee Retirement Income Security Act (ERISA). (Code Sec. 401(a)(13); Reg §1.401(a)-13(g)(2))
- The plan must meet special tests based on coverage and eligibility of employees to participate.
- The plan must not discriminate in favor of highly compensated employees with respect to contributions or benefits.
- The plan must be properly funded, and must meet certain vesting requirements.
- Under a defined benefit plan, forfeitures must not be applied to increase the benefits of the employees. (Code Sec. 401(a)(8))
- A pension plan (and certain other plans) must in general pay a married participant's benefits in the form of a qualified joint and survivor annuity, unless the participant elects otherwise (with written spousal consent). A qualified pre-retirement survivor annuity must be provided to a surviving spouse of a vested participant who dies before the annuity starts, unless the participant (with written spousal consent) elected to waive it. (Code Sec. 401(a)(11), Code Sec. 417) For plan years beginning after 2007, plans subject to the survivor annuity rules must offer a qualified survivor optional annuity (QSOA) when the QJSA or QPSA is waived. (Code Sec. 417(g)(1))
- In the event of a merger or consolidation with, or transfer of assets or liabilities to, any other plan, each participant must be entitled to a termination benefit after the merger, etc., at least equal to his or her pre-merger termination benefit. (Code Sec. 401(a)(12))
- The plan may not provide for contributions or benefits that exceed specified overall limitations (Code Sec. 401(a)(16))
- The plan must provide that benefit payments begin (unless otherwise elected) no later than the 60th day after the plan year in which occurs the latest of: (a) the date the participant reaches age 65 (or earlier retirement age), (b) the 10th anniversary of the employee's participation in the plan, or (c) the date the participant terminates service. (Code Sec. 401(a)(14); Reg §1.401(a)-14(a))

- The plan must provide certain required minimum distribution rules (Code Sec. 401(a)(9))
- A pension plan generally can't allow withdrawal of employer contributions before termination of employment or of the plan, However, under the Pension Protection Act of 2006 (P.L.109-280), a pension plan may permit benefits to be paid prior to termination if an employee is age 62 or older. (Pension Protection Act §905(b)) Employer contributions accumulated in a profit-sharing plan may be distributed after a fixed number of years (not less than two years). (Reg §1.401-1(b)(1)(ii)) A profit-sharing plan may also permit withdrawal of employer contributions for hardship or by participants with at least 60 months of participation.
- Every plan must provide that a distributee of an eligible rollover distribution may elect to have the distribution transferred directly to an eligible retirement plan. (Code Sec. 401(a)(31)(A); Reg §1.401(a)(31)-1)
- The plan can't reduce plan benefits (including death or disability) to account for post-separation social security benefit increases. (Code Sec. 401(a)(15))
- Whenever an employee's compensation is a measure under the qualified plan rules, a plan may take into account only the first $245,000 for 2011 of each employee's annual compensation. (Code Sec. 401(a)(17))
- Defined benefit plans other than government plans must meet minimum participation requirements (Code Sec. 401(a)(26)) in addition to the coverage and eligibility requirements.

Minimum funding requirement. Defined benefit and money purchase plans (including target benefit plans) must maintain a "minimum funding standard account," to which credits and charges (including interest) are made, and satisfy a "minimum funding standard" each plan year. (Code Sec. 412(a), Code Sec. 412(b))

Returning veterans. An employee who returns to a civilian employer following qualified military service is entitled to restoration of certain qualified plan benefits that would have accrued but for the absence due to military service. Qualified military service of a reemployed person must not be treated as a break in service, and must be considered service with the employer for purposes of determining the nonforfeitability and the accrual of the individual's benefits. (Code Sec. 414(u)(8)(B)) "Make-up" contributions in excess of the usual contribution and deduction limits for the year, and suspension of plan loan repayment during uniformed service do not cause loss of a plan's qualified status. (Code Sec. 414(u)(1); Code Sec. 414(u)(4)) Plans must permit returning employees to make additional elective deferrals and employee contributions, and must make matching contributions that would have been required had the deferral been made during the period of military service. (Code Sec. 414(u)(2)(A))

1. Vesting of Benefits

Qualified plans must provide that a participant's right to his or her accrued benefit vests at certain rates during the years of his or her employment. Benefits derived from employee contributions must be 100% vested at all times. (Code Sec. 411(a); Reg §1.411(a)-1(a)(2)) Benefits derived from employer contributions must become nonforfeitable when the employee reaches normal retirement age (defined below). (Code Sec. 411(a))

The plan also must meet one of two alternative minimum vesting standards for vesting in benefits derived from employer contributions before normal retirement age. For defined benefit plans, the two alternatives are (1) a five-year cliff schedule requiring full vesting after five years of service, or (2) a three-to-seven year graded schedule requiring 20% vesting after three years of service and 20% additional vesting in each of the following years. For defined contribution plans, the two alternatives provide accelerated vesting: (1) a three-year cliff schedule, or (2) a two-to-six year graded schedule. (Code Sec. 411(a)(2)

"Accrued benefit" means the participant's annual benefit (or its actuarial equivalent) starting at normal retirement age (defined benefit plans) or the balance in the participant's account (defined contribution plans). (Code Sec. 411(a)(7)(A))

Normal retirement age is the earlier of the time a participant attains normal retirement age under the plan or the later of: (1) the time the participant reaches age 65, or (2) the 5th anniversary of the individual's participation in the plan. (Code Sec. 411(a)(8))

Review Question 19

Which of the following vesting schedules can be used for employee contributions?

a. Three-year cliff vesting.
b. Five-year cliff vesting.
c. Three-to-seven year graded vesting.
d. Immediate vesting.

2. Nondiscrimination Requirements

A qualified plan other than a government plan must meet special tests designed to ensure adequate coverage of rank and file employees and avoid discrimination.

The plan must, on at least one day in each quarter of its tax year, either: (1) benefit 70% of the employees who aren't "highly compensated" (2) benefit a percentage of non-highly compensated employees that is at least 70% of highly compensated employees benefiting, or (3) meet a test under which the average benefit for the non-highly compensated is at least 70% of the average benefit for the highly compensated. (Code Sec. 410(b)(1)) This "average benefits test" also requires that the plan benefit employees under a nondiscriminatory classification. (Code Sec. 410(b)(2)) However, a plan maintained by an employer that has no employees other than highly compensated employees for a year is treated as meeting the coverage requirement for the year. (Code Sec. 410(b)(6)(F))

A qualified plan can't require as a condition of participation that any employee complete a period of service extending beyond the later of the date he or she: (1) reaches age 21, or (2) completes one year of service (or two years, if the plan provides full and immediate vesting for all participants). (Code Sec. 410(a)(1)(A), Code Sec. 410(a)(1)(B)(i))

A "highly compensated employee" is an employee who (1) was a 5% owner at any time during the determination year or the preceding year, or (2) for the preceding year, received more than a specified amount of compensation from the employer ($115,000 in 2013) and, if the employer elects, also was in the "top-paid group" (top 20%) of employees for that year. (Code Sec. 414(q))

Nondiscriminatory contributions and benefits. Contributions or benefits under a plan other than a governmental plan must not discriminate in favor of highly compensated employees. (Code Sec. 401(a)(4)) To comply, a plan must satisfy three requirements:

- either the contributions or benefits under the plan must be nondiscriminatory in amount,
- the plan's optional forms of benefit, ancillary benefits (e.g., disability benefits), and other rights and features (e.g., plan loans and investment alternatives) must be made available to employees in a nondiscriminatory manner, and
- the effect of certain plan amendments, grants of past service credit, and plan terminations must be nondiscriminatory. (Reg §1.401(a)(4)-1(b))

Defined benefit plans can be cross-tested for discrimination on the basis of equivalent employer contributions to profit-sharing plans, and vice versa. (Reg §1.401(a)(4)-8) "Catch-up" elective deferrals by older employees (see below) are not subject to nondiscrimination requirements. (Code Sec. 414(v)(3)(B))

Minimum participation requirements. A defined benefit plan other than a governmental plan isn't qualified unless, on each day of the plan year, the plan benefits at least the lesser of (1) 50 employees of the employer, or (2) the greater of 40% of employees or two employees (or one employee if there is only one employee). (Code Sec. 401(a)(26)(A)) Instead of meeting the test on each day of the plan year, compliance on a single representative "snapshot" day during the year is sufficient. (Reg §1.401(a)(26)-7(b))

Contributory plans. No discrimination must result when a plan requires an employee to contribute to a qualified plan as a condition of participation or when it permits such contributions. Employee contributions and any matching contributions the employer makes under defined contribution plans (and those under a defined benefit plan treated as made under a defined contribution plan) must meet a nondiscrimination test. This test restricts the extent to which the actual contribution percentage (ACP) of eligible highly compensated employees can exceed the ACP for all other eligible employees. (Code Sec. 401(m), Code Sec. 414(k)(2)) The current year ACP for highly compensated employees is compared to the previous year's, or electively the current year's, ACP for other employees. (Code Sec. 401(m)(2)) The ACP test can be satisfied using a safe-harbor. (Code Sec. 401(m)(11)) "SIMPLE" plans are deemed to satisfy the ACP test. (Code Sec. 401(m)(10))

3. Top-heavy Plans

A "top-heavy" plan (i.e., a plan that provides more than 60% of its benefits to key employees) must meet specified additional requirements in the areas of minimum vesting and minimum benefits or contributions for non-key employees, in determining contributions or benefits. (Code Sec. 416(a)) SIMPLE retirement plans and 401(k) plans that meet safe-harbor nondiscrimination requirements, aren't subject to the top-heavy rules. (Code Sec. 416(g)(4)(G) and (H))

Vesting requirements. For any plan year for which a plan is a top-heavy plan, an employee's rights to accrued benefits must be 100% vested after three years of service or, at the employer's option, 20% vested after two years' service and 20% in each of the following years (100% vested after six years of service). (Code Sec. 416(b)) (Note: This is the same schedule that applies to employer contributions in all defined contribution plans; see above.)

Minimum benefits or contributions. A defined benefit plan must provide a minimum annual retirement benefit, not integrated with social security, for a non-key employee equal to the lesser of: (1) 2% of the participant's average compensation for years in the testing period multiplied by his or her years of service with the employer, or (2) 20% of his or her average compensation in the years in the testing period. (Code Sec. 416(c)(1))

In a defined contribution plan, the employer must contribute for each non-key employee not less than 3% of that employee's compensation (including employer matching contributions). But the percentage doesn't have to exceed the percentage at which contributions are made, or required to be made, for the key employee with the highest contribution percentage. (Code Sec. 416(c)(2))

C. Contributions and Benefits

Subject to applicable limits, an employer can deduct its timely paid contributions to a qualified plan. (Code Sec. 404(a); Reg §1.404(a)-1(b)) However, the plan to which the contribution is made must be in existence by the end of the employer's tax year.

A contribution actually must be paid to the trust or under the plan to be deductible. (Code Sec. 404(a)) However, payments (including those made under "SIMPLE" plans (Code Sec. 404(m)(2)(B)), made after the end of a year are considered paid on the last day of the year if paid by the employer no later than the due date of its tax return (including extensions). (Code Sec. 404(a)(6)) This applies to both cash and accrual employers, even if other accrual requirements are not met. (Reg §1.404(a)-1(c))

Apart from certain "lump-sum" payments qualifying for preferential tax treatment, and "rollovers," distributions from a qualified plan generally are taxed to the employee under the annuity rules (see Module 1, *Taxation of Individuals*) in the year distributed or otherwise made available to the employee. (Code Sec. 402(a); Reg §1.402(a)-1(a)) Thus, the excess of the distribution (cash or fair market value of property) over the amount of any after-tax plan contributions made by the employee, is ordinary income. (Code Sec. 402; Reg §1.402(a)-1(a)(1)(i))

The cost of current life insurance protection under a life insurance contract purchased with employer contributions to a qualified plan (or earnings thereon) is income to the insured employee for the tax year of purchase, where the benefits are payable to the insured or his or her beneficiaries. (Code Sec. 72(m)(3); Reg §1.72-16(b)) The taxable amount is generally determined under IRS's "Table 2001."

1. Ceiling on Deductions

There is a special ceiling on deductions for contributions under a profit-sharing, stock-bonus, or "SIMPLE" plan. These deductions cannot exceed 25% of the aggregate compensation (exclusive of qualified plan contributions) paid or accrued during the tax year for all employees participating in the plan. (Code Sec. 404(a)(3)(A); Code Sec. 404(m)(1); Reg §1.404(a)-9(c)) Contributions in excess of this limit may be carried over and deducted in a later year to the extent that contributions for that later year are below the applicable percentage limit for that year. (Code Sec. 404(a)(3)(A)(ii))

The percentage of compensation limit on deductible contributions to a stock bonus or profit-sharing plan for a self-employed individual (Keogh plan) is 25% of "earned income," which is 25% of net earnings from self-employment less the self-employment tax deduction and deductible qualified plan contributions. (Code Sec. 404(a)(8)(B))

Elective deferrals are not subject to the deduction limits. (Code Sec. 404(n))

Compensation includes elective deferral amounts, amounts deferred to a cafeteria plan, and certain pre-disability compensation. (Code Sec. 404(a)(12))

If there is a mixture of one or more defined contribution plans and one or more defined benefit plans, or any combination of two or more pension trusts, annuity plans, and stock bonus or profit-sharing trusts, an overall limit on deductible contributions applies. Under this limitation, the total amount deductible for all plans is the greater of: (1) 25% of the compensation (exclusive of qualified plan contributions) paid or accrued during the tax year to the beneficiaries of the various trusts or plans, or (2) the total contributions to the trusts or plans to the extent those contributions don't exceed the amount necessary to satisfy the minimum funding standards. (Code Sec. 404(a)(7)(A)) The 25% limit does not apply if the only amounts contributed to the defined compensation plan are elective deferrals. (Code Sec. 404(a)(7)(C)(ii)

2. Overall Limit on Contributions and Benefits

A plan can't be qualified if it provides for contributions or benefits that exceed the overall limitations described below.

Defined benefit plan. Benefits under a defined benefit plan will disqualify the plan if the "annual benefit" for each participant beginning at age 65 exceeds the lesser of:

- $205,000 for 2013 (indexed for future inflation), but actuarially reduced if benefit begins before age 62, and raised if it begins after age 65), or
- 100% of the participant's average compensation for his or her high three years of compensation. (Code Sec. 415(b))

The maximum dollar benefit is reduced if the employee has less than ten years of plan participation when retirement benefits begin. (Code Sec. 415(b)(5)) This reduction doesn't apply to pro rata benefit increases under a terminating plan if there is no discrimination in favor of highly compensated employees. (Code Sec. 4980(d)(4)(C)) Neither the dollar nor the percentage limitation applies if the annual benefit payable under a defined benefit plan doesn't exceed $10,000 and the employer has never had a defined contribution plan in which the employee participated. (Code Sec. 415(b)(4))

The Pension Protection Act of 2006 (P.L.109-280) changed the definition of "high three years of compensation" for plan years beginning after 2005. Formerly, this was defined as the period of not more than three consecutive calendar years during which the participant both (a) was an active participant in the plan, and (b) had the greatest aggregate compensation from the employer. The Pension Protection Act eliminated the active participant requirement. (Pension Protection Act §832(a))

Review Question 20

For tax years beginning in 2013, the maximum annual benefit payable at retirement under a defined benefit plan is generally the lesser of (1) ________ or (2) 100% of the participant's average compensation for his or her three high three years of compensation.

a. $180,000.	b. $185,000.
c. $195,000.	d. $205,000.

Defined contribution plan. Annual additions under a defined contribution plan may not exceed the lesser of:

- $51,000 for 2013 (indexed for future inflation), or
- 100% of the participant's compensation. (Code Sec. 415(c)(1))

Annual additions include employer contributions, employee contributions other than qualified cost-of-living contributions to a defined benefit plan (Code Sec. 415(k)(2)(A)), and employee forfeitures. (Code Sec. 415(c))

Benefits provided to alternate payees under any qualified domestic relations order (QDRO) relating to a participant's benefits must be aggregated with benefits provided to the participant from all defined benefit and defined contribution plans in applying the Code Sec. 415 limitations.

3. Lump-sum Distributions

Distributions from a qualified plan to an employee or his or her beneficiaries, that are lump-sum distributions, are taxable as ordinary income, subject to income averaging for those born before 1936.

A lump-sum distribution eligible for preferential tax treatment is a distribution or payment from an exempt trust or annuity within one tax year of the recipient of the balance to the credit of the participant:

- on account of an employee's (other than a self-employed's) separation from service; or
- after attaining age 59½ (regardless of his or her separation from service); or
- on account of the employee's death; or
- on account of disability if he or she is self-employed. (Code Sec. 402(e)(4)(D))

A participant who reached age 50 before 1986 (or an individual, estate or trust that receives a distribution with respect to that employee) is permitted to elect ten-year averaging at 1986 tax rates with respect to a lump-sum distribution. This election can only be made once with respect to an employee.

4. Rollovers

A distribution from a qualified plan may be rolled over free of tax if certain requirements are met. Generally, any portion of an "eligible rollover distribution" made by a qualified plan qualifies for tax-free rollover into an "eligible retirement plan" (see below). (Code Sec. 402(c); Reg §1.402(c)-2)

Mandatory 20% withholding applies to distributions that aren't directly rolled over from trustee to trustee.

Eligible retirement plans. "Eligible retirement plans" into which employees can roll over plan distributions include:

- individual retirement accounts (IRAs),
- individual retirement annuities (other than endowment contracts),
- Code Sec. 401(a) qualified plans, or
- Code Sec. 403(a) annuities. (Code Sec. 402(c)(8)(B)), and
- Code Sec. 403(b) tax-sheltered annuities.

Under the Pension Protection Act of 2006 (P.L.109-280) individuals who receive amounts from tax-qualified retirement plans and 403(b) annuities in 2008 or later years can roll over those amounts into a Roth IRA. (Pension Protection Act §824) For any distribution from an eligible retirement plan which is contributed to a Roth IRA in a qualified rollover contribution, the individual on whose behalf the Roth IRA is maintained will have to include in gross income any amount which would have been includible were it not part of a qualified rollover contribution.

Eligible rollover distribution. Generally, an "eligible rollover distribution" is any distribution to an employee of all or any portion of the balance to his or her credit in a qualified plan. But rollovers are not allowed for required distributions, hardship distributions, annuities over life or life expectancy, installments over ten years or more, or, in certain cases, the nontaxable portion of a distribution. (Code Sec. 402(c)(4); Reg §1.402(c)-2, Q&A 3 et seq.)

60-day rule. Rollovers can be made either by electing direct trustee-to-trustee transfers, or by rolling over a distribution within 60 days after receiving it. IRS may waive the 60-day rollover requirement under a hardship exception to the 60-day rule, if an individual suffers a casualty, disaster, or other event beyond his or her reasonable control, and not waiving the 60-day requirement would be against equity or good conscience. (Code Sec. 402(c)(3)(B))

5. Required Minimum Distributions

A qualified plan must provide that the employee's entire interest begin to be distributed, starting April 1 of the calendar year following the later of the year in which he or she: (1) reaches age 70½ or (2) retires (except for 5% owners). The distributions must be spread out over no longer than

- the employee's life,
- the employee's life and the life of a designated beneficiary,
- a period of not more than the employee's life expectancy, or
- a period of not more than the employee's life expectancy and that of a designated beneficiary. (Code Sec. 401(a)(9)(A), Code Sec. 401(a)(9)(C))

A qualified plan may provide that the required beginning date for all employees (including non-5% owners) is April 1 of the calendar year following the calendar year in which the employee attained age 70½. (Reg §1.409(a)(9)-2 Q&A 2(e))

Where distributions to a participant have begun, but he or she dies before the entire interest has been distributed, the participant's remaining interest must be distributed at least as rapidly as under the method of distribution in effect at the date of death. (Code Sec. 401(a)(9)(B)(i)) Where the participant dies before receiving any required plan distributions, his or her entire interest must generally be distributed within five years after death. However, the five-year rule does not apply when the employee's interest:

- is distributed over the life of a designated beneficiary (or over a period not extending beyond the life expectancy of the beneficiary) and the distributions begin no later than one year after the date of the employee's death (Code Sec. 401(a)(9)(B)(ii), Code Sec. 401(a)(9)(B)(iii)), or
- is distributed over the life of the surviving spouse (or over a period not extending beyond his or her life expectancy), and the distributions begin no later than the date on which the employee would have reached age 70½. If the surviving spouse dies before payments must begin, then the 5-year rule applies as if the surviving spouse were the employee. (Code Sec. 401(a)(9)(B)(iv))

Review Question 21

An employee dies before receiving any distributions from a plan, naming his spouse as beneficiary. Which of the following distribution requirements applies to the employee's interest in the plan?

a. The employee's interest must be distributed within five years after his death.

b. The employee's interest may be distributed over the surviving spouse's life if distributions begin no later than one year after the date of the employee's death.

c. The employee's interest may be distributed over the surviving spouse's life if distributions begin no later than the date on which the employee would have reached age 70½.

d. The employee's interest may be distributed over the surviving spouse's life if distributions begin no later than the date on which the surviving spouse reaches age 70½.

The account owner's "designated beneficiary" is determined based on the beneficiaries designated as of the account owner's date of death who remain beneficiaries on September 30 of the year following the year of the account owner's death. (Reg §1.409(a)(9)-4, Q&A 4(a)) Any beneficiary eliminated by distribution of the benefit or through disclaimer (or otherwise) during the period between the account owner's death and September 30 of the year following the year of death is disregarded in determining the designated beneficiary for purposes of calculating RMDs. (Reg §1.409(a)(9)-4, Q&A 4(a))

Generally speaking, only an individual may be a designated beneficiary for purposes of the RMD rules. (Reg §1.401(a)(9)-4, Q&A 3) However, an underlying beneficiary of a trust may be treated as the account owner's designated beneficiary for RMD purposes when the trust is named as the beneficiary if certain requirements are met (e.g., documentation of the underlying beneficiaries of the trust must be provided timely to the plan administrator, and beneficiaries of the trust can be identified). (Reg §1.409(a)(9)-4, Q&A 6(b), Q&A 5)

Computing the required minimum distribution. In the case of lifetime distributions, the required minimum distribution (RMD) for each year is found by dividing the account balance as of the end of the preceding year by the age-based factor from the table in Reg §1.401(a)(9)-9, Q&A 2. (Reg §1.401(a)(9)-5) Portions of this table are excerpted below (the full table goes to age 115).

Uniform Lifetime Table

Employee's Age	*Distributed Period*	*Employee's Age*	*Distributed Period*
70	27.4	83	16.3
71	26.5	84	15.5
72	25.6	85	14.8
73	24.7	86	14.1
74	23.8	87	13.4
75	22.9	88	12.7
76	22.0	89	12.0
77	21.2	90	11.4
78	20.3	91	10.8
79	19.5	92	10.2
80	18.7	93	9.6
81	17.9	94	9.1
82	17.1	95	8.6

The above table is used for lifetime distributions of the account owner regardless of the identity of the beneficiary or age differential between account owner and designated beneficiary, unless the account owner's spouse is the sole beneficiary and is more than 10 years younger than the account owner, in which case the distribution period may be measured by the joint life and last survivor life expectancy of the employee and spouse, using the life expectancies in the joint and last survivor table of Reg §1.401(a)(9)-9, Q&A 3. (Reg §1.409(a)(9)-5, Q&A 4(b), Q&A 6)

Review Question 22

An employee age 76 had a balance of $100,000 in his plan account as of the end of the preceding year; his account balance for the current year is $125,000. What is the amount of the employee's required minimum distribution for the current year?

a. $4,367.   b. $4,545.

c. $4,717.   d. $5,682.

In the case of post-death distributions for non-annuity-type payouts:

- If the account has a designated beneficiary, and the account owner died before his or her required beginning date, the remaining account balance may be paid out over the remaining life expectancy of the beneficiary, using the life expectancy of the beneficiary in the Single Life Table of Reg §1.401(a)(9)-9, Q&A 1.

- If the account has a designated beneficiary, and the account owner died after the date he or she was required to begin receiving distributions, the remaining account balance may be paid out over the longer of the remaining life expectancy of the beneficiary or the remaining life expectancy of the account owner. In either instance, the life expectancy for post-death RMDs is determined using the Single Life Table of Reg §1.401(a)(9)-9, Q&A 1.
- If the account does not have a designated beneficiary and the account owner dies after his or her required beginning date, the remaining balance is paid out over the remaining life expectancy of the account owner, using the Single Life Table of Reg §1.401(a)(9)-9, Q&A 1. If the account owner dies before his or her required beginning date, the account balance must be paid out no later than 5 years after the year of the owner's death. (Reg §1.401(a)(9)-3, Q&A 1; Reg §1.401(a)(9)-5, Q&A 5)

The 50% excise tax on failures to make RMDs is waived during the first five years after the year of the account owner's death before the required beginning date if the entire benefit is distributed by the end of the fifth year following the year of death. (Reg §54.4974-2, Q&A 4)

Separate rules apply to annuity type required distributions, namely defined-benefit (i.e., pension) plan RMDs, as well as annuity contracts purchased from firms such as insurance companies to make RMDs from other qualified plans and IRAs. (Reg §1.401(a)(9)-6T)

6. Premature Distributions

Early withdrawals from a qualified retirement plan result in an additional tax equal to 10% of the amounts withdrawn that are includible in gross income. (Code Sec. 72(t)(1)) The additional tax applies to all withdrawals unless specifically excepted. Exceptions include distributions:

- made on or after age 59½;
- made to a beneficiary or estate on or after death;
- attributable to disability;
- from a qualified plan after an employee's separation from service after age 55;
- not in excess of the amount allowable as a medical expense deduction for the year, whether or not the distributee itemizes;
- that are part of a series of substantially equal periodic (annual or more frequent) payments (made after separation from service if from a qualified plan) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his or her beneficiary;
- from a qualified plan to an alternate payee under a qualified domestic relations order; and
- made on account of an IRS tax levy. (Code Sec. 72(t)(2), Code Sec. 72(t)(3))

Review Question 23

Which of the following distributions from a qualified plan is **not** exempt from the penalty for premature distributions?

a. A distribution made on account of an IRS tax levy.

b. A distribution made after age 55.

c. A distribution under a qualified domestic relations order.

d. A distribution attributable to a disability.

7. Loans from Qualified Plans

A loan from a qualified plan isn't treated as a taxable distribution to the plan participant only if it must be repaid within five years (except for certain home loans), and doesn't exceed the lesser of:

- $50,000, or
- the greater of
- half of the present value of the employee's non-forfeitable accrued benefit under the plan, or
- $10,000.

If a plan loan (when added to the employee's outstanding balance of all other plan loans at the time the loan is made and the highest outstanding loan balance during the year before the loan was made) exceeds these limits, the excess is treated (and taxed) as a plan distribution. The entire amount of a plan loan that isn't required to be repaid within five years (except for certain home loans) is treated as a plan distribution. (Code Sec. 72(p)) The outstanding balance of a plan loan is treated as distributed if the borrower fails to make a scheduled loan repayment installment before any allowable grace period expires. (Reg §1.72(p)-1, Q&A 10(b)) Loan repayment following a deemed distribution increases the participant's investment in the contract (basis). (Reg §1.72(p)-1, Q&A 21)

A plan loan must be amortized in substantially level payments, at least quarterly, over its term. (Code Sec. 72(p)(2)(C)) The level amortization requirement doesn't apply while the employee is on leave without pay for up to one year. (Reg §1.72(p)-1, Q&A 9)

D. 401(k) Plans

A 401(k) plan must meet all the normal tax qualification rules (see above), including the nondiscrimination rules, and, in addition, all of the following requirements:

- amounts must not be distributable except by reason of (1) retirement, death, disability or other separation from employment, including certain transfers in connection with the sale of a business, (2) "hardship" or attainment of age 59½ (for profit-sharing or stock bonus plans), (3) in a lump sum on termination of the plan, or (4) in a lump sum, on the employer's disposition of substantially all of its trade or business assets, or a subsidiary (Code Sec. 401(k)(2)(B))
- employer contributions made under the employee's election must be non-forfeitable at all times (Code Sec. 401(k)(2)(C));
- a covered employee must be able to elect to have the employer make plan contributions on the employee's behalf or make the payment directly to the employee in cash (Code Sec. 401(k)(2)(A)) ("negative elections" may be permitted for employees who don't affirmatively elect to receive cash);
- elective deferrals under the plan (as aggregated with all other plans, etc., of the employer) must be prohibited from exceeding the indexed dollar limits (see below);
- special nondiscrimination rules must be complied with. These rules require the plan to satisfy one of two "actual deferral percentage tests," so highly compensated employees can't elect to defer a disproportionately higher amount of their salary than non-highly compensated employees. (Code Sec. 401(k)(3)(A)) An alternative nondiscrimination safe-harbor based on employer matching or non-elective contributions also is available. (Code Sec. 401(k)(12))

A 401(k) plan may allow participants to elect to have all or part of their elective deferrals treated as Roth IRA (see Module 1, Taxation of Individuals) contributions. (Code Sec. 402A)

An in-service distribution on account of "hardship" may only be made if the employee has "an immediate heavy financial need" and the distribution is "necessary to meet such need." But a distribution may be considered for hardship only to the extent that, as shown by the employee, the need can't be relieved by certain alternate sources, e.g., loans, insurance. (Reg §1.401(k)-1(d)(3)) Hardship distributions are not rollover-eligible.

An employee may elect to defer a maximum of $17,500 for 2013 on a pre-tax basis under a 401(k) plan, SEP, or Code Sec. 403(b) tax-sheltered annuity. (Code Sec. 402(g)(1), Code Sec. 402(g)(4)) Individuals who attain age 50 by the end of the plan year may make (if their plan permits (Reg §1.414(v)-1(a))) additional pre-tax "catch-up" contributions of up to $5,500 for 2013, with inflation adjustments in later years. (Code Sec. 414(v)(2)(B)(i) and (C)) The maximum catch-up amounts apply to all qualified plans, tax sheltered annuity plans, SEPs and SIMPLE plans of an employer on an aggregated basis, as if all plans were a single plan. (Code Sec. 414(v)(2)(D))

Excess deferrals must be either corrected (i.e., distributed) by April 15 of the following tax year (Reg §1.402(g)-1(e)(2)(ii)), or included in the employee's gross income. (Reg §1.402(g)-1(a))

E. 403(b) Annuities

Employees of tax-exempt educational, charitable, religious, etc., organizations, or public schools get special tax advantages from annuities bought for them by the exempt employers.

Tax-sheltered annuities offer benefits similar to those under a qualified employee plan. Tax isn't imposed when the annuity is bought, but is deferred until payments are received. (Code Sec. 403(b); Reg §1.403(b)-1) These annuities may be bought only for common law employees of certain exempt educational, charitable, religious, etc., employers, and by or for certain self-employed ministers. (Code Sec. 403(b)(1)(A)) The annuity must be non-forfeitable (except for failure to pay premiums) and nontransferable. (Code Sec. 403(b)(1)(C); Reg §1.401-9(b)(3)) Certain elective deferral limits must be met if the annuity is part of a salary reduction arrangement. (Code Sec. 403(b)(1)(E)) Also, except for annuities bought by church employers, certain nondiscrimination tests must be met. (Code Sec. 403(b)(1)(D), (b)(12)) Tax-sheltered annuities are treated as defined contribution plans for purposes of the contribution limits (see). (Reg §1.415-6(e)(1))

The tax deferral is denied for distributions attributable to contributions made under a salary reduction agreement unless the annuity provides that payments may be paid only:

- when the employee attains age 59½, separates from employment, dies, or becomes disabled, or
- in the case of hardship. (Code Sec. 403(b)(11))

The contract may not provide for the distribution of any income attributable to such contributions in the case of hardship. (Code Sec. 403(b)(11))

If a qualifying employer buys a tax-sheltered annuity for an employee and employee's rights are non-forfeitable, the premium paid is not taxable to the employee at that time, up to the applicable limit for a defined contribution plan under Code Sec. 415 (see V.C.2.). (Code Sec. 403(b)(1), Code Sec. 415(c)(1), Code Sec. 415(k)(4)) Special limits apply for contributions by church plans. (Code Sec. 415(c)(7))

An employee of a qualifying employer can agree to reduce his or her salary or forego an increase as a means of contributing to a 403(b) plan. (Reg §1.403(b)-1(b)(3)) All of the employer's employees must generally get a chance to elect to have the employer contribute more than $200 under the salary reduction agreement, on a nondiscriminatory basis, if any employee may so elect. (Code Sec. 403(b)(12)(A)) The employee's elective deferrals for a year can't exceed the 401(k) limits, including catch-up contributions for those age 50 or over. (Code Sec. 403(b)(1)(E))

For tax years beginning after 2008, the 403(b) annuity must be maintained pursuant to a written defined contribution plan that sets out all of the material terms and conditions for eligibility, benefits, distributions, etc. (Reg §1.403(b)-3(b)(3)(i))

F. Simplified Employee Pensions (SEPs)

An employer can make deductible contributions on behalf of its employees to a simplified employee pension (SEP). These deductible employer contributions are excluded from the gross income of the employee.

A SEP is an individual retirement account or individual retirement annuity, established by an employer in which:

- The employer contributions are made only under a definite written allocation formula that is executed within the time for making a deductible contribution that specifies (1) the requirements that an employee must satisfy to share in an allocation, and (2) how the allocated amount is computed. (Code Sec. 408(k)(5))
- Employer contributions for a year must be made to each SEP of each employee who has reached age 21, performed service for the employer during at least three of the immediately preceding five years and has received at least $550 in compensation for 2013 (to be indexed for future inflation). (Code Sec. 408(k)(2))
- The employer contributions don't discriminate in favor of highly compensated employees. (Code Sec. 408(k)(3)(A))
- The employer contributions aren't conditional on the retention in the plan of any portion of the amounts contributed. (Code Sec. 408(k)(4))
- The employer doesn't restrict employee withdrawals. (Code Sec. 408(k)(4)(B)) Employer contributions are discriminatory unless they bear a uniform relationship to the first $255,000 for 2013 of the compensation (including self-employment income) of each employee maintaining the SEP. (Code Sec. 408(k)(3)(C))

Employees covered by a collective bargaining agreement and nonresident aliens may be excluded from participation in the plan and from the discrimination test under certain conditions. (Code Sec. 408(k)(3)(B))

Maximum allowable contributions made by an employer to a SEP on behalf of an employee for any year cannot exceed the lesser of:

- 25% of compensation (limited by the annual compensation limit) from the employer includible in the employee's gross income for the year (determined without regard to the employer's contributions to the SEP), or
- the dollar limitation for defined contribution plans (e.g., $51,000 for 2013).

G. SIMPLE Retirement Plans

A small employer that doesn't have a qualified plan can establish a "SIMPLE" (savings incentive match plan for employees) retirement plan, without having to meet most requirements for qualified plans. A "SIMPLE retirement plan" can be adopted by an employer with 100 or fewer employees who received at least $5,000 of compensation from the employer for the preceding year (Code Sec. 408(p)(2)(C)(i)(I)) that doesn't have another employer-sponsored retirement plan to which contributions were made or benefits accrued for the year. (Code Sec. 408(p)(2)(D)) "Employee" includes a self-employed individual. (Code Sec. 408(p)(6)(B)) A qualifying employer that maintains a SIMPLE plan but later fails to qualify may continue to maintain the plan for two years after its last year of eligibility, subject to certain restrictions for acquisitions, dispositions and similar transactions. (Code Sec. 408(p)(2)(C)(i)(II), Code Sec. 408(p)(10))

A "SIMPLE retirement account" (also called a SIMPLE IRA) into which employer contributions are made, is an individual retirement account or annuity (Code Sec. 408(p)(1)) for which the only contributions allowed are contributions under a "qualified salary reduction arrangement" and that meets certain vesting, participation and administrative requirements (Code Sec. 408(p)(1)(A)). Employees' rights to all SIMPLE IRA contributions must be nonforfeitable. (Code Sec. 408(p)(3)) All employees (except those who can be excluded from a qualified plan) must be eligible either to make a salary reduction contribution or receive nonelective contributions if they received at least $5,000 in compensation from the employer during any two preceding years (Code Sec. 408(p)(4)(A)(i)), and are reasonably expected to receive at least $5,000 in compensation during the current year. (Code Sec. 408(p)(4)(A)(ii))

Employer contributions to SIMPLE IRAs are deductible in the employer's tax year with which (or within which) the calendar year for which the contributions were made ends. (Code Sec. 404(m)(1); Code Sec. 404(m)(2)(A)) Contributions are treated as made for the tax year if they are made (a) on account of that year, and (b) not later than the time for filing that year's tax return (including extensions). (Code Sec. 404(m)(2)(B))

Contributions to SIMPLE IRAs are excluded from the employee's income similar to the rules for SEPs.

Employees designate contributions to be made to a SIMPLE plan under a "qualified salary reduction arrangement." This is a written arrangement under which an employee may elect to have the employer make elective employer contributions (expressed as a percentage of compensation, or, if the employer permits, a specific dollar amount) to a SIMPLE retirement account on behalf of the employee, or to the employee directly in cash. The amount that an employee may elect to contribute can't exceed $12,000 for 2013. (Code Sec. 408(p)(2)(A)(i), Code Sec. 408(p)(2)(A)(ii), Code Sec. 408(p)(2)(E)) Participants who are age 50 or over by the end of the plan year may make additional catch-up contributions of up to $2,500 for 2013, with inflation adjustments in later years. (Code Sec. 414(v)(2)(B)(ii), Code Sec. 414(v)(2)(C)) The employer must make either:

- a matching contribution equal to the amount the employee contributes, up to 3% (Code Sec. 408(p)(2)(C)(ii)(I)) of the employee's compensation for the year, or, electively, as little as 1% in no more than two out of the previous five years, if the employer timely notifies the employees of the lower percentage (Code Sec. 408(p)(2)(C)(ii)(II)); or
- a nonelective contribution of 2% of compensation for each employee eligible to participate who has at least $5,000 of compensation from the employer for the year. (Code Sec. 408(p)(2)(B)(i))

No other contributions may be made. (Code Sec. 408(p)(2)(A)(iv); Code Sec. 408(p)(8)) Elective employer contributions must be made no later than 30 days after the month for which the contributions are to be made. (Code Sec. 408(p)(5)(A)(i)) Matching contributions and nonelective contributions must be made by the deductible contribution due date for the year. (Code Sec. 408(p)(5)(A)(ii))

"Compensation" is wages for income tax withholding purposes plus the amount of the employee's elective deferrals (Code Sec. 408(p)(6)(A)(i)) without regard to the SIMPLE retirement plan provisions. (Code Sec. 408(p)(6)(A)(ii)) The compensation taken into account for purposes of determining the amount of the 2% nonelective contribution can't exceed the limit on compensation (under Code Sec. 401(a)(17) that may be taken into account for the year. (Code Sec. 408(p)(2)(B)(ii))

Review Question 24

The 100 employee limit for a SIMPLE retirement plan takes into account only employees who earned more than _____________ from the employer for the preceding year.

a. $2,500.
b. $5,000.
c. $11,500.
d. $17,000.

Review Question 25

An employee, age 55, works for an employer that sponsors a SIMPLE plan. The employee earns $150,000 a year. The employer's plan permits employees to elect contributions of up to 10% of compensation per year. The employer makes matching contributions to the plan and has not notified employees that it plans to make a lower percentage matching contribution for 2013. What is the maximum amount that can be contributed to the plan on behalf of the employee for 2013?

a. $19,000.
b. $16,500
c. $14,500.

Distributions from a SIMPLE IRA are taxed to the payee under the annuity rules in the year of distribution. (Code Sec. 402(h)(3)). Early withdrawals from a SIMPLE IRA are subject to a 10 percent penalty. A 25% penalty applies for withdrawals during the two-year period beginning on the date when the individual first participated in any qualified salary reduction arrangement maintained by the individual's employer under the simple retirement plan rules.

H. Nonqualified Retirement (Deferred Compensation) Plans

Nonqualified retirement plans are deferred compensation arrangements used by executives to defer current taxation of substantial amounts of income. Special rules makes it more difficult to defer tax on nonqualified retirement plans for tax years beginning after 2004.

Under pre-2005 law, the time for including nonqualified deferred compensation in an individual's gross income generally depended on whether the arrangement was unfunded or funded. If the arrangement was unfunded, then the compensation was generally includible in income when it was actually or constructively received. If the arrangement was funded, then income was includible for the first tax year in which the individual's rights were transferable or not subject to a substantial risk of forfeiture.

Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it can be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, such as a requirement to relinquish a valuable right in order to make withdrawals.

Under the special rules, all amounts deferred under a nonqualified deferred compensation (NQDC) plan are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless the plan:

- meets specified distribution, acceleration of benefit, and election requirements; and
- is operated in accordance with these requirements. (Code Sec. 409A(a)(1)(A)(i))

If an NQDC plan doesn't comply with the Code Sec. 409A rules, all amounts deferred under the plan for the tax year and all prior tax years, by any participant to whom the failure relates, are included in income for that year to the extent not subject to a substantial risk of forfeiture and not previously included in income. This amount is also subject to: (1) interest on the tax underpayments that would have occurred had the amount been included in income for the tax year when first deferred, or if later, when not subject to a substantial risk of forfeiture; and (2) a penalty of 20% of the compensation required to be included in income. (Code Sec. 409A(a)(1)(B))

Compensation is subject to a substantial risk of forfeiture if entitlement to it is conditioned on a person's performance of substantial future services or the occurrence of a condition related to the compensation's purpose (e.g., an amount conditioned on involuntary separation from service without cause), and the possibility of forfeiture is substantial. An amount isn't subject to a substantial risk of forfeiture merely because the right to the amount is conditioned upon the refraining from performance of services, such as a noncompete clause. (Prop Reg §1.409A-1(d); Reg §1.409A-1(d)(1))

An NQDC plan is any plan that provides for the deferral of compensation, other than (1) a qualified employer plan (a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE plan, qualified governmental excess benefit arrangement under Code Sec. 415(m), or eligible deferred compensation plan under Code Sec. 457(b)), and (2) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. (Code Sec. 409A(d)) It also doesn't include annual bonuses, or other annual compensation amounts, paid within 2½ months after the later of a service recipient's or service provider's tax year. (Prop Reg §1.409A-1(b)(4); Reg §1.409A-1(b)(4))

Incentive stock options (ISOs) and options granted under an employee stock purchase plan (ESPP) aren't subject to Code Sec. 409A. Nonqualified stock options and stock appreciation rights (SARs) are similarly excepted if the exercise price may never be less than the fair market value (FMV) of the underlying stock when the option or right is granted, the number of shares subject to the option are fixed on the grant date, and there is no other deferral feature. In addition, the receipt, transfer or exercise of the stock option must be subject to tax under Code Sec. 83, and only the service recipient's stock may be delivered upon a SAR's exercise. (Prop Reg §1.409A-1(b)(5); Reg §1.409A-1(b)(5))

Distribution requirement. The distribution requirement is met if an NQDC plan provides that compensation deferred under the plan cannot be distributed earlier than (1) the participant's separation from service; (2) the date the participant becomes disabled; (3) the participant's death; (4) a time specified, or a schedule fixed, under the plan as of the date of the deferral of the compensation (amounts payable on the occurrence of an event are not treated as payable at a specified time); (5) a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation; or (6) the occurrence of an unforeseeable emergency such as a severe financial hardship resulting from illness, casualty loss, etc. (Code Sec. 409A(a)(2); Prop Reg §1.409A-3(a); Reg §1.409A-3(a))

Acceleration of benefits requirement. The acceleration of benefits requirement is met if an NQDC plan doesn't allow the acceleration of the time or schedule of any payment under the plan, except as provided in IRS regs. (Code Sec. 409A(a)(3)) Changes in the form of distribution that accelerate payments generally are subject to this rule. But payments made in accordance with plan provisions for acceleration in the event of a service provider's separation from service, death or disability, or in the event of a change in control do not violate these rules. Also not in violation are payments under a domestic relations order, or to comply with a certificate of divestiture for a conflict-of-interest, or *de minimis* nonelective payments to terminate a participant's entire interest in the plan (Prop Reg §1.409A-3(h); Reg §1.409A-3(j))

Election requirements. The election requirements are met if the plan provides that compensation for services performed during a tax year can be deferred at the participant's election only if the initial deferral election is made (1) not later than the close of the preceding tax year; or (2) at another time provided in IRS regs. For performance-based compensation (e.g., bonuses), based on services performed over a period of at least 12 months, the initial deferral election must be made no later than six months before the end of the period. The time and form of distributions have to be specified at the time of initial deferral. An election made after the initial election (a redeferral election) generally must not take effect until at least 12 months after the date on which the election is made and must require deferral for a period of not less than five years from the date on which payment would otherwise have been made. (Code Sec. 409A(a)(4))

Effective dates and transitional relief. Generally, the Code Sec. 409A rules apply for amounts deferred in tax years beginning after 2004, and amounts deferred in tax years beginning before 2005 if the NQDC plan is materially modified after October 3, 2004. However, under transitional relief, a plan adopted before 2008 will not be treated as violating the Code Sec. 409A distribution, acceleration of benefit, and election requirements before 2009 if it is operated through December 31, 2008 in compliance with Code Sec. 409A and any other pre-2009 guidance, and it is amended on or before December 31, 2008 to conform to Code Sec. 409A and its final regs.

Review Question 26

Which of the following events would **not** qualify as an unforeseeable emergency permitting a distribution from a nonqualified deferred compensation plan?

a. Flood damage to a participant's home that is not covered by insurance.

b. Significant out-of-pocket medical expenses due to an illness of the plan participant.

c. College expenses of the participant's child.

d. Uncompensated medical expenses due to injury of the participant's spouse in an automobile accident.

VI. Estate and Gift Tax

Learning Objectives

After completing this section, you should be able to:

- Identify amounts includible in and deductible from a decedent's gross estate and apply the unified estate and gift tax credit.
- Differentiate between taxable and nontaxable gifts.

A. Estate Tax

The federal estate tax is imposed on the transfer of an individual's property at death and on other transfers considered to be the equivalent of transfers at death. The tax is imposed on the "taxable estate," which is the value of the total property transferred or considered transferred at death (the "gross estate"), reduced by various deductions. The tax is computed under a unified rate schedule under which lifetime taxable gifts and transfers at death are taxed on a cumulative basis.

While the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) repealed the estate and generation-skipping transfer (GST) taxes for estates of individuals dying in 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) retroactively reinstated the estate tax effective for individuals dying on or after Jan. 1, 2010. However, the executor of the estate of a decedent dying in 2010 was permitted to elect zero estate tax, subject to a modified carryover basis regime for property passing to the decedent's heirs.

Each individual can transfer a certain amount of property through lifetime gifts and at death free of estate or gift tax. This amount is generally referred to in the tax code as the applicable exclusion amount. (The applicable exclusion amount is translated into an applicable credit amount (sometimes called a "unified credit") in actually computing the estate and gift tax.) The applicable exclusion amount includes (1) a basic exclusion amount and (2) in the case of a surviving spouse, the deceased spouse's unused exclusion amount, (Code Sec. 2010(c)(2)) The basic exclusion amount is $5 million (adjusted for inflation). For 2013, the basic exclusion amount is $5,250,000.

For decedents dying and gifts made in 2013 and later years, the maximum estate and gift tax rate is 40%. (Code Sec. 2001(c) as amended by the American Taxpayer Relief Act of 2012). To calculate the estate tax, a tentative tax is computed under the unified rate schedule on the total of: (1) the amount of the taxable estate and (2) the total amount of taxable gifts made by the decedent that aren't includible in the decedent's gross estate. (Code Sec. 2001(b)(1)) This amount is then reduced by the gift tax payable on the decedent's gifts. The result is the gross estate tax payable (before credits). (Code Sec. 2001(b)(2)) The net estate tax payable is the gross estate tax minus the unified credit, and other allowable credits.

1. Gross Estate

The starting point in computing Federal estate tax liability is the gross estate. The gross estate of a decedent who is a U.S. citizen or resident generally includes the value at the time of death of all of his or her property, real or personal, tangible or intangible, wherever situated. The decedent's assets are valued at their fair market value at the time of death; or on an alternate valuation date elected under Code Sec. 2032.

Retained life estate. A decedent's gross estate includes lifetime transfers under which he or she retained the possession or enjoyment of, or the right to the income from, the transferred property. (Code Sec. 2036(a)(1); Reg §20.2036-1)

The decedent's gross estate also includes lifetime transfers where he or she retained the right to designate the person(s) to possess or enjoy the transferred property or its income. (Code Sec. 2036(a)(2))

The decedent need not have a legally enforceable right, but there must be an agreement, either express or implied, that the decedent will retain the benefit.

The possession, enjoyment or right to income is retained to the extent the income is to be applied toward the discharge of a legal obligation of the decedent or otherwise for his or her pecuniary benefit—e.g., the support of a dependent during decedent's lifetime. (Reg §20.2036-1(b)(2))

Transfers taking effect at death. The value of property is included in a decedent's gross estate if

- the decedent transferred the property during his or her lifetime, but the transferee could not possess or enjoy the property except by surviving the decedent, and
- the decedent retained a significant reversionary interest (exceeding 5% of the value of the transferred property immediately before the decedent's death). (Code Sec. 2037)

Where the value of the reversion doesn't exceed 5% so that the value of the property isn't included as a transfer taking effect at death, the value of the reversion itself can be included as property owned at death. (Reg §20.2037-1(e))

Revocable transfers. The gross estate includes the decedent's lifetime transfers if the enjoyment of the transferred property was subject at the time of the decedent's death to any change through the decedent's exercise of a power to alter, amend, revoke or terminate. This includes any power affecting the time or manner of enjoyment of property or its income. (Code Sec. 2038(a)(1))

For this purpose, revocable transfers include savings bank (Totten) trusts that are revocable in form and custodial accounts where the donor is custodian.

Jointly held property. When joint ownership was acquired by the decedent through gift, bequest, devise, or inheritance from someone else, the decedent's fractional share of the property is included in the gross estate. (Reg §20.2040-1(a)(1))

The rule is different when a joint ownership is created by co-owners. Except for husband-wife tenancies, the entire value of the property is included in the co-owner's gross estate except the part, if any, attributable to the consideration furnished by the other joint owner(s). Consideration furnished by the surviving joint owner(s) doesn't include money or property acquired from the decedent for less than a full and adequate consideration in money or money's worth. (Reg §20.2040-1(a)(2))

If an interest in property is held by a decedent and his or her spouse as tenants by the entireties or as joint tenants with right of survivorship, one half of the value of the jointly-owned interest will be included in the estate of the decedent spouse regardless of which spouse furnished the original consideration. (Code Sec. 2040(b)) Where the surviving spouse isn't a U.S. citizen, this rule applies only if the property passes in a qualified domestic trust. (Code Sec. 2056(d)(1)(B), Code Sec. 2056(d)(2))

The value of the interest in community property vested in the decedent by state law—ordinarily, half of the community property—is included in the decedent spouse's estate.

In the case of tenants in common, only the value of decedent's undivided share of the property is included in his or her gross estate.

Review Question 27

A taxpayer contributes $10,000 for the purchase of jointly owned property and his co-owner (not his spouse) contributes $20,000. At the taxpayer's death, the property is valued at $120,000. How much is included in the taxpayer's gross estate on account of the property?

a. $10,000.

b. $40,000.

c. $60,000.

d. $120,000.

Powers of appointment. If the decedent possessed a general power of appointment at the time of death, the property subject to the power is included in his or her gross estate. (Code Sec. 2041(a)) A "general" power is one exercisable in favor of the decedent, his or her creditors, the decedent's estate or the creditors of the estate. (Code Sec. 2041(b)(1))

Annuities. The value of an annuity or other payment receivable by a beneficiary is included in the decedent's gross estate if, under the contract or agreement, either:

- an annuity or other payment was payable to decedent, either alone or with another person(s), for decedent's life or for any period not ascertainable without reference to the decedent's death or for any period that doesn't in fact end before his or her death, or
- the decedent possessed, for one of the periods above, the right to receive such an annuity or other payment, either alone or with another. (Code Sec. 2039(a))

The amount included is an amount proportionate to the part of the purchase price contributed by the decedent. Contributions made by an employer are considered made by the employee if made by reason of his or her employment. (Code Sec. 2039(b))

Life insurance. Proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate, are includible in the gross estate. (Code Sec. 2042(1)) The estate needn't be specifically named as the beneficiary. (Reg §20.2042-1(b)(1))

Proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate are includible if the decedent possessed at death any "incidents of ownership" in the policy, exercisable either alone or with any other person. (Code Sec. 2042(2)) "Incidents of ownership" include the power to change the beneficiary, to revoke an assignment, to pledge the policy for a loan, etc. (Reg §20.2042-1(c)(2)), and certain reversionary interests. (Reg §20.2042-1(c)(3))

An employee can avoid estate tax on the proceeds of group term life insurance furnished by an employer by transferring the insurance before death, if:

- the group policy and applicable state law permit the employee to make an absolute assignment of all his or her incidents of ownership, and
- the employee irrevocably assigns all policy rights.

Gifts within three years of death. The value of property is included in the gross estate if

- the decedent transferred an interest in, or relinquished a power over, the property, within three years of death, and
- the value of the property would have be included in the gross estate, had the decedent retained it, under
- Code Sec. 2036 (transfers with retained life estate, etc.),
- Code Sec. 2037 (transfers taking effect at death),
- Code Sec. 2038 (revocable transfers), or
- Code Sec. 2042 (life insurance proceeds). (Code Sec. 2035(a))

This rule doesn't apply to any bona fide sale for full and adequate consideration. (Code Sec. 2035(d))

The estate also generally includes any gift tax paid by the decedent, the decedent's estate or donees on gifts made within three years of decedent's death that are included in the gross estate. (Code Sec. 2035(b))

Review Question 28

At the time of his death, a decedent has $100,000 of life insurance coverage. Under which of the following circumstances are the life insurance proceeds **not** included in the decedent's estate?

a. The insurance proceeds are payable to the decedent's estate.

b. The policy is a group-term life insurance policy that the decedent irrevocably assigned to his wife two years before his death.

c. The insurance proceeds are payable to the decedent's spouse who purchased the policy two years before the decedent's death.

d. The decedent assigned the insurance policy to his daughter but retained the right to change the beneficiary up to the time of his death.

2. Valuation of Gross Estate

The value of property included in the gross estate is the fair market value of the property at the date of the decedent's death (or at the alternate valuation date, see below). (Code Sec. 2031; Reg §20.2031-1)

IRS regulations provide rules for valuing specific types of properties including: stocks and bonds (Reg §20.2031-2); business interests (Reg §20.2031-3); notes (Reg §20.2031-4); household and personal effects (Reg §20.2031-6); and life insurance and annuity contracts. (Reg §20.2031-8)

An executor may elect to exclude from the gross estate up to 40% of the value of land subject to a qualified conservation easement meeting certain requirements and subject to a dollar cap of $500,000. (Code Sec. 2031(c)) If a qualified conservation easement is granted after the decedent's death but on or before the due date (including extensions) for the estate tax return, an estate tax charitable deduction is allowed, but only if no income tax charitable deduction is allowed to any person with respect to the grant. (Code Sec. 2031(c)(9))

The fair market value of annuities (other than commercial annuities), life estates, term of years, remainders, and reversions is their present value, as determined under IRS tables, which include an interest rate component and, if applicable, a mortality component. (Reg §20.2031-7(a); Reg §20.7520-1(a)(1))

The executor can elect (irrevocably) to use an alternate valuation date rather than the decedent's date of death to value the property included in the gross estate. This alternate date is generally six months after decedent's death or earlier date of sale or distribution. (Code Sec. 2032(a)) Alternate valuation can be elected only if its use decreases the value of the gross estate. (Code Sec. 2032(c))

Special use valuation. If certain conditions are met, an executor may elect to value qualified real property used for farming purposes or in a trade or business on the basis of the property's value for its actual use, rather than on its highest and best use. The total decrease in the value of all real property under this election may not exceed $750,000 adjusted for inflation ($1,140,000 for 2012). (Code Sec. 2032A) The resulting estate tax savings may be recaptured under certain conditions. (Code Sec. 2032A(c)

3. Computing the Taxable Estate

To arrive at the taxable estate, the following amounts are deducted from the gross estate:

- Funeral expenses. (Code Sec. 2053(a)(1))
- Administration expenses, such as executors' and administrators' commissions, attorneys', accountants' and appraisers' fees, and court costs. (Code Sec. 2053(a)(2); Reg §20.2053-3)
- Claims against the estate, including property taxes accrued before the decedent's death, unpaid income and gift taxes, and medical expenses of the decedent paid by the estate after his or her death (to the extent not claimed as an income tax deduction). (Code Sec. 2053(a)(3); Reg §20.2053-6)
- Transfers in satisfaction of claims by the decedent's former spouse. (Code Sec. 2043(b)(2))
- Indebtedness on property if the total value of the property is included in the gross estate. (Code Sec. 2053(a)(4))
- Casualty and theft losses. (Code Sec. 2054)
- Transfers to charitable and similar organizations. (Code Sec. 2055)
- Transfers to surviving spouse (marital deduction). (Code Sec. 2056)
- State death taxes. (Code Sec. 2058)

For an item to be deductible as a debt, claim, or expense it must also be allowable by the jurisdiction under which the estate is being administered. (Code Sec. 2053(a)) If, at the time of filing the estate tax return, the exact amount of a deductible debt, claim or expense isn't known, an estimated amount may be used if that amount is ascertainable with reasonable certainty and it can be shown the item will be paid. (Reg §20.2053-1(b)(3))

Marital deduction. A marital deduction is allowed for the value of all property included in the gross estate that passes to the decedent's surviving spouse in a manner qualifying for the deduction. (Code Sec. 2056(a))

Terminal interests and the marital deduction. With certain exceptions, a terminable interest doesn't qualify for the marital deduction if:

- another interest in the same property passed from the decedent to some other person for less than adequate and full consideration; and
- by reason of its passing, that other person or heirs may enjoy part of the property after the termination of the surviving spouse's interest. (Code Sec. 2056(b)(1); Reg §20.2056(b)-1(c))

A terminable interest is one that will terminate or fail after a certain period of time, the happening of some contingency, or the failure of some event to occur. (Reg §20.2056(b)-1(b))

Property in which a spouse is given only a life estate may qualify for the marital deduction as an exception to the terminable interest rule. Excepted property is known as "qualifying terminable interest property" or QTIP. QTIP treatment is available if the executor elects to have all or part of the property so qualify and the surviving spouse has a "qualifying income interest for life." A surviving spouse has such an interest if:

- the surviving spouse is entitled for life to all the income from the property, payable at least annually, or the spouse has a usufruct interest for life in the property, and
- no person (including the spouse) has a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's life. (Code Sec. 2056(b)(7))

QTIP treatment isn't defeated merely because the spouse's income interest is contingent on the executor making a QTIP election. (Reg §20.2056(b)-7(d)(3))

An annuity where only the surviving spouse has the right to receive payments before the death of that surviving spouse automatically qualifies for QTIP treatment unless the executor otherwise elects. (Code Sec. 2056(b)(7)(C)) Certain individual retirement accounts (IRAs) also qualify. (Reg §20.2056(b)-7(h),

Partial QTIP elections that relate to a fractional or percentage share of the property are allowed. (Reg §20.2056(b)-7(b)(2)) Protective QTIP elections are possible. (Reg §20.2056(b)-7(c))

When the QTIP election is made, the property is includible in the estate of the surviving spouse at its then fair market value unless he or she disposed of any part of the qualifying income interest for life. (Code Sec. 2044) The property is treated as passing from the surviving spouse. (Code Sec. 2044(c)) Where a predeceased spouse's estate made an unnecessary QTIP election that did not reduce its estate tax liability, steps may be taken so that the unneeded election will be treated as null and void for estate tax purposes. As a result, the property won't have to be included in the survivor's estate.

The surviving spouse's executor may recover the estate taxes caused by the inclusion from the persons to whom the property passes at the surviving spouse's death, unless the surviving spouse's will specifically indicates an intent to waive the right of recovery. (Code Sec. 2207A(a))

Charitable bequests. Deductions are allowed for the value of property included in the gross estate and transferred by decedent during life or by will to or for the use of the U.S., any state, political subdivision thereof, or the District of Columbia, and to various types of charitable organizations (Code Sec. 2055(a)) including foreign ones.

Strict requirements apply where the charitable bequest is of an income interest or a remainder interest. (Code Sec. 2055(e))

State death taxes. The value of the taxable estate is determined by deducting from the gross estate any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia for any property included in the gross estate. (Code Sec. 2058(a))

A deduction for state death taxes is allowed only for taxes actually paid and claimed as a deduction during the time period that ends before the later of:

- four years after the filing of the estate tax return (Code Sec. 2058(b)(1));
- 60 days after the Tax Court decision becomes final if a timely petition for redetermination of a deficiency has been filed with the Tax Court (Code Sec. 2058(b)(2)(A));
- the expiration date of the extension period if an extension of time has been granted under Code Sec. 6161 or Code Sec. 6166 for payment of the tax (Code Sec. 2058(b)(2)(B)); or
- if a timely claim for refund or credit of an overpayment of tax has been filed, the latest of:

- 60 days after the IRS mails to the taxpayer by certified or registered mail a notice of disallowance of any part of the claim (Code Sec. 2058(b)(2)(C)(i)); or
- 60 days after a decision by a court of competent jurisdiction becomes final as to a timely suit started upon the claim (Code Sec. 2058(b)(2)(C)(ii));
- two years after a notice of the waiver of disallowance is filed under Code Sec. 6532(a)(3) (Code Sec. 2058(b)(2)(C)(iii)).

4. Credits Against Estate Tax

A single unified credit applies for both estate and gift tax purposes, which effectively excludes a cumulative amount of transfers from estate and gift tax. The applicable exclusion amount for decedents dying in 2010 and later years equals the decedent's basic exclusion and, in the case of a surviving spouse, the "deceased spousal unused credit exclusion amount." (Code Sec. 2010(c)(2)) For decedents dying in 2010 and later years, the basic exclusion amount is $5 million (adjusted for inflation after 2010). The basic exclusion amount for 2013 is $5,250,000.

The applicable credit amount equals the amount of the tentative tax that would be owed under the estate rate schedule on an amount equal to the applicable exclusion amount. (Code Sec. 2010(c)(1)) For 2013, the applicable credit amount is $2,045,800, the tax that would otherwise be imposed on $5,250,000.

For the surviving spouse of a deceased spouse, the term "deceased spousal unused exclusion amount" means the lesser of:

(1) the basic exclusion amount (adjusted for inflation), or

(2) the excess of (a) the basic exclusion amount of the last deceased spouse dying after 2010 of the surviving spouse, over (b) the amount on which the tentative tax on the estate of the deceased spouse was determined. (Code Sec. 2010(c)(4))

A surviving spouse may use the deceased spousal unused exclusion amount in addition to the surviving spouse's own basic exclusion for taxable transfers made during life or at death.

Credit for tax on prior transfers. A credit is allowed against the estate tax for federal estate tax paid by the estate of another decedent (the transferor) on the transfer of property to the present decedent from that transferor where the transferor died within ten years before, or within two years after, the present decedent's death. (Code Sec. 2013)

Credit for foreign death taxes. A credit is allowed (on Form 706, Schedule P), subject to certain limits, against the estate tax for estate, inheritance, legacy, or succession taxes actually paid to any foreign country or U.S. possession. (Code Sec. 2014)

5. Estate Tax Returns and Payment of Tax

An executor must file an estate tax return (Form 706) if the decedent's gross estate at death exceeds the amount effectively exempted by the unified credit (e.g., $5,250,000 for 2013). This dollar amount is reduced by certain gifts made by the decedent. (Code Sec. 6018(a)(1), Code Sec. 6018(a)(3))

The return must be filed within nine months after the date of death. (Code Sec. 6075(a)) However, the IRS will grant an automatic six-month extension to file. The IRS may grant a six-month discretionary filing extension (1) for estates that didn't seek an automatic extension, (2) for the estates of nonresident alien, and (3) for specialized estate tax forms for various recapture of estate taxes. An executor who is abroad can request a longer discretionary extension. (Reg §20.6081-1)

Payment of tax. The estate tax must be paid at the time for filing the return. Filing extensions don't extend the time for payment, (Reg §20.6151-1) but extensions of time to pay can be granted for reasonable cause. (Code Sec. 6161(a)(1))

Special extensions are available where a future interest is included in the estate (Code Sec. 6163) or where the estate consists largely of a closely-held business. (Code Sec. 6166)

Review Question 29

When must an estate tax return be filed for a decedent?

a. Within six months of the decedent’s death.

b. By the end of the calendar year of the decedent’s death.

c. By April 15 of the year following the year of the decedent’s death.

d. Within nine months of the decedent’s death.

B. Gift Tax

The gift tax is imposed on the transfer of money or other property by gift. The tax is imposed on the transfer, not on the property transferred. It applies even though the property transferred may be exempt from income or other taxes. (Code Sec. 2501(a); Reg §25.2501-1, Reg §25.2511-1(a), Reg §25.2511-2)

Due to the “annual exclusion,” gifts made by a person who makes no gift of a present interest with a value of over $14,000 in 2013 to any one person, and who makes no gifts of future interests, aren’t subject to tax and no gift tax return need be filed. A husband and wife may consent to have gifts to others treated as made one-half by each of them. (Code Sec. 2513(a)) This “gift-splitting” effectively increases the per-donee annual exclusion for gifts by a married couple to $28,000 for 2013.

The gift tax is integrated with the estate tax under a “unified” rate schedule that imposes a single tax on transfers during life and at death. A unified credit applies for both estate and gift tax purposes, which effectively excludes a cumulative amount of transfers from estate and gift tax.

For 2010 and later years, this effectively imposes no tax on gifts unless the total amount of taxable gifts for any such year and all prior years exceeds a $5 million basic exclusion amount (indexed for inflation after 2010). For 2013, the exclusion amount is $5,250,000, resulting in a credit against the gift tax of $2,045,800.

The $5 million basic exclusion amount doesn't apply after Dec. 31, 2012. Absent further legislation, the exclusion amount will be $1 million for gifts made after 2012.

The credit against tax on gifts in a calendar year is reduced by the sum of all amounts allowable as a credit in preceding calendar periods. In determining this reduction, the gift tax rates that are in effect for the calendar year of the gift (instead of the rates in effect for the preceding calendar periods) are used in determining the amounts allowable as a credit for all preceding calendar periods. (Code Sec. 2505)

The gift tax must be paid by the person (the donor) who makes the gift. (Code Sec. 2501(a); Reg §25.2511-2(f)) It applies only to donors who are individuals (Reg §25.2501-1(b)) but a gift by a corporation may be treated as a gift by the shareholders. (Reg §25.2511-1(h)(1))

If the donor fails to pay the tax when due, the donee is also liable for the tax to the extent of the value of his or her gift. (Code Sec. 6324(b); Reg §25.2502-2, Reg §301.6324-1(b))

These rules apply to a U.S. citizen or resident no matter where the gift property (tangible or intangible) is situated. (Code Sec. 2501(a); Reg §25.2501-1(a), Reg §25.2511-3(a))

A nonresident who’s not a U.S. citizen generally is subject to gift tax only if the gift property is real estate or tangible personal property and is situated in the U.S. at the time of the gift. (Code Sec. 2501(a); Code Sec. 2511(a); Reg §25.2511-1(b); Reg §25.2511-3(a)) However, gift tax applies to transfers of U.S situated intangibles, such as stocks or bonds, by an individual who is subject to the expatriate alternative tax under Code Sec. 877 for the year of the gift. The tax is reduced by gift tax paid to a foreign country on the gift. (Code Sec. 2501(a)(3)(A)) In certain cases, gift tax may be owed on transfers of stock in foreign corporations (Code Sec. 2501(a)(5))

1. Definition of Gift

All transactions whereby property or property rights are gratuitously bestowed upon another are gifts. (Reg §25.2511-1(c))

A gift isn’t complete (i.e., taxable), until the donor parts with dominion or control over the transferred property or property interest. He or she must be left without power to change the disposition of the property either for his or her own benefit or for that of others. (Reg §25.2511-2(b))

There's no gift tax on a transfer to a political organization. (Code Sec. 2501(a)(5))

Education and medical payments. The gift tax doesn't apply to amounts paid by one individual:

- on behalf of another individual directly to a qualifying educational organization as tuition for that other individual. (Code Sec. 2503(e); Reg §25.2503-6(b)(2))
- on behalf of another individual directly to a provider of medical care as payment for that medical care. (Code Sec. 2503(e); Reg §25.2503-6(b)(3)) Payments for medical insurance qualify for this exclusion. (Reg §25.2503-6(b)(3))

These exclusions are available in addition to the annual gift tax exclusion. (Reg §25.2503-6(a)) No gift tax return is required. (Code Sec. 6019)

Contributions to qualified tuition programs and Coverdell education savings accounts (see Module 1, *Taxation of Individuals*) don't qualify for the tuition exclusion but, instead, are treated as present gifts that can qualify for the gift tax annual exclusion. A contributor isn't subject to gift tax on distributions from qualified tuition programs and Coverdell education savings accounts. (Code Sec. 529(c), Code Sec. 530(d)(3))

Below-market loans. If a below-market (or interest-free) loan is a "gift loan" (that is, a below-market loan where the forgoing of interest is in the nature of a gift), it's treated as: (1) a loan to the borrower/donee in exchange for an interest-paying note, and (2) a gift to the borrower of the funds to pay the interest. The amount of the gift equals:

- the forgone interest-excess of interest payable at the applicable federal rate over actual interest payable—if the loan is a demand loan, or
- the excess of the amount loaned over the present value (using a discount rate equal to the applicable federal rate) of all payments required under the terms of the loan, if the gift loan is a term loan. (Code Sec. 7872)

For demand loans, the gift is treated as made on the last day of the calendar year. (Code Sec. 7872(a)) For term loans, the gift is treated as made on the date the loan was made. (Code Sec. 7872(b))

These rules don't apply to certain gift loans between individuals that don't exceed $10,000. (Code Sec. 7872(c)(2))

If the outstanding balance of a gift loan made between individuals is $100,000 or less, the amount of interest treated as retransferred by the borrower to the lender each year doesn't exceed the borrower's net investment income for that year. If the net investment income is $1,000 or less, the amount treated as retransferred is zero. (Code Sec. 7872(d)(1))

Jointly owned property. A gift may result where property (real or personal, including securities) is placed in joint ownership or where joint ownership ends. Whether or not there has been a gift depends upon characteristics determined under the applicable local law.

There is an immediate gift from one individual to other joint tenants of property when:

- the individual buys the property with his or her funds but takes title with the others as joint tenants with rights of survivorship, and
- the survivorship rights may be defeated by any joint tenant severing his or her interest. (Reg §25.2511-1(h)(5))

An individual doesn't make a gift when he or she deposits funds in a joint bank account with another person if under the terms of the account the individual can regain the deposit without the other's consent. A gift is made only when and to the extent the other person withdraws money for his or her own benefit. (Reg §25.2511-1(h)(4)) Similar rules apply for joint brokerage accounts and U.S. savings bonds.

Gift tax may be imposed when jointly owned property is divided up between the co-owners, or is sold, exchanged or given away before death of one of the co-owners. This rule doesn't apply to property co-owned by spouses.

Qualified disclaimers. A qualified disclaimer (an irrevocable and unqualified refusal to accept ownership, made in writing by a specified deadline) with respect to any interest in property has the effect of treating that interest, for gift (and estate tax) purposes, as if it had never been transferred to the disclaimant. (Code Sec. 2518) And the disclaimant isn't treated as having made a gift to the person to whom the interest passes by reason of the disclaimer. (Reg §25.2518-1(b))

Review Question 30

In Year 1, a father places $150,000 in a joint savings account in the names of himself and his daughter. There are no restrictions on the right of either the father or daughter to withdraw any or all of the funds from the account without the consent of the other co-owner. In Year 2, the daughter withdraws $30,000 from the account which she uses to pay her college tuition. Which of the following is a true statement?

a. The father made a gift of $150,000 to the daughter in Year 2 when the daughter made a withdrawal from the account.

b. The father made a gift of $30,000 to the daughter in in Year 2 when she withdrew that amount from the account.

c. The daughter's $30,000 withdrawal from the account is not treated as a gift because the funds were used to pay her college tuition.

Review Question 31

In 2013, a married taxpayer pays XYZ University $30,000 to cover tuition for the taxpayer's grandson. How much of the gift is excluded for gift tax purposes?

a. $0.　　b. $13,000.

c. $28,000.　　d. $30,000.

2. Valuation of Gift

The amount of the gift is the money given or, if property is given, the property's value as of the date of the gift. (Code Sec. 2512(a))

The market value of annuities (other than commercial annuities), unitrust interests, life estates, term of years, remainders, and reversions transferred by gift is their present value (Reg §25.2512-5(a); Reg §25.7520-1(a)) determined by use of standard or special Code Sec. 7520 actuarial factors.

3. Taxable Gifts

Taxable gifts are the gifts made during the calendar year after the annual exclusion and reduced by allowable deductions. (Code Sec. 2503(a), Code Sec. 2503(b))

Annual exclusion. In 2013, **t**he first $14,000 of gifts of a present interest made by a donor to each donee in each calendar year is excluded from the amount of the donor's taxable gifts. (Code Sec. 2503(b))

No annual exclusion is allowed for gifts of future interests (Code Sec. 2503(b); Reg §25.2503-2), e.g., reversions or remainders. (Reg §25.2503-3)

A "Crummey" power (in general, a trust beneficiary's non-cumulative right to withdraw a specified amount of trust principal within a limited period) makes a transfer to the trust a gift of a present interest.

A transfer for the benefit of a minor isn't considered a gift of a future interest if the property and its income:

- may be expended by or for the benefit of the minor before he or she reaches 21, and
- any balance not so expended will pass to the minor when he or she reaches 21, or if the minor dies before 21 will go either to his or her estate or as the minor may appoint under a general power of appointment. (Code Sec. 2503(c); Reg §25.2503-4(a))

Gifts to minors made through custodians designated under Uniform Acts for gifts or transfers to minors qualify for the annual exclusion.

Marital deduction. A marital deduction is allowed for the value of all qualifying gifts made by one spouse to the other if the donee spouse is a U.S. citizen (with some exceptions) and the gift isn't a nondeductible "terminable interest." (Code Sec. 2523)

Qualified terminable interest property (QTIP) qualifies for the deduction if the donee spouse receives income payments for life and no person has a power to appoint any part of the property to anyone other than the donee spouse during that spouse's life. (Code Sec. 2523(f))

Charitable gifts. Charitable gifts and certain similar gifts are deducted in arriving at taxable gifts for the calendar year. (Code Sec. 2522)

Split gifts. A husband and wife may consent to have their gifts to others treated as if made one-half by each (Code Sec. 2513(a); Reg §25.2513-1) if:

- both spouses are U.S. citizens or residents on the date of the gift (Code Sec. 2513(a));
- both spouses consent to have all gifts made to others in the calendar year treated as split gifts (Code Sec. 2513(a), Code Sec. 2513(b), Code Sec. 2513(c); Reg §25.2513-1(b)(5));
- the consenting spouses are married to each other on the date of the gift and don't remarry during the remainder of the calendar year. (Code Sec. 2513(a))

Each spouse is liable, jointly and severally, for the entire gift tax for the period in which he or she consents to split gifts. (Code Sec. 2513(d); Reg §25.2513-4)

Gifts of community property to a third party are generally considered to have been made one half by each spouse.

Review Question 32

In 2013, a married individual gave $15,000 in cash gifts to each of 10 different donees. What is the maximum amount of the gift tax exclusion for these gifts?

a. $28,000.	b $140,000.
c. $150,000.	d. $280,000.

4. Unified Credit

A "unified" credit is allowed against gift tax on gifts made by a U.S. citizen or resident. The credit against the gift tax is the amount that exempts a basic exclusion amount of $5 million (adjusted for inflation) from tax. For 2013, the exclusion amount is $5,250,000, resulting in a unified credit of $2,045,800.

The credit against tax on gifts in a calendar year is reduced by the sum of all amounts allowable as a credit in preceding calendar periods. In determining this reduction, the gift tax rates that are in effect for the calendar year of the gift (instead of the rates in effect for the preceding calendar periods) are used in determining the amounts allowable as a credit for all preceding calendar periods. (Code Sec. 2505)

5. Computation of Gift Tax

The proper method for computing gift tax depends on whether an individual has made taxable gifts prior to the current calendar year.

If a person has not made any taxable gifts (in excess of annual exclusions and deductions) before the current calendar year, the gift tax is computed as follows:

1. The aggregate value of the total gifts made during the calendar year for which the tax is being computed is determined. If the donor is married, and his or her spouse has consented to split gifts to third parties, only half of the gifts the donor made to third parties plus half of the gifts, if any, the spouse made to third parties are included in computing the donor's total gifts. (A separate gift tax computation is made for the spouse's total gifts.)

2. Any amounts qualifying for the year's annual exclusion are deducted from the amount in (1).

3. From the excess of (1) over (2), above, the amount of charitable and marital gifts are deducted.

4. The unified rate schedule is used to compute a gift tax on the excess of (1) over the sum of (2) and (3).

5. The allowable unified credit is subtracted from the gift tax computed in (4).

Cumulative computation. When an individual has made taxable gifts prior to the current year, the prior gifts affect the amount of gift tax imposed on gifts made in the current year (Code Sec. 2502) In general the gift tax (before unified credit) is the excess of:

1. a tentative tax computed under the unified rate schedules on the aggregate sum of taxable gifts for the current calendar year for which the tax is being computed and taxable gifts for all preceding years, over

2. a tentative tax computed under the unified rate schedule on the aggregate sum of the taxable gifts for all of the years preceding the current calendar year for which the tax is being computed. (Code Sec. 2502(a))

The gift tax payable is the excess of the tentative tax in (1) over the tentative tax in (2) reduced by the unified credit allowable.

Taxable gifts for a calendar year are the total gifts for the year which are subject to gift tax less the annual exclusions and allowable deductions for the particular period. (Code Sec. 2503(a), Code Sec. 2503(b)

6. Gift Tax Returns

Any individual who makes gifts to any one donee during a calendar year which aren't fully excluded under the annual exclusion must file a gift tax return on Form 709. A return must be filed even if no tax is payable. (Reg §25.6019-1(f)) But no return is required to report a qualified transfer for educational or medical costs, most charitable transfers, or a transfer that qualifies for the marital deduction (Code Sec. 6019), except that a return must be filed to make a QTIP election. (Reg §25.6019-1(a))

The return is due on April 15 of the year following the year the gifts were made. (Code Sec. 6075) An extension for filing the income tax return automatically extends the time for filing the gift tax return for the same calendar year. (Code Sec. 6075(b)(2)) Or the donor may ask (in a letter to IRS) for a separate extension of time to file the gift tax return. (Code Sec. 6081) Use Form 8892 to request an extension of time to file Form 709 when not applying for an extension to file an income tax return or to make a payment of gift tax.

VII. Dealing with the IRS

Learning Objectives

After completing this section, you should be able to:

- Differentiate between different types of tax audits and explain the tax assessment and collection process.

- Determine when interest and penalties will be imposed by the IRS.

The return a taxpayer originally files with the IRS may show more or less tax than the taxpayer owes. A return error may be discovered by the taxpayer who files the return or it may show up in the course of an IRS examination. Either way, a taxpayer is generally entitled to a refund of a tax overpayment or is responsible for payment of any tax underpayment.

A. Tax Audits

The IRS makes certain preliminary cursory checks of every return filed; it selects returns for audit based on various criteria. Once the IRS finishes an audit, a taxpayer has various alternatives it can pursue to resolve any disputed items.

1. Mathematical Check of Returns

The IRS checks every return for mathematical errors and computes the tax using the figures on the return. If the taxpayer made a computational error resulting in an underpayment of tax, IRS sends a corrected computation and a notice and demand for payment of any balance due (which doesn't entitle the taxpayer to go to Tax Court) (Code Sec. 6213(b)(1)) or reduces any refund. (Reg §601.105(a)) Failure to include a correct taxpayer identification number (TIN) on the return, as required under Code Sec. 21 (child care credit), Code Sec. 24 (child credit), Code Sec. 25A (higher education credit), Code Sec. 32 (earned income credit), and Code Sec. 151 (personal exemptions), is treated as a mathematical or clerical error and assessed accordingly. If the EIC is claimed on net earnings from self-employment, failure to pay the proper amount of self-employment tax is treated as a mathematical error. So is failing to provide the IRS with certain information after improperly claiming the EIC. (Code Sec. 6213(g)(2)) For periods after 2003, the IRS has the authority to treat an earned income credit claim on a noncustodial parent's return as a math error. (Code Sec. 6213(g)(2)(M)) Adjustments to make an S corporation shareholder's return consistent with the corporation's return are treated as resulting from mathematical or clerical error. (Code Sec. 6037(c)(3)) Similar rules apply when beneficiaries of estates and trust file returns inconsistent with the entity's return. (Code Sec. 6034A(c)(3))

Review Question 33

Which of the following mistakes is **not** treated as a mathematical or clerical error?

a. Failure to pay self-employment tax when an earned income credit is based on self-employment income.

b. Shareholder's reporting of income from an S corporation inconsistently with what is shown on the corporation's return.

c. Claiming a personal exemption for a nondependent child.

d. Failure to include a correct taxpayer identification number for purposes of the child tax credit.

2. Check Against Information Returns

The IRS compares taxpayers' income tax returns against information returns, such as wage, interest and dividend statements, under a document matching program (Information Returns Program). If there is a mismatch, the IRS sends the taxpayer a computer-generated notice (CP-2000), which must describe the basis for and identify any amounts of taxes, additions, interest or penalties claimed to be due. (Code Sec. 7522) The notice, which isn't a demand for payment, can be challenged by the taxpayer, who has the burden of proof. IRS also matches information filed by pass-through entities (partnerships, S corporations, and trusts) to amounts the partners, shareholders, and beneficiaries report on their own returns.

3. Returns Selected for Examination

The IRS selects returns for examination based on discrepancies with information returns, a history of deficiencies, random sampling (Taxpayer Compliance Measurement Program (TCMP)), questionable refunds, etc. The IRS's computerized "discriminant function" (DIF) technique ranks and selects returns having the greatest audit potential.

The percentage of returns examined varies each year depending on IRS's available staff. Returns least likely to be audited are those on which all or most of the income was subject to withholding and where the taxpayer didn't itemize.

The IRS has developed a number of specialized audit programs designed to expeditiously identify and resolve tax issues. These specialized programs include:

Market Segment Specialization Program (MSSP). MSSP audit guidelines provide revenue agents and tax examiners with a broad and detailed review of the way a particular industry (e.g., attorneys, taxicabs, air charters, trucking, bed and breakfasts) operates and the things an agent should be looking for when reviewing a return from within that industry. The guides are available to practitioners and others.

Industry Issue Resolution Program. The IRS's Industry Issue Resolution Program exists to provide guidance to resolve frequently disputed or burdensome issues common to business taxpayers. Issues most appropriate to the program generally will have two or more of the following characteristics: uncertainty about the appropriate tax treatment of a given factual situation; the uncertainty results in frequent, often repetitive examinations of the same issue; the uncertainty results in taxpayer burden; the issue is significant and impacts a large number of taxpayers; and the issue requires extensive factual development and an understanding of industry practices such that views concerning the issue would assist IRS in determining the proper tax treatment.

Settlement initiatives. The IRS periodically offers qualifying taxpayers who have participated in various tax shelters or who have otherwise taken tax positions that IRS considers abusive an opportunity to settle on terms that are more favorable than could result if the parties litigated.

Lifestyle audits. The IRS can't use financial status or economic reality examination techniques (so called "lifestyle" audits) to determine the existence of any unreported income unless it has a reasonable indication that there is a likelihood of unreported income. (Code Sec. 7602(e))

Review Question 34

The __________ involves the selection of returns for audit based on a random sample.

a. Computerized discriminant function technique.

b. Taxpayer Compliance Measurement Program.

c. Market Segment Specialization Program.

d. Industry Issue Resolution Program.

4. Types of Examinations

The IRS fixes the time and method of examination, which must be reasonable under the circumstances. (Code Sec. 7605(a); Reg §301.7605-1(a)) Depending on the amounts and sources of income and the nature of the taxpayer's business, an examination may be conducted at: (1) an IRS office, with the taxpayer bringing (office audit) or mailing (correspondence audit) necessary records (Reg §601.105(b)(2)(ii)), or (2) the office of the taxpayer or the taxpayer's representative (field audit). (Reg §601.105(b)(3))

The IRS generally won't conduct the audit at the taxpayer's place of business if the business is so small that doing so essentially requires the taxpayer to close the business.

The taxpayer may ask to have the audit transferred to a different location, such as to the district where the taxpayer's books and records are kept. The IRS also may initiate a transfer, but the taxpayer may ask to keep the original site. (Reg §301.7605-1(e), Reg §301.7605-1(g))

5. Taxpayer's Rights in an Examination

Before or at an initial in-person interview (other than in criminal investigations), the IRS must give the taxpayer an explanation (written or oral) of the audit process (and assessment and collection) and the taxpayer's rights under that process. (Code Sec. 7521(b)(1)) The IRS may do this by distributing IRS Pub No. 1 ("Your Rights as a Taxpayer").

A taxpayer has the right to be represented by an advisor; to make certain audio (but generally not videotape) recordings of meetings (on advance notice) with the IRS agent (Code Sec. 7521(a)(1)); claim additional deductions not claimed on the return; ask that a particular technical question raised in the examination be referred to IRS's National Office for technical advice; not to be subjected to unnecessary examinations; and to claim constitutional rights if questioned about possible criminal violations.

Taxpayer representatives. The taxpayer's representative may be an attorney, CPA, enrolled agent, enrolled actuary or any other person who is permitted (under Circular 230) to represent taxpayers before the IRS, who isn't disbarred or suspended from practice before IRS, and who has a written power of attorney executed by the taxpayer. A tax return preparer may represent a taxpayer during an examination if the preparer signed the return or claim for refund for the tax year or period under examination.

Absent a summons, the IRS can't require the taxpayer to accompany the representative. (Code Sec. 7521(c))

If, during an interview, the taxpayer clearly states a desire to consult with a representative, the IRS must suspend the interview for that purpose. (Code Sec. 7521(b)(2))

An attorney-client privilege of communications has been extended to other federally authorized tax practitioners with respect to tax advice (except for certain corporate tax shelters) in any non-criminal tax matter or proceeding, for communications after July 21, 1998. (Code Sec. 7525)

An individual can check a box on his or her return to authorize IRS to communicate with the individual's paid preparer about math error notices and the status of a refund or payment but must sign a power of attorney for examination matters, underreported income, appeals and collections notices.

One-examination rule. Unnecessary examinations are barred. The IRS may make only one inspection of a taxpayer's books and records for each tax year unless the taxpayer requests otherwise, the IRS notifies the taxpayer *in writing* that an additional inspection is necessary (Code Sec. 7605(b)), or IRS suspects fraud. (Code Sec. 6212(c)) Re-examination also is permitted if the taxpayer doesn't file a timely Tax Court petition after receiving a statutory notice of deficiency, commonly known as a "90-day letter" (see VII.A.10.) for the year.

Review Question 35

Which of the following is **not** a right granted to a taxpayer in the audit process?

a. The taxpayer has the right to select any one he or she chooses as a representative before the IRS.

b. The taxpayer has the right to make audio recordings of meetings with the IRS agent.

c. The taxpayer has the right to suspend an interview with an IRS agent to consult a representative.

6. IRS Power to Summon Persons and Records

The IRS can issue a summons for a taxpayer's testimony and records (Code Sec. 7602(a), Code Sec. 7602(b)) for a legitimate purpose, provided the IRS doesn't make unreasonable demands. The summons must describe with reasonable certainty the books and records sought (Code Sec. 7603), and set the time for examination—not less than ten days from the summons date. (Code Sec. 7605(a))

If the taxpayer intentionally disregards the summons, the IRS can apply to the district court (or U.S. Commissioner) for an order directing compliance. (Code Sec. 7604(b))

The IRS may issue a summons ("third-party summons") to a person other than the taxpayer (e.g., the taxpayer's employer or a "third-party record keeper" such as a bank) for testimony and records bearing on its examination of the taxpayer. Subject to exceptions, within three days of the service of a summons on a third party, but no later than the 23rd day before the day fixed in the summons as the day when the records are to be examined, the IRS must send by registered or certified mail a notice of the summons, including a copy of the summons, and an explanation of the taxpayer's right to institute a suit to quash the summons. (Code Sec. 7609(a)(1))

The IRS generally can't contact any third parties without providing reasonable notice in advance to the taxpayer. (Code Sec. 7602(c)(1), Reg §301.7602-1)

With some exceptions, the IRS may not issue, or begin any action to enforce, any summons to produce or analyze any tax-related computer software source code. (Code Sec. 7612)

A summons can't be issued (or enforced) against a person for whom a Justice Department referral is in effect (i.e., criminal tax prosecution is recommended). (Code Sec. 7602(d))

7. Proposed Deficiencies—Revenue Agent's Report (RAR)

An IRS examiner may propose adjustments to a taxpayer's return before determining a deficiency (which generally doesn't exist until IRS issues a 90-day letter (see VII.A.10.)). The agent will discuss the proposed adjustments with the taxpayer to settle the case informally. The taxpayer can agree to the adjustments or argue they should be modified (an "unagreed" case) before the examiner submits his or her report, known as a revenue agent's report, or RAR. Once the RAR is submitted, the taxpayer can discuss and settle the case only in an Appeals Office conference (see VII.A.9.).

In an unagreed field audit case, the agent prepares a report explaining the proposed adjustments. After review by the district review staff, the RAR is sent to the taxpayer with a transmittal letter, known as a "30-day letter" (see below). (Reg §601.105(c)(2)(i))

In an office audit, the taxpayer will usually be informed of the examiner's findings and given an opportunity to agree at the end of the interview. If the taxpayer doesn't agree, the taxpayer may request an immediate meeting with an appeals officer. If the taxpayer doesn't request an immediate conference, or it isn't practicable, the RAR (and 30-day letter) will be mailed to the taxpayer. (Reg §601.105(c)(1)(ii))

8. The 30-Day Letter

If a taxpayer does not agree to the examiner's findings from a field or office audit, the IRS sends the taxpayer a transmittal letter, or "30-day letter," accompanied by an examiner's report that shows the basis for and amount of any proposed adjustments. (Code Sec. 7522(a), Code Sec. 7522(b)(3)) The letter also explains the appeal procedures and asks taxpayer to indicate, within 30 days, whether the taxpayer will:

- accept the findings and sign a waiver of restrictions on assessment (Form 870), which allows IRS to collect the deficiency without issuing a 90-day letter and limits the taxpayer's appeal to a claim or suit for refund (no Tax Court petition);
- request an Appeals Office conference (see below); or
- do nothing and IRS will send a 90-day letter (see VII.A.10.). (Reg §601.105(d)(1))

The IRS must include an explanation of the entire process from examination through collection with respect to a proposed deficiency with any first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals. This explanation must include information about the assistance available to the taxpayer from the National Taxpayer Advocate at various points in the process (see VII.B.10.).

Review Question 36

If a taxpayer does not agree to the examiner's findings from a field or office audit, the IRS sends the taxpayer a transmittal letter, also known as a(n) _______.

a. 90-day letter. b. RAR.

c. 30-day letter. d. Appeals Office conference request.

9. Appeals Office Conference

A taxpayer can arrange for an Appeals Office conference by sending a written request in response to a 30-day letter (see above) and any required protest of the proposed adjustment to the local IRS district director.

An oral request is enough to get Appeals consideration in all office or correspondence audit cases.

In a field audit case, a written protest is required if the total amount of the proposed tax increase (including penalties), proposed overassessment or claimed refund, or compromise offer, exceeds $10,000 for any tax period A written protest is optional (but a statement of issues is required) if that total amount is between $2,500 and $10,000. A written protest is not required if the total amount is less than $2,500. (Reg §601.106(a)(1)(iii)(a)) The 30-day letter contains instructions for the protest (Reg §601.105(d)(2)) and spells out the required information.

Appeals Office proceedings are informal and testimony isn't under oath, although the taxpayer may be asked to submit affidavits. (Reg §601.106(c))

An Appeals Office conference still is available to a taxpayer even after IRS has issued a 90-day letter (see below), e.g., where the taxpayer ignored the 30-day letter or where the assessment period was about to expire (or the taxpayer requested the 90-day letter). If the taxpayer then files a Tax Court petition (in an income, estate or gift tax case) or pays the additional tax assessed (in other tax cases), he or she can get an Appeals conference. (Reg §601.106(a)(1))

Under procedures prescribed by the IRS, a taxpayer may request early referral of one or more unresolved issues from either the examination or collection division, to the IRS Office of Appeals. (Code Sec. 7123(a)) The procedures identify issues that are appropriate for referral and those that aren't and set forth the manner of seeking referral.

The IRS has placed Appeals customer service representatives in each of its Appeals Offices nationwide to provide assistance to taxpayers during their appeals.

Appeals Office settlement. The Appeals Office has authority to settle all factual and legal issues raised by the examiner's report (RAR, see VII.A.7.) or by the taxpayer's protest (Reg §601.106(f)(2)) as long as the case isn't docketed in the Tax Court. (Reg §601.106(a)(2))

If the taxpayer accepts the IRS's position in full, with no concessions, the taxpayer signs a Form 870 (Form 890, in gift, estate or generation-skipping transfer tax cases), waiving restrictions on assessment. (Reg §601.106(d)(2))

If the Appeals Office makes any concessions, a Form 870-AD (Form 890-AD, in gift or estate tax cases) is executed stating that the settlement is subject to acceptance by IRS; on acceptance it won't be reopened by IRS absent fraud, malfeasance, concealment or misrepresentation of a material fact, an important mathematical mistake, or an excessive tentative NOL carryback; and the taxpayer waives the right to file a claim for refund (other than from an NOL carryback) for any years covered by the agreement.

If no settlement is reached, IRS will prepare a 90-day letter (see below). Under procedures prescribed by the IRS, either the taxpayer or IRS Office of Appeals can request nonbinding mediation on any issue that is still unresolved after the conclusion of appeals procedures, or unsuccessful attempts to enter into a closing agreement or a compromise. (Code Sec. 7123(b)(1)) To this end, IRS has established regular (i.e., non-expedited) and fast track mediation programs.

Review Question 37

Which of the following is a true statement regarding Appeals Office conferences?

a. To arrange an Appeals Office conference in a field audit case, a taxpayer must file a protest in writing if the total amount of the proposed tax increase exceeds $1,000.

b. Testimony is taken under oath in Appeals Office conferences.

c. An Appeals Office conference is no longer available to taxpayers once the IRS has issued a 90- day letter.

d. A taxpayer may be able to request early referral of one or more unresolved issues from either the examination or collection division to the IRS Office of Appeals.

10. Notice of Deficiency—90-Day Letter

A statutory notice of deficiency, or 90-day letter, tells a taxpayer that IRS has determined a deficiency (in income, estate or gift tax, or excise tax on private foundations or pension plans). This is the only notice IRS will issue for that determination.

The 90-day letter must describe the basis for and identify the amounts of tax, interest, additional amounts, additions to tax, and assessable penalties. (Code Sec. 7522(a)) The 90-day letter must be sent by certified or registered mail to the taxpayer at his or her last known address as determined under IRS regulations. (Reg §301.6212-2)

After receiving the 90-day letter, the taxpayer can: pay the deficiency, not pay and seek to rescind it, pay and file a refund claim (see VII.C.1.), take no action (let tax be assessed) and then file a compromise offer (see below), or file a Tax Court petition (see VII.D.1.).

All 90-day letters must include the date determined by IRS as the last day on which the taxpayer may file a petition with the Tax Court. (Code Sec. 6213(a)) But the Tax Court has held that failure to include the date doesn't necessarily invalidate the letter.

Notices must include information about interest (Code Sec. 6631) and penalties. (Code Sec. 6751)

11. Closing Agreements and Compromises

The taxpayer and the IRS may conclusively settle a tax dispute by entering into a final agreement to close either a tax year that has ended (Code Sec. 7121(a); Reg §301.7121-1(b)(2), Reg §601.202(a)(2)) or a *specific transaction*, past or future (using Form 906). (Reg §601.202(a)(2)) The agreement is irrevocable (except for fraud, malfeasance or misrepresentation of a material fact) and binds both parties. (Code Sec. 7121(b))

Civil or criminal tax cases can be compromised by IRS after assessment (see VII.B.1) and before referral to the Department of Justice (after referral, a compromise can be entered into only by the Attorney General). (Code Sec. 7122(a))

The IRS may compromise tax liabilities on any of these grounds: (1) doubt as to collectibility, (2) doubt as to liability, (3) economic hardship, and (4) extraordinary events beyond the taxpayer's control. (Reg §301.7122-1(b)) To make an offer, the taxpayer must file Form 656 and, except for offers based solely on doubt as to liability, Form 433-A (individuals) or Form 433-B (businesses) (sole proprietors file must file both of the latter forms) and (with some exceptions) pay a $150 processing fee. There are three ways to pay the compromised taxes including monthly payments. (Reg §301.7122-1(d)(1))

Any lump-sum offer (i.e., any offer with payment in five or fewer installments) must be accompanied by payment of 20% of the amount of the offer, and any periodic payment offer must be accompanied by payment of the amount of the first proposed installment. IRS can issue regs waiving any of the above required payments (Code Sec. 7122(c)). Such an offer is deemed accepted if IRS doesn't reject it within 24 months after it is submitted. (Code Sec. 7122(f))

IRS officers and employees use guidelines to determine whether a taxpayer's offer of compromise is adequate and should be accepted to resolve a dispute. (Reg §301.7122-1(c)(2)) However, the IRS can't reject an offer-in-compromise from a low-income taxpayer solely on the basis of the amount of the offer. (Code Sec. 7122(c))

The IRS can't give notice of a rejection of an offer until an independent administrative review of the proposed rejection is completed. (Reg §301.7122-1(f)(2))

A taxpayer may appeal a rejection of an offer to compromise to the IRS Office of Appeals if, within the 30-day period commencing the day after the date on the letter of rejection, the taxpayer requests an administrative review in the manner provided by IRS. (Reg §301.7122-1(f)(5)(i))

Review Question 38

Which of the following is **not** one of the grounds on which the IRS can base a compromise of tax liability?

a. Economic hardship.

b. Prior record of prompt tax payments.

c. Doubts as to collectibility.

d. Doubts as to liability.

B. Deficiencies and Assessments

A deficiency is the excess of:

1. a taxpayer's correct tax liability over
2. the amount by which:
    a. the tax shown on the return (mathematical or clerical errors corrected), plus the amounts previously assessed (or collected without assessment) as a deficiency exceeds
    b. the amount of any rebates (credits, refunds, or other repayments). (Code Sec. 6211(a), Code Sec. 6213(b))

The correct tax and the tax shown on the return are computed without regard to credits for estimated taxes and taxes withheld under Code Sec. 31 (i.e., on wages, including excess social security withholdings, and back-up withholding). (Code Sec. 6211(b)(1)) For purposes of determining a deficiency, any excess of the additional child tax credit for families with three or more children, the gasoline and special fuel tax credit under Code Sec. 34, and the earned income credit over the tax imposed by subtitle A (without taking into account those credits) and any excess of those credits shown by the taxpayer on the return over the amount shown as tax on the return (without taking into account those credits) is taken into account as a negative amount of tax. (Code Sec. 6211(b)(4)) If no return was filed, or if a return doesn't show any tax, the deficiency equals the entire amount of the correct tax. Additional taxes reported on an amended return filed after its due date are treated as "tax shown" on the return, not deficiencies. (Reg §301.6211-1(a))

If a taxpayer elects to have the IRS compute the tax, the IRS's computation of tax imposed is the "tax shown" on the return. (Code Sec. 6211(b)(3))

Where a deficiency on a joint return is challenged by only one spouse, the deficiency as to that spouse is reduced by any tax collected from the other spouse.

1. Assessments—General Rules

As a general rule, all taxes must be assessed:

- within three years after the date the return was filed, or
- if the tax is payable by stamp, within three years after the date any part of the tax was paid. (Code Sec. 6501(a))

A return filed before the filing deadline is considered filed on the due date. (Code Sec. 6501(b)(1)) But a return of tax withheld (from wages or at source) for any period ending with or within a calendar year is, if filed before April 15 of the next calendar year, considered filed on April 15. (Code Sec. 6501(b)(2); Reg §301.6501(b)-1(b))

The assessment period for a late-filed return starts on the day after the actual filing, whether the lateness is due to taxpayer's delinquency or under a filing extension granted by IRS. (Code Sec. 6501(a))

The assessment period for items of a partnership, S corporation, trust or estate that are passed through to and reported by the partners, shareholders or beneficiaries, respectively, is based on their returns (not the partnership's, etc.). (Code Sec. 6501(a)).

If within 60 days before the limitations period expires, IRS receives an amended return that shows an increase in tax liability, IRS has 60 days from the receipt to assess the additional tax. (Code Sec. 6501(c)(7))

Unless the taxpayer and the IRS sign a closing agreement (see VII.A.11.), the taxpayer voluntarily pays the deficiency or signs a Form 870 agreeing to the deficiency (see VII.A.8.), or IRS determines collection is in jeopardy, the IRS can't assess deficiencies in income, estate, and gift taxes or the excise taxes on private foundations and qualified pension, etc., plans until after the taxpayer has had an opportunity to make a Tax Court appeal. (Code Sec. 6213(a))

A taxpayer who claims that the assessment of a tax is barred by the expiration of the limitations period must raise the issue and has the burden of proof.

Review Question 39

Jack Brown is a partner of XYZ partnership. XYZ's 2013 partnership return is due on March 17, 2014, but XYZ files the return on March 3. Brown's 2013 personal return is due April 15, 2014; but, after getting a filing extension, he files the return on June 30, 2014. When does the period of assessment begin for items of XYZ's return passed through to Brown?

a. March 17, 2014.

b. April 15, 2014.

c. June 30, 2014.

d. June 29, 2014.

2. Carrybacks and Carryovers

A deficiency attributable to a taxpayer's carryback of a net operating loss (NOL), capital loss, or business credit may be assessed at any time before expiration of the period applicable to the year the loss was sustained or the credit earned. (Code Sec. 6501(h), Code Sec. 6501(j)) A deficiency attributable to a foreign tax credit carryback may be assessed up to one year after the credit year's assessment period expires. (Code Sec. 6501(i))

Where a credit carryback results from the carryback of an NOL, capital loss or other credit carryback from a later year, a deficiency for the carryback year can be assessed at any time before the expiration of the period for the later year. (Code Sec. 6501(j))

3. Six-year Assessment Period

The assessment period is six years for income tax (or estate, gift or excise tax) returns that omit from gross income (or gross estate, total gifts made in the return period, or excise tax) more than 25% of the gross income (or gross estate, total gifts or excise tax) that is reported. But these "omissions" don't include amounts for which adequate information is given on the return or attached statements. (Code Sec. 6501(e))

4. Indefinite Assessment Period

The assessment period is open indefinitely if a taxpayer:

- fails to file a required return (Code Sec. 6501(c)(3)),
- files a false or fraudulent income, gift or estate tax return with intent to evade tax; (Code Sec. 6501(c)(1))
- willfully attempts in any manner to defeat and evade taxes (Code Sec. 6501(c)(2));
- fails to pay any part of a tax required to be paid by stamp (Code Sec. 6501(a); Reg §301.6501(a)-1);
- for gift tax, fails to show or adequately disclose a gift. (Code Sec. 6501(c)(9), Reg §301.6501(c)- 1(e), Reg §301.6501(c)-1(f))
- is subject to the tax on termination of private foundation status.

The penalties for promoting abusive tax shelters, or for aiding and abetting an understatement, can be assessed at any time, as can the penalty (but not the tax) imposed on a return preparer for willful tax understatements. (Code Sec. 6696(a))

5. Interest and Penalties

Interest may be assessed when the underlying tax is collectible. (Code Sec. 6601(g))

For income, estate, gift and certain excise taxes, the negligence and fraud penalties are assessed like deficiencies. So are the delinquency penalties, but only if attributable to a deficiency and not if measured by the tax shown on the return. The penalty for estimated tax underpayments is assessed as a deficiency only if no return is filed. (Code Sec. 6665(b); Reg §301.6659-1(c))

6. Jeopardy Assessments

If the IRS believes assessment or collection of a deficiency will be jeopardized by delay, it can immediately assess the deficiency (plus any interest and penalties) and demand payment. (Code Sec. 6861(a); Reg §301.6861-1(a)) However, within 60 days after making the assessment, the IRS must issue the taxpayer a 90-day letter (see VII.A.10.) if it hasn't already done so. (Code Sec. 6861(b)) The IRS Chief Counsel must pre-approve jeopardy assessments. (Code Sec. 7429(a)(1)(A))

The IRS can presume the collection of income tax is in jeopardy if an individual who has physical possession of more than $10,000 in cash or cash equivalents (e.g., foreign currency, bearer obligations, coins, precious metals or stones, jewelry, postage stamps, or other specified exchange mediums of a type frequently used in illegal activities) denies ownership of it and doesn't claim it belongs to another identifiable person who acknowledges ownership. (Code Sec. 6867(a), Code Sec. 6867(d); Reg §301.6867- 1(f)(2), Reg §301.6867-1(f)(3)) The entire amount of the cash is presumed to represent taxable income of the possessor for the year that is taxable at the highest individual tax rate. (Code Sec. 6867(b)) The possessor is treated as the taxpayer for assessment and collection purposes (unless the true owner comes forward), but not for purposes of administrative or judicial review of the assessment. (Code Sec. 6867(b), Code Sec. 6867(c); Reg §301.6867-1(c), Reg §301.6867-1(d), Reg §301.6867-1(f)(4))

The IRS can also terminate a tax year and demand immediate payment of income taxes for the current and preceding year, if it finds that a taxpayer plans to leave (or remove his or her property from) the U.S. quickly, conceal him or herself or property in the U.S., or do any other act that would prejudice the collection of those taxes ("termination assessment"). Within 60 days after the due date (with extensions) of the taxpayer's return for the full tax year or, if later, the date the return is actually filed, the IRS must issue a 90-day letter to the taxpayer for the full year. (Code Sec. 6851(a), Code Sec. 6852(a))

There are procedures for administrative and judicial review of jeopardy and termination assessments (Code Sec. 7429) and for stay of collection. (Code Sec. 6863)

Review Question 40

Which of the following is a true statement regarding jeopardy assessments?

a. Within 30 days of making a jeopardy assessment, the IRS must issue a 90-day letter.

b. The IRS can issue a jeopardy assessment against an individual who is in possession of more than $10,000 of cash even though the individual claims the cash belongs to another party and the other party acknowledges ownership.

c. There are no procedures for an administrative review of a jeopardy assessment.

d. The IRS can terminate a tax year and demand immediate payment of income taxes for the current and preceding year if it finds that a taxpayer plans to leave the U.S. quickly.

7. Voluntary Extension of the Assessment Period

At any time *before* expiration of the assessment period, a taxpayer and IRS can agree in writing (usually on one of the Form 872 series) to extend the assessment period (except for estate taxes). The taxpayer and the IRS can also enter into successive agreements further extending the period. (Code Sec. 6501(c)(4)) Form 872 is generally referred to by the IRS as a "consent," although tax practitioners sometimes refer to it as a "waiver."

Restricted consent. A restricted consent postpones the close of the tax year with respect to an unsettled issue. It is used where some issues are resolved, but settlement of others must await the establishment of an IRS position through a court decision, etc., or where other equally meritorious circumstances exist.

Indefinite consent—Form 872-A. A taxpayer whose case is before the Appeals Office (see VII.A.9.) can execute Form 872-A, which provides for an indefinite extension of the assessment period. It expires 90 days after: (1) Appeals receives notice (on Form 872-T) of the taxpayer's desire to terminate the extension, (2) the IRS mails Form 872-T to the taxpayer, or (3) the IRS mails a 90-day letter (see VII.A.10.).

The IRS must notify the taxpayer of the taxpayer's right to refuse to extend the period of limitations on assessment, or to limit the extension to particular issues or to a particular period of time, on each occasion when the taxpayer is requested to provide consent. (Code Sec. 6501(c)(4)(B))

8. Suspension of the Assessment Period

A 90-day letter (see VII.A.10.) suspends the assessment period. It stops running on the date IRS mails the letter, and doesn't resume until 60 days after: (1) the 90-day period (150 days if the letter is addressed to a person outside the U.S.) if no Tax Court petition is filed, or (2) the date the Tax Court's decision becomes final if a Tax Court petition is filed. (Code Sec. 6503(a))

A taxpayer's application for a Taxpayer Assistance Order (see VII.B.10.) also suspends the assessment period until the date the National Taxpayer Advocate makes a decision. (Code Sec. 7811(d))

The assessment period is suspended in Tax Court employment tax determinations. (Code Sec. 7436(d)(1))

For returns of corporations being examined under the coordinated examination program or a successor program, the issuance of a "designated summons" to determine the amount of tax also suspends the assessment period, pending final resolution of its enforcement. (Code Sec. 6503(j))

9. Relief for Barred Years

Generally, after the period for assessment or refund has run, the IRS can't make an assessment and a taxpayer can't get a refund. But, in certain circumstances an otherwise closed year may be reopened under the Code's "mitigation" provisions. (Code Sec. 1311, Code Sec. 1312, Code Sec. 1313)

If the statutory mitigation conditions aren't met, relief from the limitation periods may be available in the district court under the doctrine of equitable recoupment (closed year's overpayment or underpayment used to offset open year's deficiency or refund)

10. National Taxpayer Advocate

The Office of the Taxpayer Advocate is headed by the National Taxpayer Advocate, who is appointed by the Treasury Secretary after consultation with the IRS Oversight Board and the IRS Commissioner, and reports directly to the Commissioner. (Code Sec. 7803(c)(1)) The Office's functions are to assist taxpayers in resolving problems with the IRS, identify areas where taxpayers have problems dealing with the IRS, propose changes in IRS administrative practices to mitigate these identified problems, and identify potential legislative changes that may resolve taxpayer problems. (Code Sec. 7803(c)(2)(A))

On a taxpayer's application or in a signed written statement containing the information prescribed in IRS regulations) to the Office of the Taxpayer Advocate, the National Taxpayer Advocate (or his or her designee) can issue a Taxpayer Assistance Order (TAO) if it is determined that the taxpayer is suffering (or will suffer) significant hardship because of IRS administration of the tax laws or if the taxpayer meets other requirements provided in regulations. (Code Sec. 7811(a)(1); Reg §301.7811-1(b)(1))

The hardship in question can be the result of action or inaction on the part of the IRS. (Reg §301.7811- 1(a)(1)) A "significant hardship" is a serious privation caused or about to be caused to the taxpayer as the result of the particular manner in which the internal revenue laws are being administered by the IRS. Mere economic or personal inconvenience to the taxpayer isn't significant hardship. (Reg §301.7811-1(a)(4)(ii)) Significant hardship includes, among other things, an immediate threat of adverse action; a delay of more than 30 days in resolving taxpayer account problems; the incurring by the taxpayer of significant costs (including fees for professional representation) if relief isn't granted; or irreparable injury to, or a long-term adverse impact on, the taxpayer if relief isn't granted. (Code Sec. 7811(a)(2))

C. Refunds

An overpayment is the excess of the amount paid (or withheld) as tax over the taxpayer's correct tax liability. It includes the part of a correct tax paid after the applicable assessment period has run. (Code Sec. 6401)

As a general rule, an overpayment can be recovered as a refund or credit only by the taxpayer who owed the tax. A person who pays another person's taxes can't get a refund of the tax paid unless his or her payment was involuntary (e.g., by an erroneous IRS lien).

Electronic filers may elect to have their refunds deposited directly into their bank accounts. Paper filers elect direct deposit by filling in the appropriate blanks on the "Refund" lines of Form 1040.

A refund may be claimed for a deceased taxpayer by attaching Form 1310 (not needed for surviving spouse filing jointly with decedent) to the decedent's final return.

The IRS may first credit an overpayment (including interest) against any of the taxpayer's past due tax liability (including interest, additions, or penalties). (Code Sec. 6402(a), Reg §301.6402-3(a)(5))

If a state notifies the Treasury that a taxpayer owes any child support payments, it must first apply the taxpayer's overpayment to those past-due obligations, before making any refund or credit. If a federal agency notifies the Treasury of any past-due, legally enforceable nontax debt a taxpayer owes the agency, the IRS must apply the balance (i.e., after the child support offset) of the taxpayer's overpayment to that nontax debt. (Code Sec. 6402(d)) Refunds can be offset by state income tax debts. (Code Sec. 6402(e)) Any overpayment remaining after these three permitted reductions can be reduced to recover overpayments made to the taxpayer under state family aid plans approved under part A of Title IV of the Social Security Act. (Code Sec. 6402(f))

A spouse should file Form 8379 to prevent his or her share of a joint return refund from being used to satisfy the other spouse's obligations.

1. Refund Claim

To get a refund, a taxpayer must file a timely written claim. For income, gift and federal unemployment taxes, a separate claim must be made for each tax year or period. (Reg §301.6402-2(a), Reg §301.6402-2(d))

Official refund claim forms are:

- Form 1040X (amended U.S. individual income tax return). (Use Form 1040, Form 1040A, or Form 1040-EZ only for refund of over-withheld taxes or excess estimated taxes.) (Reg §301.6402-3(a)(2), Reg §301.6402-4)
- Form 1120 or Form 1120X (original or amended corporate income tax return). (Reg §301.6402- 3(a)(2))
- Amended returns for taxpayers who filed a form other than Form 1040, Form 1040A, Form 1040- EZ or Form 1120 (e.g., a return for an estate or trust). (Reg §301.6402-3(a)(4))
- Form 843 for refunds of non-income taxes (Reg §601.105(e)(1)), except excise taxes reported on Form 720, Form 730, or Form 2290. Form 720X and Form 8849 are used for excise tax refund claims. The IRS must explain disallowances of refund claims. (Code Sec. 6402(j))

2. Deadline for Refund Claims

A claim for credit or refund of a tax paid by return must be filed within the later of: (1) three years from the date the return was timely or untimely filed (or the due date if filed earlier), or (2) two years from the date the tax was paid. If the required return wasn't filed, the claim must be filed within two years from when the tax was paid. (Code Sec. 6511(a)) A remittance accompanying an automatic filing extension is a tax payment for this purpose.

However, a longer refund claim period applies in these cases:

- If a taxpayer and the IRS execute one of the Form 872 series extending the assessment period (see VII.B.7.), the claim can be filed within six months after the expiration of the extended assessment period. (Code Sec. 6511(c)(1))
- For an overpayment resulting from carryback of an NOL, net capital loss, or business credit, the period expires three years after the time the return is due (including extensions) for the year the loss or credit arose, not the year to which it's carried back. (Code Sec. 6511(d)(2), Code Sec. 6511(d)(4))
- For an overpayment resulting from the payment or accrual of foreign taxes for which a foreign tax credit is allowed, the claim period is ten years. (Code Sec. 6511(d)(3))
- For an overpayment resulting from a bad debt or from worthless securities, the claim period is seven years. (Code Sec. 6511(d)(1))
- For self-employment tax claims attributable to Tax Court employment status proceedings, the claim period is two years after the calendar year in which the Tax Court determination becomes final. (Code Sec. 6511(d)(7))

- The two-year period for filing a refund suit is suspended where a declaratory judgment action is brought as to an estate's eligibility to make installment payments of estate tax under Code Sec. 6166, until the decision of the Tax Court has become final. (Code Sec. 7479(c))

Also, the limitations period is suspended during any period an individual is unable to manage his or her financial affairs by reason of a medically-determinable physical or mental impairment, if the impairment either (1) can be expected to result in death or (2) has lasted, or can be expected to last, for a continuous period of not less than 12 months. The limitations period isn't stopped during any period that the individual's spouse or any other person is authorized to act in financial affairs on his or her behalf. The taxpayer must prove eligibility for suspension by filing statements required by IRS including one from a physician. (Code Sec. 6511(h))

Review Question 41

Which of the following statements regarding the deadline for filing refund claims is correct?

a. The limitation period for refund claims is extended for one year in the case of an individual who has a physical impairment that is expected to last not less than 12 months.

b. For an overpayment resulting from a bad debt or from worthless securities, the limitations period for filing a refund claim is increased from three years to seven years.

c. If a required return isn't filed, a refund claim must be filed within three years from when the tax was paid.

d. When a taxpayer files a refund claim based on a carryback of a net operating loss, the taxpayer must generally file the claim within three years of the due date of the return for the carryback years.

3. Limits on Amount of Refund or Credit

If a claim is filed within three years from the time the return was filed, the refund or credit is limited to the portion of tax paid during the three years (plus the period of any filing extension) immediately preceding the filing of the claim. (Code Sec. 6511(b)(2)(A))

If the claim isn't filed within the three-year period, the refund or credit is limited to the portion of the tax paid during the two years immediately preceding the filing of the claim. (Code Sec. 6511(b)(2)(B)) This two-year limitation also applies if a claim, but no return, was filed. (Reg §301.6511(b)-1(b)(1)(iii))

Where no claim is filed and a refund or credit is allowed by the IRS within three years from the time the return was filed, the refund or credit is limited to the portion of the tax paid during the three years immediately before the allowance. If the refund or credit is not allowed within that three-year period, it's limited to the portion of the tax paid during the two years immediately before the allowance. (Code Sec. 6511(b)(2)(C))

For purposes of determining the amount of an individual taxpayer's refund or credit under these rules, the refund claim periods described above are suspended during any period when the individual is unable to manage his or her financial affairs (see above). (Code Sec. 6511(h))

4. Interest on Overpayments

Interest on overpayments is allowed. (Code Sec. 6611(a)) The interest (compounded daily) runs from the date of the overpayment to a date not more than 30 days before the refund is made (or to the unextended return due date for the amount against which the overpayment is credited). (Code Sec. 6611(b))

But no interest is payable on a refund arising from an original income, employment, excise, estate or gift tax return if the refund is made within 45 days after the later of the return due date (without extensions) or the date the return was filed. (Code Sec. 6611(e)(1); Reg §301.6611-1(g)) If a refund arising from an amended return or refund claim is issued within 45 days, no interest is payable for that up-to-45-day period. (Code Sec. 6611(e)(2))

The overpayment date for taxes withheld or paid as estimated taxes is the unextended due date of the return. (Code Sec. 6513(b))

Overpayments resulting from the carryback of an NOL, net capital loss, business credit, or foreign tax credit, are considered not to have been made before the "filing date" for the tax year in which the loss or credit arose or the foreign tax was in fact paid or accrued. (Code Sec. 6611(f)) Similarly, where a business credit carryback is attributable to an NOL, etc., carryback from a later year, the overpayment is considered not to have been made before the filing date for that later year. (Code Sec. 6611(f)(3))

For refunds or credits arising from an adjustment initiated by IRS, the interest period is reduced by 45 days. (Code Sec. 6611(e)(3))

With respect to returns filed after the due date (with extensions), no interest is payable for the period preceding the actual filing date. (Code Sec. 6611(b)(3)) And, no interest is payable on an estate's overpayment unless it shows that the interest (and refund) won't escheat to the state. (Code Sec. 6408)

For calendar quarters beginning after 1998, the overpayment rate for corporations except corporations with large overpayments (see below) is the AFR (applicable federal rate) plus two percentage points. However, the overpayment rate for individuals is the AFR plus 3 percentage points (i.e., the same as the underpayment rate, see below). (Code Sec. 6621(a)(1))

For corporations, the rate is reduced to the AFR plus 0.5 percentage points, to the extent the overpayment for any period exceeds $10,000. (Code Sec. 6621(a)(1))

Review Question 42

On April 15, 2013, the deadline for filing 2012 returns, Jane Smith received a six-month extension for filing her 2012 return. She filed her 2012 return on July 5, 2013, and claimed a refund. The IRS issued a refund check on August 13, 2013. Which of the following statements is correct?

a. The IRS owes interest on the overpayment for the period between the date of the overpayment and the date 30 days before Smith's refund check is issued.

b. The IRS owes interest on the overpayment for the period between the date of the overpayment and April 15, 2013.

c. The IRS owes interest on the overpayment for the period between the date of the overpayment and the date Smith filed her 2012 return.

d. The IRS owes no interest on the overpayment.

5. Quick Refunds

A taxpayer who reports a carryback of a capital loss, net operating loss (NOL), business credit, or capital loss from a section 1256 contract under Code Sec. 1212(c) can quickly recover a refund based on the carryback by filing Form 1045 (individuals) or Form 1139 (corporations). The appropriate form must be filed on or after the date the return for the loss or credit year is filed and within 12 months after the end of the tax year from which the carryback is made. (Code Sec. 6411(a); Reg §1.6411-1(b)(1))

The IRS has 90 days from the later of the date the claim is filed or the last day of the month in which the loss year return is due (with extensions), to make any credit or refund. (Code Sec. 6411(b); Reg §1.6411-3)

The IRS's determination is tentative. If the claim is rejected, the taxpayer can't sue but must first file a standard refund claim. (Code Sec. 6411(a); Reg §1.6411-3(c)) Even if the IRS grants the refund, it can later examine the loss year return and the refund application. The IRS may assess any part of the refund it finds excessive, without issuing a 90-day letter. (Code Sec. 6213(b)(3))

A corporation that overpaid its estimated tax can get a refund within 45 days after filing Form 4466. (Code Sec. 6425(b)(1), Code Sec. 6425(b)(2); Reg §1.6425-1(b)) The form must be filed after the close of the corporation's tax year and on or before the 15th day of the third month after the end of the year (or before the corporation first files its income tax return for that year, if earlier). (Code Sec. 6425(a)(1); Reg §1.6425- 1(c)(1)) The corporation's estimated tax overpayment must be at least 10% of its revised expected annual tax and at least $500. (Code Sec. 6425(b)(3)) If the refund is excessive, an addition to tax equal to the underpayment interest rate, times the excessive amount is imposed. (Code Sec. 6655(h))

6. Refund Suits

A taxpayer must file a refund claim with IRS before starting a suit for refund (or credit). (Code Sec. 7422(a)) The refund suit can't be started before six months from filing the claim (unless IRS acts on the claim in that period) or after two years from the date IRS mails a notice of disallowance. (Code Sec. 6532(a)(1)) The taxpayer can waive (on Form 2297) issuance of this notice and the two-year period will start on the date the waiver is filed. (Code Sec. 6532(a)(3)) Also, the taxpayer and IRS can execute a Form 907 extending the two-year period. (Code Sec. 6532(a)(2))

D. Tax Litigation

A taxpayer may go to:

- the Tax Court to set aside a deficiency determined by IRS (Code Sec. 6214(a));
- a U.S. district court or the U.S. Court of Federal Claims to recover an overpayment of taxes (after filing a refund claim) (Code Sec. 6532(a));
- a U.S. district court or the U.S. Court of Federal Claims to determine the correct amount of an estate's estate tax liability (or for any refund of the estate's estate tax liability) (Code Sec. 7422(j)(1));
- the Tax Court, the district court for the DC Circuit or the U.S. Court of Federal Claims for a declaratory judgment on the tax status of a charity or foundation (Code Sec. 7428(a));
- the Tax Court for a declaratory judgment on retirement plan qualification (Code Sec. 7476(a)), eligibility for deferral of estate tax on a closely held business interest (Code Sec. 7479), or the value of certain gifts made (Code Sec. 7477);
- the Tax Court for review of IRS's failure to abate interest (Code Sec. 6404(g));
- the Tax Court for a worker classification determination in certain cases (Code Sec. 7436);
- a district court to enjoin IRS from assessing and collecting a tax in certain cases, or to get damages for IRS's unauthorized collection activities or failure to release a lien (Code Sec. 7432, Code Sec. 7433);
- a bankruptcy court to sue for up to $1 million in damages for willful IRS violations of automatic stay or discharge in bankruptcy. (Code Sec. 7433(e)).

For taxpayers other than certain large partnerships, corporations, and trusts, the IRS has the burden of proof in any court proceeding with respect to any factual issue relevant to ascertaining a taxpayer's liability for any tax imposed by subtitle A or B of the Code (e.g., income and self-employment, gift, estate, and generation-skipping transfer taxes) if the taxpayer: introduces credible evidence with respect to the issue; has complied with the substantiation requirements; has maintained all required records; and has cooperated with reasonable IRS requests for witnesses, information, documents, meetings, and interviews. (Code Sec. 7491(a)) The IRS has the burden of production (i.e., to come forward initially with evidence) in any court proceeding with respect to the liability of any individual for any penalty imposed by the Code. (Code Sec. 7491(c))

1. The Tax Court

To get Tax Court review of a deficiency, a taxpayer must file a petition with the Tax Court at Washington, D.C., in response to a notice of deficiency (90-day letter, see VII.A.10.) from the IRS. The petition must be filed within 90 days (150 days if the notice is addressed to a person outside the U.S.) after the deficiency notice is mailed (i.e., postmarked). A petition is treated as timely if it's filed with the Tax Court on or before the last date specified by IRS in the 90-day letter for filing it. (Code Sec. 6213(a))

The Tax Court's jurisdiction generally is limited to the review (without a jury) of deficiencies asserted by the IRS (and not paid when the 90-day letter is issued). However, although the Tax Court cannot generally hear a refund claim, it can order payment of a refund if it determines the taxpayer overpaid. (Code Sec. 6512(b)) But it can't grant equitable relief. The Tax Court has jurisdiction to order a refund of any amount collected during a period when IRS was prohibited from collecting a deficiency by levy or court proceeding but only if a timely petition for a redetermination of the deficiency has been filed and only with respect to the deficiency at issue. (Code Sec. 6213(a)) The Tax Court has jurisdiction to review the IRS's failure to abate interest to taxpayers within certain net worth limits who bring an action within 180 days of a final adverse determination, and to order abatement if the IRS abused its discretion. (Code Sec. 6404(i)) It can also determine worker classification in certain cases and the correct amount of employment taxes that relate to such determinations. (Code Sec. 7436) The Tax Court has jurisdiction to determine innocent spouse relief when a deficiency has been issued and the taxpayer elects regular or separate innocent spouse relief but it can't rule on the timeliness of an assessment in reviewing a denial of innocent spouse relief. It can review denials of equitable "innocent spouse" relief for taxes arising or remaining unpaid on or after December 20, 2006. (Code Sec. 6015(e)) The Tax Court generally is barred from determining whether the tax for any period not before it has been overpaid or underpaid. However, for Tax Court actions or proceedings for which a decision has not become final as of August 17, 2006, it may apply the doctrine of equitable recoupment. (Code Sec. 6214(b))

Special informal procedures apply, at a taxpayer's election and with the Tax Court's concurrence, to any Tax Court case where neither the amount (including any additions to tax, additional amounts and penalties) of the deficiency disputed nor of any claimed overpayment exceeds $50,000. The taxpayer thus gets the court's decision faster and more easily, but gives up the right to appeal. (Code Sec. 7463) Where a deficiency exceeds $50,000, the taxpayer can concede enough of the deficiency to bring it down to that threshold.

The IRS District Counsel will refer all docketed Tax Court cases to the Appeals Office for consideration of settlement (unless Appeals issued the deficiency notice, in which case there will be no referral if there is little likelihood that all or part of the case can be settled in a reasonable period of time). Counsel and Appeals can agree otherwise, work together, or transfer the case back and forth to promote efficient disposition of the case. The taxpayer-petitioner and/or his or her representative will be notified as to who has the case and the settlement authority.

If the taxpayer and IRS agree on a settlement, they enter into a written agreement stipulating the amount of any deficiency or overpayment. This stipulation is filed with the Tax Court which will enter a decision in accordance with it.

Review Question 43

Which of the following is the Tax Court **not** authorized to do?

a. Grant equitable relief.

b. Order a refund when the claimed overpayment exceeds $50,000.

c. Determine the correct employment tax liability in certain cases involving worker classification.

d. Review the IRS's failure to abate interest to taxpayers within certain net worth limits.

2. Appeals

Decisions of the Tax Court and U.S. district courts are appealable to a U.S. Court of Appeals. The appeal is made generally in the circuit where the taxpayer's legal residence (for appeals from Tax Court) or the trial court (for appeals from district courts) is located. U.S. Court of Federal Claims decisions may be appealed to the Court of Appeals for the Federal Circuit.

Appeals from the U.S. Courts of Appeal are heard by the U.S. Supreme Court.

3. Recovery of Attorneys' Fees and Costs

Taxpayers whose net worth doesn't exceed specified limits, who meet other requirements, and who prevail against the U.S. in court (or at the administrative level) may be awarded reasonable litigation and administrative costs (including the costs of recovering the award). (Code Sec. 7430) The limit on attorney fee recoveries is $180 per hour for 2012. (Code Sec. 7430(c)(1)) Administrative costs can be awarded from the date IRS sends the "30-day letter" (see VII.A.8.). (Code Sec. 7430(c)(2))

To avoid an award of fees, IRS must establish that its position was substantially justified. (Code Sec. 7430(c)(4)(B)) IRS losses on similar issues in other circuits are taken into account in determining whether its position was substantially justified (Code Sec. 7430(c)(4)(B)(iii)). Costs can be awarded where a taxpayer makes an offer, IRS rejects it and later gets a judgment equal to or less than the offer. (Code Sec. 7430(c)(4)(E)(i); Reg §301.7430-7T)

E. Interest and Penalties

Interest is charged on underpayments of tax. Various civil and criminal penalties are imposed on taxpayers (and/or return preparers) who violate the tax law.

1. Interest on Underpayments and Penalties

Interest is generally payable whenever any tax or civil penalty isn't paid when due (Code Sec. 6601(a)), even if the taxpayer has been granted an extension of time to pay the tax. (Code Sec. 6601(b)(1); Reg §301.6601-1(a)) There's no interest on late payments of estimated tax (Code Sec. 6601(h)) (but comparable penalties apply) or unemployment tax. (Code Sec. 6601(i)) Interest is payable on an erroneous refund or credit. (Code Sec. 6602)

Interest on unpaid tax liabilities runs from the last day prescribed by the Code for payment (disregarding extensions or any installment payment agreement) (Code Sec. 6601(b)(1)), to the date paid. (Code Sec. 6601(a)) However, where the tax is paid within 21 days after notice and demand (10 business days if the amount is $100,000 or more), interest stops on the date of the notice and demand. (Code Sec. 6601(e)(3))

Also, where a taxpayer consents to immediate assessment (by signing one of the Form 870 waiver of assessment series, see VII.A.8.) and IRS doesn't make notice and demand for payment within 30 days of the filing of that consent, interest stops running during the period beginning immediately after that 30th day and ending with the date of the notice and demand. (Code Sec. 6601(c))

Interest on civil penalties runs from the date of notice and demand if not paid within 21 days after that date (10 business days for amounts of $100,000 or more). (Code Sec. 6601(e)(2)(A)) But for the penalties for failure to file, valuation misstatement (income tax) or understatement (estate or gift tax), substantial understatement, negligence, and fraud, the interest period begins on the return due date (with extensions). In either case, the interest stops on the date the penalty is paid. (Code Sec. 6601(e)(2)(B))

The rate of interest on tax underpayments and penalties is keyed to the short-term federal rate for the previous calendar quarter plus three percentage points (two percentage points in the case of a corporation) (Code Sec. 6621(a)(2)) and is compounded daily.

If a C corporation's tax underpayment for any tax period exceeds $100,000, a higher interest rate (AFR plus five percentage points) applies for the period after the 30th day after a notice (or proposed notice) of deficiency. (Code Sec. 6621(c)(3); Reg §301.6621-3)

A net interest rate of zero applies to equivalent amounts of underpayments and overpayments. (Code Sec. 6621(d)) Taxpayers must request interest netting under a procedure making use of Form 843.

Interest on a deficiency isn't eliminated when the deficiency is eliminated by a net operating loss (NOL), net capital loss, or business or foreign tax credit carryback. Interest accrues from the original due date to the filing date for the tax year in which the carryback arose (or, with respect to any portion of a credit carryback attributable to a carryback from a later year, to the filing date for that later year). (Code Sec. 6601(d))

An underpayment of tax in one year may be paid by crediting against it an overpayment of tax in another year. (Code Sec. 6402(a)) No interest accrues on any portion of the underpayment so paid for any period after the return due date (without extension) for the overpayment year or, if later, when the offsetting return is filed. This rule doesn't apply to the extent the net interest rate of zero applies. (Code Sec. 6601(f))

When a taxpayer elects to apply an overpayment to the following year's estimated taxes, the overpayment will be applied to unpaid installments of estimated tax due on or after the date(s) the overpayment arose, in the order in which they are required to be paid to avoid an estimated tax penalty. IRS will assess interest on a later determined deficiency for the overpayment year only from the date(s) that the overpayment is applied to the following year's estimated taxes.

A cash deposit made in conformity with IRS rules may be used to pay income, gift, estate, or generation-skipping tax or certain excise taxes that have not yet been assessed at the time of the deposit. (Code Sec. 6603(a)) The amount of the deposit that is later used by IRS to pay tax is treated as a tax payment at the time of the deposit, for purposes of determining whether the taxpayer owes interest on an underpayment of tax. (Code Sec. 6603(b)) Interest may be allowed on the return of all or part of such a deposit.

Under IRS rules, the taxpayer must remit to the IRS Center where it must file, or the office where the return is under exam, a check or a money order accompanied by a written statement designating the remittance as a deposit. The written statement also must include: (1) the type(s) of tax; (2) the tax year(s); and (3) an IRS-prescribed statement identifying the amount of and basis for the disputable tax.

Review Question 44

Which of the following statements is correct regarding interest on underpayments and penalties?

a. There is no interest charged on an erroneous refund.

b. If an individual's tax underpayment for any tax period exceeds $100,000, a higher interest rate (AFR plus five percentage points) applies.

c. Interest on a deficiency is eliminated when the deficiency is eliminated by a net operating loss carryback.

d. Interest on a deficiency generally stops running on the date of a notice and demand if the tax is paid within 21 days after notice and demand.

2. Abatement or Suspension of Interest, Penalties and Additions to Tax

Subject to exceptions, the imposition of interest and penalties with respect to any failure relating to a timely filed individual income tax return must be suspended if, before the end of the 36-month period beginning on the date the return is filed or, if later, the date it's due (without regard to extensions), IRS fails to provide a notice to the taxpayer specifically stating the taxpayer's liability and the basis for the liability. (The period is 18 months for notices provided on or before November 27, 2007.) The suspension period begins on the day after the end of the 36-month period and ends on the date that's 21 days after IRS provides the notice. (Code Sec. 6404(g))

The IRS has discretion to abate any interest that was assessed because of a deficiency attributable to any unreasonable error or delay by an IRS officer or employer acting in an official capacity when performing a managerial or ministerial act. Interest due on a notice of deficiency may also be abated to the extent any error or delay in payment is attributable to an IRS employee or officer being erroneous or dilatory in performing a managerial or ministerial act, but only if no significant aspect of the error or delay can be attributed to the taxpayer involved. (Code Sec. 6404(e)(1); Reg §301.6404-2)

The IRS must abate any portion of any penalty or addition to tax attributable to erroneous written advice (as specifically defined) (Reg §301.6404-3(c)(1)) furnished to a taxpayer by an IRS officer or employee acting in an official capacity in response to a specific written request. The taxpayer must have reasonably relied on the advice (Code Sec. 6404(f)(1), (f)(2)(A)), and the portion of the penalty or addition to tax must not have resulted from the taxpayer's failure to provide adequate or accurate information. (Code Sec. 6404(f)(2)(B))

An abatement request is made on Form 843 (as annotated and with certain attachments as required by regulations). (Reg §301.6404-3(d))

If IRS extends the time for filing income tax returns and for paying income tax with respect to those returns for any taxpayer located in an area that is federally-declared a disaster area, IRS must also abate, for the same period, any interest that would otherwise be due on the extended income tax. (Code Sec. 6404(h)) If there's a postponement of tax-related deadlines under Code Sec. 7508A (due to a disaster or terroristic or military action) as well as an additional income tax return filing extension under Code Sec. 6081 and a tax payment extension under Code Sec. 6161, interest on an underpayment of income tax that arises during that period will be abated for the time period disregarded under the Code Sec. 7508A extension rules and the time periods covered by the filing and payment extensions. (Reg §301.7508A-1(f))

Certain civil penalties won't be imposed if the taxpayer's failure to perform the required act was due to reasonable cause—e.g., reliance on tax expert or IRS advice, irregularities in mail delivery, death or serious illness, unavoidable absence, casualty, disaster. Generally, a taxpayer who challenges IRS's imposition of a civil penalty has the burden of showing that his or her failure was due to reasonable cause and not willful neglect.

No accuracy-related or fraud penalty (see below) applies with respect to any portion of an underpayment for which the taxpayer shows reasonable cause and that he or she acted in good faith. (Code Sec. 6664(c)(1))

3. Failure to File Penalty

The penalty for failure to file income, estate, or gift tax returns is 5% of the amount of tax required to be shown on the return (less any earlier payments and credits) if the failure is for not more than a month (Code Sec. 6651(b)(1)), plus an additional 5% for each month (or fraction of a month) that the failure continues without reasonable cause, but not more than 25%. (Code Sec. 6651(a)(1))

There's a minimum penalty for failure to file any income tax return within 60 days of the due date (including extensions), except if due to reasonable cause and not willful neglect. For returns required to be filed after December 31, 2008, the minimum penalty is $135. (Code Sec. 6651(a) as amended by the Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245)

The failure-to-file penalty (5%) is reduced (but not below the above minimum) by the amount of any failure-to-pay penalty (see below) for that month. (Code Sec. 6651(c)(1)) The 25% ceiling is applied to each penalty before making this reduction. If the failure to file is fraudulent, the penalty is increased to 15% per month (or fraction), up to a 75% maximum. (Code Sec. 6651(f))

If the date prescribed for filing the return or paying tax is the last day of a calendar month, each succeeding calendar month or fraction thereof during which a failure to file or pay tax continues constitutes a month for penalty purposes. If the date prescribed for filing the return or paying tax is a date other than the last day of a calendar month, the period which terminates with the numerically corresponding date in the succeeding calendar month and each such successive period constitutes a month. In the case of February, if there is no date corresponding to the date prescribed for filing the return or paying tax, the period from such date in January through the last day of February constitutes a month for penalty purposes. Thus, if a return is due on January 30, the first month ends on February 28 (or 29 if a leap year), and the succeeding months end on March 30, April 30, etc. If a return is not timely filed or tax is not timely paid, the fact that the date prescribed for filing the return or paying tax, or the corresponding date in any succeeding calendar month, falls on a Saturday, Sunday, or a legal holiday is immaterial in determining the number of months for which a penalty applies. [Reg. §301.6651-1(b)]

For failure to file partnership returns or other information returns, see VII.E.8.

4. Failure to Pay Penalty

A penalty is imposed on a taxpayer who, without reasonable cause, fails to pay the tax shown on a return (including a substitute return) or an assessed deficiency of that tax by the prescribed date. The penalty is ½ % of tax shown (or assessed) for each month (or fraction of a month) that it isn't paid, but not more than 25%. (Code Sec. 6651(a)(2); Code Sec. 6651(a)(3)) The penalty is increased to 1% per month or fraction of a month (up to the 25% penalty maximum) if the tax isn't paid within ten days after IRS serves notice of levy. (Code Sec. 6651(d)) The penalty is reduced to 1/4 % per month for individuals paying in installments. (Code Sec. 6651(h))

An individual who gets an automatic extension of time for filing is subject to the penalty (absent reasonable cause) if any additional payment due with the extended return either: (1) exceeds 10% of the total shown on Form 1040, or (2) isn't paid by the extended filing date. (Reg §301.6651-1(c)(3))

Review Question 45

Bill Wilson's 2012 tax return was due April 15, 2013, but he filed on July 12, 2013. He did not get a filing extension and he had no reasonable cause for the late filing. The tax shown on his return was $400 which he paid when he filed his return. Which of the following is a true statement?

a. Wilson owed a failure-to-file penalty of $60 and a failure-to-pay penalty of $6.

b. Wilson owed a failure-to-file penalty of $135 and a failure-to-pay penalty of $6.

c. Wilson owed a failure-to-file penalty of $54 and a failure-to-pay penalty of $6.

d. Wilson owed a failure-to-file penalty of $135 and a failure-to-pay penalty of $135.

5. Accuracy-related Penalty and Erroneous Refund Penalty

A 20% "accuracy-related" civil penalty applies if any portion of an understatement of tax on a tax return is due (absent reasonable cause) to:

- negligence;
- substantial income tax valuation misstatements;
- income tax understatements;
- estate or gift tax valuation understatements;
- or pension liability overstatements. (Code Sec. 6662(a), Code Sec. 6662(b), Code Sec. 6664(c)(1); Reg §1.6662-2(a))

The accuracy-related penalty doesn't apply to any portion of an underpayment for which the fraud penalty (see below) is imposed. (Code Sec. 6662(b)) Also, the penalty applies only if a return is filed by the taxpayer (not by IRS). (Code Sec. 6664(b); Reg §1.6662-2(a))

Review Question 46

A 20% accuracy-related penalty is imposed if any portion of an understatement of tax on a tax return is due to:

I. Negligence
II. Fraud
III. Substantial income tax valuation understatements
IV. Reasonable cause

a. I and II only
b. I and III only
c. III and IV only
d. II and III only

Negligence. The "accuracy-related" penalty is imposed if any part of an underpayment of tax is due either to negligence or to disregard of rules or regulations without intent to defraud. The penalty is 20% of the portion of the underpayment attributable to the negligence, etc. (Code Sec. 6662(a), Code Sec. 6662(b)(1))

"Negligence" includes any failure to make a reasonable attempt to comply with the law or to exercise ordinary and reasonable care in preparing a tax return, as well as failure to keep adequate books and records or to substantiate items properly. "Disregard" includes any careless, reckless or intentional disregard. (Code Sec. 6662(c); Reg §1.6662-3(b))

The failure by a taxpayer/payee to report properly on a return an amount reported as paid to him by a payor on an information return is strong evidence that any portion of an underpayment attributable to that failure is negligent.

The penalty won't be imposed with respect to income tax underpayments attributable to a position contrary to a revenue ruling or notice, if the position has a "realistic possibility" of being sustained on its merits. (Reg §1.6662-3(a)) The penalty won't be imposed if a position contrary to a rule or regulation is disclosed on Form 8275 (Form 8275-R, if contrary to a regulation), has a reasonable basis (stricter than "realistic possibility") and represents a good faith challenge to the rule or regulation. (Reg §1.6662-3(b)(3); Reg §1.6662-7(b))

Valuation misstatements. The accuracy-related penalty is imposed on a taxpayer if any value (or adjusted basis) claimed on an income tax return is 150% or more of the correct figure (Code Sec. 6662(e)(1)(A)).

The penalty equals 20% of the portion of any income tax underpayment that results from the misstatement (except to the extent the fraud penalty is imposed) (Code Sec. 6662(a), Code Sec. 6662(b))- 40% if the misstatement is gross: (a) the misstatement is above 200% or (b) the correct value or basis is zero). (Code Sec. 6662(h); Reg §1.6662-5(g))

The penalty doesn't apply unless the amount of the underpayment for the tax year attributable to all misstatements for the year exceeds $5,000 ($10,000 for corporations other than S corporations or personal holding companies). (Code Sec. 6662(e)(2))

Reasonable cause excuses the penalty. However, there is no disclosure exception. (Code Sec. 6664(c)(1); Reg §1.6662-5(a))

Appraisers may also be subject to a penalty for valuation misstatements. For appraisals prepared for returns or submissions filed after August 17, 2006, a penalty is imposed on any person who:

- prepares a property appraisal and knows, or reasonably should have known, that the appraisal would be used in connection with a return or a refund claim, and
- the claimed property value on the return or refund claim that is based on the appraisal results in a substantial valuation misstatement or a gross valuation misstatement for the property. (Code Sec. 6695A(a))

The amount of the penalty equals the lesser of 125% of the gross income for preparing the appraisal received by the person who prepared it or an amount that is the greater of: (a) 10% of the underpayment attributable to the misstatement, or (b) $1,000. (Code Sec. 6695A(b))

Substantial understatements of income tax. The 20% accuracy-related penalty is imposed on any portion of an underpayment that (absent reasonable cause) is attributable to any substantial understatement of income tax, self-employment tax or unrelated business income tax. (Code Sec. 6662(a), Code Sec. 6662(b)(1); Reg §1.6662-4(b)(3))

An understatement is "substantial" if it exceeds the greater of: (1) 10% of the tax required to be shown on the return, or (2) $5,000 ($10,000 for corporations other than S corporations and personal holding companies). (Code Sec. 6662(d)(1); Reg §1.6662-4(b)(1))

An understatement is the excess of (1) the amount of tax required to be shown on the return, over (2) the amount of tax that's shown (or withheld) reduced by any rebate. (Code Sec. 6662(d)(2)(A); Reg §1.6662-4(b)(2), Reg §1.6662-4(b)(3)) The understatement is reduced to the extent it is attributable to any item (other than tax shelter items) for which:

- there is or was substantial authority for how the taxpayer treated it (Code Sec. 6662(d)(2)(B)(i)), or
- the relevant facts affecting the item's tax treatment are adequately disclosed either on the return (IRS each year lists which items on the return qualify) or on a Form 8275 (Form 8275-R if the taxpayer's position is contrary to a regulation) attached to the return and there's a reasonable basis for the taxpayer's treatment of the item. (Code Sec. 6662(d)(2)(B)(ii); Reg §1.6662-4(f))

For tax shelter items, a noncorporate taxpayer's understatement is reduced only to the extent there is or was substantial authority for that treatment and the taxpayer reasonably believed the treatment was more likely than not proper. There is no disclosure exception. Corporate taxpayers get no reduction. (Code Sec. 6662(d)(2)(C); Reg §1.6662-4(g))

"Substantial authority" exists for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions (in light of the pertinent facts and circumstances). (Reg §1.6661-3(b)(1)) "Authorities" include the Code (and other statutes), temporary, proposed, and final regulations, cases, administrative pronouncements (Rev Ruls, Rev Procs, private letter rulings, technical advice memoranda, actions on decisions, General Counsel Memoranda, press releases, Notices, and similar documents), tax treaties (and regulations and official explanations), Congressional intent (in reports, etc.) and General Explanations of Tax Laws after enactment (Blue Books). (Reg §1.6661-3(b)(2))

Penalty for understating value of property on gift or estate tax returns. If the value of any property claimed on any gift or estate tax return is 65% or less of the correct value, the 20% accuracy-related penalty is imposed on an underpayment of tax that's attributable to that understatement. (Code Sec. 6662(a); Code Sec. 6662(b)(5); Code Sec. 6662(g)(1)) The penalty is increased to 40% for gross misstatements—i.e., if the claimed value is 40% or less of the correct figure. (Code Sec. 6662(h)(1); Code Sec. 6662(h)(2)(C)) The penalty applies only if the portion of the underpayment attributable to all these undervaluations for the tax period exceeds $5,000. (Code Sec. 6662(g)(2))

Overstatement of pension liabilities. A taxpayer who (absent reasonable cause) substantially overstates pension liabilities for a tax year is subject to the accuracy-related penalty if the overstatement results in an income tax underpayment of $1,000 or more. (Code Sec. 6662(a), Code Sec. 6662(b)(4), Code Sec. 6662(f)(2)) The penalty equals 20% of the underpayment (40% for "gross" overstatements). (Code Sec. 6662(a), Code Sec. 6662(h)(1))

Pension liabilities are substantially overstated if the actuarial determination of the liabilities taken into account in computing the contribution deduction is at least 200% of the correct amount. (Code Sec. 6662(f)(1)) The overstatement is "gross" if it's 400% or more of the correct figure. (Code Sec. 6662(h)(2)(B))

Penalty for filing erroneous refund claim. The Small Business and Work Opportunity Tax Act of 2007 (PL 110-28, 5/25/2007) created a new penalty for filing an erroneous refund claim. Under the Act, if a claim for refund or credit for income tax (other than a claim for refund or credit relating to the earned income credit) is made for an "excessive amount," the person making the claim is liable for a penalty equal to 20% of the excessive amount. (Code Sec. 6676(a))

An "excessive amount" is the amount by which the amount of a person's claim for refund or credit for any tax year exceeds the amount of the claim allowable under the Code for that tax year. (Code Sec. 6676(b))

The penalty doesn't apply if it is shown that the claim for the excessive amount has a reasonable basis. (Code Sec. 6676(a)) Thus, the penalty is equal to 20% of the disallowed portion of the claim for refund or credit for which there is no reasonable basis for the claimed tax treatment.

The penalty doesn't apply to any portion of the excessive amount or credit which is subject to any of the accuracy-related penalties explained above or for the fraud penalty explained below. (Code Sec. 6676(c))

The penalty applies to a claim filed or submitted after May 25, 2007.

Penalty on undisclosed foreign financial assets understatement. For tax years beginning after Mar. 18, 2010, a 40% penalty is imposed on any understatement attributable to an undisclosed foreign financial asset. (Code Sec. 6662(j)(3)) The term "undisclosed foreign financial asset" includes all assets subject to information reporting requirements under Code Sec. 6038 (return of U.S. person who controls a foreign corporation or partnership), Code Sec. 6038B (return of U.S. person making certain "outbound" transfers to foreign entities), Code Sec. 6038D (self-reporting required for "specified foreign financial assets"), Code Sec. 6046A (return of U.S. person who acquires, disposes of, or has substantial changes in, foreign partnership interests), or Code Sec. 6048 (certain information reporting as to foreign trusts) for which the required information wasn't provided by the taxpayer as required under the applicable reporting provisions. (Code Sec. 6662(j)(2)) An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving the asset. (Code Sec. 6662(j)(1))

Review Question 47

Which of the following is a true statement regarding the 20% accuracy-related penalty?

a. If property is valued at $50,000 for estate tax purposes and the correct value is $100,000, the accuracy-related penalty equals 20% of the $50,000 undervaluation, or $10,000.

b. If property donated to a charitable organization is valued at $60,000 and the correct value is $50,000, the accuracy-related penalty for valuation misstatements equals 20% of the income tax shortfall resulting from the overstated charitable deduction.

c. If a taxpayer reports an income tax liability for the year of $74,000 and the correct figure is $80,000, the taxpayer is not liable for the 20% accuracy-related penalty for a substantial understatement of income tax.

d. If a taxpayer values a gift for gift tax purposes at $30,000 and the correct value is $100,000, the accuracy-related penalty is equal to 20% of the gift tax understatement attributable to the undervaluation.

6. Fraud Penalty

Fraudulent underpayment of tax required to be shown on a return results in a civil penalty of 75% of the portion of the underpayment attributable to fraud. (Code Sec. 6663(a))

The fraud penalty can be imposed only if a return is filed by the taxpayer (not by IRS). (Code Sec. 6664(b)) It won't be imposed where the taxpayer shows reasonable cause for the underpayment, and that he or she acted in good faith. (Code Sec. 6664(c)(1))

Imposition of the fraud penalty on any part of an underpayment precludes imposition of any of the accuracy-related penalties on that same part. (Code Sec. 6662(b))

If IRS establishes that any part of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except for any part the taxpayer establishes (by a preponderance of the evidence) isn't so attributable. (Code Sec. 6663(b))

7. "Responsible Person" Penalty

Willful failure to collect or account for and pay over a tax or willful attempt to evade or defeat a tax, by a "responsible person" required to collect, account for, and pay over the tax carries a civil "trust fund recovery penalty" equal to 100% of the total tax evaded or not accounted for and paid over. (Code Sec. 6672) IRS can't assess the penalty without notifying a responsible person of its intent to do so at least 60 days before making notice and demand for the penalty (unless collection is in jeopardy). (Code Sec. 6672(b)) A "responsible person" is an officer or employee of the corporation, or a partner or employee of a partnership, who is under a duty to perform the act at issue. (Code Sec. 6671(b)) Unpaid volunteer board members of exempt organizations who aren't involved in day-to-day financial activities and don't know about the failure are exempt from the penalty, unless that results in no one being liable for it. (Code Sec. 6672(e))

IRS must disclose, at the written request of a responsible person, the names of other responsible persons and the collection activities related to them. (Code Sec. 6103(e)(9)) Responsible persons who pay more than their proportionate share of tax have the right to recover the excess from other responsible persons. (Code Sec. 6672(d))

The penalty applies to an employer's failure to make advance earned income credit payments to an employee who has a valid certificate in effect (Code Sec. 3507(d)(4)) unless the employer has properly withheld and deposited all income and FICA taxes for the employee. (Reg §31.3507-1(c)(4))

8. Information Return Penalties

A payor who, without reasonable cause, fails to timely file a required information return in the required manner (e.g., electronically), or fails to include all of the information required to be shown on the return, or includes incorrect information, is subject to a penalty. The penalty for failing to timely file or failing to include required information is $100 for each return, up to a $1,500,000 calendar year maximum ($500,000 if gross receipts don't exceed $5 million), (Code Sec. 6721(a), Code Sec. 6721(d)(1)(A)) The penalty and maximum are reduced to $30 per return ($250,000 maximum—$75,000 if gross receipts test is met) if corrected within 30 days from the required filing date, or to $60 per return ($500,000 maximum—$200,000 if gross receipts test is met) if corrected on or before Aug. 1. (Code Sec. 6721(b), Code Sec. 6721(d))

A payor who, without reasonable cause, fails to timely furnish a payee statement to the person prescribed, fails to include all of the required information on the statement, or includes incorrect information, is subject to a penalty of $100 up to a $1,500,000 calendar year maximum. This penalty is also subject to reductions for correction within specified periods. (Code Sec. 6722(a), Code Sec. 6722(b), Code Sec. 6724(a)) However, subject to exceptions, the above penalties are increased with no calendar year maximum if the failure is due to intentional disregard. (Code Sec. 6721(e), Code Sec. 6722(c))

The penalties won’t apply to a *de minimis* number of information returns that don’t include all the required information, or that include incorrect information, if the failure is corrected by August 1 of the calendar year in which the required filing date occurs. This exception for any calendar year is limited to ten information returns or, if greater, ½% of the total number of information returns the payor is required to file that year (Code Sec. 6721(c)), and doesn’t apply to returns that aren’t due on February 28 or March 15. (Reg §301.6721-1(d)(4)) A person who is the subject of a fraudulent information return may sue the filer for damages (Code Sec. 7434(a)) of the greater of (1) $5,000, or (2) actual damages plus costs, and, in the court’s discretion, reasonable attorney’s fees. (Code Sec. 7434(b)) The court must specify the correct amount, if any, that should have been reported on the return. (Code Sec. 7434(e)) The person bringing the action must provide a copy of the complaint to the IRS. (Code Sec. 7434(d))

Partnership returns. The civil penalty for the failure to timely file a partnership return is $195 per partner for each month (or fraction of a month) that the failure continued, up to a maximum of 12 months. (Code Sec. 6698(b))

S corporation returns. Prior to the enactment of the Mortgage Forgiveness Debt Relief Act of 2007 Mortgage Relief Act (PL 110-142, there was no penalty for failure to timely file an income tax return for an S corporation. The Mortgage Relief Act added a new section to the Code that imposed a penalty on S corporations that fail to file timely S corporation returns. (Code Sec. 6699 as added by the Mortgage Forgiveness Debt Relief Act of 2007) Under this section:

(I) if an S corporation that is required to file an income tax return for any tax year:

(A) fails to file a timely return (taking into account any filing extension), or

(B) files a return which fails to show the required information,

(II) it is liable for a penalty (late filing penalty) for each month (or fraction thereof), not to exceed 12 months, during which the failure continues, unless the failure is due to reasonable cause. (Code Sec. 6699(a))

The monthly penalty amount equals:

(1) $195, multiplied by

(2) the number of persons who were shareholders in the S corporation during any part of the tax year. (Code Sec. 6699(b))

Review Question 48

Which of the following statements regarding information return penalties is **incorrect**?

a. If a payor’s gross receipts don’t exceed $5 million a year, the maximum calendar year penalty for failing to timely file information returns is reduced.

b. The penalty for failing to timely file is reduced if the failure is corrected within 30 days of the due date.

c. The Code provides a *de minimis* exception to the penalty for providing incorrect information on an information return if no more than 20 returns during the calendar year are incorrect.

d. No penalty is imposed for failing to comply with the rules requiring magnetic media filing of information returns if a payor files only a limited number of returns.

9. Tax Shelter Penalties

The Internal Revenue Code contains a number of penalty provisions aimed at abusive tax shelters.

Disclosure of reportable transactions. A penalty is imposed on any person who fails to include on any return or statement any information regarding a reportable transaction that's required under Code Sec. 6011 to be included with the return or statement. (Code Sec. 6707A(a)) The penalty is $10,000 for natural persons and $50,000 for others (increased to $100,000 and $200,000 if a listed transaction is involved. (Code Sec. 6707A(b)) A $200,000 penalty applies for failing to disclose certain penalties on SEC reports. (Code Sec. 6707A(e)) The penalty applies regardless of whether the transaction results in a tax understatement.

A reportable transaction is any transaction for which information must be included with a return or statement because it is of a type that IRS has determined under regulations under Code Sec. 6011 as having a potential for tax avoidance or evasion. A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by IRS as a tax avoidance transaction for Code Sec. 6011 purposes. (Code Sec. 6707A(c)).

Understatement penalty. A 20% accuracy-related penalty applies for reportable transaction understatements. (Code Sec. 6662A(a)) The penalty is 30% for any portion of any reportable transaction understatement for which specified disclosure rules are not met. (Code Sec. 6662A(c))

A reportable transaction understatement is the sum of

1. the amount of the increase (if any) in taxable income resulting from a difference between (a) the proper tax treatment of an item subject to the penalty rules and (b) the taxpayer's treatment of the item (on the taxpayer's tax return), multiplied by the highest noncorporate rate (or corporate tax rate, in the case of a corporation), and
2. the amount of the decrease (if any) in the total amount of income tax credits which results from a difference between (a) the taxpayer's treatment of an item subject to the penalty rules (on the taxpayer's tax return) and (b) the proper tax treatment of the item. (Code Sec. 6662A(b)(1)(B))

For this purpose, any reduction in the excess of deductions allowed in the tax year over gross income for the year, and any reduction in the amount of capital losses which would (without regard to the capital loss carryover rules) be allowed for the year, is treated as an increase in taxable income. (Code Sec. 6662A(b)(1))

An item is subject to the penalty rules if the item is attributable to any listed transaction and any reportable transaction (other than a listed transaction) if a significant purpose of the transaction is federal income tax avoidance or evasion. (Code Sec. 6662A(b)(2)(B)) Listed and reportable transactions are defined under the Code Sec. 6707A penalty rules for reportable transactions for which disclosure is required (Code Sec. 6662A(d))

Except as provided in regs, no tax treatment included with an amendment or supplement to a tax return is taken into account in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by IRS regarding the examination of the return or any other date specified by IRS. (Code Sec. 6662A(e)(3))

The only exception to the penalty is a limited reasonable cause exception that applies only if certain disclosure, substantial authority and reasonable belief requirements are met. (Code Sec. 6662A(d))

Material advisor penalty. A material advisor who fails to file a timely information return required under Code Sec. 6111(a), or who files a false or incomplete information return, for a reportable transaction (including a listed transaction) is subject to a penalty of $50,000 for each failure. However, if the failure relates to a listed transaction, the penalty is increased to the greater of: (1) $200,000, or (2) 50% of the gross income received by the material advisor that is attributable to aid, assistance, or advice which is provided for the listed transaction before the date that the advisor files an information return that includes the transaction. If the reporting failure for a listed transaction is due to an intentional failure or act, the 50% of gross income penalty amount (item 2 above) is increased to 75% of gross income. (Code Sec. 6707(a), Code Sec. 6707(b))

Tax shelter promoter penalties. A person who promotes an abusive tax shelter is subject to a penalty equal to the lesser of $1,000 or 100% of the gross income derived or to be derived from the activity. However, if an activity on which the penalty is imposed involves a false or fraudulent statement, the penalty equals 50% of the gross income derived or to be derived by that person from the activity. (Code Sec. 6700(a)) The IRS may seek an injunction to stop any action or failure to take action:

- that is subject to penalty under Code Sec. 6700, Code Sec. 6701 (aiding or abetting an understatement, Code Sec. 6707 (failure to furnish information regarding reportable transactions), and Code Sec. 6708 (failure to provide list of advisees with respect to reportable transactions) or
- in violation of any requirement imposed by Regs issued under Section 330 of Title 31 of the U.S. Code (rules regulating the practice of taxpayer representatives before the Department of the Treasury), i.e., the Circular 230 rules. (Code Sec. 7408)

Penalty for transaction lacking economic substance. For underpayments attributable to transactions entered into after Mar. 30, 2010, a 20% penalty applies to an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking "economic substance" or failing to meet the requirements of any similar rule of law. (Code Sec. 6662(b)(6)) The penalty rate is increased to 40% if the taxpayer doesn't adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return. (Code Sec. 6662(i)(1) No reasonable cause and good faith exception applies. (Code Sec. 6664(c)(2)) This provision doesn't apply to personal transactions of individuals, only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. (Code Sec. 7701(o)(5)(B))

A transaction is treated as having economic substance only if (apart from Federal income tax effects): (1) the transaction changes in a meaningful way the taxpayer's economic position, and (2) the taxpayer has a substantial purpose for entering into the transaction. (Code Sec. 7701(o)(1)) Any State or local income tax effect which is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. (Code Sec. 7701(o)(3)) A purpose of achieving a favorable accounting treatment for financial reporting purposes isn't taken into account as a non-Federal-income-tax purpose if the origin of the financial accounting benefit is a reduction of Federal income tax. (Code Sec. 7701(o)(4))

Review Question 49

The Internal Revenue Code provides several penalties for abusive tax shelters. Match the type of penalty from the following list with the corresponding amount of the penalty.

a. Taxpayer's failure to disclose
b. Promotion of abusive tax shelter
c. Material advisor's failure to disclose
d. Accuracy-related penalty for

1. 50% of gross income derived from reportable transactions from the activity.
2. $10,000 for natural persons, $50,000 for others.
3. 20% of tax understatement reportable transaction.
4. $50,000 per failure reportable transactions.

10. Other Civil Penalties

Other civil penalties are provided for:

- failure to file information returns for dividend payments under $10 (Code Sec. 6652(a));
- failure to file actuarial report of pension plan (Code Sec. 6692);
- failure to file annual return for a pension plan (Code Sec. 6652(f));
- failure to file annual return for an exempt organization or private foundation (Code Sec. 6652(c));
- failure by an exempt organization to report excise tax on personal benefit contracts (Code Sec. 170(f)(10)(F)(iii));

- failure by any person, under a duty to comply with Code Sec. 6104(d) requirements relating to public inspection of, and provision of copies of, exempt organization annual returns or exempt status application materials, (Code Sec. 6652(c)(1)(C), Code Sec. 6652(c)(1)(D));
- failure to file fringe benefit plan return, (Code Sec. 6652(e));
- failure to provide a written explanation to the recipient of a qualified rollover distribution, (Code Sec. 6652(i));
- failure to file report on deductible employee contributions, (Code Sec. 6652(g));
- failure to file notification of change of status of pension plan, (Code Sec. 6652(d)(2));
- failure to keep records necessary for plan administrators to meet reporting requirements, (Code Sec. 6704);
- failure to file registration statement of pension plan (Code Sec. 6652(d)(1)) or to give a plan participant a statement of the information in the statement, (Code Sec. 6690);
- failure to file individual retirement account, simple retirement account, medical savings account, Coverdell education savings account, and qualified tuition program reports, (Code Sec. 6693);
- overstatement reported on return by IRA participant of the amount of designated nondeductible contributions, (Code Sec. 6693(b));
- failure to keep records for reporting on pension, annuity, etc., payments subject to withholding, (Code Sec. 6704(a));
- failure to notify recipients of plan distributions of their option to elect out of withholding, (Code Sec. 6652(i));
- failure by a corporation that issues qualified small business stock to make prescribed reports to IRS, (Code Sec. 6652(k));
- failure to file certain returns for foreign corporations, partnerships (Code Sec. 6679)
- failure to file information returns in connection with foreign corporations and partnerships (Code Sec. 6038(b), Code Sec. 6038(c); Code Sec. 6038A(d); Code Sec. 6038B(c); Code Sec. 6038C(c));
- failure of foreign corporations to file PHC (personal holding company) tax returns, (Code Sec. 6683);
- failure to keep records, furnish information, or file DISC (domestic international sales corporation) returns, (Code Sec. 6686);
- failure to keep records, furnish information or file returns for a FSC (foreign sales corporation) (or former FSC), (Code Sec. 6686);
- failure to file required information on foreign trusts, (Code Sec. 6677);
- failure to meet FIRPTA (Foreign Investment in Real Property Tax Act) reporting requirements, (Code Sec. 6652(f));
- failure to file notice of redetermination of certain foreign taxes, (Code Sec. 6689);
- failure to withhold tax on U.S. income of certain foreign persons, (Code Sec. 1463);
- failure to disclose a treaty-based position taken on a return that overrules or otherwise modifies the tax law, (Code Sec. 6712);
- failure by individual who loses U.S. citizenship or terminates U.S. residency to file expatriate information statement. (Code Sec. 6039G(d));
- failure by an exempt organization to disclose that information it is offering to sell or soliciting money for is available free from the federal government, (Code Sec. 6711);
- failure by an exempt organization to disclose that fund-raising solicitations are nondeductible as charitable contributions, (Code Sec. 6710);
- failure by an exempt organization to make the required disclosure for quid pro quo contributions of $75 or more, (Code Sec. 6714);

- willful failure to make available for inspection or provide copies of, a return or application for exemption of certain exempt organizations (Code Sec. 6685);
- any repeated or willful and flagrant act or failure to act by any person who becomes liable for any excise tax on a private foundation by reason of the act or failure to act, (Code Sec. 6684);
- making a negligent or fraudulent misstatement in connection with the issuance of a mortgage credit certificate or failing to file the required report, (Code Sec. 6709);
- failure to file returns with respect to qualified rental housing projects, (Code Sec. 42(l)(2), Code Sec. 6652(j));
- failure to deposit taxes (an IRS procedure explains how IRS applies deposits in determining the penalty when there is a shortfall) (Code Sec. 6656(a))
- use of bad checks or money orders to pay taxes, (Code Sec. 6657);
- failure to pay stamp taxes, (Code Sec. 6653);
- claiming excessive gasoline tax rebates, (Code Sec. 6675);
- filing a frivolous income tax return, (Code Sec. 6702);
- use of Tax Court primarily for delay or where: taxpayer's position is frivolous or groundless, the taxpayer hasn't exhausted administrative remedies, or the taxpayer has instituted a frivolous or groundless claim for damages against the U.S., (Code Sec. 6673);
- failure to supply taxpayer identification numbers, (Reg §301.6723-1(a));
- failure to report tips, (Code Sec. 6652(b));
- failure by broker to provide back-up withholding notice, (Code Sec. 6705);
- failure to file information return for change in control or recapitalization of corporation, (Code Sec. 6652(l));
- making a false statement that results in reduced amounts of withholding (Code Sec. 6682) or that relates to the applicability of backup withholding. (Code Sec. 6682)

11. Criminal Penalties

Tax evasion is a felony punishable by a fine of up to $100,000 ($500,000 for a corporation) and/or up to five years' imprisonment, plus costs of prosecution. The elements of the crime are willfulness, an attempt to evade tax and additional tax due. (Code Sec. 7201)

Other criminal penalties (fines and/or imprisonment) are imposed for:

- willful failure to file a return (Code Sec. 7203);
- willful filing of a false or fraudulent return (Code Sec. 7207);
- willful failure to pay a tax (Code Sec. 7203);
- willful failure to collect or pay over a tax as required (Code Sec. 7202);
- willful failure to furnish a W-2 to employees in the manner, at the time or with the information required, or willful filing of a false or fraudulent W-2 (Code Sec. 7204);
- willful failure to keep proper records (Code Sec. 7203);
- willful failure to supply tax information (Code Sec. 7203);
- failure to obey a summons (Code Sec. 7210);
- various other offenses relating to returns, statements, stamp taxes, etc.

F. Tax Collection

The IRS has broad tax collection powers, including seizure and sale of a taxpayer's property (levy and distraint) and liens.

Within 60 days after a tax has been assessed, the IRS must send the taxpayer a notice of the amount assessed and a demand for payment, before it can start administrative collection proceedings. (Code Sec. 6303(a), Code Sec. 6331(a)) The taxpayer usually has at least ten days from a date stated in the notice and demand to pay the tax, unless IRS finds that collection is in jeopardy. (Code Sec. 6331(a); Reg §301.6331-1(a)(3))

The Internal Revenue Code allows the IRS to enter into "qualified tax collection contracts" which use private companies to collect taxes owed to the federal government. (Code Sec. 6306(a))

1. Collection Period

The IRS must generally start distraint or court proceedings within ten years after assessment (Code Sec. 6502(a)). But if no return is filed, a collection suit may be brought at any time, without assessment. (Code Sec. 6501(c)(3))

The collection period is suspended under various circumstances. For example, if a person requests a hearing regarding a levy (see below), the levy actions which are the subject of the requested hearing and the running of any limitations period under Code Sec. 6502 (collection after assessment), Code Sec. 6531 (criminal prosecutions), or Code Sec. 6532 (refund suit periods) are suspended for the period during which the hearing, and appeals from the hearing, are pending. The suspension period can't expire before the 90th day after the day on which there is a final determination in the hearing. (Code Sec. 6330(e)(1); Reg §301.6330-1(g))

2. Federal Tax Liens

Federal tax liens are claims against a taxpayer's property for payment of delinquent taxes (including any interest, additional amounts, additions to tax, assessable penalties, or accrued costs). There are various federal tax liens, including:

- general tax lien, which applies to all property, both real and personal, tangible and intangible including a tenancy by the entirety and an heir's interest in an estate even though he or she later attempts to disclaim it (Code Sec. 6321; Reg §301.6321-1);
- gift tax lien (Code Sec. 6324(b); Reg §301.6324-1(b));
- estate tax lien (Code Sec. 6324(a); Reg §301.6324-1(a));
- special lien for deferred estate tax attributable to a farm or other closely held business (Code Sec. 6324A; Reg §20.6324A-1, Reg §301.6324A-1);
- special lien for recapture of estate tax attributable to special use valuation of a farm or closely held business (Code Sec. 6324B; Reg §20.6324B-1);
- special lien for recapture of estate tax attributable to the deduction for family owned business interests for individuals dying before 2004. (Code Sec. 2057(i)(3)(P));
- generation-skipping transfer tax lien. (Code Sec. 2661; Reg §26.2662-1(f))

The IRS must give written notice of its filing of a notice of lien (NFTL), to the person whose property is to be subject to the lien, not more than five days after it files the notice of lien (Code Sec. 6320(a); Reg §301.6320-1(a)) The IRS must hold a Collection Due Process hearing with respect to the filing if the taxpayer timely requests one (using Form 12153). (Code Sec. 6320(b)(1); Reg §301.6320-1(b))

Priority of tax liens is governed by federal, not state, law. The general rule is that a lien first in time is first in right. But a tax lien is subordinated to certain later liens that arise either before notice of the tax lien (Form 668) is filed, or before the other lienor has actual knowledge of it. This protects purchasers for adequate consideration without actual notice, mortgagees, pledgees and other lienors whose rights arose before notice of the tax lien was filed. (Code Sec. 6323(a); Reg §301.6323(a)-1) It also protects certain interests arising after the notice was filed, e.g., attorney's liens and certain security interests. (Code Sec. 6323(b); Reg §301.6323(b)-1)

Special gift and estate tax liens don't have to be filed to be superior to claims arising after the special lien arises. But certain later purchasers and creditors are protected, including holders of a security interest and holders of mechanics', repairmen's and attorney's liens. (Code Sec. 6324A(d)(3), Code Sec. 6324B(c)(1))

The IRS may withdraw a notice of lien if it was filed prematurely or otherwise not in accordance with its administrative procedures, and for certain other reasons. (Code Sec. 6323(j)(1)) At the taxpayer's request, IRS must make reasonable efforts to notify credit reporting agencies and creditors specified by the taxpayer of the withdrawal of the notice. (Code Sec. 6323(j)(2))

IRS regulations explain how a request for a withdrawal of a federal tax lien is made. (Reg §301.6323(j)-1)

3. Seizure and Sale

IRS has power to collect taxes by levy and distraint. This means it may seize any property (unless it's exempt) of a delinquent taxpayer (whether held by the taxpayer or someone else), sell it, and apply the proceeds to pay the unpaid taxes. The property seized may be real, personal, tangible, or intangible, including receivables, evidences of debt, securities (Code Sec. 6331(a)) and, to the extent they exceed a specified amount, present and future wages. (Reg §301.6331-2(c))

The IRS must give the taxpayer 30 days' advance written notice before it can levy on any of the taxpayer's property, except where collection is in jeopardy. (Code Sec. 6331(d))

Subject to exceptions, the IRS may not levy against a person's property or right to property unless it notifies the person in writing of the right to, and the opportunity for, a pre-levy Collection Due Process hearing with IRS (a CDP hearing). (Code Sec. 6330(a)(1); Reg §301.6330-1(a)(1)) The notice—the Collection Due Process Hearing Notice (CDP Notice)—must be given at least 30 days before the day of the first levy with respect to the unpaid tax for the tax period. (Code Sec. 6330(a)(2)) A person who receives a CDP Notice may request a hearing (using Form 12153) with the IRS Office of Appeals within the 30-day period beginning on the day after the date of the CDP Notice. (Code Sec. 6330(b)(1); Reg §301.6330-1(b)(1), Reg §301.6330- 1(c)(1)) A person who requests a CDP hearing can appeal the determination reached at the hearing within 30 days of the date the determination was made. (Code Sec. 6330(d); Reg §301.6330-1(f))

A penalty (plus costs and interest) applies if a person fails or refuses to surrender the property subject to an IRS levy. (Code Sec. 6332(d))

If the IRS is unable to sell the seized property for the minimum price it establishes, it can return the property to the taxpayer and add the cost of the unsuccessful sale to the unpaid tax liability. (Code Sec. 6335(e)(1)(D))

Certain payments are subject to continuous levy under IRS's Federal Payment Levy Program. (Code Sec. 6331(h)(1))

Exemptions. There are exemptions for certain kinds of income (Code Sec. 6334(d)) and property (e.g., clothing, tools) (Code Sec. 6334(a); Reg §301.6334-3(d)), and a complete exemption for a taxpayer's principal residence unless a judge or magistrate approves the levy in writing. (Code Sec. 6334(a)(13)(B)) There also is an exemption for real property used as a residence by a taxpayer, or any nonrental real property of the taxpayer used by any other individual as a residence, if the amount of the levy is $5,000 or less (Code Sec. 6334(a)(13)(A)), as well as an exemption for tangible personal property or real property (other than real property which is rented) used in a trade or business of an individual taxpayer, unless collection is in jeopardy or the levy is approved in writing by an IRS district director or assistant district director. (Code Sec. 6334(a)(13)(B)) Levy is prohibited where an installment agreement (see VII.F.6.) is pending or in effect (Code Sec. 6331(k), Reg §301.6331-4) for unpaid divisible taxes (provided a portion of the tax is paid and other conditions are met) (Code Sec. 6331(i)) or where an offer-in-compromise (see VII.A.11.) is pending. (Code Sec. 6331(k))

Wrongful seizures. If the IRS has wrongfully levied on property, it may, on written request, return the specific property seized (or the proceeds from its sale) or the amount of money levied on

(Code Sec. 6343(b)), with interest at the overpayment rate (Code Sec. 6343(c)). The IRS may also return (without interest) property, including money deposited in the Treasury, that has been levied on if IRS determines that: (1) the levy was premature or otherwise was not in accordance with its administrative procedures (Code Sec. 6343(d)(2)(A)); (2) the taxpayer has agreed to pay the underlying tax liability in installments, unless the agreement provides otherwise (Code Sec. 6343(d)(2)(B)); (3) the return of the property will make collection of the underlying tax liability easier (Code Sec. 6343(d)(2)(C)); or (4) the return of the property is in the taxpayer's best interests, as determined by the National Taxpayer Advocate (see VII.B.10.), and the IRS and the taxpayer or the National Taxpayer Advocate consent. (Code Sec. 6343(d)(2)(D))

If the IRS wrongfully seizes property of a person other than the taxpayer, the third party may sue (in district court) for its return (or the sale proceeds, if it has been sold) (Code Sec. 7426), but must start the suit within nine months from the date of levy. (Code Sec. 6532(c)(1))

The third party may also recover damages (subject to limits) if the action results in a finding that any IRS officer or employee recklessly, intentionally, or negligently disregarded any Code or regulation provision. (Code Sec. 7426(h)). Regulations spell out procedures for claiming damages. (Reg §301.7426-2) Damages are limited to the lesser of (1) $1 million ($100,000 for negligence) or (2) the actual, direct economic damages thus sustained plus the costs of the action. (Code Sec. 7433; Reg §301.7433-1)

4. Bankruptcy or Receivership

A receiver in a receivership proceeding must give IRS notice of the receivership. (Code Sec. 6036; Reg §301.6903-1(b)(2)) But a bankruptcy trustee, debtor-in-possession, or other like fiduciary in a bankruptcy proceeding is not required to give notice (Reg §301.6036-1(a)(1)(i)), because notice under the Bankruptcy Rules is sufficient.

The filing of a federal bankruptcy petition (but not the start of a state receivership proceeding) automatically stays any tax proceedings against the taxpayer-debtor.

The running of the assessment period (see VII.B.1.) is suspended from the date a bankruptcy or receivership proceeding is instituted until 30 days after IRS has received notice of the proceeding, but the suspension may not exceed two years. (Code Sec. 6872; Reg §301.6872-1)

Although a taxpayer's bankruptcy triggers an immediate assessment, collection of the tax is stayed while the taxpayer-debtor's assets are under the control of a federal or state court in bankruptcy or receivership proceedings.

With some exceptions, debtor relief proceedings don't discharge the taxpayer's liability for taxes or interest (including certain post-petition interest).

A taxpayer may petition a bankruptcy court for damages (subject to limits) if, in connection with any collection of tax, an IRS officer or employee willfully violates any provision of 11 USCS 362 (relating to the automatic stay which arises when a debtor files a bankruptcy petition) or 11 USCS 524 (relating to the effect of a bankruptcy discharge, which operates as an injunction against the commencement or continuation of any action to collect a discharged debt as a personal liability of the debtor). (Code Sec. 7433(e)) Procedures for doing so are contained in regulations. (Reg §301.7433-2)

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amends the U.S. Bankruptcy Code by adding new responsibilities for debtors. In general, it requires that debtors comply with their tax-filing responsibilities, make available previously-filed tax returns, in many cases, and seek credit counseling services. Most BAPCPA provisions apply to cases filed on or after October 17, 2005.

Under the Act, if debtors fail to file a return that becomes due after the date of their bankruptcy petition, or fail to file an extension, IRS may request the Court to order a conversion (change from Chapter 7 to Chapter 11 or from Chapter 11 to Chapter 13, for example) or dismiss the case. (11 USCS 521) Conversion or dismissal may also be ordered if a Chapter 11 debtor fails to timely pay tax obligations owed after the date of the bankruptcy petition. (11 USCS 1112)

To have their plan confirmed, Chapter 13 debtors must also file all tax returns with IRS for the four-year period before the bankruptcy petition. The debtor must establish filing by the first meeting of creditors. (11 USCS 1325, 11 USCS 1308)

5. Transferee Liability

A transferee is liable for a taxpayer-transferor's unpaid taxes (and interest and penalties) where:

- the transfer is void or voidable under rules of equity,
- transferee liability is imposed by statute, or
- transferee liability arises under contract.

Transferees include a donee, heir, legatee, devisee or distributee of a decedent's estate; a shareholder of a dissolved corporation; the assignee or donee of an insolvent person; certain fiduciaries; a successor in a tax-free corporate reorganization; and various other classes of distributees. (Code Sec. 6901(h); Reg §301.6901-1(b))

The IRS must assess the (first) transferee within one year after the limitations period against the transferor has run. (Code Sec. 6901(c)(1))

6. Installment Payment Agreements

The IRS may enter into a written agreement allowing a taxpayer to satisfy liability for any tax in installment payments. (Code Sec. 6159(a); Reg §301.6159-1(a)) An individual who owes $10,000 or less and meets other conditions can require the IRS to enter into an installment agreement. (Code Sec. 6159(c))

The IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the agreement's life. (Code Sec. 6159(a)) However, the mandatory rule, which requires IRS to enter into an installment agreement with an individual taxpayer who owes $10,000 or less, applies only if the agreement provides for full payment of the tax liability. (Code Sec. 6159(c))

A taxpayer uses Form 9465 (attached to his or her balance due return) to request an installment agreement. The IRS may require the taxpayer to agree to certain terms and conditions. (Reg §301.6159-1(b)(1))

A user fee is imposed for entering into, or restructuring or reinstating, an installment agreement. (Reg §300.0, Reg §300.1, Reg §300.2)

An installment payment agreement remains in effect for its term unless the taxpayer fails to comply with it. (Code Sec. 6159(b)(2); Reg §301.6159-1(b)(3)) However, the IRS may modify or terminate the agreement under certain circumstances after 30 days' notice to the taxpayer. (Code Sec. 6159(b)(3); Reg §301.6159-1(c)(2)(i); Reg §301.6159-1(c)(4))

Review Question 50

Which of the following is a true statement regarding the IRS's tax collection procedures?

a. The IRS must generally start distraint or court proceedings within five years after assessment.

b. Priority of tax liens is governed by state law.

c. Nonrental residential property is generally exempt from seizure and sale if the amount of the levy is $5,000 or less.

d. If the IRS wrongfully seizes property of a person other than the taxpayer, the third party may sue to recover the property, but may not sue for economic damages.

G. Regulation of Tax Return Preparers

A tax return preparer ("preparer") is any person (including a partnership or corporation) who for compensation prepares, or employs another to prepare, all or a substantial portion of an income, estate, gift, employment or excise tax return, an exempt organization returns or a refund claim. (Code Sec. 7701(a)(36)(A))

A person may also be a "preparer" of a related return if an entry on a return he or she actually prepared (e.g., partnership or S corporation return) is directly reflected on the related return (e.g., partner's or shareholder's return), and the entry is a substantial portion of the related return. (Reg §301.7701-15(b)(3))

A portion of a return prepared by any one of several persons won't be "substantial" if, aggregating all schedules, etc., he or she prepared, that portion involves amounts of gross income, deductions, or amounts on which credits are based that are: (1) less than $2,000, or (2) less than $100,000 and less than 20% of the gross income (adjusted gross income, for individuals) as shown on the return. (Reg §301.7701-15(b)(2))

A tax consultant is a "preparer" even though he or she may do no more than review a return already prepared by the taxpayer.

A person is a "preparer" if he or she supplies enough information and advice to make the actual filling out of a return a mere mechanical or clerical matter (Reg §301.7701-15(a)(1)), but not if he or she merely furnishes typing, reproducing or other mechanical assistance with respect to preparing a return. (Code Sec. 7701(a)(36)(B)(i))

A person who provides a computerized return preparation service is a preparer if his or her computer programs provide substantive tax determinations, but not if his or her services are limited to mechanical calculations and processing.

Beginning in 2011, the IRS instituted new regulatory requirements for tax return preparers who prepare all, or substantially all, of a federal tax return for compensation,

For returns prepared after December 31, 2010, all tax return preparers (including attorneys, certified public accountants, and enrolled agents) must have a Preparer Tax Identification Number (PTIN). All preparers (including those with previously assigned PTINs) must apply for a PTIN and pay an annual fee of $64.25. As part of the new PTIN requirements, the IRS will verify if tax return preparers are compliant with their personal and business tax obligations.

Final regulations issued in 2011 imposed additional requirements for tax return preparers (other than attorneys, CPAs, and enrolled agents) including registration, competency testing, continuing education requirements, and ethical standards. (Reg. Sec. 10.1 et seq.) However, in January 2013, the United States District Court for the District of Columbia ruled that the IRS lacked statutory authority to promulgate or enforce the regulatory requirements for tax return preparers and permanently enjoined the Internal Revenue Service from enforcing requirements for registered tax return preparers. (Loving v. IRS, 111 AFTR 2d ¶ 2013-385(DC DC 01/18/2013). The court subsequently modified its order to clarify that the injunction does not affect the requirement for all paid tax returns preparers to obtain a PTIN. Consequently, that requirement remains in place. The IRS has filed an appeal of the District Court decision.

1. Preparer Obligations

An income tax return preparer must:

- Sign the return in the manner prescribed by IRS in forms, instructions or other appropriate guidance (Code Sec. 6695(b)) after it is completed and before it is presented to the taxpayer for signature. If the preparer is unavailable for signature, another preparer must review the entire return and sign it. (Reg §1.6695-1(b)(1)) If more than one return preparer is involved in preparation of a return, the individual with primary responsibility for the overall substantive accuracy is considered to be the return preparer. (Reg §1.6695-1(b)(2))
- Enter the preparer's ID number (PTIN; applied for on Form W-7P), (Code Sec. 6109(a)(4)) and the address where the return was prepared on any return he or she prepares. If there is a partnership or employment arrangement between two or more preparers, the identifying number of the partnership or employer must also appear on the return or claim for refund.. (Reg §1.6109-2(a))
- Furnish the taxpayer with a completed copy of the return (Code Sec. 6107(a)) in the form and manner prescribed by IRS in forms, instructions, or other guidance. (Reg §1.6107-1T(a))

- Retain for three years a completed copy of each return or a list of the name and TIN of each taxpayer for whom a return was prepared (Code Sec. 6107(b)).
- Retain a record of the name, TIN, and principal place of work of each income tax return preparer employed or engaged by the preparer/employer during each July 1 through June 30 period. (Reg §1.6060-1(a)(1))

Electronic filing requirement. The Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-92) mandates electronic filing by "specified tax return preparers" who prepare 11 or more individual or trust returns [Code Sec. 6011(e)(3)]..

2. Tax Return Preparer Penalties

An income tax return preparer who fails to perform his or her obligations is subject to the following civil penalties (up to a maximum $25,000 per calendar year for any single type of failure):

- $50 for each failure to sign a return as required. (Code Sec. 6695(b))
- $50 for each failure to show a taxpayer ID number or PTIN as required. (Code Sec. 6695(e))
- $50 for each failure to furnish completed copy of return to the taxpayer. (Code Sec. 6695(a))
- $50 for each failure to retain a copy of a prepared return or to include it on a list of prepared returns. (Code Sec. 6695(d))
- $50 for each failure to retain and make available a record of the preparers employed or engaged, plus $50 for each failure to include a required item in the record required to be retained and made available. (Code Sec. 6695(e))
- $500 (with no annual maximum) for each income tax check issued to a taxpayer that the preparer endorses or otherwise negotiates, except where the preparer is a bank and deposits the check to the taxpayer's account in the bank. (Code Sec. 6695(f))
- $100 for each failure to follow regulatory due diligence requirements as shown on Form 8867 in claiming the earned income credit. (Code Sec. 6695(g); Reg §1.6695-2(b))

Improper disclosure or use of information by return preparers is subject to a civil penalty of $250 for each improper disclosure or use ($10,000 maximum per calendar year), (Code Sec. 6713(a)) as well as a criminal penalty. (Code Sec. 7216)

The IRS may petition a district court to enjoin a preparer from engaging in specific misconduct, but only if an injunction is appropriate to prevent recurrence of the misconduct. If the court finds that the preparer has continually or repeatedly engaged in this misconduct and an injunction isn't sufficient to prevent the preparer's interference with proper tax administration, it can enjoin the preparer from practicing. (Code Sec. 7407(b))

3. Understatements by Return Preparers

Under the Small Business and Work Opportunity Tax Act of 2007 (PL 110-28), a tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an "unreasonable position" (defined below) must pay a penalty for each return or claim equal to the greater of:

- $1,000 or
- 50% of the income derived (or to be derived) by the tax return preparer for preparing the return or claim. (Code Sec. 6694(a)(1))

As a general rule, a position is "unreasonable" unless:

- there is or was substantial authority for the position, or
- the position was properly disclosed and there is a reasonable basis for the position. (Code Sec. 6694(a)(2))

However, in the case of a position with respect to a tax shelter or a reportable transaction, a position will be deemed unreasonable unless it is reasonable to believe that the position would more likely than not be sustained on its merits. No penalty will be imposed if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith. (Code Sec. 6694(a)(3))

A tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to "willful or reckless conduct" (defined below) must pay a penalty for each return or claim equal to the greater of:

- $5,000 or
- 50% of the income derived (or to be derived) by the tax return preparer for preparing the return or claim. (Code Sec. 6694(b)(1))

"Willful or reckless conduct" is conduct by the tax return preparer which is:

- a willful attempt to understate the tax liability on the return or claim, or
- a reckless or intentional disregard of rules or regulations. (Code Sec. 6694(b)(2))

Any penalty payable by a person due to willful or reckless conduct in connection with a return or refund claim will be reduced by the penalty paid by that person due to an unreasonable position. (Code Sec. 6694(b)(3))

4. Criminal Penalty for False or Fraudulent Tax Advice

Any person who willfully aids or assists in, or procures, counsels or advises the preparation or presentation of a materially false or fraudulent return, affidavit, claim or other document, is subject to a criminal penalty of up to $100,000 ($500,000 for a corporation) and/or up to three years' imprisonment, plus costs of prosecution. (Code Sec. 7206(2))

5. Penalty for Aiding and Abetting Understatement of Tax Liability

A penalty of $1,000 ($10,000 for a corporation) (Code Sec. 6701(b)) is imposed on any person who:

- aids or assists, procures or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim or other document connected with any matter arising under the internal revenue laws,
- knows (or has reason to believe) that the portion will be used in connection with any material matter arising under those laws, and
- knows that an understatement of another person's tax would result from that use (Code Sec. 6701(a)) even if there is no actual understatement.

The penalty applies whether or not the taxpayer knew of or gave consent to the understatement. (Code Sec. 6701(d))

The term "advises" includes the actions of lawyers and accountants who counsel a particular course of action and appraisers who falsely or fraudulently overstate the value of property in a qualified appraisal (of property for which a charitable contribution is claimed. (Reg §1.170A-13(c)(3)(iii))

Unlike return preparer penalties which apply only to "paid" preparers, the aiding and abetting penalty applies regardless of whether a fee is charged.

6. Damages for Inducing Unauthorized Disclosure by Taxpayer's Representative

If an officer or employee of the U.S. intentionally compromises the determination of any tax due from an attorney, CPA, or enrolled agent representing a taxpayer, in exchange for information conveyed by the taxpayer to that representative for purposes of obtaining advice on the taxpayer's tax liability, the taxpayer may bring a civil action for damages against the U.S. in a U.S. district court (Code Sec. 7435(a)) unless the information was conveyed by the taxpayer for the purpose of perpetrating a fraud or crime. (Code Sec. 7435(f)) Damages are limited to the lesser of $500,000 or the sum of: (1) actual direct economic damages, and (2) the costs of the action. Damages don't include the taxpayer's liability for any civil or criminal penalties or other losses attributable to incarceration or the imposition of other criminal penalties. (Code Sec. 7435(b))

Solutions to Module 3 Review Questions

1. a. Incorrect. When an estate distributes appreciated property to satisfy a bequest of a specific dollar amount it will recognize gain. (Reg §1.661(a)-2(f)(1))

   b. Correct. When an estate distributes appreciated property to satisfy a bequest of a specific dollar amount it will recognize gain determined as if the property were sold for its fair market value. Here, $100,000 fair market value minus the estate's $96,000 basis results in $4,000 of gain. (Reg §1.661(a)-2(f)(1))

   c. Incorrect. When an estate distributes appreciated property to satisfy a bequest of a specific dollar amount it will recognize gain, but not in the amount of the entire basis of the property. (Reg §1.661(a)-2(f)(1))

   d. Incorrect. When an estate distributes appreciated property to satisfy a bequest of a specific dollar amount it will recognize gain, but generally not in an amount equal to the total value of the property. (Reg §1.661(a)-2(f)(1))

2. a. Incorrect. This answer incorrectly assumes that the estate's charitable deduction is equal only to the amount actually paid out to charity during the tax year.

   b. Incorrect. This answer incorrectly assumes that the estate's charitable deduction is equal only to the amount permanently set aside for charitable purposes during the tax year.

   c. Correct. An estate may deduct any amount of gross income, without limitation, that, under the terms of the governing instrument is paid or permanently set aside during the tax year for a charitable purpose. (Code Sec. 642(c)(2))

3. a. Incorrect. Trusts other than simple trusts are entitled to a personal exemption of $100, not estates. (Code Sec. 642(b))

   b. Incorrect. Simple trusts are entitled to a personal exemption of $300, not estates.

   c. Correct. Estates are entitled to a personal exemption of $600. (Code Sec. 642(b))

   d. Incorrect. This is the amount of the personal exemption for an individual, not an estate.

4. a. Incorrect. A deduction is allowed for the administration costs of an estate. (Code Sec. 642(g))

   b. Incorrect. Although the administration costs may be deducted on the estate's income tax return, another option is available.

   c. Incorrect. Although the administration costs may be deducted on the estate's income tax return, they may not be deducted on the decedent's final income tax return. (Code Sec. 642(g))

   d. Correct. The executor may elect to deduct administration expenses either on the estate or income tax return. (Code Sec. 642(g))

5. a. Incorrect. A reversionary interest worth less than 10% of the trust can cause it to be treated as a grantor trust. (Code Sec. 673(a))

   b. Correct. A reversionary interest worth more than 5% of the value of the trust will cause it to be treated as a grantor trust. (Code Sec. 673(a))

6. a. Incorrect. A tax deduction is allowed for a decedent's unrecovered investment in an annuity contract under IRS laws.

   b. Correct. Per Code Sec. 67(b)(10), a decedent's unrecovered investment in an annuity contract is an itemized deduction that is not subject to the 2%-of-AGI floor.

   c. Incorrect. IRS Code allows a tax deduction is allowed for a decedent's unrecovered investment in an annuity contract; however, this answer does not describe the proper tax treatment of that deduction.

   d. Incorrect. A tax deduction is allowed for a decedent's unrecovered investment in an annuity contract; however, the deduction is not claimed by the decedent's estate under IRS Code.

7. a. Incorrect. If 10% of an organization's net earnings inure to a private individual, the organization will fail to qualify as exempt. (Code Sec. 501(c)(3))

   b. Correct. Under Code Sec. 501(c)(3), to qualify as exempt, none of the net earnings of an organization may inure to the benefit of any private shareholder or individual.

8. a. Correct. The specific deduction allowed an exempt organization for purposes of computing UBTI is $1,000. (Code Sec. 512(b)(12))

   b. Incorrect. The specific deduction allowed an exempt organization for purposes of computing UBTI is lower than $1,250. (Code Sec. 512(b)(12))

9. a. Incorrect. Private foundations are generally exempt from income tax but may be subject to several excise taxes.

   b. Incorrect. If a private foundation transfers all of its net assets to one or more 50% charities that have been in existence for at least 60 months, the foundation is exempt from the termination tax.

   c. Incorrect. Organizations that are organized and operated exclusively for testing for public safety are not private foundations under Code Sec. 509(a)(4).

   d. Correct. Under Code Sec. 4940(a), an exempt private foundation is liable for a 2% excise tax on its net investment income for the tax year. However, if the foundation makes certain charitable contributions, the tax is reduced to 1%. (Code Sec. 4940(e))

10. a. Incorrect. The mandatory accrual rule doesn't apply to S corporations. (Code Sec. 447(c)(1))

    b. Incorrect. The mandatory accrual rule doesn't apply to a "family corporation" in which members of the same family own at least 50% of (a) the total combined voting power of all voting stock, and (b) the total number of shares of all other classes of stock.

    c. Correct. The mandatory accrual rule applies to C corporations with more than $1 million of gross receipts. Raisers and harvesters of nut and fruit trees are covered by the rule.

    d. Incorrect. The mandatory accrual rule applies to C corporations with more than $1 million of gross receipts. However, sod farms are not covered by the rule under Code Sec. 447(a).

11. a. Incorrect. Livestock held for breeding, may be inventoried at the taxpayer's election; raised livestock must be inventoried only by farmers using the unit-livestock-price method. (Reg §1.61-4(b), Reg §1.471-6(b))

    b. Incorrect. Inventories may be used for hens primarily held for egg production which are also held for sale after their egg-producing life.

    c. Correct. A farmer using inventories must inventory all poultry, raised or purchased, held primarily for sale. (Reg §1.61-4(b))

    d. Incorrect. Livestock held for dairy purposes, may be inventoried at the taxpayer's election; raised livestock must be inventoried only by farmers using the unit-livestock-price method. (Reg §1.61-4(b), Reg §1.471-6(f))

12. a. Incorrect. If the benefit of fertilizer lasts substantially more than a year, the taxpayer may capitalize the costs, but is not required to do so. (Code Sec. 180(a))

    b. Incorrect. If the benefit of fertilizer lasts substantially more than a year, the taxpayer may deduct the costs currently, but is not required to do so.

    c. Incorrect. If fertilizer expenses are capitalized, the portion deducted each year need not be the same if benefits are clearly greater in the early years.

    d. Correct. If the benefit of fertilizer lasts substantially more than a year, the taxpayer may either capitalize the costs or elect to deduct them in the year paid or incurred per Code Sec. 180(d).

13. a. Incorrect. Per the Internal Revenue Code, a two-year carryback period generally applies for NOLs, but special rules apply for farmers.

    b. Incorrect. A carryback period longer than three years may be used to the extent an NOL is attributable to farming losses per Code Sec. 172(b)(1)(F)(ii)(III).

    c. Correct. Farming losses (any NOL attributable to the income and deductions of a farming business, but not in excess of the taxpayer's NOL for the year) may be carried back five years. (Code Sec. 172(b)(1)(G))

    d. Incorrect. Under Code Sec. 172(b)(1)(G), 20 years is the NOL carryforward period.

14. a. Incorrect. Per Code Sec. 127, an educational assistance program is not a qualified benefit.

    b. Incorrect. Meals and lodging furnished for the employer's convenience under Code Sec. 119 are not considered a qualified benefit.

    c. Incorrect. Neither an educational assistance program or meals and lodging provided for the employer's convenience are qualified benefits.

    d. Correct. A dependent care assistance program and employer contributions to a health savings account are considered qualified benefits under Code Secs. 129 and 106(d).

15. a. Incorrect. Because of the employment relationship, a scholarship granted by an employer to an employee or to an employee's child will generally indicate that the scholarship isn't excludable because it is payment for services.

    b. Incorrect. The education received under a Code Sec. 127 educational assistance program is excludible even if it qualifies the employee for a new trade or business.

    c. Correct. Under Code Sec. 127, the maximum amount of educational assistance that an employee can receive tax free under an educational assistance plan during any calendar year is $5,250.

    d. Incorrect. The exclusion for qualified tuition reductions generally does not apply to graduate level education. (Code Sec. 117(d)(2))

16. a. Incorrect. The amounts listed in the group-term life insurance cost table are monthly rates, not annual rates. Kimble received 12 months of coverage in year 2.

    b. Incorrect. The age to be used in the group-term life insurance cost table is the age at the end of the employee's tax year. In Kimble's case, she is age 30 at the end of Year 2.

    c. Correct. The cost per $1,000 per year for someone who is Kimble's age is $.96 (12 x .08). Thus, Kimble's additional income for year 2 is $48 (50 × $.96).

    d. Incorrect. Under Code Sec. 79(a), the cost of the first $50,000 of Kimble coverage is excludible from income.

17. a. Incorrect. Archer MSA contributions can be made by either the employer or the employee, but not both.

    b. Incorrect. Self-employeds can make contributions to Archer MSAs as well as to HSAs. (Code Secs. 106 and 220)

    c. Incorrect. Distributions from HSAs or from Archer MSAs that are not used for medical expenses are generally subject to a 20% penalty tax.

    d. Correct. In the case of Archer MSAs, the maximum annual contribution for individual coverage is limited to 65% of the deductible under the high deductible plan and the maximum annual contribution for family coverage is limited to 75% of the deductible.

18. a. Incorrect. A profit-sharing plan is a type of defined contribution plan that provides for individual accounts for participants and for benefits based on those accounts.

    b. Correct. Under Code Sec. 401(f), a qualified pension plan provides systematically for the payment of definitely determinable benefits to employees (and their beneficiaries) after retirement over a period of years, usually for life.

    c. Incorrect. A "401(k) plan" (also known as cash or deferred arrangement or CODA) is a popular feature of profit-sharing and stock bonus plans, both of which are defined contribution plans that provide for individual accounts for participants and for benefits based on those accounts.

    d. Incorrect. A stock bonus plan is a type of defined contribution plan that provides for individual accounts for participants and for benefits based on those accounts.

19. a. Incorrect. Three-year cliff vesting may be used for employer contributions in a defined contribution plan; however, a different vesting requirement applies to employee contributions.

    b. Incorrect. Five-year cliff vesting may be used for employer contributions to a defined benefit plan; however, a different vesting requirement applies to employee contributions.

    c. Incorrect. Three-to-seven-year graded vesting may be used for employer contributions to a defined benefit plan; however, a different vesting requirement applies to employee contributions.

    d. Correct. Under Code Sec. 411(a), benefits derived from employee contributions must be 100% vested at all times.

20. a. Incorrect. The dollar limitation in the benefit limitation formula for defined benefit plans was $180,000 in 2007.

    b. Incorrect. The dollar limitation in the benefit limitation formula for defined benefit plans was $185,000 in 2008.

    c. Incorrect. The dollar limitation in the benefit limitation formula for defined benefit plans was $195,000 in 2009-2011.

    d. Correct. For 2013, benefits under a defined benefit plan cannot exceed the lesser of $205,000 or 100% of the participant's average compensation for his or her high three years of compensation.

21. a. Incorrect. Where an employee dies before receiving any required plan distributions, his or her entire interest must generally be distributed within five years after death. However, the five-year rule does not apply when certain distributions are made to the employee's surviving spouse.

    b. Incorrect. Where an employee dies before receiving any required plan distributions, distributions may be made over the life of the employee's surviving spouse. However, those distributions are not required to begin one year after the date of the employee's death.

    c. Correct. Where an employee dies before receiving any required plan distributions, distributions may be made over the life of the employee's surviving spouse if distributions begin no later than the date on which the employee would have reached age 70½.

    d. Incorrect. Where an employee dies before receiving any required plan distributions, distributions may be made over the life of the employee's surviving spouse. However, the date on which the surviving spouse reaches age 70½ is not the required beginning date for those distributions.

22. a. Incorrect. It appears that that you selected the age-based factor from the Uniform Life Table for an employee younger than age 76.

    b. Correct. In the case of lifetime distributions, the required minimum distribution (RMD) for each year is found by dividing the account balance as of the end of the preceding year ($100,000) by the age-based factor from the Uniform Life Table (22).

    c. Incorrect. It appears that that you selected the age-based factor from the Uniform Life Table for an employee older than age 76.

    d. Incorrect. It appears that you used the employee's account balance for the current year when calculating the required minimum distribution.

23. a. Incorrect. Under Code Sec. 72(f)(2), a distribution made on account of an IRS tax levy is specifically excepted from the penalty for premature distributions.

b. Correct. Under the Internal Revenue Code, a distribution made after age 55 is excepted from the premature distribution penalty only if it is made after an employee's separation from service.

c. Incorrect. A distribution from a qualified plan to an alternate payee under a qualified domestic relations order is specifically excepted from the penalty for premature distributions. (Code Sec. 72(f)(2))

d. Incorrect. A distribution attributable to a disability is specifically excepted from the penalty for premature distributions under Code Sec. 72(f)(2).

24. a. Incorrect. $2,500 is the amount of catch-up contributions to a SIMPLE retirement plan allowed for 2012 by participants age 50 and over. (Code Sec. 414(v)(2)(B)(ii))

b. Correct. All employees receiving at least $5,000 of compensation from the employer for the preceding year are counted in applying the 100-employee limit for SIMPLE retirement plans. (Code Sec. 408(p)(2)(C)(i)(I))

c. Incorrect. Employee contributions to a SIMPLE retirement plan can't exceed $11,500 for 2012. (Code Sec. 408(p)(2)(A)(i))

d. Incorrect. $17,000 is the maximum employee elective deferral to a 401(k) plan, SEP, or Code Sec. 403(b) tax-sheltered annuity for 2012.

25. a. Correct. The employee may elect an employer contribution of $12,000 (the maximum for 2013), may make $2,500 of catch-up contributions available to employees age 50 or over, and will receive $4,500 of employer matching contributions (3% of $150,000 of compensation), for a total of $19,000.

b. Incorrect. This answer choice does not include the catch-up contribution available to employees age 50 and older.

c. Incorrect. This answer choice does not include the employer matching contribution.

26. a. Incorrect. An "unforeseeable emergency" includes severe financial hardship to the participant resulting from loss of the participant's property due to casualty.

b. Incorrect. An "unforeseeable emergency" includes severe financial hardship to the participant resulting from an illness of the participant.

c. Correct. An "unforeseeable emergency" includes only severe financial hardship due to extraordinary and unforeseeable circumstances arising as a result of events beyond the participant's control.

d. Incorrect. An "unforeseeable emergency" includes severe financial hardship to the participant resulting from an accident of the participant's spouse.

27. a. Incorrect. The amount includable in a decedent's gross estate on account of jointly owned property is not limited to the amount contributed by the decedent for purchase of the property.

b. Correct. Because the taxpayer contributed one-third of the property's purchase price ($10,000 out of a total cost of $30,000), one-third of the property's value ($40,000 out of a total value of $120,000) is included in the taxpayer's estate at death.

c. Incorrect. If an interest in property is held by a decedent and his or her spouse as tenants by the entireties or as joint tenants with right of survivorship, one half of the value of the jointly owned interest will be included in the estate of the decedent spouse regardless of which spouse furnished the original consideration. However, a different rule applies to other joint owners.

d. Incorrect. The entire value of jointly owned property is included in a co-owner's gross estate only if the surviving owner(s) did not supply any consideration for the purchase of the property.

28. a. Incorrect. Per Code Sec. 2042(l), proceeds of insurance payable to the decedent's estate are includible in the decedent's gross estate.

    b. Incorrect. An employee can avoid estate tax on the proceeds of group term life insurance furnished by an employer by transferring the insurance before death. However, the life insurance proceeds are included in the gross estate if the decedent transferred an interest in the policy within three years of death and the proceeds would have be included in the gross estate had the decedent retained the policy.

    c. Correct. Proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate are includible only if the decedent possessed at his or her death any incidents of ownership in the policy. Since the policy was purchased and owned by the decedent's spouse, the decedent did not possess incidents of ownership at his death.

    d. Incorrect. Proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate are includible if the decedent possessed at his or her death any incidents of ownership in the policy, including the right to change the beneficiary of the policy.

29. a. Incorrect. The executor of a decedent's estate has more than six months following the decedent's death to file the estate tax return per Code Sec. 6075(a).

    b. Incorrect. The estate tax return deadline is not tied into a calendar year. The deadline depends on date of the decedent's death. (Code Sec. 6075(a))

    c. Incorrect. The estate tax return deadline is not a fixed date. The deadline depends on the date of the decedent's death. (Code Sec. 6075(a))

    d. Correct. The return must be filed within nine months after the date of death. (Code Sec. 6075(a)) However, the IRS will grant an automatic 6-month extension to file.

30. a. Incorrect. The daughter's withdrawal does not result in a $150,000 gift in Year 1 because she didn't withdraw $150,000 in that year.

    b. Correct. An individual doesn't make a gift when he or she deposits funds in a joint bank account with another person if under the terms of the account the individual can regain the deposit without the other's consent. A gift is made only when and to the extent the other person withdraws money for his or her own benefit.

    c. Incorrect. A payment of tuition on behalf of another individual is excluded from gift tax only if payment is made directly to a qualifying educational organization as tuition for that individual.

31. a. Incorrect. The transfer qualifies for a gift tax rule that excludes all or a portion of the gift from the gift tax. (Code Sec. 2503(e))

    b. Incorrect. An annual per-donee exclusion of $14,000 normally applies to 2013 gifts, but a special rule applies to tuition payments.

    c. Incorrect. An annual per-donee exclusion of $28,000 normally applies to 2013 gifts by married taxpayers, but a special rule applies to tuition payments.

    d. Correct. The gift tax does not apply to amounts paid on behalf of another individual directly to a university as tuition for that individual. (Code Sec. 2503(e)) Thus, the full $30,000 tuition payment is excluded from the gift tax.

32. a. Incorrect. The maximum annual exclusion for a single gift by a married couple that elects gift splitting is $28,000 for 2013. However, a larger maximum exclusion applies in the case of multiple gifts.

    b. Incorrect. A single individual can claim a maximum exclusion of $140,000 for gifts to 10 donees in 2013. However, a larger maximum exclusion applies to gifts made by a married individual.

    c. Correct. If the couple elects to split the gifts, the maximum exclusion is $28,000 per donee or the actual amount of the gift if less. (Code Sec. 2513(a)) Thus, in this case the full amount of the gifts (10 × $15,000 per donee = $150,000) may be excluded.

    d. Incorrect. A $280,000 exclusion exceeds the total amount of gifts made by the individual in 2013.

33. a. Incorrect. If the EIC is claimed on net earnings from self-employment, failure to pay the proper amount of self-employment tax is treated as a mathematical error.

    b. Incorrect. Adjustments to make an S corporation shareholder's return consistent with the corporation's return are treated as resulting from mathematical or clerical error.

    c. Correct. While not providing the necessary taxpayer identification number of a dependent is considered a mathematical error, claiming an exemption for a nondependent is not.

    d. Incorrect. Failure to include a correct taxpayer identification number on a return, as required under Code Sec. 24 for the child tax credit is treated as a mathematical or clerical error.

34. a. Incorrect. The IRS's computerized discriminant function technique ranks and selects returns having the greatest audit potential.

    b. Correct. Under the Taxpayer Compliance Measurement Program, the IRS selects returns for examination based on random sampling.

    c. Incorrect. The Market Segment Specialization Program provides revenue agents and tax examiners with a broad and detailed review of the way a particular industry operates and the things an agent should be looking for when reviewing a return from within that industry.

    d. Incorrect. The IRS's Industry Issue Resolution Program exists to provide guidance to resolve frequently disputed or burdensome issues common to business taxpayers.

35. a. Correct. The taxpayer is not free to select anyone he or she chooses as a representative. The representative must be either an attorney, CPA, enrolled agent, enrolled actuary or someone else who is permitted (under Circular 230) to represent taxpayers before the IRS, who isn't disbarred or suspended from practice before IRS, and who has a written power of attorney executed by the taxpayer.

    b. Incorrect. A taxpayer does have the right to make certain audio (but generally not videotape) recordings of meetings (on advance notice) with the IRS agent. (Code Sec. 7521(a)(1))

    c. Incorrect. If, during an interview, the taxpayer clearly states a desire to consult with a representative, the IRS must suspend the interview for that purpose. (Code Sec. 7521(b)(2))

36. a. Incorrect. The 90-day letter is what the taxpayer receives if he or she doesn't respond to the transmittal letter.

    b. Incorrect. While the revenue agent's report may accompany the transmittal letter, the letter itself is not known as an RAR.

    c. Correct. If a taxpayer does not agree to the examiner's findings from a field or office audit, the IRS sends the taxpayer a "30-day letter," accompanied by an examiner's report that shows the basis for and amount of any proposed adjustments.

    d. Incorrect. A taxpayer may request an Appeals Office conference in response to the transmittal letter.

37. a. Incorrect. In the case of a field audit, protests must be writing only if the total amount of the proposed tax increase exceeds $10,000.

    b. Incorrect. Appeals Office proceedings are informal and testimony isn't under oath, although the taxpayer may be asked to submit affidavits.

    c. Incorrect. An Appeals Office conference still is available to a taxpayer even after IRS has issued a 90-day letter.

    d. Correct. Under procedures prescribed by the IRS, a taxpayer may request early referral of one or more unresolved issues from either the examination or collection division to the IRS Office of Appeals.

38. a. Incorrect. Economic hardship is one of the grounds on which the IRS can compromise a tax liability. (Reg §301.7122-1(b))

b. Correct. A taxpayer's prior record of prompt tax payments is not one of the grounds on which the IRS can compromise a tax liability. (Reg §301.7122-1(b))

c. Incorrect. Doubts as to collectability is one of the grounds on which the IRS can compromise a tax liability. (Reg §301.7122-1(b))

d. Incorrect. Doubts as to liability is one of the grounds on which the IRS can compromise a tax liability. (Reg §301.7122-1(b))

39. a. Incorrect. The assessment period does not begin on the date XYZ's return is due. (Code Sec. 6501(a))

b. Incorrect. The assessment period does not begin on the original due date of Brown's return. (Code Sec. 6501(a))

c. Incorrect. The assessment period does not begin on the date a late return is filed under a filing extension. (Code Sec. 6501(a))

d. Correct. In the case of a late-filed return (including filing extensions), the assessment period begins on the day after the return is filed. Thus, the assessment period begins on June 29, 2013.

40. a. Incorrect. The IRS has to issue a 90-day letter within 60 days of a jeopardy assessment.

b. Incorrect. In this situation, the IRS can issue a jeopardy assessment only if the other party denies ownership of the cash.

c. Incorrect. There **are** procedures for an administrative review of a jeopardy assessment. (Code Sec. 7429)

d. Correct. The IRS can terminate a tax year and demand immediate payment of income taxes for the current and preceding year if it finds that a taxpayer plans to leave the U.S. quickly.

41. a. Incorrect. The limitations period is suspended for the duration of the impairment.

b. Correct. For an overpayment resulting from a bad debt or from worthless securities, the claim period is seven years.

c. Incorrect. If the required return has not been filed, the claim must be filed within two years from when the tax was paid.

d. Incorrect. For an overpayment resulting from carryback of an NOL the period expires three years after the time the return is due (including extensions) for the year the loss or credit arose, not the year to which it's carried back.

42. a. Incorrect. This would be true only if the IRS issued the refund check more than 45 days after the refund claim was filed.

b. Incorrect. This is not a true statement for more than one reason. For example, interest is generally payable on an overpayment for the period between the date of the overpayment and a date not more than 30 days before a refund is made.

c. Incorrect. This is not a true statement for more than one reason. For example, interest on an overpayment does not stop running at the point the taxpayer files a refund claim.

d. Correct. No interest is payable on a refund arising from an original income tax return if the refund is made within 45 days after the later of the return due date (without extensions) or the date the return was filed. In this case, the IRS issued the refund within 45 days of the date the return was filed.

43. a. Correct. The Tax Court is not authorized to grant equitable relief. (Code Sec. 6512(b))

    b. Incorrect. The $50,000 limit on a claimed overpayment is relevant only in determining whether the taxpayer can elect to utilize special informal Tax Court procedures.

    c. Incorrect. The Tax Court can determine worker classification in certain cases and the correct amount of employment taxes that relate to such determinations.

    d. Incorrect. The Tax Court has jurisdiction to review the IRS's failure to abate interest to taxpayers within certain net worth limits who bring an action within 180 days of a final adverse determination, and to order abatement if the IRS abused its discretion.

44. a. Incorrect. Interest is charged on an erroneous refund. (Code Sec. 6602)

    b. Incorrect. The higher interest rate on large tax underpayments applies only to C corporations.

    c. Incorrect. Interest on a deficiency isn't eliminated when the deficiency is eliminated by a net operating loss, net capital loss, or business or foreign tax credit carryback. (Code Sec. 6601(d))

    d. Correct. Where the tax is paid within 21 days after notice and demand (10 business days if the amount is $100,000 or more), interest stops on the date of the notice and demand.

45. a. Incorrect. This is not a true statement. This answer correctly computes the failure-to-file penalty ($60 for three months) and the failure-to-pay penalty ($6 for three months). However, $66 is not the amount of Wilson's penalty.

    b. Correct. Wilson is subject to the minimum failure-to-file penalty—the lesser of $135 or the tax shown on the return ($400). In addition, Wilson owes a failure-to-pay penalty of $6 (1/2% per month for three months), which does not reduce the minimum failure-to-file penalty.

    c. Incorrect. While the failure-to-file penalty ($60 for three months) is reduced by the amount of the failure-to-pay penalty ($6 for three months), this answer does not take into account the minimum failure-to-file penalty.

    d. Incorrect. There is a minimum failure-to-file penalty, but there is no minimum failure-to-pay penalty.

46. a. Incorrect. While the 20% accuracy-related penalty does apply to negligence, it does not apply in cases of fraud.

    b. Correct. Under the Internal Revenue Code, the 20% accuracy-related penalty applies to cases of negligence and substantial income tax valuation understatements.

    c. Incorrect. While the 20% accuracy-related penalty applies to substantial income tax valuation understatements, reasonable cause is a defense against the accuracy-related penalty.

    d. Incorrect. While the 20% accuracy-related penalty does apply to substantial income tax valuation understatements, it does not apply in cases of fraud.

47. a. Incorrect. The penalty is equal to 20% of the tax understatement, not 20% of the amount of the undervaluation.

    b. Incorrect. The accuracy-related penalty for valuation misstatements applies only if the valuation claimed is 150% or more of the correct valuation.

    c. Correct. An understatement is generally considered "substantial" only if it exceeds the greater of: (1) 10% of the tax required to be shown on the return, or (2) $5,000. The understatement in this case does not exceed 10% of the tax required to be shown on the return.

    d. Incorrect. The 20% penalty is increased to 40% for gross misstatements—i.e., the claimed value is 40% or less of the correct figure.

48. a. Incorrect. This is a true statement. If a payor’s gross receipts don’t exceed $5 million a year, the maximum calendar year penalty for failing to timely file information returns is reduced from $250,000 to $100,000.

b. Incorrect. This is a true statement. The penalty is reduced from $50 per return to $15 per return (if the gross receipts test is met) if the failure is corrected within 30 days from the required filing date.

c. Correct. This is not a true statement. The *de minimis* exception for any calendar year is limited to ten information returns or, if greater, 1/2% of the total number of information returns the payor is required to file that year.

d. Incorrect. This is a true statement. No penalty will generally be imposed solely by reason of any failure to comply with the rules requiring filing on magnetic media except to the extent the failure is with respect to more than 250 returns.

49. a. 2. The penalty imposed on a taxpayer for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 for others.

b. 1. A person who promotes an abusive tax shelter is subject to a penalty equal to 50% of the gross income derived or to be derived from the activity if it involves a false or fraudulent statement.

c. 4. Any material advisor who fails to file an information return, or who files a false or incomplete information return, for a reportable transaction is subject to a penalty of $50,000 for each failure.

d. 3. In general, a 20% penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.

50. a. Incorrect. The IRS must generally start distraint or court proceedings within ten years after assessment.

b. Incorrect. Priority of tax liens is governed by federal, not state law.

c. Correct. There is an exemption for real property used as a residence by a taxpayer, or any nonrental real property of the taxpayer used by any other individual as a residence, if the amount of the levy is $5,000 or less. (Code Sec. 6334(a)(13)(A))

d. Incorrect. A third party may recover damages for a wrongful seizure (subject to limits) if there is a finding that any IRS officer or employee recklessly, intentionally, or negligently disregarded any Code or regulation.

Module 3 Glossary

ACCOUNTABLE PLANS. An employee expense reimbursement plan under which the employer does not report the reimbursed amounts to the employee as wages. The reimbursements made by the employer to the employee are not taxable to the employee.

ACCRUAL METHOD. Accounting method in which items are recognized and reported when all events have occurred to fix the right to receipt of the income or to establish the fact of liability.

ADJUSTED GROSS INCOME (AGI). All taxable income of an individual filer from whatever sources derived less certain deductions allowed as defined in IRC Sec. 62. AGI is used as a threshold in individual income taxation to calculate eligibility (or phaseout of eligibility) for many deductions, credits, or taxability of specific types of income.

AMORTIZATION. Similar to depreciation and typically used in connection with intangible costs. Using amortization, a taxpayer can recover the cost or basis in property proportionately over a specific number of years or months.

APPLICABLE FEDERAL RATE (AFR). Interest rates issued monthly by the federal government and used, among other purposes, for imputing interest on below-market loans.

BASIS. A measure of a taxpayer’s investment in property that is used for computing gain or loss on the sale of the property and for other tax purposes.

BELOW-MARKET LOAN. A demand loan (on which interest is payable at a rate below the applicable federal rate, or a term loan where the amount loaned is more than the present value of all payments due under the loan.

CASH METHOD. An accounting method under which income is reported in the year in which it is actually or constructively received. Expenses are generally deducted in the year they are paid.

CHARITABLE REMAINDER TRUST. A trust as defined in IRC Sec.664 into which the donor transfers property to which he or she, and any other named beneficiaries, retains an income interest for life (or a specified term of years not exceeding 20), with the remainder passing to the named charity or charities at the death of the last beneficiary (or the expiration of the term of years). The donor receives an immediate charitable income tax deduction for the actuarial value of the remainder interest.

COMPENSATION. Income received as payment for services rendered.

DEFERRAL. Recognizing and reporting items in a time period subsequent to the period of realization.

DEFINED CONTRIBUTION PLAN. A profit-sharing plan or other employment-based retirement plan in which benefits depend on investment performance.

DEFINED BENEFIT PLAN. A pension plan or other employment-based retirement plan that promises retirees a certain benefit upon retirement, regardless of investment performance.

DEPENDENT. A qualifying child or qualifying relative of the taxpayer for whom the taxpayer may claim an exemption.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP). A defined contribution plan that is either a stock bonus plan or a stock bonus plan and a money purchase plan, into which the employer contributes either cash or shares of its own stock and that invests primarily in qualifying employer securities.

FIDUCIARY. An individual or entity holding a position of trust or confidence. Used here in connection with trusts and estates.

GROSS INCOME. All income from all sources (other than tax-exempt income) that must be included on a taxpayer's tax return.

INDIVIDUAL RETIREMENT ACCOUNT (IRA). A retirement account set up by an individual as a means of setting money aside for his or her retirement years.

LEGACY. A gift of money or other property made by a decedent's will.

QUALIFIED RETIREMENT PLAN. A pension, profit sharing or stock bonus trust plan that can provide tax-deferred benefits because it does not discriminate in favor of highly compensated employees and meets a number of other requirements specified by the Internal Revenue Code.

RECAPTURE. An inclusion in income of an amount allowed as a deduction in a prior year.

ROTH IRA**.** An individual retirement account that accepts nondeductible contributions but allows tax-exempt withdrawals.

SAVINGS INCENTIVE MATCH PLAN FOR EMPLOYEES (SIMPLE). An employment-based defined-contribution plan available only to small businesses. Plan may offer limited tax-deferred retirement benefits with exemption from certain tax rules in exchange for meeting statutory mandates regarding vesting and employer contributions.

SIMPLE TRUST. A trust which, generally, must distribute all income received during the tax year.

SIMPLIFIED EMPLOYEE PENSION (SEP). An employment-based defined-contribution plan available only to small businesses which allows an employer to contribute directly to an employee's individual retirement account without having to meet all of the conditions facing qualified plans.

TAX YEAR. The time period covered by a tax return. Usually this is January 1 to December 31, a calendar year, but taxpayers can elect fiscal tax year with different beginning and ending dates.

TAXABLE INCOME. AGI less the greater of the standard deduction or total itemized deductions, less personal and dependency exemptions.

TRANSFER TAX. Tax imposed on transfers of property by gift or death of the transferor. It is composed of the following: (1) estate transfer tax, (2) gift transfer tax, and (3) generation skipping transfer (GST) tax.

UNRELATED BUSINESS TAXABLE INCOME (UBTI). Income generated by a tax-exempt organization when it conducts a business activity not substantially related to its tax-exempt purpose. UBTI is subject to income tax.

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EXAMINATION FOR CPE CREDIT

RIA's 2014 Federal Tax Review Course

Module 3 (QZN146)

Test Instructions

1. Following these instructions is an examination consisting of multiple choice questions. You may complete the exam by logging on to our online grading system at **cl.thomsonreuters.com.** Click the purchase link and a list of exams will appear. You may search for the exam using the acronym QZN146. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   If you prefer, you may continue to mail your completed answer sheet to the address below. The answer sheet is identified with the acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

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RIA's 2014 Federal Tax Review Course Examination for Module 3, Specialized Tax Issues

Section I: Taxation of Trusts, Estates, and Decedents

1. Where state law vests legal title to a decedent's real estate directly in the decedent's beneficiaries, income from the property is taxed:

   a. To the estate and not the beneficiaries.

   b. To the beneficiaries and the estate in equal amounts.

   c. To the beneficiaries and not the estate.

   d. To both the beneficiaries and the estate.

2. Under the terms of its governing instrument, an estate pays $10,000 during the tax year for a charitable purpose. The estate:

   a. Cannot deduct the amount paid.

   b. Can deduct the amount paid subject to the 2% floor on miscellaneous itemized deductions.

   c. Can deduct the amount paid up to 10% of its gross income.

   d. Can deduct the amount paid without limitation.

3. The standard deduction of a trust or estate is:

   a. $600.

   b. $300.

   c. $100.

   d. $0.

4. Which of the following powers would **not** cause the grantor of a trust to be treated as the trust's owner under the grantor trust rules?

   a. Power to revoke the trust.

   b. The power to borrow money from the trust.

   c. A power held by an independent trustee to distribute trust income to beneficiaries.

   d. Power to amend the trust.

5. Which of the following statements is **incorrect** regarding the taxation of trusts and estates?

   a. Trust income that is passed to a beneficiary retains the same character in the beneficiary's hands as when received by the trust.

   b. A trustee may not elect to treat any part of the trust's estimated tax payments as paid by a beneficiary.

   c. A trust computes its tax using a tax rate schedule that is unfavorable relative to the rate schedules applicable to individuals.

   d. When a trust terminates, it no longer is a separate tax entity.

Section II: Exempt Organizations

6. For a 501(c)(3) organization that makes a lobbying election, permissible lobbying expenditures for any tax year can't exceed a maximum of:

   a. $2 million   b. $1 million

   c. $500,000   d. $250,000

7. An exempt social welfare club has $500,000 of annual gross receipts. What amount of those gross receipts can be from use of the club's facilities and services by the general public without jeopardizing the organization's tax exemption?

    a. $250,000 b. $175,000

    c. $26,250 d. $0

8. Which of the following would most likely be classified as an unrelated business of an exempt organization?

    a. Sale of products produced by individuals in a sheltered workshop that is run by an exempt charity as part of its exempt function.

    b. Receipt of money from a corporation to fund a charity event in return for acknowledgment of the corporation in the event's program.

    c. Operation of a bingo game by an exempt organization in a state that prohibits gambling.

    d. Distribution of pens bearing an organization's name that cost $5 in return for charitable donations.

9. A private foundation (other than an operating foundation) that fails to distribute its income for a tax year by the end of the next year is subject to an initial tax equal to _____ of the income.

    a. 10% b. 20%

    c. 30% d. 50%

Section III: Taxation of Farming

10. A farmer can elect to deduct the costs of certain purchased animals or plants either for the year they are purchased or for the year they are sold, if the method chosen clearly reflects income. Which of the following purchases is **not** eligible for the election?

    a. Baby chicks bought for raising and resale.

    b. Hens bought for egg production.

    c. Christmas tree seedlings bought for cultivation before sale.

    d. Bean seeds bought for cultivation before sale.

11. If a farmer wishes to report income or loss from crops in the year they are harvested and sold but the process of planting, harvesting, and sale isn't completed within the same year, what accounting method should the farmer seek to use (with IRS consent)?

    a. The cash method. b. The accrual method.

    c. The crop method. d. The hybrid method.

12. Which farm property can be depreciated under MACRS using the 150% declining balance method?

    a. Purchased dairy cows included in inventory b. A farm tractor

    c. A barn d. Fruit trees

13. Which of the following is a correct statement regarding income averaging?

    a. An individual engaged in farming may elect five-year income averaging.

    b. An individual engaged in farming may elect three-year income averaging for both the regular income tax and the AMT.

    c. Three year farm income averaging applies only to elected farm income.

    d. Three-year farm income averaging is mandatory for an individual engaged in farming.

Section IV: Employee Benefit Plans

14. Which of the following benefits may **not** be offered under a cafeteria plan?

    a. Adoption assistance. b. Group-term life insurance.

    c. Long-term care insurance. d. Vacation days.

15. In Year 1, an employee incurs $5,000 of expenses in connection with the adoption of a child who is not a U.S. citizen or resident. The employee receives a $5,000 reimbursement under his employer's adoption assistance program in Year 1. However, in Year 2, the employee's adoption plans fall through and the adoption is never finalized. Which of the following is a true statement?

    a. The employee can exclude the $5,000 adoption assistance payment from income in Year 1.

    b. The employee must report the $5,000 adoption assistance payment as income for Year 1, but can claim a $5,000 exclusion for Year 2.

    c. The employee must report the $5,000 adoption assistance payment as income for Year 1 and cannot claim an offsetting exclusion for any year.

    d. The employee must report the $5,000 adoption assistance payment as income for Year 2.

16. For married couples filing jointly, the exclusion for dependent care assistance payments provided by an employer cannot exceed the lesser of (1) the earned income of the lower earning spouse or (2) ________.

    a. $1,000 b. $2,400

    c. $2,500 d. $5,000

17. An employee who receives $60,000 of group term life insurance coverage must include the cost of $___________of insurance in gross income.

    a. 0 b. 10,000

    c. 50,000 d. 60,000

18. An employee who attends graduate school at night incurs the following expenses: $4,500 for tuition, $250 for textbooks, $100 for transportation, and $100 for meals. What is the maximum amount that the employee can receive as a reimbursement under her employer's educational assistance plan?

    a. $5,250 b. $4,950

    c. $4,850 d. $4,750

19. A distribution from a health savings account (HSA) that is not used to pay qualified medical expenses of the account holder and/or spouse and dependents is generally subject to a ______ penalty tax.

    a. 5% b. 10%

    c. 20% d. 25%

20. Which of the following is not a "qualifying event" that would entitle an employee or an employee's dependents to COBRA health care continuation coverage?

    a. Death of the employee. b. Divorce.

    c. Termination of the employer's health plan. d. Termination of employment.

Section V: Employee Retirement Plans

21. A qualified plan that pays benefits in the form of the employer corporation's own stock is a __________________.

    a. Money purchase pension plan. b. Stock bonus plan.

    c. 401(k) plan. d. Profit-sharing plan.

22. What is the maximum period of time for full vesting of employer matching contributions to a defined contribution plan?

    a. Three years. b. Five years.

    c. Six years. d. Seven years.

23. Annual additions under a defined contribution plan may not exceed the lesser of an annual inflation-adjusted amount or ______ of the participant's compensation.

    a. 25% b. 50%

    c. 75% d. 100%

24. If a taxpayer fails to receive the required minimum distribution from a qualified plan, an excise tax will apply equal to ______ of the required amount that was not distributed.

    a. 10% b. 15%

    c. 25% d. 50%

25. A premature distribution from a qualified plan will result in an additional tax equal to ______ of the amounts withdrawn that are includible in gross income unless an exception applies.

    a. 5% b. 10%

    c. 25% d. 50%

26. The maximum amount that an employee under age 50 may elect to defer under a 401(k) plan is ________ for 2013.

    a. $12,000 b. $14,000

    c. $17,500 d. $23,000

27. The maximum "catch-up" that may be made to a 401(k) plan by an employee age 50 or over is ________ for 2013.

    a. $5,000 b. $5,500

    c. $6,000 d. $6,500

28. A SIMPLE retirement plan cannot be established by an employer with more than _____ employees who received at least $5,000 of compensation from the employer for the preceding year.

    a. 25 b. 50

    c. 100 d. 250

29. The limit on "catch-up" contributions to a SIMPLE IRA by employees age 50 or over is ________ for 2013.

    a. $2,000 b. $2,500

    c. $3,000 d. $4,000

30. If nonqualified deferred compensation is required to be included in gross income, the tax on the compensation is increased by interest and an amount equal to ______ of the compensation.

    a. 10% b. 20%

    c. 30% d. 50%

Section VI: Estate and Gift Tax

31. Which of the following is **not** deductible from the gross estate in arriving at the taxable estate?

    a. Funeral expenses.

    b. Administration expenses such as attorneys' fees and accountants' fees.

    c. Transfers to charitable organizations.

    d. Medical expenses paid by the decedent in the year of death.

32. Which of the following statements regarding extensions for estate tax returns is correct?

    a. The IRS will not extend the filing deadline on an estate tax return.

    b. The IRS will grant an automatic 6-month extension to file.

    c. For an estate return, an extension also extends the time to pay any tax due.

    d. The IRS does not grant any discretionary filing extensions on estate returns.

33. Jane and John, a married couple, purchased property as joint tenants with right of survivorship. Jane contributed $50,000 of the purchase price and John contributed $100,000. At John's death, the property is worth $300,000. What amount is included in John's gross estate?

    a. $300,000

    b. $150,000

    c. $200,000

    d. $100,000

34. For 2013, the unified credit effectively exempts the first ___________ of transfers from the gift tax.

    a. $1 million

    b. $5 million

    c. $1,772,800

    d. $5,250000

35. A married couple made a $30,000 gift to their child in 2013, which they elected to treat as a "split gift." What is the amount of the annual gift tax exclusion for the gift?

    a. $0

    b. $14,000

    c. $28,000

    d. $30,000

Section VII: Dealing with the IRS

36. The _____________ provides revenue agents and tax examiners with broad and detailed reviews of the way particular industries (e.g., attorneys, taxicabs, air charters, trucking, bed and breakfasts) operate and the things an agent should be looking for when reviewing a return from within a particular industry.

    a. Market Segment Specialization Program.

    b. Industry Issues Resolution Program.

    c. Taxpayer Compliance Measurement Program.

    d. Information Returns Program.

37. Which of the following is **not** a type of IRS audit?

    a. Field

    b. Correspondence

    c. Telephone

    d. Office

38. Which of the following options is **not** available to a taxpayer upon the receipt of a 30-day letter from the IRS?

    a. Accept the IRS findings and sign a waiver of the restrictions on assessment.

    b. Request an Appeals Office conference.

    c. File a Tax Court petition.

    d. Do nothing and await the receipt of a 90-day letter.

39. To arrange an Appeals Office conference in a field audit case, a written protest is required if the proposed tax increase exceeds $______.

    a. 1,000

    b. 2,000

    c. 5,000

    d. 10,000

40. As a general rule, all taxes must be assessed within ____ years after the date the return was filed.

a. Two
b. Three
c. Four
d. Five

41. The standard assessment period is increased to six years for income tax returns that omit from gross income more than ______ of the gross income that is reported.

a. 10%
b. 20%
c. 25%
d. 50%

42. Which of the following statements regarding refund claims is **incorrect**?

a. A person who pays another person's taxes generally can't get a refund of the tax paid.

b. Federal tax refunds can be offset by state income tax debts.

c. A refund claim for a tax paid by return must be filed within the later of: (1) three years from the date the return was filed (or the due date if filed earlier), or (2) four years from the date the tax was paid.

d. In the case of returns filed after the due date (with extensions), no interest is payable on a refund for the period preceding the actual filing date.

43. No interest is payable on a refund arising from an original income tax return if the refund is made within ____days after the later of the return due date (without extensions) or the date the return was filed.

a. 30
b. 45
c. 60
d. 75

44. A corporation that overpaid its estimated tax can get a refund within _____ days after filing Form 4466.

a. 30
b. 45
c. 60
d. 90

45. The minimum penalty for failure to file an income tax return within 60 days of the due date is the lesser of $________ or the amount of tax required to be shown on the return.

a. 50
b. 75
c. 135
d. 200

46. An understatement of tax is considered "substantial," and thus subject to the 20% accuracy-related penalty, if it exceeds the greater of: (1)______% of the tax required to be shown on the return, or (2) $________.

a. 10; 5,000
b. 10; 20,000
c. 20; 5,000
d. 20; 20,000

47. Fraudulent underpayment of tax required to be shown on a return results in a civil penalty of ______% of the portion of the underpayment attributable to fraud.

a. 25
b. 50
c. 75
d. 100

48. If a claim for refund or credit for income tax is made for an "excessive amount," the person making the claim is liable for a penalty equal to ______ of the excessive amount.

a. 5%
b. 10%
c. 20%
d. 25%

49. Which of the following is a true statement regarding the tax shelter penalty provisions?

    a. The penalty for failing to disclose "reportable transactions" applies only when a transaction results in a tax understatement.

    b. A $100,000 penalty applies for failing to disclose certain penalties on SEC reports.

    c. Any material advisor who fails to file an information return, or who files a false or incomplete information returns, for a "reportable transaction" is subject to a penalty of $5,000 for each failure.

    d. A person who promotes an abusive tax shelter is subject to a penalty equal to 50% of the gross income derived or to be derived from the activity if the activity involves a false or fraudulent statement.

50. Improper disclosure or use of information by tax return preparers is subject to a civil penalty of $________ for each improper disclosure or use.

    a. 100 b. 250

    c. 500 d. 1,000

EXAMINATION FOR CPE CREDIT ANSWER SHEET

RIA's 2014 Federal Tax Review Course Module 1

QZN144

CTEC No. 3039-CE-0291

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47.	○	○	○	○
48.	○	○	○	○
49.	○	○	○	○
50.	○	○	○	○

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42.	○	○	○	○
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49.	○	○	○	○
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QZN146

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